

IFRS

## New on the Horizon: Accounting for rate- regulated activities

### Interim relief for first-time adopters

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# Interim relief for first-time adopters

On 25 April 2013, the IASB released long-awaited proposals to ease the transition to IFRS for entities subject to rate regulation. The IASB proposes an interim standard that would provide temporary guidance until its comprehensive project on accounting for rate-regulated activities is complete. The proposals would only apply to companies that are yet to make the transition to IFRS.

These proposals are expected to remove barriers to the adoption of IFRS in some jurisdictions. The lack of specific guidance on accounting for rate-regulated activities under IFRS is often seen as a hurdle that holds companies back from adopting IFRS in certain parts of the world, including North America and India. These proposals may accelerate the adoption of IFRS by rate-regulated companies in those jurisdictions.

Accounting for rate-regulated activities has been hotly debated for many years, as IFRS currently does not contain specific accounting requirements for such activities. By contrast, some national accounting frameworks include specific guidance on accounting for the effects of rate regulation, under which the timing of recognition of revenues or expenses is aligned with rate-setting mechanisms set out by regulatory authorities. This often reduces volatility in reported earnings. The proposed interim IFRS would allow a so-called 'grandfathering approach', meaning that entities subject to rate regulation could opt to continue to apply their existing, local accounting principles to regulated activities. This is similar to the approach previously taken by the IASB for insurance and extractive industries.

To clearly show the effect of accounting for rate-regulated activities, grandfathered regulatory deferral account balances would be presented separately in the financial statements. Entities that already apply IFRS would not be allowed to change back to their previous local accounting approach, or to re-instate regulatory deferral account balances that they eliminated when they adopted IFRS.

The proposed interim standard would result in diversity between those entities yet to transition to IFRS and those that already have. In this regard, the separate presentation would be helpful for users in comparing entities by transparently reporting the impact of recognising regulatory deferral account balances in the statement of financial position. However, we expect that some countries that recently transitioned to IFRS, such as Brazil and Korea, will have mixed views. They would have welcomed the relief offered by the interim standard.

In the meantime, it will remain unclear whether or when regulatory deferral account balances can be recognised under IFRS in the future – a question that the IASB is considering in its comprehensive project, which is unlikely to conclude for several years.

We hope that this publication helps you to better understand the proposals and their impact on the requirements of other standards.

Phil Dowad, KPMG's global IFRS revenue recognition and provisions leader  
**KPMG International Standards Group**

## 1. Key facts

- On 25 April 2013, the IASB published its exposure draft ED/2013/5 *Regulatory Deferral Accounts* (the ED). It aims to provide temporary guidance for entities yet to transition to IFRS on accounting for regulatory deferral account balances, pending the finalisation of the IASB's comprehensive project on rate-regulated activities.
- The IASB has cautioned that by proposing an interim standard it is in no way anticipating the outcome of the comprehensive project.
- To qualify for the proposals, an entity is required to meet the following scope criteria:
  - the entity's activities are subject to rate regulation – i.e. an authorised body sets the price the entity can charge and the price is designed to recover allowable costs;
  - the entity is a first-time adopter of IFRS; and
  - the entity recognised regulatory deferral account balances under its existing local accounting requirements immediately before adopting IFRS.
- A subsequent change in accounting policy to discontinue recognition of regulatory deferral account balances would be permissible; however, an entity would not be permitted to begin recognising such balances after initial adoption of the proposals.
- An entity that meets the scope criteria has the option to elect to continue applying its previous GAAP requirements for recognition and measurement – i.e. to apply a 'grandfathering' approach.
- The grandfathering provisions do not apply to presentation. The proposals would require an entity to present regulatory deferral account balances separately.
- The ED proposes new disclosures regarding the nature, risk and effects of rate regulation to help users to understand the rate regulation to which the entity is subject.
- In applying the interim proposals, an entity would also need to consider the interaction of regulatory deferral account balances with other standards on transition to IFRS – for example:
  - deferred tax on regulatory deferral account balances would be presented with the regulatory deferral account line items;
  - earnings per share would be presented including and excluding the impact of regulatory deferral account balances;
  - impairment testing in accordance with IAS 36 *Impairment of Assets* would not be required for regulatory deferral account balances; however, IAS 36 would apply to cash generating units that include such balances;
  - regulatory deferral account balances would be outside the scope of the measurement requirements of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*; and
  - additional disclosures under IFRS 12 *Disclosure of Interests in Other Entities* would be required if an entity's interests in other entities contain regulatory deferral account balances.

## 2.

## How this could impact you

- **Critical decision upon first-time adoption:** On transition to IFRS, an entity would need to make a decision whether to continue with the recognition of regulatory deferral account balances. The election to apply the interim standard would be available only on transition, and a decision to cease recognition of regulatory deferral account balances could not be reversed.
- **Transition considerations:** The 'deemed cost exemption' in IFRS 1 *First-time Adoption of International Financial Reporting Standards* would be available, such that entities would not be required to separate out a regulatory component included in the carrying amount of property, plant and equipment or intangible assets at the date of transition.
- **Judgement required in measurement:** An entity would need to consider the impact on the measurement of its regulatory deferral account balances of the rate regulator having to approve the allowable cost, if that had been its approach under previous GAAP. An entity would therefore need to exercise judgement if the costs sought to be recovered are unusual or one-off in nature.
- **Maintaining multiple accounting records:** An entity may need to upgrade its accounting systems to ensure that records are maintained under IFRS, previous GAAP and any specific requirements of the regulator, depending on how its regulatory deferral account balances are determined.
- **Impact on other IFRSs:** Although the interim standard would ease the transition to IFRS, an entity may need to consider the interaction of regulatory deferral account balances with the application of other IFRSs. Applying the interim proposals could affect the way certain other IFRS requirements are applied – e.g. the way in which IAS 36 applies to a cash-generating unit with regulatory deferral account balances.
- **Preparing for new presentation requirements:** The proposals do not permit grandfathering of the presentation requirements. An entity would need to prepare for the new separate presentation requirements – e.g. revising its account mapping in the consolidation system and amending the format of the financial statements.
- **Extensive disclosures:** Several additional qualitative and quantitative disclosures may be required. An entity would need to assess whether its accounting systems are capable of generating the information required in a timely manner.



