Emerging Economies Group

Accounting for Rate Regulated Activities

Issues for Discussion

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Accounting for Rate Regulated Activities

1. Background

1.1 Regulators across the world, apart from the overall governance, have a common objective of public welfare and promote the orderly growth and development of the industries and protect the interests of the consumers, i.e., ensuring the goods and services are available to the public in just and fair manner. Depending on the nature of economy, i.e., capitalist, socialist, communist etc., the manner in which this objective is achieved by regulators often differ. However, they are directed towards the same common objective in different degrees.

Regulation

1.2 Regulation on public and commercial entities is a common form of regulation across the world to achieve this objective. These regulations can be in different forms such as regulations on entry into any sector, regulations on investments by different categories of investors, regulations on operating mechanism, regulations on capital, regulations on use of funds, i.e., investments, regulations on price charged to customers or regulations on any other commercial or operating mechanism etc.

Rate Regulation

1.3 Rate regulation is a form of restrictive regulation imposed often by the regulators on public and private corporations in setting the prices that can be charged to end customers for services or products. The goal of rate regulation is to set "just and reasonable rates," that is, the rates charged to customers should be reasonable and that allow the entity to also earn a

fair rate of return. A key aspect of rate regulation is that the regulator is empowered to determine prices that bind the entity's customers under a statute or otherwise.

1.4 Generally, rate regulation is imposed when an entity has a monopoly or a dominant market position that gives it excessive market power, particularly over 'essential' goods or services, such as ***water, electricity, fertilizers, insurance, transport, hospitals, telecommunications, pipelines and other utilities***. In such situations, there is a lack of competition to constrain the prices that the entity can charge. To control this, governments may impose rate regulation generally through a 'regulatory authority' that aims to set 'just and reasonable rates'.

1.5 At the same time, given that these sectors are generally very important in any economy and are capital intensive, their continuance, unlike any other commercial entity, is also an important objective for the regulators and, therefore, often, the rates are prescribed in a manner that provide a fair return on the capital as well as operating expenditures of producing organizations.

1.6 While such legislative rate regulations may provide the general guidelines and consideration for determining prices, the regulatory authorities determine particular methodologies to be adopted for fixing the prices. The regulations also provide the framework to the entity for charging the customers for the regulated goods or services. Entities subject to these price regulations are not allowed to charge prices for regulated goods and services higher than those approved by the regulatory authorities. In a way, regulator acts on behalf of the customers, who due to such essential nature of goods and services and trade conditions, do not individually have any bargaining power with the entity. Agreements between the entity and the customer as well as the commercial operations and financial conditions of the regulated entities, therefore, cannot be fully understood without having regard to these rate regulations.

Select mechanisms of rate regulations

1.7 There are different methods of rate regulation and many variations within each type. The application of rate regulation differs depending on the nature of industry, general practices in the economy, other objectives of the regulators and the entity being regulated. Although the regulatory effect on future prices might be similar, the differences between rate regulation regimes lead to different rights and obligations for the rate-regulated entity.

1.8 There is no universal method of rate regulation. The rate-setting process and the application of that process can vary from one jurisdiction to another. Within a jurisdiction, it can vary from one entity to another. In addition, rate regulation is constantly evolving.

1.9 In most cases, governments impose rate regulation by creating legislation setting up a regulatory authority and giving it jurisdiction to approve the rates of a specific entity or categories of entities (for example, electric distribution utilities). The legislation empowering a regulatory authority usually provides little guidance on how rates are to be established, except that the rates must be "just and reasonable". Usually, regulatory authorities have significant discretion in deciding the regulatory methodology that is used in setting allowed rates and how that methodology is applied. There are a number of basic regulatory methodologies and, for each, there can be applications that vary with the regulator, the entity being regulated and the circumstances faced.

1.10 As mentioned earlier, entities falling within the jurisdiction of the regulatory authority are generally not allowed to charge prices higher than those approved by the regulatory authority.

1.11 Based on the above discussion, it is clear that the rate regulation impacts the profitability – both current as well as future, level of operations, rights and obligations of an entity and therefore appropriate reflection of these in the financial statements is absolutely critical for the users of such financial statements.

1.12 In order to give effect to such regulations appropriately in the financial statements for stakeholders to understand their impact on any entity, it is important that different kinds of rate regulations are understood clearly. Given the width of this topic, it is not possible to lay out exhaustively, all the possible alternatives in which the rate regulations are usually imposed by the regulators, however, some of the commonly used mechanisms are explained below.

Cost-of- service regulation

1.13 In the past, the primary regulatory methodology for the major utilities was cost-of-service regulation, also referred to as return-on-rate base regulation. Under this approach, rates are set to give the entity the opportunity to recover its costs of providing the public service plus a fair return. In such a scheme, it is important to note that the rates are set by a process of working backwards from the desired return on the rate base, to derive a revenue requirement and using a volume estimate to set the rate. The regulator would allow an increase in the rates to allow the entity to recover particular “allowable” costs or in other cases require a reduction in rates charged to eliminate excess profits. Such rate changes are usually applied prospectively and so there is usually a ‘time lag’, e.g., an entity may incur higher than expected costs of raw materials in the current period but cannot increase prices to reflect this until later periods.

1.14 The regulator usually allows the entity to charge a price based on the capital as well as allowable operating costs of production of goods or services and a fair margin on the investments. Regulators often prescribe the efficiency with which an entity needs to operate by considering the level of operations and capital costs that are allowed to be charged to the end customers. Depending on the reasons, regulators may also permit increase or decrease in the price for future sales based on the under or over recovery of earlier period costs (either actual or estimated). The methodology used by regulators is often known through the regulations, rules or past practices.

Price-cap mechanism

1.15 In recent years, there has been a trend to use performance-based regulatory methodologies, such as price-cap regulation. With price-cap regulation, initial rates often reflect the cost of service, but are allowed to increase, or are required to decrease, in accordance with a formula over time. The main difference between cost-of-service regulation and price-cap regulation is that the latter does not 'guarantee' that the regulated entity will recover its costs and earn a specified return. Under such regulation, it may not even be certain that the utility will be viable at the prices the regulator permits.

