REGULATORY DEFERRAL ACCOUNTS
INTERNATIONAL FINANCIAL REPORTING BULLETIN 2013/17

Summary

In April 2013, the International Accounting Standards Board (IASB) published Exposure Draft ED/2013/5 *Regulatory Deferral Accounts*. The ED proposes requirements for an interim standard in relation to what are termed 'regulatory deferral accounts', that arise in relation to rate regulated entities when accounted for by non-IFRS GAAP in specific jurisdictions.

The interim standard, should the proposals be taken forward, would not affect the IASB's more comprehensive rate regulated project, which was re-opened in September 2012.

The proposed scope of ED is particularly narrow, such that the proposals would only apply to:

- Entities preparing their first IFRS financial statements (i.e. transitioning to IFRS), and then
- Only those entities that are involved in rate-regulated activities that meet both the criteria requirements of the ED:
  - i. An authorised body (termed the 'rate regulator') restricts the price that the entity can charge its customers for the goods or services that the entity provides, and that price binds the customers
  - ii. The price established by regulation (the rate) is designed to recover the entity's allowable costs of providing the regulated goods or services (while this does not require a one-to-one matching of costs, it does require the existence of an identifiable causal effect that links the regulatory deferral account to the rate-setting mechanism).

Entities within the scope of the ED would be afforded an exemption from the requirements of paragraph 11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. In preparing their first IFRS financial statements (and all IFRS financial statements for subsequent periods thereafter) they would continue to apply their previous local GAAP accounting policies for the recognition, measurement and impairment of regulatory deferral account balances.

The ED also highlights and provides application guidance in respect of other IFRS that would need to be considered alongside the local GAAP accounting policy in order for these regulatory deferral accounts to be accounted for correctly in an entity's IFRS financial statements, including:

- IAS 10 *Events after the Reporting Period*
- IAS 21 *The Effects of Changes in Foreign Exchange Rates*
- IAS 33 *Earnings per Share*
- IAS 36 *Impairment of Assets*
- IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*
- IFRS 12 *Disclosure of Interests in Other Entities*.

STATUS
Exposure Draft

EFFECTIVE DATE
To be confirmed

ACCOUNTING IMPACT
Only applicable to entities that are yet to prepare their first IFRS compliant financial statements and who have asset and/or liability balances recognised in accordance with their locally issued GAAP related to rate regulated activities .

Because the proposals would lead to a (short-term) loss of comparability between rate regulated entities, including between those applying the proposals (on account of differing requirements between local GAAPs) as well as those entities that already report in accordance with IFRS and would not be eligible to adopt the interim standard, the ED proposes requiring a number of specific and additional presentation and disclosure requirements. These include:

- Separate presentation, in an entity's statement of financial position, of regulatory deferral account debit and credit balances from its other assets and liabilities
- Separate presentation, in the entity's statement of profit or loss and other comprehensive income, of movements in regulatory deferral account debit and credit balances from other income and expense items
- Specific qualitative and quantitative disclosures (including reconciliations) to assist users in determining:
  - The nature of, and the risks associated with, the rate regulation that restricts the price that the entity can charge customers for the goods and services it provides
  - The effects of that rate regulation on its financial position, financial performance and cash flows.

These disclosure requirements are discussed in more detail in section 5 of this Bulletin.

The proposed effective date is yet to be confirmed.

The IASB has requested comments on the ED by 4 September 2013.

Background

In many jurisdictions, the charges that entities in certain industries can demand from their customers for the delivery of goods and services are set by regulatory bodies or governments. Common examples often include entities involved in the transportation and utility sectors. This price-setting activity by these regulatory bodies and governments is more commonly referred to as *rate regulation*.

At present, there is currently no IFRS that specifically addresses the accounting requirements for entities subject to rate regulation.

This is in contrast to some national accounting standard-setting bodies that either permit or require entities to capitalise in their statements of financial position specific rate-regulated assets and liabilities. These amounts are often referred to as ‘regulatory deferral accounts’ (or ‘regulator variance accounts’).

As more jurisdictions that currently permit or require the recognition of regulatory deferral accounts begin transitioning to IFRS, questions have been raised about whether these regulatory deferral accounts meet the definition of assets and liabilities in accordance with the current IFRS *Conceptual Framework*.

The accounting for rate-regulated activities had previously been addressed by the IASB in 2009, with the publication of an exposure draft *Rate-regulated Activities*, which focused solely on ‘cost-of-service’ schemes. However the project was ultimately suspended as the IASB determined that, based on the responses received from constituents, that there were numerous fundamental complexities surrounding the issue and therefore a timely resolution could not be reached.