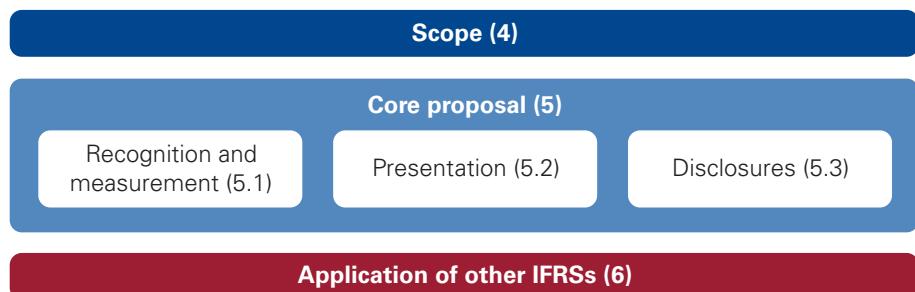
## 3. Introduction

The ED proposes that the recognition and measurement of regulatory deferral account balances would be grandfathered; however, it does require the separate presentation of these balances, as well as additional disclosures. The proposals also consider the interaction of other IFRSs with regulatory deferral account balances.

For these purposes, a 'regulatory deferral account balance' would be any expense (income) deferral or variance account that:

- is or will be permitted by the rate regulator to be included in a future rate-setting decision; and
- would not otherwise be recognised as an asset or liability under IFRS.

The following diagram summarises how the key concepts of the proposals are explained throughout this publication. The corresponding section numbers are in brackets.



This publication only addresses the interim standard, which has been proposed as a temporary solution while the IASB conducts a comprehensive project that will include a full analysis of the accounting impact of various forms of rate regulation.

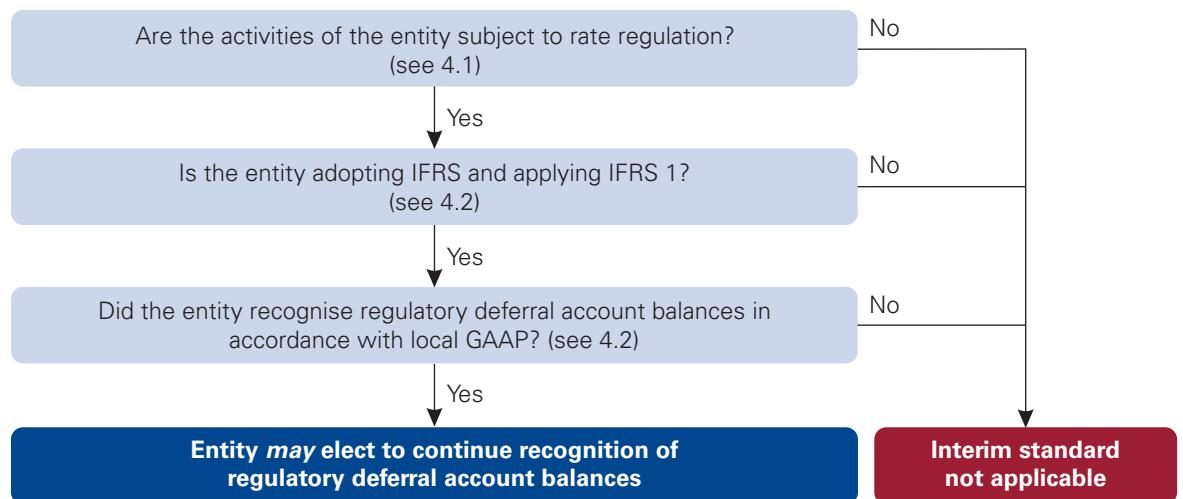
The proposals do not include an effective date. However, it is proposed that early adoption would be permitted, and therefore an entity would be able to adopt the amendments at the same time as it transitions to IFRS.

The comment deadline for the ED is 4 September 2013.

## 4.

## Scope and objective

The following chart explains the scope of the interim proposals. Each question is discussed in the section marked in brackets.



### 4.1

## Activities subject to rate regulation

*ED 7, Appendix A*

The ED would apply to the operating activities of entities that are subject to rate regulation. An entity may have several activities, some of which may be rate-regulated and some not. This ED is intended to apply only to those activities that are rate-regulated.

An entity's activities would be in the scope of the proposals if they meet the following core criteria:

- an *authorised body* restricts the price that the entity can charge its customers;
- that *price is binding* on its customers; and
- the price established is designed to *recover the entity's allowable costs* of providing regulated goods or services.

### An authorised body

*ED 7, Appendix A*

The rate-setter (regulator) restricting the price that the entity can charge its customers would need to be an authorised body. The regulator can be empowered by statute or contract and does not have to be a third party to the entity. An example of this may be a commission or co-operative arrangement in which the governing body of the entity itself acts as a regulator.

### A binding price

Under the proposals, the price that the entity charges customers would need to be binding. The ED allows different prices for different categories of customers; both the categories of customer and the rates would need to be determined by the regulator. Prices cannot be negotiable on an individual customer basis.