1.16 For many essential commodities, regulators proscribe a cap on the prices that can be charged by the entity to the end customers. Prices are allowed to be determined by the entities subject to an overall cap. Under the price-cap mechanism, the regulator may also sometimes bear the additional burden through a separate subsidy provided directly by the government. Such mechanisms are usually witnessed in sectors such as gas, petroleum, fertilizers and chemicals in different parts of the world. For instance, regulators require minimum interest rates to be paid on deposits generally for any specific kind of deposit scheme or any specific category of customer segment in the banking sector. Similar caps on interest rates that can be charged to customers in specific categories are also prevalent, e.g., micro-finance lending.

Pay per use

1.17 Many instances can be seen where the prices are determined based on unit of consumption and fixed for each unit. The prices cannot be changed without specific approval of the regulatory authorities. For example, airport cess included in the air ticket is usually fixed in nature. Similarly, road toll charges are fixed per use. Transportation sector is often regulated on this basis.

Price based on approvals

1.18 For many industries and sectors, regulatory authorities determine the prices based on each individual circumstance. Usually, the company is required to provide the details of the goods and services including the operating mechanism and financial details to the regulators and regulators may approve or make changes to the prescribed pricing. In many jurisdictions, insurance schemes require specific approval of regulators before being marketed to consumers.

Hybrid methodology

1.19 There could also be hybrid methodology which is a combination of the price-cap and cost-of-service methodologies. Rate under this method is generally set based on price formula and at the end of the period, the actual return on equity is compared to the allowed return on equity. A portion of earnings in excess of that allowed must be returned to customers through a reduction in future rates. In some cases, a portion of any earnings below that allowed is also recovered from customers through an increase in future rates. The hybrid methodology increases the incentive for the utility to improve its efficiency and reduce costs to its customers, because it is allowed to retain a portion of cost savings.

1.20 Increasingly, regulators are moving towards performance-based regulation whereby initial rates often reflect the cost of service but are allowed to increase in accordance with a regulated formula. Further, price can be based on efficiencies or target costs.

1.21 Continuous evolution of rate regulation may embrace various other rate methodologies. As a matter of concern, there is need to understand various possible rate methodologies due to changing economies globally and consider it for development of accounting guidance on this topic.

Sectors/Industries which are usually affected by rate regulation could include

1.22 In various countries, the following industries are often affected by rate regulation:

- Power and utilities
- Fertilizers
- Water
- Oil and gas
- Telecommunications
- Pipelines
- Transport Infrastructure
- Hospitals
- Highways
- Airports
- Pharmaceuticals
- Banking and finance
- Insurance
- Build-Operate-Own-Transfer (‘BOOT’) or Build-Operate-Transfer (‘BOT’) type arrangements

The above is not an exhaustive list of industries affected by rate regulations. It is also important to consider that it may not be necessary that industries which are regulated by certain legislations are also regulated from a rate perspective.

Financial statements implications of rate regulation

2.1 Rate regulation has an economic impact on the timing and the amount of revenue of the rate-regulated entity and the impact can be either positive or negative. The nature of rate regulation not only has the impact on the current profitability but also the future profitability of the entity. Also, there are many aspects of rate regulations, which are qualitatively important for the users of the financial statements.

2.2 These rate regulations may often give rise to many rights and obligations for the entities. Some of these rights and obligations may include:

- Right to recover an allowable level of costs (whether or not incurred by the entity);
- Right to recover specific types of costs without limit, if and when incurred;
- Allowance by way of subsidy or grant from regulators;
- Obligation to refund saving in costs;
- Rights or obligations may arise due to qualitative factors such as efficiency, service levels, demand, supply etc.

2.3 In the past, rate regulation was used to apply to an entire entity. With acquisitions, diversification and deregulation, rate regulation may now be applied to only a portion of an entity's activities. Hence, an entity may have both regulated and non-regulated activities. Therefore, it is arguably imperative for standard setters to bring in differentiation between rate regulated activities and non-rate regulated entities.

2.4 As can be seen from above, with the different manners of price regulations and their impact on the financial statements, also the widespread nature of sectors in which such rate regulations are usually prevalent, the need for understanding the financial statement impact of such items by the stakeholders either through appropriate accounting or disclosures cannot be ignored.

3. Current Accounting Framework for Rate Regulated Activities ('RRA')

3.1 At present, there is no established guidance or framework available in the International Financial Reporting Standards (IFRS) on the accounting treatment or any other aspects of financial reporting for the rights and obligations as well as any other financial statement implications of rate regulations.

3.2 In some jurisdictions, including North America and India, lack of specific guidance on accounting for rate regulated activities is seen as one of the factors for non-adoption of International Financial Reporting Standards ('IFRS').

3.3 In view of many queries being received by the International Accounting Standards Board ('IASB') on this topic from as early as 2005, in 2008, the IASB added a technical project to its agenda and an Exposure Draft of the proposed IFRS on "Rate Regulated Activities" ('IFRS ED') was issued in 2009. Based on 156 comments that were received on this topic and various implementation issues and challenges, the project was suspended in September 2010.

3.4 The IASB has recently restarted its comprehensive project on rate regulated activities ('RRA') and intends to conduct a full analysis of the accounting impacts of the various forms of rate regulation and issue a discussion paper (DP) in the coming months.

3.5 For development of the DP, the IASB in March 2013 has issued a document titled 'Request for Information ('RFI')– Rate Regulation' seeking high-level overviews of the types of rate regulations currently in force which will be used to develop the comprehensive accounting guidance. However, it is expected that the project will take a significant amount of time to be completed and, hence, the IASB has issued Exposure Draft in April 2013, as an Interim Standard, *Regulatory Deferral Accounts*, for comments to be received by 4th September, 2013. This paper, therefore, attempts to raise issues relevant for the Discussion Paper for formulation of comprehensive standard.

3.6 US GAAP, ASC 980 – Regulated Operations ('US GAAP guidance') deals with accounting for regulatory assets and liabilities. The US GAAP guidance prescribes conditions that an entity or the activity should meet to apply this standard, accounting for discontinuance of rate regulations, impact on other assets and deferred costs, specific examples for phase-in plans, sale and lease back transactions, intangibles and goodwill, property, plant and equipment, liabilities, asset retirement and environmental obligations, contingencies, debt, revenue recognition, compensation and retirement benefits, income taxes, interest and consolidation rules etc.

3.7 In the RFI, the IASB has mentioned that the IFRIC had concluded in the past that requirements of SFAS 71 (now known as topic ASC 980) were not indicative of the requirements of IFRS.

3.8 In India, the Institute of Chartered Accountants of India (ICAI), issued a Guidance Note on Accounting for Rate Regulated Activities in February 2012 ('Indian GN') which is largely based on the ED issued by IASB though there are some differences. However, as on date, the implementation date for the Guidance Note has not been notified.

