

GN(A) 30 (Revised 2015)

Guidance Note on Accounting for Rate Regulated Activities

Foreword to the Second Edition

Keeping in view the accounting issues faced by the rate regulated entities operating in certain types of rate regulation, namely 'cost of service regulation', the Institute of Chartered Accountants of India issued in 2012, the Guidance Note of *Accounting for Rate Regulated Activities*. However, the date from which this Guidance Note would be effective was not announced as it was felt that some aspects were needed to be addressed for its effective implementation. The Accounting Standards Board while finalising the revised Guidance Note also noted that even at the international front, number of initiatives were being undertaken with regard to accounting for rate regulated activities, such as decision of IASB to start research project on rate regulated activities and issuance of IFRS 14, *Regulatory Deferral Accounts*. Accordingly, in this edition of the Guidance Note certain changes with respect to presentation requirements have been also made to make this Guidance Note consistent with the Ind AS 114, *Regulatory Deferral Accounts* formulated corresponding to IFRS 14. Further, this Guidance Note also includes some illustrative examples for the effective and consistent application of the principles enunciated in this Guidance Note.

I would like to extend by heartiest congratulations to CA. Sanjeev Maheshwari, Chairman, Accounting Standards Board and members of the Accounting Standards Board and others who have contributed in the finalisation of this second edition of the Guidance Note.

I hope that this endeavour of the Accounting Standards Board will go a long way in establishing sound accounting principles and provide guidance to the members as well as to others concerned.

New Delhi
February 04, 2015

CA. K. Raghu
President

Preface to the Second Edition

In 2012, the ICAI considering the concerns raised by many stakeholders with regard to need to have specific accounting guidance for the rate regulated entities, finalised and issued the Guidance Note on *Accounting for Rate Regulated Activities*. The objective of the Guidance Note was to establish consistent accounting practices for the rate regulated activities. However, keeping in view the complex nature of rate regulated environments prevailing in the country, it was felt that for the consistent application of principles provided in the Guidance Note, certain issues need to be resolved for application of the principles of the Guidance Note. Therefore, it was decided to postpone the date from which this Guidance Note would be effective. In the meantime, the IASB as an interim measure issued IFRS 14, *Regulatory Deferral Accounts*, which allows rate regulated entity to grandfather the accounting policies followed by the entities as per their previous GAAP for the accounting of rate regulated activities. It was noted that most of the rate regulated entities which would be covered by this Guidance Note would also be required to apply Ind AS. Accordingly, the ICAI finalised Ind AS 114, *Regulatory Deferral Accounts* corresponding to IFRS 14. Further, for smooth transitioning to Ind ASs by the rate regulated entities covered by this Guidance Note, the Board decided to change certain presentation requirements of the Guidance Note to make them consistent with Ind AS 114. Accordingly, in this edition of the Guidance Note, apart from addition of certain illustrative examples, some modifications in the presentation requirements have also been made.

I would like to convey my sincere thanks to our Honourable President CA. K. Raghu and Vice-President CA. Manoj Fadnis in providing unflinching support on various activities of the Board. I would like to convey my sincere thanks to CA.S. Santhanakrisnan, Vice- Chairman, ASB for his constant support and co-operation.

I would also like to acknowledge the invaluable contribution made by CA. Naveen N. D Gupta, Convener of the Study Group, CA. Ravindra Vadali, CA. K. Sreekant, CA. Amal Sinha, CA. Archana Bhutani and other experts in this endeavour of the Accounting Standards Board. I am also thankful to various representatives of industry for giving their invaluable comments and suggestions on the draft Guidance Note.

I sincerely believe that this Guidance Note will go a long way in establishing sound accounting and reporting principles in the rate regulated entities.

New Delhi
February 04, 2015

CA. Sanjeev Maheshwari
Chairman

Foreword to the First Edition

In India, some of the large public sector and private sector entities are involved in businesses which are regulated in one form or the other by a statute in India. The object of regulation is typically to promote the orderly growth and development of the regulated industry, protect the interest of consumers, regulate competition and monitor social and environmental issues within the industry. Generally, price or rate regulation is provided in the industries in which the general public is interested like electricity, telecommunication etc.

The rate regulation, as presently prevailing in India in respect of industries such as electricity, does result in creation of a right (asset) or an obligation (liability), as the case may be, as envisaged by the accounting framework, while it may not be so in respect of other industries. So, not accounting for the right to receive cash flows or the obligation to refund cash flows under such a regulatory requirement would not reflect a true and fair view of assets/liabilities and income/expenses as reflected in the financial statements. To provide guidance in this regard and to address the industry- specific accounting issues relating to rate regulated activities, a need was being felt for bringing out a pronouncement with a view to bring about establishment of sound accounting principles. It is heartening to note that the Accounting Standards Board of the Institute has formulated this 'Guidance Note on Accounting for Rate Regulated Activities'.