However, based on the feedback from constituents in relation to the IASB's agenda consultation outreach in 2011, a comprehensive *Rate-regulated Activities* project was re-opened in September 2012. The first stage of this project is to gather information via a Discussion Paper that identify and more clearly articulate:

a) The common features of rate regulation

b) Whether these common features create economic resources for, or claims against, a rate-regulated entity that should be recognised in IFRS financial statements

c) The information about the consequences of rate regulation that would be most useful for users of IFRS financial statements.

This discussion paper, *Rate Regulation*, was released by the IASB in March 2013 (with comments to be received by 30 May 2013).

In the meantime, the IASB has proposed to release an interim standard to assist first time adopters of IFRS in accounting for rate-regulated activities in the lead-up to the completion of the IASB's comprehensive project. ED/2013/05 contains the proposed requirements for this interim standard.

Summary of the ED's proposals

1. Objective

The objective of the ED is to specify the financial reporting requirements for regulatory deferral account balances that arise when an entity is subject to rate regulation.

2. Scope

(i) Applicable entities

The ED proposes a very narrow scope. Only entities that are preparing their first IFRS financial statements are able to apply the proposals (both in the period in which they prepare their first IFRS financial statements, and in each subsequent period).

Therefore, the proposals would not be available to entities that have previously already adopted IFRS.

(ii) Applicable rate-regulation activities

The proposals would only apply to rate-regulated activities that meet <u>**both**</u> the following criteria:

i. An authorised body (termed the 'rate regulator') restricts the price that the entity can charge its customers for the goods or services that the entity provides, and that price binds the customers

ii. The price established by regulation (the rate) is designed to recover the entity's allowable costs of providing the regulated goods or services. While this does not require a one-to-one matching of costs, it does require the existence of an identifiable causal effect that links the regulatory deferral account to the rate-setting mechanism.

3. Summary of the proposals

(i) Summary of the proposals in general

The ED proposes that in preparing its first IFRS financial statements, an entity within the scope of the ED shall continue to apply its previous GAAP accounting policies for the recognition, measurement and impairment of regulatory deferral account balances.

Consequently, the ED exempts an entity from applying paragraph 11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. IAS 8.11 requires an entity to apply the requirements of other IFRSs dealing with similar and related issues, as well as the definitions, criteria, and concepts of the *Framework*, in developing accounting policies in the absence of a specific IFRS in accordance with IAS 8.10.

However, under the proposals an entity is permitted to change its accounting policy of its previous GAAP should the change result in the financial statements either being:

- More relevant to the economic decision-making needs of users, and no less reliable
- More reliable, and no less relevant to the economic decision-making needs of users.

(ii) Additional guidance in relation to interaction with other IFRSs

While an entity within the scope of the proposals would continue to apply the recognition, measurement and impairment requirements of its previous GAAP when accounting for regulatory deferral account balances (rather than applying IFRSs), there are still a number of situations where other IFRSs may still be required to be applied in order that an appropriate accounting approach is applied.

The application of these IFRS's are outlined in detail in appendix B and paragraph 17of the ED, and are summarised in the table on the next page.

IAS 10 *Events after the Reporting Period*

Estimates used in determining regulatory deferral account balances

IAS 10 is to be applied in determining whether information obtained after reporting date but prior to the authorisation of the financial statements, relating to estimates and assumptions used in determining the recognition and measurement of its regulatory deferral account balances are:

- Adjusting events
- Non-adjusting events.

IAS 12 *Income Taxes*

Application of IAS 12

IAS 12 is to be applied to all activities including rate regulation activities.

Where rates are permitted or required to be increased to recover some or all of an entity's tax expense

In this circumstance, local GAAP may require an entity recognising a regulatory deferral account balance in relation to income tax.

In situations where the recognition of such a regulatory deferral account balance in itself results in a temporary difference in accordance with IAS 12, deferred tax would be required to be recognised.

Presentation

Any deferred tax balance recognised, and any movement in those balances during the period in relation to regulatory deferral account balances, is to be presented within the separate regulatory deferral account line item (see section 5), rather than being presented separately in accordance with IAS 12.

The entity is however able to present the deferred tax balance, and the movement in those balances during the period, alongside the regulatory deferral account line items as part of its analysis of the regulatory deferral account line item (see section 5).