3.9 In the absence of detailed guidance on this topic under most GAAPs, diverse practices have evolved and there is no consistency of accounting policies followed globally. In some jurisdictions, this impact is recognized in the financial statements of rate-regulated entities as a regulatory asset (a right to charge higher prices in the future) or as a regulatory liability (an obligation to reduce prices in the future) such as the United States and Canada whereas in certain other jurisdictions, this impact is not recognized as an asset or a liability.

4. Objective of this Paper

4.1 In an effort to contribute to the IASB's development of an IFRS for rate regulated activities, the ICAI proposed this topic at the last Emerging Economies Group (EEG)meeting held on December 4 and 5, 2013, at Sao Paulo, Brazil, as the topic for discussion at the next EEG meeting. This paper addresses various topics of RRA that may be discussed and considered including related issues and questions, when establishing accounting framework/guidance for RRA including definition, scope, identification, accounting treatment including other areas.

4.2 The objective of this paper is to raise issues and questions related to RRA so that the members of the EEG have an active discussion on this topic and that the result of EEG discussion may contribute to the RRA research project for development of the Discussion Paper for final IFRS.

4.3 Below are the key topics discussed in this paper:

i. A measurement and recognition standard verses a disclosure standard
ii. Scope of rate regulated activities to be covered and related guidance
iii. Recognition of regulatory assets and liabilities:
   - Can regulatory assets/liabilities be recognized under the existing Conceptual Framework?
   - Should other factors such as demand and supply be also considered?
   - Timing of recognition of regulatory assets/liabilities
iv. Nature of regulatory assets and liabilities
v. Measurement of regulatory assets and liabilities
vi. Presentation of impact of regulatory assets and liabilities in financial statements

5. A measurement and recognition standard verses a disclosure standard

5.1 It may be noted that most GAAPs do not have any specific accounting guidance for the rate regulated activities. One of the main reasons for lack of any accounting guidance on this topic is the lack of consensus and failure of many past endeavors such as the IFRS ED, to be able to effectively and appropriately deal with the accounting for rate regulated activities.

5.2 One of the qualitative characteristics of financial statements is comparability across entities for transactions which are similar though may have been structured differently. For instance, the IFRS ED which only sought to cover the cost of service rate regulated activities, did not effectively address the other forms of rate regulations. The current US GAAP guidance also deals primarily with the cost of service regulations. The same is true of the Indian GN.

5.3 It is also true that given the nature of this topic, it has become difficult to establish a standard which can effectively provide the accounting framework for different kinds of rate-regulated activities as discussed above, partially also because the standard setters may not themselves be aware of different mechanisms of rate regulations that exist. Developing a global standard universally applicable to different jurisdictions which have different regulatory objectives and mechanisms is therefore a difficult task which could lead to many controversies and may still be unable to deal with the issue at hand.

5.4 Having said that, the role of private corporations in the sectors mentioned above, both within individual nations as well as multinational corporations across the globe and regulated by the regulators due to various economic as well as political considerations, is increasing, Many constituents argue that while it is difficult, it is imperative that the standard setters should think about some framework through which the information

relevant to the users of the financial statements affected by the regulatory mechanism is conveyed to them in an appropriate, consistent and reliable manner.

5.5 One alternative is to attempt to provide an accounting framework through which the rights and obligations of such entities are accounted for in the financial statements. This is the ultimate long term objective of the IASB and a framework for which is yet to be identified. If successful, that would be ideal. However, everyone is aware of the challenges in establishing such a standard.

5.6 An alternative view could be that until a well considered and a comprehensive framework is identified and agreed to establish this accounting framework, the information relevant to the users could be conveyed in the form of disclosures, footnotes and explanatory notes to the financial statements. The details around rights, obligations, nature and impact of transactions affected by regulation could be provided to the users in the financial statements in a qualitative manner such that the users can qualitatively ascertain the impact of this on the reported financial statements. This approach is very similar to the disclosure standards such as segment reporting, EPS, related party disclosures etc., that convey useful information to the users of the financial statements.

5.7 It is also important to note that the IASB has restarted its project on conceptual framework and it is understood that the concepts of regulatory assets and liabilities would also be considered while developing the new framework to ensure consistency.

5.8 Some others argue that a proforma disclosure could be prescribed in the disclosure standard with details around management estimates, judgments and uncertainties giving the impact of the rate regulated activities. This approach would result in consistency across the entities and at the same time would also provide more useful (both quantitative as well as qualitative) information to the users of the financial statements.

5.9 The proponents of a disclosure or a disclosure with a proforma adjustment approach support their argument on the fact that frequent changes in measurement guidelines affect

the credibility of standard setting process and reduce the consistency of financial statements over a period of time.

5.10 Another section also believes that an accounting standard within the current conceptual framework can be developed for rate regulated activities. For example – the reimbursement cost model, i.e., accounting for items for which reimbursement is expected is a common accounting matter. Similarly, accounting for items of refund to customers is a routine matter of revenue as well as liability accounting. These frameworks are being used in many countries at present and some believe that these would continue to be relevant for future accounting issues including in respect of rate regulated activities. According to the proponents of this view, a recognition and measurement standard can be developed supported by the existing Conceptual Framework.

Questions

1 Considering the expected changes in the conceptual framework, is there any merit in issuing only a disclosure standard for RRA and attempt a recognition and measurement standard once the ambiguity over the definition of an asset/ liability is removed in the Conceptual Framework being developed by the IASB?

2 Should the IASB consider development of a recognition and measurement standard?

The subsequent sections of this paper examine issues in development of a recognition and measurement standard within the existing Conceptual Framework.

6. Scope of rate regulated activities to be covered and related guidance

6.1 As mentioned above, rate regulation is usually prescribed in various forms. The available accounting literature currently considers only the cost of service rate regulation mechanism. It does not deal with other forms of rate regulations that are prevalent.