I would like to congratulate CA. Manoj Fadnis, Chairman, Accounting Standards Board and members of the Accounting Standards Board and others who have made invaluable contribution in the formulation of this Guidance Note.

I hope that this endeavour of the Accounting Standards Board will go a long way in establishing sound accounting principles and provide guidance to the members as well as to others concerned.

New Delhi
February 12, 2012

CA. G. Ramaswamy
President

Preface to the First Edition

In India, regulators in certain sectors such as electricity allow the entities falling in their domain to charge rates from their customers that are based on allowable costs like interest cost, depreciation, operating and maintenance including a reasonable mark-up.

From rate regulation, an issue arises as to whether an entity should recognise in its financial statements the right to recover incurred costs or the obligation to refund amounts received for which costs have not been incurred through future tariff adjustments. Recognition of the right to recover incurred costs in the future or the obligation to refund amounts received in the financial statements of the entity would arise if they meet the definition of assets and liabilities as provided in the *Framework for the Preparation and Presentation of Financial Statements* issued by the Institute of Chartered Accountants of India.

Keeping in view this, the Accounting Standards Board has formulated this '*Guidance Note on Rate Regulated Activities*' which deals with the effects on an entity's financial statements of its operating activities that provide goods or services whose prices are subject to cost-of-service regulation. This Guidance Note provides guidance on the measurement basis of a regulatory asset or a regulatory liability and the disclosures that identify and explain the amounts recognised in the financial statements arising from a regulatory asset or a regulatory liability. The Guidance Note will assist users of those financial statements to understand the nature and financial effects of its rate- regulated activities.

I would like to convey my sincere thanks to our Honourable President CA. G. Ramaswamy and Vice-President CA. Jaydeep N. Shah in providing unflinching support on various activities of the Board. I would like to convey my sincere thanks to CA.S. Santhanakrisnan, Vice- Chairman, ASB for his constant support and co-operation.

I would also like to acknowledge the invaluable contribution made by Shri Naveen N. D Gupta, Convener of the Study Group , Shri. Ravindra Vadali, Shri K. Sreekant, Shri Amal Sinha, Shri Udit Sinha and other experts in this endeavour of the Accounting Standards Board. I am also thankful to various representatives of industry for giving their invaluable comments and suggestions on the draft Guidance Note.

Compendium of Guidance Notes - Accounting

I sincerely compliment Dr. Avinash Chander, Technical Director and CA. Geetanshu Bansal, Senior Executive Officer, of the Institute of Chartered Accountants of India in finalising the draft of the Guidance Note.

I sincerely believe that this Guidance Note will go a long way in establishing sound accounting and reporting principles in the rate regulated entities.

New Delhi
February 11, 2012

CA. Manoj Fadnis
Chairman
Accounting Standards Board

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Guidance Note on Accounting for Rate Regulated Activities

Introduction

Background

1. Regulation of different economic activities through bodies established under statute or otherwise can be found in many countries. The object of regulation is typically to promote the orderly growth and development of the regulated industry, protect the interests of consumers, regulate competition, monitor social and environmental issues within the industry etc. Regulation of utilities like telecommunication, electricity and water often aims to control prices, ensure service quality, protect the environment and establish an investment environment capable of attracting capital at reasonable cost. In India we have different bodies such as the Reserve Bank of India, Securities and Exchange Board of India, Insurance Regulatory and Development Authority, Central Electricity Regulatory Commission, State Electricity Regulatory Commissions, Directorate General of Hydrocarbons (DGH), Telecom Regulatory Authority of India etc., for regulating different sectors.

2. Regulation can take many forms depending upon the industry and objectives to be achieved. Rate regulation is one of the main forms of regulation often found in the utility sector or in sectors dealing with 'public goods' or other important goods and services. For example, in India, electricity prices are regulated by the CERC/ SERCs, fertilizer prices and highway tolls are regulated by the Government.

Framework for Rate Regulation

3. 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. Regulatory authorities are usually set up under a legislation which stipulates their constitution, functions, powers etc. While such legislation may provide the general guidelines and considerations for determination of tariffs, the regulatory authority decides the particular methodology to be adopted for tariff setting

which is notified through regulations or rules. The regulator from time to time issues orders for tariff setting in individual cases which provide further guidance on the implementation of the notified regulations and rules. The legislation, regulations, rules and tariff orders provide the entity with the framework for charging the customers for the regulated goods and services.