### Observations – Pricing in practice

Many companies set different prices for different categories of customers. For example, a power company may have two main types of electricity tariffs: one for wholesale customers and one for retail customers.

In some markets, it is unusual for all customers within a category to be charged the same price – e.g. wholesale customers may pay different rates based on their usage.

In such situations, the key question would be whether the prices are binding.

### Recovery of allowable costs

#### *ED 8, Appendix A*

Under the proposals, the price established by regulation would need to be designed to recover allowable costs – i.e. costs that are specific to the entity and for which the regulated rate is intended to provide recovery. This criterion requires that there be an identifiable causal effect that links the allowable costs to the rate-setting mechanism.

#### *ED BC23–BC25*

A number of rate-regulatory methodologies exist, and the ED does not deal with all of these. The objective of most methodologies is to balance both customer and investor interests. Examples of different methodologies include the following.

- **Cost-of-service regulation:** Under this methodology, rates are set by working backwards from a desired return on the investment made by the entity and the allowable costs incurred by the entity. This establishes the amount of revenue that is considered reasonable, which – together with estimates of future volume – is used to establish the rates.
- **Price-cap regulation:** Under this methodology, initial rates may reflect cost of service; however, they are allowed to increase, or are required to decrease, over time based on a formula.
- **Hybrid methodologies:** Combinations of both of the above methodologies exist that use incentive-based rate-setting mechanisms with cost-of-service rebasing. In such scenarios, the regulator sets the price based on actual cost recovery, and part of the price is based on efficiencies or target costs.

### Observations – Uncertainty with respect to scope

Assessing whether a form of rate regulation meets the two scoping criteria would be an essential first step in evaluating whether to apply the interim standard.

The exposure draft *Rate-regulated Activities* published by the IASB in July 2009 was criticised for having too narrow a scope, targeting only those entities subject to cost-of-service regulation. The current proposals are intended to have a broader scope, but it seems that an identifiable ‘cause and effect’ relationship between allowable costs and rate setting would still be required.

The Board will look at scoping more generally in its comprehensive project; the key question at this stage is whether the scope criteria are sufficiently clear to ensure consistent application in the jurisdictions likely to be affected throughout the period in which the interim standard remains in force.

## 4.2 First-time adopters only

ED 4-5, BC31

In addition to the above scope conditions, the proposals would be available only to entities that:

- are first-time adopters of IFRS; and
- recognised regulatory deferral account balances in their financial statements in accordance with the reporting requirements applied immediately before transition to IFRS (previous GAAP) for annual periods immediately preceding the initial application of the interim standard.

The proposals would therefore allow entities to ease their transition to IFRS, because their accounting policies for rate regulation would require no significant changes until the comprehensive project has been finalised.

### Observations – Opportunity for some jurisdictions, but no relief for others

Entities that already apply IFRS would not be allowed to change back to their previous local accounting approach, or to re-instate regulatory deferral account balances that they eliminated when they adopted IFRS. Some countries that recently transitioned to IFRS, such as Brazil and Korea, will have mixed views. They would have welcomed the relief offered by the interim standard.

The proposals are intended to benefit some jurisdictions that are expecting to transition to IFRS in the near future. However, in jurisdictions where reporting is based on local versions of IFRS that do not fully comply with IFRS, the proposals may create an incentive to identify opportunities that would allow an entity to apply the interim standard – e.g. by issuing a statement of compliance with 'full' IFRS, rather than a local version of IFRS.

An entity transitioning to IFRS would need to consider whether to continue to recognise regulatory deferral account balances, bearing in mind the implications for the application of other IFRSs (see section 6).

### Observations – Decision whether to continue with the recognition of regulatory deferral account balances

On transition to IFRS, an entity that meets the scope requirements may opt to continue its existing practice of recognising and measuring regulatory deferral account balances based on its previous GAAP requirements. In arriving at a decision, an entity would need to consider various factors – for example:

- whether it would be possible to achieve a smooth transition to IFRS;
- the fact that the outcome and expected completion date of the comprehensive project are not known; and
- the impact of discontinuing the recognition of regulatory deferral account balances – e.g. on financial ratios.

Entities applying the interim standard may need to maintain multiple accounting records – e.g. records that are based on:

- IFRS, including separate presentation of all regulatory deferral account balances;
- previous GAAP requirements, for measuring regulatory deferral account balances; and
- regulatory requirements, if any.

Applying the interim standard could affect the application of other IFRSs, and require reconciliations between the different sets of accounting records (see section 6).

Depending upon the regulatory requirements, there may be multiple-level assurance requirements, which could increase the cost of reporting. Entities may therefore need to consider upgrading their accounting systems.

## 4.3 Changes in accounting policy after transition

ED 11-13

An entity that recognises regulatory deferral account balances on transition to IFRS would subsequently be able to change its accounting policy to discontinue recognition of such balances, provided that the entity meets the criteria in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* – i.e. the change would result in information that is reliable and more relevant.

However, a subsequent change in accounting policy to begin recognising regulatory deferral account balances would not be permitted.

The following chart summarises the position on subsequent changes in accounting policies.