6.2 Para 3 of ED of IFRS on RRA prescribed the scope of the ED as follows:

"An entity shall apply this [draft] IFRS to its operating activities that meet the following criteria:

i. *an authorized body ('the regulator') establishes the price the entity must charge its customers for the goods or services the entity provides, and that price binds the customers; and*

ii. *the price established by regulation (the 'rate') is designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a specified return (cost of service regulation). The specified return could be a minimum or range and need not be a fixed or guaranteed return.*

6.3 US GAAP prescribes the following under topic ASC 980.

The guidance in the Regulated Operations Topic applies to general-purpose external financial statements of an entity that has regulated operations that meet all of the following criteria:

a) *The entity's rates for regulated services or products provided to its customers are established by or are subject to approval by an independent, third-party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers.*

b) *The regulated rates are designed to recover the specific entity's costs of providing the regulated services or products. This criterion is intended to be applied to the substance of the regulation, rather than its form. If an entity's regulated rates are based on the costs of a group of entities and the entity is so large in relation to the group of entities that its costs are, in essence, the group's costs, the regulation would meet this criterion for that entity.*

c) *In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the entity's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs. This last criterion is not intended as a requirement that the entity earn a fair return on shareholders' investment under all conditions; an entity can earn less than a fair return for many reasons unrelated to the ability to bill and collect rates that will recover allowable costs. For example, mild weather might reduce demand for energy utility services. In that case, rates that were expected to recover an entity's allowable costs might not do so. The resulting decreased earnings do not demonstrate an inability to charge and collect rates that would recover the entity's costs; rather, they demonstrate the uncertainty inherent in estimating weather conditions. This requirement must also be evaluated in light of the circumstances. For example, if the entity has an exclusive franchise to provide regulated services or products in an area and competition from other services or products is minimal, there is usually a reasonable expectation that it will continue to meet the other criteria. Exclusive franchises can be revoked, but they seldom are. If the entity has no exclusive franchise but has made the very large capital investment required to provide either the regulated services or products or an acceptable substitute, future competition also may be unlikely.*

6.4 The guidance and scope provided under the Indian GN is similar to IFRS ED.

Authority for rate regulation

6.5 The scope under the guidance currently available under various GAAPs requires that the prices should be determined by an authorized body/ regulator for the purpose of recognition of a regulatory asset or liability. However, there is no guidance on who would qualify to be an authorized body or a regulator.

6.6 It may also be considered whether a contract between two parties can also be considered within the scope of rate regulation, e.g., a long-term supply contract between a customer and the supplier where the supplier is allowed to true-up the price charged per unit to the customer in case the cost of production increases in excess of a pre-determined level. It is common in the construction sector to have an escalation clause in the contract which allows the contractor to recover the additional costs incurred by lodging a claim with the customer. However, the claim is generally recognized only when it is approved by the customer or on realization. In these cases, the right to recover the costs is derived from a contractual arrangement and not from a regulator.

Methodologies of rate regulation

6.7 As elaborated earlier, prices can be controlled by regulators in various forms such as cost-of-service basis (providing for identified actual allowable costs plus a reasonable return), maximum cap basis, incentive based schemes, schemes using hybrid methodologies etc. The limited guidance currently available only addresses regulations where the prices are determined on the cost-of-service basis. If the prices are determined on other basis, there is still no accounting guidance available. The pricing mechanism such as price caps, range mechanism, hybrid mechanism, pay per use, pay based on approvals etc., are other mechanisms which are also forms of rate regulated pricing, but are not covered by the standards and, therefore, leave a significant portion of rate regulated activities uncovered by any standard.

6.8 Various schemes could include cap on the rate of return, right to recover an allowable level of costs (whether or not incurred by the entity) or right to recover specific types of costs without limit if and when incurred. However, current literature does not seem to provide detailed accounting guidance for recognition of different kinds of rights and obligations available in schemes floated by regulators. In summary, due to lack of detailed accounting guidance there is inconsistency in accounting practices followed globally by regulated entities. For example, some regulators determine rates based on assumed or targeted costs or industry averages, rather than the actual cost incurred or expected to be incurred by the entity. Activities regulated in this manner, even though almost akin to a cost of service mechanism, are not covered in the existing literature.

6.9 The rate regulated schemes could be influenced by various objectives of regulators such as restriction on price (fixed price, price cap or price range), influencing the level of supply and demand, restricting or encouraging competition etc. Different types of schemes could potentially include various rights by which regulated entities will be able to recover excess costs incurred, losses incurred, incentives based on efficiency, efficiency on service levels, increase in capacity etc. Similarly, these schemes could also include obligation to refund saving in cost or income generated by operations.

6.10 It is important to note that all regulations or schemes may not require recognition of assets and liabilities. Accordingly, guidance on rate regulation would help in ensuring consistency in application of the accounting principles.

Binding price

6.11 The guidance currently available also requires that the price that the entity charges the customers must be binding for the activities to be covered in scope. However, it also mentions that if different prices for different categories of customers are provided, both

the categories of customers and the prices must be determined by the regulator. It is common that even within the same category, customers are charged different prices which may happen due to competition. Since in this case the prices are no longer fixed by the regulator and is based on the arrangement between the customer and the entity, these would be out of scope of the guidance currently available.

6.12 The issue around the coverage and scope of the standard has already been a major area of debate.

Questions

1 What are the different kinds of rate regulations that should be considered in the Discussion Paper?

2 Should the proposed standard also cover arrangements where the prices are not determined by regulators but are arrangements between two parties that give one party a right/ obligation to recover/ refund fixed or determinable amount of money from/ to the other party under a contract?

3 Should the proposed standard include only those arrangements where the prices are determined by a regulator? Who should be included in the definition of a regulator?

4 Should the Discussion Paper cover all types of regulations or restrict it to the ones that may result in recognition of regulatory assets and/or liabilities?

5 What types of rate regulations can give rise to recognition of regulatory assets and/or liabilities?

7. Recognition of regulatory assets and regulatory liabilities

*7.1 **Can regulatory assets/liabilities be recognized under the existing framework?***

7.1.1 Under the guidance currently available, a regulatory asset is an entity's right to recover fixed or determinable amounts of money as a result of actual or expected actions of the regulator. Similarly, a regulatory liability is an obligation to refund or adjust fixed or determinable amounts of money as a result of actual or expected actions of the regulator.

Regulatory asset

7.1.2 A question arises whether the regulatory asset, the way it is defined and recognized, meets the definition and recognition criteria of asset in accordance with the existing Conceptual Framework.

Definition under IFRS ED

7.1.3 An entity's right to recover specific previously incurred costs and to earn a specified return by increasing rates in future periods as a result of the actual or expected actions of its regulator.

Definition under Indian GN

7.1.4 An entity's right to recover fixed or determinable amounts of money towards incurred costs as a result of the actual or expected actions of its regulator under the applicable regulatory framework.