4. Entities subject to price regulation are not allowed to charge prices for regulated goods or services other than those approved by the regulatory authority. In those circumstances, the regulator acts on behalf of the customers who individually would have no bargaining power with the entity. The regulator also acts on behalf of the entity. Agreements between a rate-regulated entity and its customers cannot be understood without reference to the regulation in place. Therefore, it can be said that such agreements are different from the agreements between an entity and its customers in a non-regulated environment.

Methods and Process of Rate Regulation

5. There are several basic methods for rate regulation and in each case, the application of a particular methodology may vary with the regulator, the entity being regulated and the circumstances faced. Some of the forms of rate regulation are cost of service regulation, price-cap mechanisms or a hybrid methodology featuring combinations of price cap and cost-of-service approaches.

6. Under the cost-of-service regulation (also referred to as return-on-rate-base regulation) rates are set to give the entity the opportunity to recover its costs of providing the good or service plus a fair return. Under price cap regulation, the regulator caps the rates at which the entity can charge for the goods or services. In such cases, while the initial rates may reflect the cost of service, subsequent increases or decreases may be made in accordance with a formula.

7. The regulators may adopt several approaches for cost-of-service regulation. The regulator may stipulate the various costs which can be covered under the tariff, the admissible rate of return and the mechanism for recovery of the tariffs. Alternatively, the regulator establishes the revenues required to cover the expected cost of providing the regulated service, including a fair return on the investment in the regulated operations. This amount is called the "revenue requirement". The regulator then sets rates that will provide the entity with a reasonable opportunity to recover its revenue requirement.

8. Not all costs that an entity incurs are automatically recoverable from its customers. Regulators typically review entities' costs to ensure that they were

appropriately incurred to provide the regulated service and were 'prudent'. When a regulator decides that a cost was not prudently incurred, it may disallow all or part of the cost, thereby reducing (or eliminating) any future recovery of that cost. Consequently, a cost must be permitted by the regulator to be included in the determination of rates. In cost-of-service regulation, such costs are the actual or estimated costs for which revenue is intended to provide recovery and include costs of debt and a reasonable return on shareholders' investments.

9. Cost-of-service rate-making does not necessarily equal a one-for-one pass-through of all costs. Regulations enable for rate fixation which provides that the entity will recover its costs using reasonable assumptions regarding demand as well as normal expenditures. The regulator to promote efficiencies may stipulate performance norms for recovery of some costs or may provide recovery of some elements of cost as per norms while other elements are recovered at actuals. For example, tariff regulations issued by many of the SERCs in the electricity sector in India classify costs into 'controllable' and 'uncontrollable' costs and provide for adjustment of tariffs for the 'uncontrollable costs' during 'truing up' process while variations in the 'controllable costs' are to be borne by the entity. In some cases, the regulators also prescribe a formula for sharing efficiency gains between the entity and the customers, such as the gains on account of reduction in distribution losses etc.

10. The regulatory mechanism provides for a rate review or 'truing up' exercise at periodic intervals to adjust the rates, downward or upward, to ensure recovery of costs and a reasonable return on investment. For 'truing up' of the initially determined rates, the entity provides the regulator with details of actual costs, capital expenditure etc., based on audited accounts and other supporting evidence. The regulator reviews the details of actual costs provided by the entity and may also provide opportunity to other stakeholders to submit their comments on the entity's application for rate review. Upon such review, the regulator determines the additional costs which can be recovered by the entity or amounts which need to be refunded to the customers.

11. Following the truing up exercise, the regulator usually adjusts the rates to be charged from customers so as to ensure recovery of additional costs or refund of amounts, as the case may be. The regulators may also decide not to immediately adjust the rates due to various considerations, for example, to avoid rate fluctuations or to smooth out an increase in rates, and require the regulated entity to defer the recovery or refund of the difference between the expected and actual amount of those costs. This results in a portion of the costs (or cost savings) of one period being included or adjusted in the revenue of another period.

Objectives

12. This Guidance Note deals with the effects on an entity's financial statements of its operating activities that provide goods or services whose prices are subject to cost-of-service regulation.
13. The objectives of this Guidance Note are to recommend:
 - (i) the recognition of a regulatory asset or regulatory liability if the regulator permits the entity to recover specific previously incurred costs or requires it to refund previously collected amounts and to earn a specified return on its regulated activities by adjusting the prices it charges to its customers;
 - (ii) the measurement basis of a regulatory asset or regulatory liability both on initial recognition and at the end of each subsequent reporting period; and
 - (iii) the disclosures that identify and explain the amounts recognised in the entity's financial statements arising from a regulatory asset or regulatory liability and assist users of those financial statements to understand the nature and financial effects of its rate-regulated activities.

