

Accounting by Rate Regulated Entities



Accounting by rate regulated entities has been a subject matter of extensive discussion since long, nationally as well as internationally. Rate regulated entities are those entities which are subject to a regulation that determines tariffs at which the goods or services are sold by such entities. The relevant regulation generally specifies a particular methodology for setting the tariff to be charged by the entity from its customers, for example, recovery of cost with a reasonable mark-up. Common examples of rate regulated entities are entities in utility sector, say, electricity, water, etc. Due to involvement of a regulation specifying tariffs, rate regulated entities sometimes face peculiar accounting issues which require special consideration.

Guidance Note on Accounting for Rate Regulated Activities

In India, the Institute of Chartered Accountants of India (ICAI) issued a Guidance Note in February 2012 to deal with accounting for rate regulated activities. However, the said Guidance Note was not made effective as it was felt that some aspects were needed to be addressed for its effective implementation. The ICAI has now issued the revised Guidance Note on the subject in February 2015 ('the Guidance Note'), which is effective from accounting periods commencing on or after 1st April 2015. Early application of the Guidance Note is permitted. In the revised Guidance Note, certain presentation related changes have been made as compared to its earlier

version. Further, certain illustrative examples have also been added to provide more guidance. It may be noted that all the rate regulated activities are not covered by the Guidance Note. The scope of the Guidance Note is described as below:

Regulator (an authorised body empowered by the Statute/ Government or its authorised agency, to set rates that bind an entity's customers).

Regulation establishing the price (the 'rate'), which is designed to recover specific costs incurred by the entity along with a specified return (may be a fixed, minimum or a range).

Entity subject to rate regulation ('rate regulated entity')

Customers (to whom the rate regulated entity provides goods or services at the regulated rate)



CA. Jiten Chopra &
CA. Ashish Bansal

(The authors are members of the Institute. They may be reached at jchopra03@gmail.com and abansal44@gmail.com)

The key accounting issue in case of rate regulated entities is that the timing could be different of the incurrence of costs by an entity to provide goods and services and recovery of such costs through tariff. This raises an issue as to whether an entity should recognise an asset (referred to as 'regulatory asset') in respect of costs already incurred by it for which it has a right to recover in future under the relevant regulatory framework.

Any other activities of an entity which are not subject to price regulation are not within the scope of the Guidance Note. Further, the Guidance Note covers only those regulations which determine an entity's prices (rates) in such a way which have a cause-and-effect relationship between the entity's specific costs and its revenues (defined as 'cost of service regulation') and not the regulations which determine rates based on targeted or assumed costs, for example- industry averages.

Key Accounting Issue for Rate Regulated Entities

The key accounting issue in case of rate regulated entities is that the timing could be different of the incurrence of costs by an entity to provide goods and services and recovery of such costs through tariff. This raises an issue as to whether an entity should recognise an asset (referred to as 'regulatory asset') in respect of costs already incurred by it for which it has a right to recover in future under the relevant regulatory framework. Similarly, whether a liability (referred to as 'regulatory liability') should be recognised in respect of tariff already collected by the entity for which it has an obligation to adjust or refund in future under the relevant regulatory framework. For example, at the beginning of year 1, an entity estimates ₹100 as its costs to provide certain services. As per the applicable rate regulation, the tariff is determined based on actual cost incurred plus a mark-up of 10%. In case there is a difference between the estimated cost and actual cost, the same is adjusted in the tariff for the next year. In year 1, the entity actually incurred ₹120 as cost as compared to ₹100 estimated by it at the beginning of the year. The additional cost of ₹20 along with the mark-up will be recovered as an increased tariff for year 2 as per the relevant regulation. In this example, if the entity does not recognise its right to recover the additional cost at the end of year 1, its statement of profit and

loss would reflect a loss of ₹10 (revenue of ₹110 less total cost of ₹120) and in year 2, there would be an increased profit of ₹22 (₹20 plus mark-up), which does not seem appropriate. On the other hand, if, in year 1, ₹22 is recognised as a regulatory asset with a credit to statement of profit and loss, there would be a profit of ₹12 (revenue of ₹110 plus credit for regulatory asset of ₹22 less total cost of ₹120), with no impact on the statement of profit and loss for year 2. Considering such divergence in accounting practices, the Guidance Note has been issued with an objective to establish consistent accounting principles for the entities involved in rate regulated activities.

Recognition and Measurement of Regulatory Assets and Regulatory Liabilities

The Guidance Note requires that a regulatory asset should be recognised 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 regulators under the applicable regulatory framework and the amount can be measured reliably. Similarly, a regulatory liability should be recognised (i) when an entity has a present obligation as a result of 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 should be noted that the recognition of regulatory asset and regulatory liabilities is in addition to the assets and liabilities recognised in accordance with the accounting standards in the normal course.

As per the Guidance Note, measurement of regulatory asset and regulatory liabilities should reflect the best estimate of the amount expected to be recovered or refunded or adjusted as future cash flows under the regulatory framework and should be on an undiscounted basis. These assets and liabilities are subject to review at each reporting date to reflect current best estimate.