Guidance under US GAAP (ASC 980)

7.1.5 As per ASC 980-10, a principal consideration introduced by rate regulation is the cause-and-effect relationship of costs and revenues. Thus, an incurred cost for which a regulator permits recovery in a future period is accounted for like an incurred cost that is reimbursable under a cost-reimbursable-type contract, i.e., recognition of a regulatory asset.

7.1.6 An incurred cost is defined in ASC 980-10 (Statement 71) as "a cost arising from cash paid out or obligation to pay for an acquired asset or service, a loss from any cause that has been sustained and must be paid for." Equity return (or an allowance for earnings on shareholders' investment), however, is not an incurred cost that would otherwise be charged to expense.

7.1.7 ASC 980-340-25 states that the "rate action of a regulator can provide reasonable assurance of the existence of an asset." All or part of an incurred cost that would otherwise be charged to expense should be capitalized as a regulatory asset if:

- It is probable that future revenues in an amount approximately equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate making purposes.

- The regulator intends to provide for the recovery of that specific incurred cost rather than to provide for expected levels of similar future costs.

Issues and discussion points

7.1.8 A fundamental and conceptual issue arises whether the regulatory assets meet the definition of 'asset' under the conceptual framework.

7.1.9 The IASB Conceptual Framework defines an asset "as a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise."

7.1.10 In case of a rate regulation based on recovery of costs, the resource is the right conferred by the regulator whereby the costs incurred by the entity would result in future cash inflows by way of increase in revenues. In such cases, the incurrence of costs creates an enforceable right to set rates at a level that permits the entity to recover those costs, plus a specified return, from an aggregate customer base. For example, if the regulator has approved certain additions to be made by the entity in its assets base during the tariff period, which would be added to the asset base for tariff setting, the entity upon making such additions, obtains the right to recover the costs and return as provided in the regulatory framework though the actual recovery through rates may take place in the future.

7.1.11 The right to recover the costs incurred can in itself be considered as a resource arising as a result of past events and from which future increased revenues would arise.

7.1.12 The cause-and-effect relationship between an entity's costs and its rate-based revenue can further demonstrate that an asset exists. In this case, the entity's right that arises as a result of regulation relates to identifiable future cash flows linked to costs it previously incurred, rather than a general expectation of future cash flows based on the existence of predictable demand. The binding regulations/orders of the regulator for recovery of incurred costs together with the actual incurrence of costs by the entity would satisfy the definition of 'asset' as per the Framework since the entity's right (to recover amounts through future rate adjustments) constitutes a resource arising as a result of past events (incurrence of costs permitted by the regulator for recovery from customers) from which future economic benefits are expected to flow (increased cash flows through rate adjustments).

7.1.13 It could be argued that though the entity has a right to recover the costs incurred, it does not control the resource as the recoverability of the future cash flows is dependent on the customers using the service. Also, the individual members of the broad customer-base would change over time. As a counter to this point of view, it is argued that the regulation governs the entity's relationship with its customer base as a whole and hence the rate regulation creates a present right to receive from or a present obligation to pay economic benefits to that aggregate customer base. Although, the individual members of that broad customer group may change over time, the relationship between the entity and the customer group continues to remain. The regulator has the authority to permit the entity to set rates at a level that will ensure the entity to receive the future cash flows from the customers as a whole. Therefore, it could be concluded that recognition of regulatory assets and regulatory liabilities should be considered at the aggregate customer level.

7.1.14 Further, the Framework states that control over the future economic benefits is sufficient for an asset to exist even in the absence of legal rights. The key notion is that the entity has access to a resource and can limit others' access to that resource which is satisfied in case of the right provided by the regulator to recover incurred costs through future rate adjustments. Any issues regarding recoverability of the amounts should not affect the recognition of the right in the financial statements. The issues on recoverability should, however, need to be considered in the measurement of the regulatory assets and liabilities.

Regulatory liability

Definition under IFRS ED

7.1.15 An entity's obligation to refund previously collected income and to pay a specified return by decreasing rates in future periods as a result of the actual or expected actions of its regulator.

Definition under Indian GN

7.1.16 An entity's obligation to refund or adjust fixed or determinable amounts of money as a result of actual or expected action of its regulator under the applicable regulatory framework.

Guidance under US GAAP (ASC 980)

7.1.17 As per ASC 980-405-25-1 rate actions of a regulator can impose a liability on a rate-regulated utility, usually to its customers. The following are examples of ways in which regulatory liabilities can be imposed:

- A regulator may require refunds to customers.
- A regulator can provide provisions in rates for costs not yet incurred.
- A regulator can require that a gain be given to customers by amortizing amounts to reduce future rates.

7.1.18 Thus, a rate-regulated entity should recognize an obligation to refund revenues as a regulatory liability, if it is probable that through the ratemaking process there will be a corresponding decrease in future revenues.

Issues and discussion points

7.1.19 Similar to the discussion on regulatory assets, the same question as to whether the proposed regulatory liability would meet the definition of 'liability' as per the Framework is under discussion.

7.1.20 Under the IASB Conceptual Framework, a 'liability' is defined as "a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits."

7.1.21 In case of a rate regulation based on recovery of costs, an obligation arises because of a requirement to refund the customers excess amounts collected in previous periods. In such cases, collecting amounts in excess of costs and the allowed return creates an obligation to return the excess collection to the aggregate customer base. For example, if the tariffs initially are set to assume a certain level of costs towards energy purchased but the actual costs incurred by the entity are less than such assumed levels, the entity would be obliged to make a refund following the 'truing up' exercise by the regulator. It could again be argued that the requirement to refund the excess amount collected is not a present obligation but a future obligation that would arise only when the customer is billed for future usage at a reduced rate. However, the counter argument can be that the obligation is a present obligation relating to amounts the entity has already collected from customers owed to the entity's customer base as a whole, not to individual customers and also that the regulator has the authority to ensure that future cash flows from the customer base as a whole would be reduced to refund amounts previously collected. The obligation exists even though its amount may be uncertain which needs to be factored in the measurement of the regulatory liability and would not preclude recognition of the regulatory liability.

7.1.22 It is understood that the reason for suspension of the earlier project on rate regulation by IASB was lack of clarity on whether the regulatory assets or liabilities meet the definitions of an asset and a liability under the Conceptual Framework. In the light of the recent developments, where the IASB has started a comprehensive project and is carrying out its analysis from the beginning, the above conclusions made in the US GAAPs, IFRS ED and the Indian GN may merit reconsideration.