	Entity electing to grandfather	Entity not electing to grandfather
Expand the range of regulatory deferral account balances to recognise	✗	—
Reduce the range of regulatory deferral account balances to recognise	✓	—
Discontinue recognition of regulatory deferral account balances	✓	—
Start to recognise regulatory deferral account balances	—	✗

✓ Allowed  
✗ Prohibited  
— Not applicable

ED BC48

### Observations – Changes in accounting policy restricted

Entities that do not currently recognise regulatory deferral account balances cannot apply the proposals and begin to recognise such balances. Similarly, entities applying the grandfathering approach would not be permitted to subsequently begin to recognise categories of regulatory deferral account balances for which the entity did not elect an accounting policy for recognition at the time of transition. The IASB's rationale for these restrictions is that starting to recognise such balances would not make the financial statements more reliable under the requirements of IAS 8, given that the policy may need to change again following completion of the IASB's comprehensive project.

## 5. Core proposals

### 5.1 Recognition and measurement

ED 14–15, B1

The ED proposes that once the scope criteria have been met, an entity could elect to apply its existing local GAAP accounting policies to the recognition and measurement of regulatory deferral account balances on transition to IFRS. The entity would apply the policy consistently in subsequent periods. See section 4.3 for a discussion on changes in accounting policies.

For these purposes, a regulatory deferral account balance would be any cost deferral or variance account that:

- a rate regulator permits to be included in a future rate-setting decision; and
- would not otherwise be recognised as an asset or liability under IFRS.

The proposals provide examples of allowable costs that might be recognised, including:

- volume or price variances;
- approved green energy initiatives;
- non-directly attributable overhead costs;
- project cancellation costs;
- storm damage costs; and
- deemed interest.

An entity would need to consider the degree to which the rate regulator is *expected* to allow specific costs to be included in determining future rates.

#### Observations – Continued use of judgement in estimating the ‘expected action’

By acknowledging the relevance of expected actions of the regulator, the IASB is recognising the way that many existing rate-regulation schemes operate. For example, in some cases:

- an entity incurs costs and then submits a statement to the regulator for approval; or
- the regulator approves a rate to be charged over a period of time, which then is subject to revision.

Even though approval generally takes several months, in most cases an entity will be able to make a reasonable estimate of the costs that will be approved by the regulator. The entity's expectation is generally based on historical actions taken by the regulator, informal decisions made by the regulator, guidance and rules published by the regulator, and in some cases industry practice.

If the costs that an entity seeks to recover are of an unusual or one-off nature, then unless the entity has received approval at least in principle, it would need to make assumptions as to whether the regulator is expected to approve these costs. This could be difficult and would involve judgement.

ED 9–10

The IASB proposes an exemption from applying the requirements of paragraph 11 of IAS 8 – i.e. a grandfathering approach whereby entities would not need to consider for regulatory deferral account balances:

- the requirements in IFRS on similar and related issues; or
- the definitions, recognition criteria and measurement criteria in the *Conceptual Framework*.

Under the proposals, the entity would account for all other assets and liabilities in accordance with applicable IFRSs, unless a specific exemption applies. The interaction of the proposals with other IFRSs is discussed in more detail in section 6.

### Observations – Grandfathering is not a new concept to IFRS

The approach proposed by the IASB for rate regulation is not new. The Board took a similar approach for the insurance and extractive industries on issuing IFRS 4 *Insurance Contracts* and IFRS 6 *Exploration for and Evaluation of Mineral Resources*, respectively. Both of these standards were issued in 2004 with the intention that they would be superseded by more comprehensive standards. At the time of writing, both of these 'interim' standards remain in force. In light of this, some may be concerned that the proposed interim standard on regulatory deferral accounts could be part of IFRS for many years.

#### IFRS 10.19

An entity's previous GAAP may not have required accounting policies of subsidiaries to be harmonised on consolidation, resulting in tension between the proposals and IFRS 10 *Consolidated Financial Statements*.

### Example – Consolidation

Parent P is a company with two subsidiaries operating in different countries and providing services that are rate-regulated.

- Subsidiary A has been recognising regulatory deferral account balances under previous GAAP.
- Subsidiary B has not been recognising regulatory deferral account balances under previous GAAP.

On transition to IFRS, Parent P will be required to apply uniform accounting policies on consolidation under IFRS 10. Accordingly, if Parent P meets the scope criteria and elects to apply the ED, then it would recognise regulatory deferral account balances for its subsidiaries' rate-regulated activities in the consolidated financial statements. However, tension arises between the ED and the requirements of IFRS 10 because:

- the proposals are only available to entities that recognised regulatory deferral account balances in their financial statements immediately preceding initial application of the ED; and
- Parent P would not have previously recognised regulatory deferral account balances related to Subsidiary B.

## 5.2 Presentation requirements

ED 18-21, IE12

Under the proposals, regulatory deferral account balances would be presented separately from assets, liabilities, income and expenses recognised in accordance with other standards as follows.

- **In the statement of financial position:** Regulatory deferral account balances would be presented – without offsetting of debit and credit balances – in separate line items, distinguishing them from other assets and liabilities.
- **In the statement of profit or loss and OCI:** The net movement in all regulatory deferral account balances would be presented in a separate line item in the statement of profit or loss and other comprehensive income.

### Example – Presentation requirements

The proposals would result in diversity in practice, because entities would follow different accounting policies for the recognition and measurement of regulatory deferral account balances based on previous GAAP requirements. Therefore, to ensure transparency of reporting and effective comparability, the ED proposes the separate presentation of regulatory deferral account balances.