Presentation and Disclosure of Regulatory Assets and Regulatory Liabilities

As per the Guidance Note, an entity should present regulatory assets and regulatory liabilities as current/ non-current, as the case may be, separately from other assets and liabilities. With regard to statement of profit and loss, a separate line item

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should be presented for the net movement in all regulatory assets and regulatory liabilities for the reporting period. The Guidance Note also prescribes elaborate disclosures with regard to rate regulated activities.

Ind-AS 114 and Its Interaction with the Guidance Note

The Ministry of Corporate Affairs has notified Ind-AS 114 *Regulatory Deferral Accounts*, in February 2015, along with other Ind-ASs. This Ind-AS is similar to corresponding International Financial Reporting Standard (IFRS) 14 issued by the International Accounting Standards Board (IASB), except certain clarificatory and terminology related changes. An entity is permitted to apply Ind-AS 114 in its first Ind-AS financial statements, if and only if, it:

- conducts rate regulated activities; and
- recognised amounts that qualify as regulatory deferral account balances in its financial statements in accordance with previous GAAP.

For the above purpose, it is clarified that the Guidance Note would be considered as previous GAAP. Therefore, an entity that has recognised regulatory assets and regulatory liabilities as per the Guidance Note would be permitted to apply the requirements of Ind-AS 114, if it elects to do so. For example, if a rate-regulated entity, which is required to comply with Ind-AS for the first time in its financial statements for the year ending 31st March 2017 (with an opening balance sheet as at 1st April 2015), has early adopted the Guidance Note in respect of its financial statements for the year ended 31st March 2015, it would be permitted to apply the requirements of Ind-AS 114 in its first Ind-AS financial statements.

It may be noted that if an entity fulfils the above criteria, the adoption of Ind-AS 114 is optional for it. However, this option is required to be exercised in the first Ind-AS financial statements itself (except where an entity comes into existence or whose activities

become subject to rate regulation later). Further, if an entity elects to apply Ind-AS 114, it cannot apply the requirements of Ind-AS on selective basis. It has to apply all the requirements of Ind-AS 114 to all regulatory deferral account balances that arise from all its rate regulated activities.

Like corresponding IFRS, Ind-AS 114 is an interim standard and does not deal with all the aspects of accounting by entities that are engaged in rate regulated activities. Ind-AS 114 primarily enables a rate regulated entity to continue to apply previous GAAP accounting policies. However, such an entity should comply with the presentation related requirements of Ind-AS 114, which may require changes in the manner of presentation used by the relevant entities under previous GAAP. Further, such an entity also needs to consider the interaction of other Ind-AS with Ind-AS 114, example- Ind-AS 114 requires that the deferred tax related to regulatory deferral account balances should not be recognised with the tax expense line item in the statement of profit and loss but should be recognised with or alongside the related line items that are presented in the statement of profit and loss for the movements in regulatory deferral account balances.

It may be noted that the presentation related requirements of the Guidance note are largely aligned with Ind-AS 114 since both the Guidance Note and Ind-AS 114 require separate presentation of regulatory assets and regulatory liabilities in the balance sheet with a view to ensure comparability with entities not subject to rate regulation or entities that do not elect to apply Ind-AS 114. However, it may be mentioned that there are a few differences in the presentation requirement between the two, example- the Guidance Note requires current/ non-current classification of regulatory assets and liabilities, while Ind-AS 114 requires that it should not be so classified. Further, Ind-AS 114 requires presentation of additional basic and diluted earnings per share calculated using the earnings after excluding the movement in regulatory account balances.

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International Developments

IFRS 14 *Regulatory Deferral Accounts* was issued by IASB in January 2014 and is effective for annual reporting periods beginning on or after 1st January 2016 with an early application choice. IFRS 14 is issued as an interim standard to provide short-term guidance for first-time adopters of IFRS until the research project is completed. As a part of the research project, the IASB has issued a Discussion Paper in September 2014. The discussion paper does not include specific accounting proposals but it explores several possible approaches that the IASB could consider when deciding how best to report the financial effect of a defined type of rate regulation. The IASB discussed comments summary on the Discussion Paper and still continues with further consultations/ deliberations. In future meetings, the

IASB will consider possible accounting models that could be included in a further Discussion Paper on the accounting for rate-regulated activities. Considering the current status of the research project, it seems that issuance of a comprehensive literature dealing with rate regulated activities by IASB is likely to take substantial time.

Conclusion

The area of financial reporting by rate regulated entities is still evolving. In India, the issuance of the Guidance Note should bring consistency to a large extent in the way the rate regulated entities account for the regulatory assets and liabilities. Further, the relevant presentation and disclosure requirements should be helpful for the users to understand and assess the impact of rate regulation on the financial statements of a rate regulated entity. While the issuance of Ind-AS 114 will also enable the Ind-AS entities to continue with the accounting policies followed by them under previous GAAP in their first Ind-AS financial statements, these entities need to carefully evaluate the implications of presentation related requirements of Ind-AS 114 and make a policy choice whether to adopt Ind-AS 114. ■