7.1.23 In a cost-of-service regulation, the entity has more than a simple right to charge users; it has a right to recover its costs plus a specified return although that right is implemented by rate adjustments for practical reasons. Rate regulations are enforceable and may create legal rights and obligations that the rate-regulated entity should account for.

Questions

1 As the regulator gives a right/ obligation to the entity to recover / refund the additional/ reduced costs incurred, considering the above arguments, does such a right or an obligation meets the definition of an asset or liability under the current Conceptual Framework?

2 In case it is concluded that the definition of an asset or liability under the current Conceptual Framework is not met, since the Conceptual Framework project has also been restarted, should the IASB consider a change in the definitions of asset and liability to consider rate regulation situation as well? If yes, what should be the changes?

3 Do 'expected actions of a regulator' as per ED of IASB sufficient to meet the definitions of 'asset' and 'liability' under the existing Conceptual Framework or such expected actions should be considered in the context of the 'existing regulatory framework' as in the Indian GN?

7.2 Should other factors such as demand and supply be also considered?

7.2.1 The entire discussion on the rate regulated activities is based on the premise that usually and largely there is direct linkage between an approval or expectation of approval of higher or lower rate by the regulator and charging of that higher or lower rate by the entity.

7.2.2 There is significant merit in considering this argument and also a commercial argument to the extent that if a regulator has approved a higher price, it is more likely than not

that an entity will charge that higher price or if a regulator has approved a lower price, the entity has no option but to charge a lower price.

7.2.3 However, it could also be possible that if the entity increases, the price the customers may reduce the consumption of the product or switch to an alternative good or service. Hence, the recognition of the regulatory asset should not be just based on the price but should also be influenced by other factors such as demand and supply. It could thereby be argued that the ability to charge a higher or lower price in itself does not give rise to an asset or liability.

7.2.4 This creates an element of doubt whether there is a direct linkage between the decisions and approvals of the regulators with the corresponding increase or decrease in prices by the entity or there are any additional factors also contributing to this increase or decrease. Could there be situations, where a regulator approves x increase in the price but the entity ultimately makes a (x-y) increase in the price considering the resultant impact on demand and, if possible, how should such situations be viewed considering the fact that an element of price increase or decrease by any entity is due to the market conditions also apart from the approval of the regulators.

7.2.5 It may be argued that in such a case, the measurement of the amount of regulatory assets recognized could consider the impact of the market conditions, i.e., the cash flows estimates could take into account consideration of demand and supply factors. In case a regulatory asset is recognized considering the market conditions and in a subsequent period these estimates undergo a change which raises a question on the recovery of the recognized regulatory assets, then the amount of regulatory assets may be included with other assets and liabilities of the cash-generating unit and tested for impairment. This could be considered appropriate as regulatory assets and liabilities do not generate cash flows that are largely independent from other assets of the entity.

7.2.6 It could be argued that the ability to charge a higher or lower price does not give rise to an asset or liability. For example, to withstand competition, an other than rate-regulated

entity may decide to decrease the price but this does not give rise to a liability. Similarly, if such an entity intends to increase the price in future, it does not give rise to an asset. However, in the case of rate regulation, the regulator has the right to require the entity to decrease price as it is linked to less costs incurred in the past or higher than anticipated profits made in the past. However, in case of an other than rate regulated entity, where the entity reduces the price due to competition, there is no link to previously incurred costs or profits which is established in the case of rate regulation.

Questions

1 Should existence of regulatory assets and regulatory liabilities consider market conditions and be based not only on the prices determined by the regulator, or, should market conditions be considered for measurement of regulatory assets and liabilities?

2 Would it be appropriate to recognize regulatory assets and liabilities in one period and impair them subsequently based on the market conditions?

7.3 **Timing of recognition of regulatory assets/liabilities**

7.3.1 Paragraph 83 of the *Framework* indicates that an asset or liability should be recognized if:

(a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and

(b) the item has a cost or value that can be measured reliably.

7.3.2 Paragraph 85 of the *Framework* explains that this notion of probability is used in the same sense as it is employed in other standards and defined in the Glossary, i.e., ‘more likely than not’. The IFRS ED concluded that if rate-regulated activities satisfied the

scope criteria in the proposed IFRS, the actions of a regulator provide reasonable assurance that the economic benefit will flow to or from the entity. In addition, because regulatory assets and regulatory liabilities relate to specifically identifiable amounts expended or collected by the entity, the ED concluded that reliable measurement was possible.

7.3.3 The Board decided that once the scope criteria have been satisfied, assets and liabilities exist meet the criteria for recognition. As a result, the Board decided not to propose a separate recognition criteria in the draft IFRS.

7.3.4 As per the Indian GN, a regulatory asset should be recognized when it is probable that the future economic benefits associated with it will flow to the entity as a result of the actual or expected actions of the regulator under the applicable regulatory framework and the amount can be measured reliably. If the recovery of the incurred costs is at the discretion of the regulator, the right can at best be said to be a contingent asset. In such a case it would not be appropriate to recognize an asset till the approval of the regulator is received. For example, if additions to the rate base are subject to the approval of the regulator, the entity should not recognize a regulatory asset on account of costs incurred on capital additions before approval of the regulator since the recovery of additional amounts through tariffs is contingent upon approval by the regulator.

7.3.5 With regard to the regulatory liability, the Indian GN requires that such a liability should be recognized:

(i) When an entity has a present obligation as a result of a past event;

(ii) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(iii) A reliable estimate can be made of the amount of the obligation

It may thus be noted that Indian GN primarily lays down the recognition criteria based on the Conceptual Framework.

7.3.6 The US GAAP guidance states that an incurred cost that would otherwise be charged to expense should be capitalized as a regulatory asset if it is probable that future revenues in an amount approximately equal to the capitalized cost will result from inclusion of that cost in allowable costs for ratemaking purposes and the regulator intends to provide for the recovery of that specific incurred cost rather than to provide for expected levels of similar future costs.