Scope

14. An entity should apply this 'Guidance Note' to its operating activities that meet the following criteria:
 - (i) 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. The specified return could be a minimum or range and need not be a fixed or guaranteed return.
15. If regulation establishes different rates for different categories, such as different classes of customers or volumes purchased, the related operating activities of an entity are within the scope of this 'Guidance Note' provided that the regulator approves the definition and the rate for each of those categories and that all customers of the same category are bound by the same rate.

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16. Activities of an entity which are subject to other forms of regulation are not covered by this Guidance Note. For example, the telecom sector in India, though regulated by the Telecom Regulatory Authority of India (TRAI), is not subject to price regulation which provides for recovery of entity specific costs plus a specified return. Similarly, some regulations determine rates based on targeted or assumed costs, for example industry averages, rather than the actual costs incurred or expected to be incurred by the entity. Activities regulated in this way are not within the scope of this Guidance Note.

17. Where the prices an entity charges its customers for the goods or services it provides are regulated according to a 'price cap', the entity cannot charge more than the set prices. Under such regulation the buyer is assured of the result while the supplier takes the risk and receives the rewards from additional effort or from the implementation of cost-reducing innovations. Though the prices are regulated and bind customers, this Guidance Note does not cover such activities because prices are not designed to recover the entity's specific costs to provide the goods or services.

18. Regulators may require a regulated entity to maintain its accounts in a form that permits the regulator to obtain the information needed for regulatory purposes. This Guidance Note does not address an entity's accounting for reporting to regulators (regulatory accounting).

19. Rate regulation may be applied to all or only a portion of an entity's activities. In some cases, an entity may have both regulated and non-regulated activities. In others, the entity may be permitted to negotiate rates individually with some customers. This Guidance Note applies only to the activities of an entity that meet the criteria set out in paragraph 14.

20. The entity should determine at the end of each reporting period whether its operating activities during the reporting period meet the criteria in paragraph 14 for application of this Guidance Note.

Definitions

21. The following terms are used in this Guidance Note with the meanings specified:

- (i) A **regulator** is an authorised body empowered by statute or by any government or any authorised agency of a government to set rates that binds an entity's customers.
- (ii) **Cost of Service** regulation is a form of regulation for setting an entity's

prices (rates) in which there is a cause-and-effect relationship between the entity's specific costs and its revenues.

- (iii) A **regulatory asset** is 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.
- (iv) A **regulatory liability** is 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.

Accounting issues arising from Rate Regulation

22. Rate regulation of an entity's business activities creates operational and accounting situations that would not have arisen in the absence of such regulation. With cost-of-service regulation, there is a direct link between the costs that an entity is expected to incur and its expected revenue as the rates are set to allow the entity to recover its expected costs. However, there could be a significant time lag between incurrence of costs by the entity and their recovery through tariffs. Recovery of certain costs may be provided for by regulation either before or after the costs are incurred. Rate regulations are enforceable and can create legal rights and obligations for the entity.

23. An issue therefore arises as to whether an entity should recognise in its financial statements the right to recover incurred costs or the obligation to refund amounts received for which costs have not been incurred through future tariff adjustments. Recognition of the right to recover incurred costs in the future or the obligation to refund amounts received in the financial statements of the entity would arise if they meet the definition of assets and liabilities as provided in the *Framework for the Preparation and Presentation of Financial Statements* issued by the Institute of Chartered Accountants of India.

Regulatory assets

24. The Framework, defines an 'asset' as follows:

"An *asset* is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise."

In a cost-of-service regulation, the resource is the right conferred by the regulator whereby the costs incurred by the entity result in future cash flows. In such cases, incurrence of costs creates an enforceable right to

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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. While adjustment of future rates is the mechanism the regulator uses to implement its regulation, the right in itself is a resource arising as a result of past events and from which future cash inflows are expected.

25. The cause-and-effect relationship between an entity's costs and its rate-based revenue demonstrates 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).

26. As regards the 'control' criterion in the definition of an asset as per the Framework, it may be argued that though the entity has a right to recover the costs incurred, it does not control the same since it cannot force individual customers to purchase goods or services in future. In this regard, it may be mentioned that the rate regulation governs the entity's relationship with its customer base as a whole and therefore creates a present right to recover the costs incurred from an aggregate customer base. Although the individual members of that group may change over time, the relationship the regulator oversees is between the entity and the group. The regulator has the authority to permit the entity to set rates at a level that will ensure that the entity receives the expected cash flows from the customers' base as a whole. 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 though they certainly merit consideration in its measurement.