IAS 21 *The Effects of Changes in Foreign Exchange Rates*

Deferral account balances denominated in a foreign currency

IAS 21 must be applied to these deferral account balances, and to movements in these balances.

IAS 33 *Earnings per Share*

Presentation of basic and diluted earnings per share

Calculation of basic and diluted earnings per share excludes the net movement in the regulatory deferral account balances.

IAS 36 *Impairment of Assets*

Impairment of regulatory deferral account balances

As the ED allows an entity to apply its previous local GAAP in respect of impairment of regulatory deferral account balances, the requirements of IAS 36 are not applicable to those balances.

Impairment of cash generating units (CGU) containing regulatory deferral account balances

IAS 36 is to be applied in assessing whether regulatory deferral account balances are to be included in a CGU for the purpose of the impairment test.

If it is determined that an impairment loss is to be recognised, the related requirements of IAS 36 are applied (i.e. the impairment loss applied first to any goodwill included in the CGU, and then proportionally to any other remaining balances).

IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

Presentation

Any regulatory deferral account balances, and the net movement in those balances during the period, included in a discontinued operation are to be presented within the separate regulatory deferral account line item (refer to section 5), rather than being presented as part of the 'single-line' approach in accordance with IFRS 5.

However, an entity is permitted to present the deferral account balances belonging to a discontinued operation, and the net movement in those balances during the period, alongside the regulatory deferral account line items as part of its analysis of the regulatory deferral account line item (refer to section 5).

IFRS 12 *Disclosure of Interests in Other Entities*
Disclosures of deferral account balances in material subsidiaries with non-controlling interests, material joint ventures, and material associates – Disclose the net movement in regulatory deferral account balances as required by IFRS 12.12(e) – Disclose the regulatory deferral account debit balance, the regulatory deferral account credit balance, and the net movement in those balances during the period for each entity as required by IFRS 12.
Disclosures of gain or loss on the loss of control over a subsidiary – Disclose the requirements of IFRS 12.19 as well as the portion of that gain or loss that is attributable to derecognising regulatory deferral account balances in the former subsidiary at the date when control is lost.

Figure 1: Application of other IFRS's on regulatory deferral balances

4. *Presentation*

(i) Regulatory deferral account balances

The ED proposes that an entity present the following as separate line items in the statement of financial position:

– The total of all regulatory deferral account debit balances (i.e. what would have been 'assets' under local GAAP)

– The total of all regulatory deferral account credit balances (i.e. what would have been 'liabilities' under local GAAP).

In addition, an entity must use additional sub-totals in order to clearly distinguish the above line items from the entity's other asset and liability line items that are presented in accordance with other IFRSs. The figure below is an extract from illustrative example 3 of the ED.

XYZ Group—Statement of financial position as at 31 December 20X7		
	31 Dec 20X7	31 Dec 20X6
ASSETS		
Non-current assets		
…	…	…
Total non-current assets	**901,620**	**945,460**
Current assets		
…	…	…
Total current assets	**464,640**	**476,410**
Total assets before regulatory balances	**1,366,260**	**1,421,870**
Regulatory deferral account debit balances	100,240	102,330
Total assets	**1,466,500**	**1,524,200**
EQUITY AND LIABILITIES		
Equity attributable to owners of the parent		
…	…	…
	903,700	782,900
Non-controlling interests	70,050	48,600
Total equity	**973,750**	**831,500**
Non-current liabilities		
…	…	…
Total non-current liabilities	177,650	238,280
Current liabilities		
…	…	…
Total current liabilities	217,140	377,950
Total liabilities and equity before regulatory balances	**394,790**	**616,230**
Regulatory deferral account credit balances	97,960	79,470
Total liabilities	**492,750**	**692,700**
Total equity and liabilities	**1,466,500**	**1,524,200**

Figure 2: Example presentation of the additional sub-totals required to distinguish regulatory deferral account balances from other line items in the statement of financial position

(ii) Movement in regulatory deferral account balances

The net movement in all regulatory deferral account balances for the reporting period, except for amounts acquired or disposed of, are presented as separate line statement of profit or loss and other comprehensive income (or in the separate statement of profit or loss).

In addition, additional sub-totals are required in order clearly to distinguish the net movement in all regulatory deferral account balances during the reporting period from the other income and expense line items that are presented in accordance with other IFRSs. The figure below is an extract from illustrative example 3 of the ED.