7.3.7 With regard to recognition of rate regulated liabilities, the US GAAP require that where the refunds that meet the criteria of standards on *Accounting for Contingencies*, the same should be recognized as liabilities. Further, a regulator may provide current rates intended to recover costs that are expected to be incurred in future with the understanding that if those costs are not incurred, future rates will be reduced by corresponding amounts. Those amounts shall be recognized as liabilities and taken to income only when the associated costs are incurred. Another situation can be where a regulator requires that a gain or other reduction of net allowable costs be given to customers over future periods. That would be accomplished, for rate-making purposes, by amortizing the gain or other reduction of net allowable costs over those future periods and reducing rates to reduce revenues in approximately the amount of the amortization. If a gain or other reduction of net allowable costs is to be amortized over future periods for rate-making purposes, the regulated enterprise shall not recognize that gain or other reduction of net allowable costs in income of the current period. Instead, it shall record it as a liability for future reductions of charges to customers that are expected to result.

7.3.8 While the guidance is largely similar there are some inconsistencies relating to timing of recognition of regulatory assets, which could have a significant impact.

7.3.9 The Indian GN requires the regulatory assets and liabilities to be recognized based on the expected actions of the regulator under the *regulatory framework*. However, the IFRS ED and US GAAP guidance allows recognition of regulatory assets based on the intention or expected actions of the regulator without referring to the *regulatory framework*. Thus, in case of US and IFRS ED, for usual costs, an entity will be able to make an estimate of the costs that will be approved by the regulator which will be based on historical actions of the regulator and guidance provided by the regulator. However, in case the costs to be recovered are of unusual or one-off nature, it will be very difficult and involve significant judgment to recognize a regulatory asset. From Indian GN, it would appear that in case the expected actions of the regulator are covered under the regulatory framework, i.e., the relevant rules and regulations, only then the regulatory assets and liabilities can be recognized. In other words, if additional costs are incurred that are not presently covered under the existing laws and regulations, the same cannot be considered for the purpose of recognition of assets.

7.3.10 Due to lack of detailed application guidance in this respect, various practices are prevalent in the industry on the timing of recognition of a regulatory asset including

- Recognition using internal assessments in the year when the costs are incurred based on the management's assessments that such costs would be permitted for billing.
- Recognition at the time claims and tariff revision requests are submitted to the regulators.
- Recognition of assets on the basis of final approvals by the regulators when no uncertainties exist though amounts may be billed and collected later.

Questions

1 Given the debate around the definitions of 'asset' and 'liability', should the timing of recognition of such asset/liability be re-visited and more guidance be provided and

indicative examples on the timings of the recognition of regulatory assets/liabilities, considering the various points of time at which these can be recognized, be developed?.

2 Should indicators of the probable recovery of assets as guidance also be provided?

8 Nature of regulatory assets and liabilities

8.1 Regulatory assets and liabilities that would arise out of the application of the guidance available will not qualify to be financial instruments under IFRS. As per IAS 32, *Financial Instruments – Presentation,* financial instruments, financial assets and liabilities are defined as under:

*A **financial instrument** is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.*

*A **financial asset** is any asset that is:*

(a) cash;

(b) an equity instrument of another entity;

(c) a contractual right:

(i) to receive cash or another financial asset from another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

(d) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not

include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that contracts for the future receipt or delivery of the entity's own equity instruments.

A ***financial liability*** *is any liability that is:*

(a) a contractual obligation :

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

Typically, regulatory assets or liabilities that would be recognized would not be financial instruments. The entity does not have the right to request

reimbursement from, or the obligation to make payments to, individual customers for fixed or determinable amounts. Rather, rights or obligations created as a result of rate regulation are rights from or obligations to an aggregate customer base.

8.2 It may also need to be examined whether the regulatory assets can be considered to be intangible assets within the meaning of IAS 38, *Intangible Assets*. In this regard, it may be noted that IAS 38 defines an 'intangible asset' as an asset that is identifiable, non-monetary asset without physical substance. IAS 38 defines 'monetary assets' as money held and assets to be received in fixed or determinable amounts of money. It may be argued that the regulatory assets represent the assets to be received in determinable amounts of money and, therefore, these are not intangible assets. This is because the amounts of regulatory assets can be determined based on the rate regulations prescribed by the relevant authority. Accordingly, the regulatory assets are of the nature of monetary assets and are not intangible assets. This seems to be the approach followed by the IFRS ED and the Indian GN in view of the fact that the regulatory assets are required to be measured at recoverable amounts of money rather than at cost which would have been the case had these been considered as intangible assets within the meaning of IAS 38 which requires measurement of intangible assets at cost.

8.3 In some respects, regulatory liabilities are similar to liabilities recognized in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, in which the identity of the party to whom the obligation is owed is not known. In other respects, regulatory liabilities resemble obligations to perform future services recognized in accordance with IAS 18, *Revenue*. In rare circumstances, the regulator may direct that specific amounts should be paid to or recovered from specific customers. In that case, the definition of a financial instrument would be satisfied.

Question

1 Should the IFRS on Rate Regulated Activities provide detailed guidance to determine the nature of the regulatory assets and liabilities?

9. Measurement of regulatory assets/liabilities

9.1 On initial recognition and at the end of each subsequent period, the Indian GN requires the regulatory asset or regulatory liability to be measured at the best estimate of the amount expected to be recovered or refunded or adjusted as future cash flows under the regulatory framework. The Indian GN prohibits regulatory asset or regulatory liability to be discounted to its present value. The Indian GN also states that the estimates of the amount expected to be recovered, refunded or adjusted are determined by the judgement of the management of the entity considering various factors such as:

- statutes or regulations that specifically provide for the recovery of the cost in rates;
- formal approvals from the regulator specifically authorizing recovery of the cost in rates;
- previous formal approvals from the regulator allowing recovery for substantially similar costs (precedents) for a specific entity or other entities in the same jurisdiction;
- written approval from the regulator (although not a formal approval) approving future recovery in rates;
- uniform regulatory guidance providing for the treatment of various costs that the regulator typically follows in setting rates;
- opinions of independent experts regarding recoverability of the cost on the basis of regulations and past practice.
- any additional evidence provided by events after the balance sheet date, where appropriate as per the applicable Accounting Standard.

9.2 The Indian GN also requires estimates of the amount expected to be recovered, refunded or adjusted to be reviewed at least at the end of each reporting period to reflect the current best estimates. If expectation differs from previous estimates, the changes should be accounted for as a change in an accounting estimate.

9.3 Under the US GAAP guidance, the incurred cost that would otherwise be charged to expense should be capitalised as a regulatory asset if conditions of recognition are met. Subsequently, actions of the regulator would reduce or eliminate the value of the asset or if the regulator allows recovery of costs which were previously excluded from allowable cost, it would result in recognition of a new asset. US GAAP guidance does not require any discounting of the amount capitalised as regulatory asset or regulatory liability.