#### Example presentation of the statement of financial position

Extract: Statement of financial position	Note	20X7	20X6
<b>Assets</b>			
Non-current assets	a	x	y
Current assets	b	x	y
<b>Total assets before regulatory balances</b>	c	<b>x</b>	<b>y</b>
Regulatory deferral account debit balances	d	x	y
<b>Total assets</b>		<b>x</b>	<b>y</b>
<b>Equity and liabilities</b>			
Total equity	e	<b>x</b>	<b>y</b>
Non-current liabilities	f	x	y
Current liabilities	g	x	y
<b>Total liabilities before regulatory balances</b>		x	y
Regulatory deferral account credit balances	d	x	y
<b>Total liabilities</b>		x	y
<b>Total equity and liabilities</b>		x	y

### Example presentation of the statement of profit or loss and OCI

Extract: Statement of profit or loss and OCI	Note	20X7	20X6
Revenue	h	x	y
Cost of sales	i	x	y
<b>Gross profit</b>		<b>x</b>	<b>y</b>
Other income	j	x	y
Expenses	k	x	y
<b>Results from operating activities</b>		<b>x</b>	<b>y</b>
Net finance cost	l	x	y
Share of profit of associates and joint ventures	m	x	y
<b>Profit before tax and regulatory account movements</b>		<b>x</b>	<b>y</b>
Income tax expense	n	x	y
Net movement in regulatory deferral accounts	d	x	y
<b>Profit for the year</b>		<b>x</b>	<b>y</b>

#### ED BC62

Entities would not be required to classify regulatory deferral account balances as current and non-current line items, and debit and credit balances should not be offset. This is because it would require significant judgement and effort to determine the timing of recovery or reversal for each regulatory deferral account debit or credit balance. The objective of separate presentation is to isolate the impact of these balances from the financial reporting requirements of other standards.

#### Observations – Impacts on financial ratios and KPIs

The proposals do not permit grandfathering of presentation requirements, but require separate line items for regulatory deferral account balances on the face of the primary financial statements. The ED does not conclude on whether regulatory deferral account debit balances represent financial, tangible or intangible assets.

Entities should consider the implications of these presentation requirements on their financial ratios and their reporting to banks and other financial institutions on compliance with covenants. Similarly, key performance indicators for internal reporting may need to be revisited.

## 5.3 Disclosure requirements

ED 22-33

The proposed disclosure requirements focus on information to enable users of the financial statements to evaluate the nature of, risks associated with, and financial effect of rate regulation on an entity's financial position, performance and cash flows.

The disclosure requirements primarily fall under two categories, and include the following.

The features of rate regulation
<ul style="list-style-type: none"> <li>• Nature and extent of rate regulated activities.</li> <li>• Identity of the rate regulator and, if the regulator is a related party under IAS 24 <i>Related Party Disclosures</i>, then disclosure of that fact.</li> <li>• Risks and uncertainties that affect the future recovery of the regulatory deferral account balance including demand risks, regulatory risks, currency risks or market risks.</li> <li>• Nature of the regulatory rate-setting process.</li> </ul> <p>These disclosures can either be included in the financial statements or incorporated by cross-reference to other documents – e.g. management commentary.</p>
Effects on the financial statements
<ul style="list-style-type: none"> <li>• For each individually material category of regulatory deferral account balances, and for others in aggregate, the entity would present a reconciliation in a tabular format or another more appropriate format, including at least the following elements: <ul style="list-style-type: none"> <li>– amounts recognised in the statement of financial position;</li> <li>– amounts recognised in the statement of profit or loss and OCI; and</li> <li>– any other changes, either through business combinations or through changes in foreign currency rates, discount rates or estimated cash flows.</li> </ul> </li> <li>• The expected period of recovery and the rate of return.</li> <li>• Income tax on regulatory deferral account balances.</li> <li>• Amounts not recoverable and the reasons for their not being recoverable.</li> </ul>

Section 6 of this publication looks at the disclosure requirements arising from other standards.

ED 23

### Observations – Extensive disclosure requirements

The proposals include a catch-all requirement to disclose any additional information that an entity believes would be required to meet the disclosure objectives. Therefore, an entity would need to exercise judgement in determining which disclosures to include in the financial statements.

There is no current requirement for other entities with rate-regulated activities to make equivalent disclosures under current IFRS. It will be interesting to see whether there is pressure from users for entities already using IFRS to adopt these disclosures as 'best practice' to enhance comparability.

## 6. Application of other IFRSs

### 6.1 General approach

ED 16-17 B3

The normal requirements of other IFRSs would apply to regulatory deferral account balances; however, there are some exceptions and additional requirements, which are discussed in this section. In the absence of any specific exception, exemption, or additional requirement in the proposals, if other standards have different measurement requirements from the existing accounting policy under previous GAAP, then those standards take precedence in recognising and measuring regulatory items.

Standards that might need to be applied include, for example:

- IAS 21 *The Effects of Changes in Foreign Exchange Rates* – to be applied in translating regulatory deferral account balances that are denominated in a foreign currency; and
- IAS 10 *Events after the Reporting Period* – to be applied in identifying whether subsequent events should be taken into account in estimates and assumptions that are used in recognising and measuring regulatory deferral account balances.

#### Observations – Opening IFRS statement of financial position

Although the ED allows grandfathering of existing accounting policies, it does not mean that an entity could necessarily carry forward the regulatory deferral account balances that it has recognised and measured in accordance with its previous GAAP to its first IFRS financial statements without adjustments.

To determine the amount of regulatory deferral account balances for the statement of financial position at the entity's date of transition, other standards would need to be taken into account, and resulting adjustments made to the amounts carried forward from the previous GAAP.

ED B2-B17

The ED proposes specific exceptions, exemptions and additional requirements in applying the following standards:

- IAS 12 *Income Taxes*;
- IAS 33 *Earnings per Share*;
- IAS 36 *Impairment of Assets*;
- IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*; and
- IFRS 12 *Disclosure of Interests in Other Entities*.