XYZ Group—Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7		
	31 Dec 20X7	31 Dec 20X6
Revenue	390,000	355,000
...	...	...
Profit before tax and regulatory account movements	**118,747**	**102,420**
Income tax expense	(40,417)	(32,000)
Net movement in tax regulatory deferral account	(3,170)	(12,320)
Net movement in other regulatory deferral accounts	(20,410)	7,400
Profit for the year from continuing operations	**124,750**	**65,500**
Loss for the year from discontinued operations	(3,500)	-
PROFIT FOR THE YEAR	**121,250**	**65,500**

Figure 3: Example presentation of the additional sub-totals required to distinguish regulatory deferral account balances from other line items in the statement of profit or loss and other comprehensive income

5. Disclosure

(i) General disclosure objective

The ED proposes specific disclosures to identify clearly:

- The nature of, and the risks associated with, the rate regulation that restricts the price that the entity can charge customers for the goods and services it provides
- The effects of that rate regulation on its financial position, financial performance and cash flows.

In order to meet these requirements an entity must consider:

- Whether the rate-regulated activities are material to the financial performance or position of the entity
- The level of detail that is necessary to satisfy the disclosure requirements
- How much emphasis to place on each of the various requirements
- How much aggregation or disaggregation to undertake
- Whether users of financial statements need additional information to evaluate the quantitative information disclosed.

(ii) Explanation of activities subject to rate regulation

For each portion of rate-regulated activities that is material to the financial performance or position of the entity, an entity must disclose:

- A brief description of the nature and extent of the rate-regulated activities
- A brief description of the nature of the regulatory rate-setting process
- The identity of the rate regulator, and if a related party, disclose this fact with an explanation of how it is related
- How the future recovery of each regulatory deferral account debit balance or reversal of each regulatory deferral account credit balance is affected by risks and uncertainty, for example:
  - Demand risk (e.g. changes in consumer attitudes, availability of alternative sources of supply, levels of competition etc.)
  - Regulatory risk (e.g. the submission or approval of a rate-setting application, expected future regulatory actions etc.)
  - Other risks (e.g. currency, other market risks).

The above information must be presented either:

- In the financial statements
- Another statement (i.e. management commentary, risk report) that is available at the same time and with the same ease as the financial statements, with a cross reference to this other statement in the financial statements.

(iii) Explanation of recognised amounts

For each regulatory deferral account balances, disclosure of the basis of initial and subsequent recognition and measurement – including an assessment of recoverability and allocation of impairment loss.

For each portion of rate-regulated activities that is material to the financial performance or position of the entity (and for others in aggregate), disclose for each cost or income category that is individually material (and for others in aggregate):

- A tabular reconciliation between the opening and closing amounts. While the level of detail is a matter of judgement, the following components would usually be relevant:
  - Amounts recognised in the current period as regulatory deferral account balances to be recovered or reversed in the current or future periods
  - The amount recognised relating to balances that have been recovered, amortised or reversed in the current period
  - Other amounts (i.e. items acquired or assumed in a business combination, items disposed of, the effects of changes in foreign exchange rates, changes in discount rates, changes in estimated cash flows).

If a single cause has a significant effect on a regulatory deferral account balance, the entity shall disclose it separately.

- The rate of return or discount rate allowed (or required) by the rate regulator to reflect the time value of money that is applicable to each regulatory deferral account balance
- The remaining periods over which the entity expects to recover or amortise/reverse the carrying amount of each regulatory deferral account debit/credit balance.

In addition, the entity applies presentation requirements of other IFRSs identified in Figure 1 above:

- Presentation as a separate category of deferral account (in the reconciliation required above) the deferred tax that arises in respect of the regulatory deferral account debit and credit balances
- Addition basic and diluted earnings per share calculated using the earnings amounts required by IAS 33 but excluding regulatory amounts
- Any regulatory deferral account balances, and the net movement in those balances, that is related to a discontinued operation or a disposal group are presented as part of the regulatory deferral account balances and movements as opposed to within the disposal groups or discontinued operations as would usually be required by IFRS 5
- The regulatory deferral account debit and credit balances and the net movement in the balances relating to interest in a subsidiary, associate or joint venture, where this disclosure is required by IFRS 12.

When the regulatory deferral account balance is no longer fully recoverable, disclose:

- That fact
- The reasons why it is not recoverable
- The amount of the reduction in the regulatory deferral account balance.

6. Transition

There are no specific transitional requirements in the ED.

First time adopters of IFRS will also be able to obtain relief from the requirements of IFRS 1 *First-time Adoption of International Financial Reporting Standards*, including the use of previous GAAP carrying amounts as deemed cost for property, plant and equipment and intangible assets.

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