9.4 IFRS ED requires the regulatory assets and liabilities to be measured at the present value of the expected future cash flows. This will require use of an expected cash flow approach based on multiple probability weighted cash flow projections discounted at a rate that would reflect the risk attributable to the specific regulatory asset or liability. The ED further provides guidance of the indicators, similar to those contained in Indian GN (see paragraph 8.1 above) that an entity should consider in accessing the probability of recovery. Similar to Indian GN, the estimates of expected cash flows should be reviewed and adjusted at the end of every reporting period.

Cost of self-constructed or internally generated assets

9.5 In some cases, a regulator requires an entity to include as part of the cost of property, plant and equipment or internally generated intangible assets, amounts for rate fixing purposes that would not be included by non-regulated entities. Such amounts may be indirect overheads not permitted in accordance with IAS 16 or IAS 38 or the cost of financing construction or development that is not in accordance with IAS 23 *Borrowing Costs.* The regulator may require a computed interest cost and a designated cost of equity funds to be included in the cost of the asset.

9.6 Two alternatives exist for accounting for these costs. Proponents of the first alternative believe that regulatory assets that would be recognized as a result of the IFRS ED do not have the same characteristics as assets recognized in accordance with other IFRSs. Therefore, proponents of this alternative believe that all regulatory assets should be presented separately from assets recognized in accordance with other IFRSs.

9.7 Proponents of the second alternative believe that some regulatory assets that would be recognized as a result of the proposed IFRS are so closely related to other assets of the entity that accounting for them separately does not provide additional information to users. Proponents of this alternative believe that when regulatory assets are complementary to other assets and have similar useful lives, there is no need to incur the costs of separate accounting. In accordance with this alternative, an entity includes the cost of the regulatory asset in the cost of the asset recognized in accordance with other IFRSs as a single asset.

9.8 IFRS ED concluded that when it is highly probable that the regulator will require amounts to be included in the cost of self-constructed or internally generated assets that would not be permitted in accordance with IFRSs, those amounts should be included in the cost of the assets rather than being accounted for separately in accordance with the proposed IFRS. The IFRS ED concluded that an exception to the principles in the proposed IFRS was justified on cost-benefit grounds.

9.9 On a perusal of paragraph 9.8 above, it is apparent that the IFRS ED lays down two principles of measurement: (i) at present value of the expected future cash flows and (ii) at cost in respect of the regulatory assets included in the cost of self-constructed property, plant and equipment or internally generated intangible assets as an exception to the measurement principle at (i). This does not seem to be appropriate as it is felt that the measurement principles of all types of regulatory assets should be the same. Further, it also does not appear to be appropriate to include the cost pertaining to regulatory assets

as the cost of property, plant and equipment as this would lead to incomparability with the non-rate regulated entities. In other words, it would be appropriate if the cost of property, plant and equipment and internally generated intangible assets should continue to be governed by IAS 16 and IAS 38 respectively and the relevant regulatory assets/liabilities are measured on uniform basis and reflected separately. This seems to be the approach followed in the Indian GN as it states that other Accounting Standards (IFRSs) should continue to be applied in the same manner as in the case of non-regulated enterprises. Thus, under Indian GN, costs pertaining to property, plant and equipment which results in creation of regulatory assets are to be measured and reflected as other regulatory assets. On the other hand, apparently US GAAPS seem to follow the treatment as proposed in the IFRS ED.

Questions

1. Should regulatory assets be measured at
   (i) Historical cost
   (ii) The amount expected to be recovered or refunded or adjusted as future cash flows under the regulatory framework, without discounting
   (iii) At the present value of expected future cash flows
   (iv) Any other measurement basis?

2. Should regulatory assets that result because the regulatory authorities permit inclusion of expenses in the cost of self-constructed property, plant and equipment for rate regulation purposes which are otherwise to be expensed under the relevant IFRS be measured at
   (i) the basis consistent with other regulatory assets and liabilities as per (i) above, or
   (ii) at cost as an exception to (i) above?

3. Should the regulatory assets of the type covered at (ii) above be included as part of the cost of property, plant and equipment or intangible assets or the same should be reflected separately, along with the other regulatory assets and liabilities?

10. Presentation of impact of regulatory assets and liabilities

Presentation in statement of comprehensive income

10.1 The guidance available under IFRS ED and Indian GN is focused towards recognition and measurement of regulatory assets and liabilities from the perspective of statement of financial position. However, the corresponding accounting impact on the statement of comprehensive income has not been clearly provided in IFRS ED as well as Indian GN. Due to lack of guidance, several accounting practices could emerge. For example, should the right to recover already incurred cost by increase of future rate be recognized as revenue in the year in which it will be recognized and disclosed as a separate line item as additional revenue due to increase in rate. Alternatively, the entity may treat this as normal revenue with no separate disclosure. The other accounting treatment could be that since the future rate increase corresponds to already incurred costs, the amount should be reduced from costs. The collection of the rate increase in the subsequent periods would result in derecognition of the regulatory asset. In case of regulatory liabilities, opposite accounting treatment as explained above for regulatory assets could be followed by regulated entities.

10.2 Following are the accounting practices that currently exist due to lack of specific guidance for treatment of regulatory assets and liabilities in the statement of comprehensive income:

- Presented as part of revenues, as and when approved
- Presented as part of revenues, as and when accrued
- Presented as a separate line on the income side

- Reduced from the overall amounts from the total costs by way of future adjustment to the cost and revenue

10.3 Under US GAAP, it is mentioned that the incurred cost would be recognized as regulatory asset if certain conditions are met which would be amortized over future periods consistent with the related increase in customer revenues. Similarly, regulatory liabilities would be created by deferring revenue which would be amortized over future periods consistent with the related decrease in customer revenues. With regard to income and expense recognition in respect of rate regulated liabilities, reference may be made to paragraph 7.3.7.

Presentation in statement of financial position

10.4 Diversity of accounting practices exist for presentation of regulatory assets and liabilities due to lack of notified guidance under IFRS.

10.5 General practices followed by companies are as follows:

- Disclosed as regulatory assets or liabilities
- Disclosed as receivables or payables
- Disclosed as other assets or liabilities
- No disclosure – various companies have not made disclosure regarding impact of regulatory assets or liabilities in the financial statements

Question

1. How should the impact of rate regulated assets and liabilities be presented in the statement of comprehensive income and statement of financial position?

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