Regulatory liabilities

27. The Framework defines a liability as 'a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits'. In cost-of-service regulation, an obligation arises because of a requirement to refund to 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 set 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. Such 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. It is not a possible future obligation because 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. An economic obligation is something that results in reduced cash inflows, directly or indirectly, as well as something that results in increased cash outflows. Obligations link the entity with what it has to do because obligations are enforceable against the entity by legal or equivalent means.

Nature of regulatory assets and regulatory liabilities

28. Regulatory assets and regulatory liabilities that would be recognised as a result of application of this Guidance Note are not financial instruments since 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 under a contract.

29. The regulatory assets are also not intangible assets as per AS 26, *Intangible Assets* since they are not identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. Accordingly, it would be appropriate to classify the assets and liabilities arising out of rate regulation separately from other assets and liabilities.

Recognition

30. 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 regulator under the applicable regulatory framework and the amount can be measured reliably.

31. Probability refers to the degree of uncertainty that future economic benefits associated with the regulatory asset will flow to the entity. Therefore, the probability criterion is said to be met when there is a reasonable assurance that future economic benefits will flow from the regulatory asset to the entity. A regulatory asset can be recognised when the regulatory framework provides for the recovery of the incurred costs and the entity has incurred such costs. 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 as per Accounting Standard (AS) 29, *Provisions, Contingent Liabilities and Contingent Assets*. In such case it would not be appropriate to recognise an asset till the approval of the regulator is received. For example, if any additions to the rate base are subject to the approval of the regulator, the entity should not recognise 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.

32. In some cases, a regulator permits an entity to include in the rate base, as part of the cost of self-constructed (tangible) fixed assets or internally generated intangible assets, amounts that would otherwise be recognised as expense in the statement of profit and loss in accordance with Accounting Standards. After the construction or generation is completed, the resulting cost is the basis for depreciation or amortisation and unrecovered investment for rate determination. A regulatory asset should be recognised by the entity in respect of such costs since the same is recoverable from the customers in future through tariffs.

33. As regards the criterion for reliable measurement, since the recoverable amount is linked to the specific costs incurred which are permitted to be recovered by the regulatory framework, meeting the same may not present much difficulty for regulatory assets.

34. A regulatory liability should be recognised:

- (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

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

35. Since in a cost-of-service regulation, the tariffs are subjected to 'truing up' based on actual costs incurred and prudence checks by the regulator, if the costs incurred by the entity are lower than those initially considered for rate determination, the entity has no realistic alternative to making a refund to the customers. Similarly, if the tariffs are set assuming certain level of additions to the asset base and the actual additions by the entity are lower, the entity would be required to refund a portion of the tariffs collected due to the lower additions to the asset base. The regulatory framework may also provide for other circumstances which would warrant a refund of the amounts collected to the customers directly or indirectly through a downward adjustment of rates. For example a electricity distribution entity may have an obligation to share gains from reduction of distribution losses with the consumers in a specified ratio which would be passed on to consumers through an adjustment in future tariffs. Such amounts should be recognised as a liability if on the balance sheet date it is probable that the entity would be required to make refund upon review by the regulator and a reliable estimate can be made of the amount of refund.

36. Regulated entities should comply with the requirements of the Accounting Standards in the same way as other entities. Therefore, if the criteria in paragraph 14 are satisfied, the entity should recognise regulatory assets and regulatory liabilities in accordance with this Guidance Note in addition to the assets and liabilities recognised in accordance with the Accounting Standards in the normal course. The manner of creating regulatory assets and liabilities is illustrated in Appendix I.

Measurement

37. On initial recognition and at the end of each subsequent reporting period, an entity should measure a regulatory asset or regulatory liability at the best estimate of the amount expected to be recovered or refunded or adjusted as future cash flows under the regulatory framework. A regulatory asset or regulatory liability should not be discounted to its present value.

38. Estimates of the amount expected to be recovered, refunded or adjusted are determined by the judgment of the management of the entity considering various factors such as:

- (i) statutes or regulations that specifically provide for the recovery of the cost in rates;
- (ii) formal approvals from the regulator specifically authorising recovery of the cost in rates;

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

Impairment

39. An entity should review the estimates of the amount expected to be recovered, refunded or adjusted at least at the end of each reporting period to reflect the current best estimate. If expectation differs from previous estimates, the changes should be accounted for as a change in an accounting estimate in accordance with relevant requirements of the applicable Accounting Standard. If an entity concludes that it is not reasonable to assume that it will be able to collect sufficient revenues from its customers to recover its costs, this is an indication that the cash-generating unit in which the regulatory assets and regulatory liabilities are included may be impaired. Accordingly, the entity shall test that cash-generating unit for impairment in accordance with AS 28 *Impairment of Assets*.