#### Observations – Isolation of regulatory deferral account balances

The exceptions, exemptions and additional requirements have been devised to achieve two objectives. One is to remove conflicts between the grandfathered accounting policy and other IFRSs, and the other is to enhance the isolation of regulatory deferral account balances from normal IFRS accounting.

However, at this stage it is not clear whether the IASB would achieve its objectives through these exceptions alone. For example, it is not clear how IFRS 3 *Business Combinations* would be applied if the acquiree recognised regulatory deferral account balances.

## 6.2 IAS 12 Income Taxes

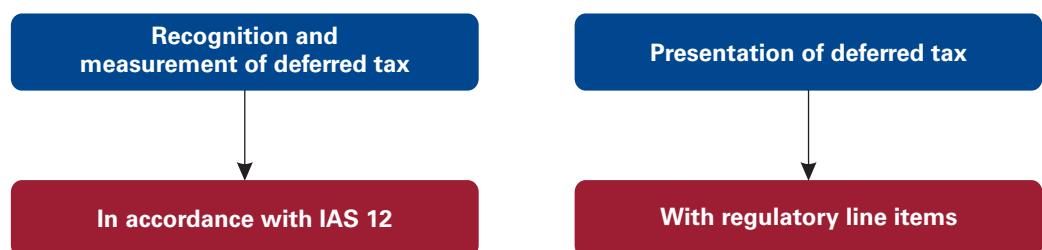
### ED B4

Deferred tax would be recognised and measured on regulatory deferral account balances in accordance with IAS 12, which is consistent with the general approach to applying other IFRSs. However, the amounts recognised would be included with the regulatory line items, instead of within tax line items, with clear disclosure.

### ED B6

An entity may either:

- present the deferred tax amount as a separate item alongside the regulatory deferral account balance or movement in regulatory deferral accounts; or
- disclose it as part of the required reconciliation of regulatory line items.



### Observations – Deferred tax on a temporary difference in a regulatory deferral account

An entity applying the ED might or might not have recognised deferred tax with regard to temporary differences on regulatory deferral account balances in accordance with its previous GAAP. Because the existing policy on recognising deferred tax would not be grandfathered, on applying IAS 12 an entity would recognise deferred tax arising from temporary differences in regulatory deferral account balances. This may change the net amount of the regulatory deferral account balances compared with the pre-transition financial statements.

### ED B5

IAS 12 would apply to a rate-regulation scheme in which a deferred tax expense is an allowable cost of providing the regulated goods or services. In this case, the entity would recognise a regulatory deferral account balance for income tax. On transition to IFRS, an additional temporary difference may arise on this regulatory deferral account balance, for which further recognition of deferred tax might be required.

### Observations – Deferred tax expense/income comprising allowable costs

In combination with deferred tax accounting under IAS 12, the accounting for regulatory deferral account balances would be complex when the deferred tax expense/income comprises an allowable cost that would be recovered by adjusting future prices for goods or services.

Deferred tax expense/income would arise on other pre-tax regulatory deferral account balances, and the resulting deferred tax would itself require additional regulatory deferral account balances. This interaction between deferred tax and regulatory deferral account balances would gross up the amount of both regulatory deferral account balances and deferred tax.

An entity that recovers deferred tax expense/income through rate regulation would need to devise an appropriate method to determine the amount of deferred tax and regulatory deferral account balances to recognise in such a situation. It would do so by considering the rate-regulation mechanism and taxation to which the entity is subject.

## 6.3

## IAS 33 *Earnings per Share*

### ED B7

An entity subject to rate regulation would be required to present earnings per share (EPS) both including and excluding the movements in the regulatory deferral account balances, with equal prominence.

Aside from removing the net movements of regulatory deferral account balances from the calculation, EPS is calculated in the normal way to determine basic and diluted EPS before net movements in regulatory deferral account balances.

### Observations – EPS and tax effects of regulatory items

Because the tax expense for regulatory deferral accounts is adjusted in the regulatory line item, the EPS calculation that excludes the movements in regulatory deferral account balances would also exclude the tax effects on regulatory items.

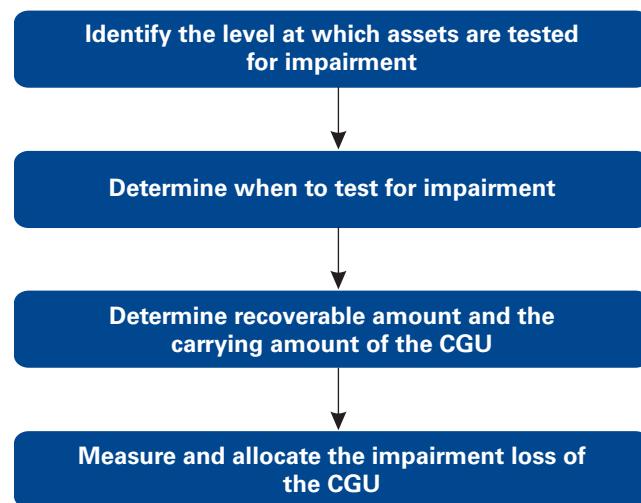
### Example – EPS presentation

	Note	20X7	20X6
<b>Profit for the year</b>		<b>x</b>	<b>y</b>
<b>Earnings per share</b>			
Basic earnings per share	p	x	y
Diluted earnings per share	p	x	y
Basic earnings per share before net movement in regulatory deferral accounts	p	x	y
Diluted earnings per share before net movement in regulatory deferral accounts	p	x	y

## 6.4

## IAS 36 *Impairment of Assets*

An entity would take the following steps in performing impairment tests under IAS 36.



### 6.4.1

#### Level of impairment test

*ED B9–B10*

Because an entity would continue to apply its existing accounting policies under previous GAAP to the measurement of regulatory deferral account balances, IAS 36 would not apply to impairment testing of such balances. However, the proposals would require an entity to apply the requirements of IAS 36 to a cash-generating unit (CGU) that includes regulatory deferral account balances.

##### Observations – Level of impairment test

In many cases, a regulatory deferral account balance would be likely to form part of a wider CGU and would therefore be subject to impairment testing at that level.

### 6.4.2

#### Impairment test for a CGU

*IAS 36.9–10*

If a CGU contains goodwill, or if some or all of the impairment indicators described in IAS 36 have been identified in the CGU, then an entity would test the CGU for impairment.

*ED B10, IAS 36.74–79*

Under the proposals, an entity would apply the requirements of IAS 36 in identifying the recoverable amount and the carrying amount of a CGU. Those requirements focus on consistency between the ways in which the recoverable amount and the carrying amount of a CGU are determined – i.e. a 'like with like' comparison.

*IAS 36.50(b), 55*

If a regulatory deferral account balance is included in an impairment test of a CGU, then the requirements of IAS 36 would apply in determining the recoverable amount and the carrying amount of the CGU. For example, in calculating value in use of the CGU, an entity would follow either:

- the pre-tax principle that requires the use of pre-tax cash flows and a pre-tax discount rate; or
- a post-tax approach that would result in a value in use consistent with the pre-tax principle.

### Observations – Applying the pre-tax principle of IAS 36

Rate-regulation regimes in which tax expense can be recovered as an allowable cost would add complexity to an impairment test. An entity may pay taxes that its future price would allow the entity to recover. It is not clear how such regulations would affect estimations of cash flows and discount rate.

#### 6.4.3

*ED B10,  
IAS 36.104–108*

### Measurement and allocation of the impairment loss

When a CGU that includes a regulatory deferral account balance is tested for impairment, the IAS 36 requirements are applied to any impairment loss recognised as a result of the impairment test. The requirements include the following.

- An impairment loss is recognised to the extent that the carrying amount of a CGU exceeds its recoverable amount.
- Any impairment loss of a CGU is allocated first by writing down the goodwill that is allocated to the CGU (if any). The remaining amount is allocated against the CGU's other assets that are in the scope of IAS 36.
- No asset is written down below its recoverable amount or zero.
- A liability is recognised for any unallocated impairment loss only if it is required by another standard.
- The impairment loss is generally reversed if the recoverable amount of the CGU subsequently increases.

### Observations – Allocating an impairment loss within the CGU

The recoverable amount of a CGU that provides a rate-regulated activity would be the same regardless of whether the entity recognises regulatory deferral account balances in its financial statements. This is because cash flow projections would include the future price effect of the rate regulation in both cases. As a result, applying the ED may affect the outcome of impairment testing. Including a regulatory deferral debit/credit account balance in the carrying amount of a CGU is likely to result in a larger/smaller impairment loss respectively.

Although a CGU containing regulatory deferral account balances would be tested for impairment in accordance with IAS 36, regulatory deferral account balances would be treated in the same way as other specific items within the CGU that are excluded from the scope of IAS 36.

As a result, if the impairment loss of the CGU is allocated against other assets within the CGU, then a larger/smaller impairment loss is likely to be recognised on those assets compared to an entity that does not apply the ED. It is not clear whether the IASB intended these consequences.

## 6.5

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

### ED B11

The classification criteria of IFRS 5 for presenting held-for-sale or discontinued operations would apply to a disposal group or a discontinued operation that includes regulatory deferral account balances; however, those balances would be outside the scope of the measurement requirements of the standard.

### ED B12

An entity would present regulatory deferral account balances that relate to the discontinued operation and/or disposal group with the separate line items for regulatory items, rather than reclassifying them into the amounts presented as 'non-current assets held for sale' or 'profit or losses from discontinued operations' in accordance with IFRS 5.

Judgement may be needed in deciding whether to highlight the amount included in regulatory line items in either of the following ways:

- presenting separately the amount alongside the regulatory deferral account balances; or
- identifying the amount as part of the analysis of the regulatory line item in a disclosure note.

If a discontinued operation/disposal group that meets the classification criteria of IFRS 5 includes regulatory deferral account balances, then such balances and the other assets/liabilities within the discontinued operation/disposal group would be measured and presented as follows.

Regulatory deferral account balances	Other assets/liabilities	
Measurement	Previous GAAP	IFRS
Presentation	With the regulatory line item	Within the discontinued/disposal line item

### IFRS 5.23

#### Observations – Measurement of a disposal group

Any assets or liabilities that are not within the measurement scope of IFRS 5 are included in a disposal group containing those assets or liabilities, which is measured at the lower of its carrying amount and fair value less costs to sell. Losses on the disposal group are allocated to the assets or liabilities that are in the scope of the measurement requirement.

Under the proposals, regulatory deferral account balances would be outside the scope of the measurement requirements of IFRS 5. If the regulatory deferral account balances are debits, then the carrying amount of a disposal group with such balances would therefore be higher than that of a disposal group that does not include such balances, whereas the fair value less costs to sell of both disposal groups would be the same. As a result, impairment losses allocated to other assets within the disposal group would be affected by the recognition of regulatory deferral account balances, similar to the impairment of a CGU (see 6.4.3). It is not clear whether the IASB intended these consequences.

## 6.6

## *IFRS 12 Disclosure of Interests in Other Entities*

The ED proposes additional disclosure requirements if an entity's interests in its subsidiaries, associates or joint ventures contain regulatory deferral account balances.