De-recognition

40. An entity should derecognise the entire carrying amount of regulatory assets and regulatory liabilities when the underlying activities fail to meet the criteria in paragraph 14 and any resulting loss/gain should be recognised in the statement of profit and loss.

41. If it is no longer probable that the future economic benefits associated with a regulatory asset will flow to the entity or an outflow of resources embodying economic benefits will be required to settle a regulatory liability, the regulatory asset or liability, as the case may be, should be de-recognised and any resulting loss/gain should be recognised in the statement of profit and loss.

Presentation

42. An entity should present regulatory assets and regulatory liabilities as current/non-current, as the case may be, in the balance sheet, separately from other assets and liabilities.
43. An entity shall not offset rate regulated assets and liabilities and should present separate line items in the balance sheet for:
- (a) the total of all regulatory assets; and
 - (b) the total of all regulatory liabilities. An entity shall present a separate line item in the statement of profit and loss, for the net movement in all regulatory assets and regulatory liabilities for the reporting period. (Refer to illustrative examples given in Appendix 1).
44. An entity shall present separate line item under tax expense for the differed tax expense/saving related to regulatory account balances. (Refer to illustrative examples given in Appendix 1).

Disclosures

45. An entity should disclose information that:
- (i) enables users of the financial statements to understand the nature and the financial effects of rate regulation on its activities; and
 - (ii) identifies and explains the amounts of regulatory assets and regulatory liabilities, and related income and expenses, recognised in its financial statements.
46. An entity should disclose the fact that some or all of its operating activities are subject to rate regulation, including a description of their nature and extent.
47. An entity should disclose the break-up of regulated assets and regulated liabilities into major components of the respective balances in the notes to accounts.
48. For each set of operating activities subject to a different regulator, an entity should disclose the following information:
- (i) an explanation of the approval process for the rate subject to regulation (including the rate of return), including information about how that process affects both the underlying operating activities and the specified rate of return;

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- (ii) the indicators that management considered in concluding that such operating activities are within the scope of this 'Guidance Note', if that conclusion requires significant judgement;
- (iii) significant assumptions used in measurement of regulatory assets and regulatory liabilities including:
 - (a) the supporting regulatory action, for example, the issue of a formal approval for costs to be recovered pending a final ruling at a later date and that date, when known, or
 - (b) the entity's assessment of the expected future regulatory actions.

An entity should disclose the above information for each category of regulatory asset and regulatory liability that is subject to a different regulator.

49. A disclosure should be made of reconciliation from the beginning to the end of the period, in tabular format unless another format is more appropriate, of the carrying amount in the balance sheet of the regulatory asset and regulatory liability, including at least the following elements:

- (i) the amount recognised in the statement of profit and loss relating to balances from prior periods collected or refunded in the current period.
- (ii) the amount of costs incurred in the current period that were recognised in the balance sheet as regulatory assets and regulatory liabilities to be recovered or refunded in future periods.
- (iii) other amounts that affected the regulatory asset and regulatory liability, such as items acquired or assumed in amalgamation etc., or the effects of changes in foreign exchange rates or estimated cash flows. If a single cause has a significant effect on the regulatory asset and regulatory liability, the entity should disclose it separately.

50. When an entity derecognises regulatory assets and regulatory liabilities in accordance with paragraphs 41 and 42 because the related operating activities fail to meet the criteria in paragraph 14, it should disclose a statement to that effect, the reasons for the conclusion that the criteria in paragraph 14 are not met, a description of the operating activities affected and the amount of regulatory assets and regulatory liabilities derecognised.

51. If the disclosures required by paragraphs 46-49 of this Guidance Note do not meet the objectives set out in paragraph 45, the entity should disclose whatever additional information is necessary to meet those objectives.

Effective date

52. An entity shall apply this Guidance Note for accounting periods beginning on or after April 01, 2015. Early adoption of this Guidance Note is permitted.

Transition

53. An entity should recognise regulatory assets and liabilities in accordance with this Guidance Note on the date on which this Guidance Note becomes effective for the entity with corresponding credit/charge to opening balance of revenue reserves.