### *ED B14*

For each of its subsidiaries that have non-controlling interests that are material to the entity, the entity would disclose the net movement in regulatory deferral account balances allocated to non-controlling interests.

### *ED B15–B16*

For each of its subsidiaries that have non-controlling interests that are material to the entity, or for each associate or joint venture that is material to the entity, an entity would disclose:

- the regulatory deferral account balances;
- the net movement in those balances; and
- other summarised financial information required in IFRS 12 for subsidiaries, joint ventures and associates.

Also, for all individually immaterial joint ventures or associates, the entity would disclose these amounts in aggregate, separately for joint ventures and associates.

### *ED B17*

When an entity loses control over a subsidiary, the entity would disclose the portion of gain or loss that is attributable to derecognising regulatory deferral account balances in the former subsidiary.

### **Example – Loss of control over subsidiary subject to rate regulation**

Company P sells 100% of subsidiary S for 1,300 in cash. At that date, the carrying amount of net assets of S in P's consolidated financial statements is 1,000, including a regulatory deferral debit account of 200 relating to S's rate-regulated activity.

P would recognise a gain of 300 (1,300 - 1000) and disclose 200 as the amount that is attributable to derecognising regulatory deferral account balances.

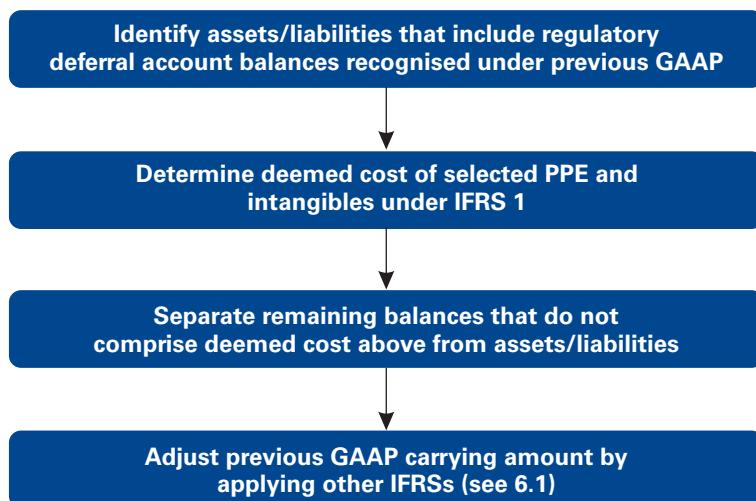
## 6.7

## IFRS 1 *First-time Adoption of International Financial Reporting Standards*

### IFRS 1.D8B, ED BC61

IFRS 1 includes an optional exemption permitting a first-time adopter of IFRS to use the carrying amounts of property, plant and equipment (PPE) or intangible assets that were determined under previous GAAP on an item-by-item basis ('deemed cost exemption'). This exemption would provide relief from the requirement to separate out the regulatory component of the carrying amount of items of PPE or intangible assets at the date of transition.

An entity applying both the proposed standard and the IFRS 1 exemption should follow the steps below to determine initial regulatory deferral account balances at the date of transition to IFRS.



### Observations – Deemed cost vs regulatory deferral account balances

The deemed cost exemption is optional and would have an impact not only on the initial accounting in the opening IFRS statement of financial position but also on subsequent accounting.

If an entity elected to apply the deemed cost exemption, then the regulatory deferral account balance already recorded within the cost of PPE or intangibles would remain in these accounts. It would be subject to IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets* for subsequent accounting and IAS 36 for impairment evaluation.

If an entity recognised regulatory deferral account balances as other assets in accordance with previous GAAP – e.g. financial assets – then it would not be able to use the deemed cost exemption.

### Example – Subsequent accounting under previous GAAP

Entity Y uses deemed cost for all balances previously recognised as PPE on transition to IFRS at the beginning of Year 1. These balances total 100. Under IFRS, Y depreciates the relevant item of PPE over 10 years. At the end of Year 1, the regulatory deferral debit account balance determined by its previous GAAP increases to 150.

Entity Y would recognise a regulatory deferral account debit balance of 50 in the statement of financial position, with a net movement in regulatory deferral account balances of 50. However, Y has also recognised depreciation expense of 10 under IFRS, attributable to a regulatory item included in PPE, by applying the deemed cost exemption. Therefore, applying the deemed cost exemption would affect Y's profit before tax.

The following demonstrates the accounting after adopting the standard, depending on whether the deemed cost exemption is applied.

	Deemed cost exemption not applied		Deemed cost exemption applied	
	1 Jan 20X3	31 Dec 20X3	1 Jan 20X3	31 Dec 20X3
Property, plant and equipment	-	-	100	90
Regulatory deferral debit balance	100	150	-	50
Net movement in regulatory deferral accounts	n/a	50	n/a	50
Depreciation	n/a	-	n/a	10
Profit before tax	n/a	50	n/a	40

# About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

## Content

Our *New on the Horizon* publications are prepared on the release of a new proposed IFRS or proposed amendment(s) to the requirements of existing IFRSs. They include a discussion of the key elements of the new proposals and highlight areas that may result in a change of practice.

This edition of *New on the Horizon* considers the requirements of the IASB's proposed interim standard for regulatory deferral accounts (the exposure draft).

The text of this publication is referenced to the exposure draft and to selected other current IFRSs in issue at 15 May 2013. References in the left-hand margin identify the relevant paragraphs.

Further analysis and interpretation will be needed for an entity to consider the potential impact of the exposure draft in light of the entity's own facts, circumstances and individual transactions. The information contained in this publication is based on initial observations developed by the KPMG International Standards Group and these observations may change.

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