Appendix I

Illustrative Examples

Example 1 Rate Regulated Entity

XYZ Ltd. is an entity engaged in the business of transmission of power. As per the tariff regulations, entities engaged in business of transmission of power are allowed certain costs (operating and maintenance) on actual basis for the tariff fixation purpose. However, tariffs for the period are determined at the beginning of the period on the basis of the estimated costs expected to be incurred during the period. In other words, entities engaged in business of transmission of power are allowed to recover the differential of certain estimated costs (O&M) considered for the tariff fixation and the actual cost incurred through a truing up mechanism. As per the truing-up mechanism, once approved by the regulators that the extra cost incurred was justifiable, entities recover the same from its customers who actually consumed the power by raising a separate invoice for the reimbursement of extra cost or by issuing debit or credit note in favour of the customers.

During the year 2013-14, XYZ Ltd. incurred a sum of ₹ 120 crore towards the Operating and Maintenance (O&M) cost against the estimate of ₹ 100 crore for the same considered for the tariff fixation purpose.

XYZ Ltd., as permitted by the tariff regulation, has raised an additional invoice to its customers for the differential amount of ₹ 20 Crore (120 crore – 100 crore) plus mark-up.

Solution:

This Guidance Note covers 'cost of service' type of rate regulation only, where the recovery of excess cost or excess revenue incurred/received in the current period is through adjustment of future tariff to be charged from the customers for the services to be provided in future. In the given case, the recovery of actual cost (O&M) incurred by the entity in excess of the estimate considered for the tariff fixation purpose is not to be adjusted for determining the future tariff rather it is to be recovered by the entity from its past customers without impacting the future tariff to be charged. Accordingly, this type of regulation does not fall within the scope of this Guidance Note.

Paragraph 36 of this Guidance Note requires that regulated entities should comply with the requirements of the Accounting Standards in the same way as other entities. It is observed that in respect of the regulation in this case, the right to reimbursement of actual cost incurred plus mark up on actual basis

from the customers who actually consumed the power falls within the scope of Accounting Standard (AS) 9, *Revenue Recognition*. Accordingly, revenue should be recognised in accordance with the requirements and AS 9. In view of this, in this case, the right of recovery of actual costs does not lead to creation of a regulatory asset.

Example 2— Rate Regulatory Liability

Company XYZ Ltd. is operating in the rate regulatory framework, where regulatory framework allows capitalisation of certain foreign exchange differences (short term and long term) which otherwise are required to be recognised in the statement of profit and loss for the purpose of tariff fixation. Company XYZ Ltd. is allowed to capitalise the exchange differences arising on foreign currency borrowings made for acquisition of Plant and Machinery in the carrying value of Plant and Machinery for the purpose of tariff determination.

Company XYZ Ltd. borrowed a sum of USD1000 crore on 01 April, 2012, for tenure of one year for the purpose of acquisition of a plant. The loan is repayable on bullet terms. The spot rate prevailing as on 01 April, 2012, was USD1 = INR 60. Exchange rate prevailing as on the date of repayment, i.e., 31 March, 2012, is USD1 = INR 59.

Entries to be passed in the books of XYZ Ltd.:

2012-13

1. According to paragraph 9 of AS 11, *The Effects of Changes in Foreign Exchange Rates*, foreign currency loan is converted in the reporting currency by applying the exchange rate prevailing on the transaction date.

1.4.2012	Bank A/c	Dr.	60,000
	Loan Liability A/c	Cr.	60,000
(Being borrowing made in foreign currency) (USD1000 X INR 60)			

2. Fixed asset is purchased using the borrowed funds and recognised at cost as per Accounting Standard (AS) 10, *Accounting for Fixed Assets*

1.04.2012	Fixed Asset A/C	Dr.	60,000
	Bank A/c	Cr.	60,000
(Being machinery purchased as funded from the borrowing)			

3. According to paragraphs 11 and 13 of AS 11, *The Effects of Changes in Foreign Exchange Rates*, exchange difference gain arising on repayment of loan is recognised as income

Accounting for Rate Regulated Activities

31.3.2013	Loan Liability A/c Dr.	1000
	Exchange differences A/c Cr.	1000
(Being the loan liability restated using the closing rate prevailing on repayment date). {USD1000 (60-59)}		

4. Loan repaid on due date

31.3.2013	Loan Liability A/c Dr.	59000
	Bank A/c Cr.	59000
(Being the loan repaid)		

5. As per the regulatory framework, exchange differences arising on foreign currency loan are allowed to be adjusted in the carrying value of the assets for the tariff fixation purpose. However, in accordance with Accounting Standard (AS) 11, such exchange differences have to be recognised in statement of profit and loss as evidenced by entry 3 above. The obligation to lower the tariff in future due to exchange gains arising in the current year on repayment of loan is recognised as regulatory liability. Such increase in liability is recognised as expense in accordance with the *Framework for the Preparation and Presentation of Financial Statements* issued by the ICAI.

31.3.2013	Regulatory Income/Expense Dr.	1,000
	Regulatory Liabilities A/c Cr.	1,000
(being regulatory liability created)		

6. Transfer of Regulatory Income/ Expense to Profit and loss A/c.

31.3.2013	Profit and Loss A/C Dr.	1,000
	Regulatory Income/Expense Cr.	1,000
(being regulatory Income/Expense transferred to Profit and loss.)		

2013-14

7. The above exchange gains are recouped by way of lower depreciation for the tariff fixation purposes. The depreciation is charged over the life specified in the tariff regulations (assumed to be 10 years in this case). The recoupment of deprecation is recognised as a settlement of regulatory liability and corresponding credit to the statement of profit and loss.

31.3.2014	Regulatory Liability A/c Dr.	100
	Regulatory Income/expense Cr.	100
(Being reduction in tariff compensated by other income)		

XYZ Ltd.
Statement of Profit and Loss for the period ended 31.3.2013
 (Figures other than the above have been assumed).

Particular	Amount (₹ crore)
Sales	12000
Other Income (including foreign exchange gains)	2600
Total Income	14600
Raw Material Consumed	6800
Increase/decrease of WIP and FG	1200
Employee Benefits	1250
Depreciation/Amortization	750
Total Expenses	10000
Profit Before Tax (PBT) and Rate Regulated Activities (RRA)	4600
(Add) Regulatory Income/Expense	(1000)
PBT	3600
Less: Tax Expense*	
Current Tax (4600 @35%)	(1610)
Deferred Tax other than RRA	(100)
Deferred Tax saving pertaining to RRA (1000@35%)	350
Profit After Tax (PAT)	2240

* Tax rate assumed to be 35%.

Extract of Balance Sheet of XYZ Ltd. as on 31.3.2013.

Equity and Liabilities	Amount (₹ crore)
Non-current liabilities	
Other long term liabilities- Regulatory Liability	900
Current liabilities	
Other current liabilities- Regulatory Liability (regulatory liability expected to be repaid in next year)	100
TOTAL	1000

Example 3—Rate Regulatory Asset

Company XYZ Ltd. is operating in the rate regulatory framework, where regulatory framework allows capitalisation of interest cost which otherwise is required to be recognised in the statement of profit and loss for the purpose of tariff fixation. Company XYZ Ltd. is allowed to capitalise all interest cost incurred on borrowings obtained for the purpose of acquiring fixed assets for the tariff determination purpose as per the regulatory framework. The useful life of the fixed asset is estimated to be 10 years with no residual value at the end of useful life.

Company XYZ Ltd. borrowed a sum of ₹ 6000 crore on 01 April, 2012, for a tenure of 10 years for the purpose of acquisition of a plant. Company XYZ Ltd. incurred interest expense amounting to ₹500 Crore during the period of abnormal suspension for the financial year ended 31st March, 2013, which as per Accounting Standard (AS) 16, *Borrowing Costs*, is required to be recognised in the statement of profit and loss as an expense.

Entries to be passed in the books of XYZ Ltd.:

1. Machinery purchased using the money borrowed in reporting currency recognised at cost in accordance with AS 10, *Accounting for Fixed Assets*.

1.4.2012	Bank A/c Dr.	6000
	Loan Liability A/c Cr.	6000
(Being money borrowed)		
1.04.2012	Fixed Asset A/c Dr.	6000
	Bank A/c Cr.	6000
(Being Machinery purchased using the borrowing)		

2. Interest incurred during the period of abnormal suspension is recognised as expense in accordance with paragraph 17 of the Accounting Standard (AS) 16, *Borrowing Costs*.

31.3.2013	Interest Expense A/c Dr.	500
	Loan Liability A/c Cr.	500
(Being interest incurred during abnormal suspension recognised as expense)		

3. As per the regulatory framework, interest incurred during the period of abnormal suspension is allowed to be adjusted in the carrying value of the assets for the tariff fixation purpose. However, in accordance with Accounting

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Standard (AS) 16, such interest expense has to be recognised in the statement of profit and loss as evidenced by entry 2 above. The right to recover interest cost through higher tariff in future period is recognised as regulatory asset. Such increase in asset has been recognised as income in accordance with the *Framework for the Preparation and Presentation of Financial Statements* issued by the ICAI.

31.3.2013	Regulatory Asset A/c Dr.	500
	Regulatory Income/Expense Cr.	500
(Being interest incurred during abnormal suspension recognised as regulatory asset as it is recoverable through tariff fixation)		

4. Transfer of Regulatory Income/ Expense to Profit and loss A/c.

31.3.2013	Regulatory Income/Expense Dr.	500
	Profit and Loss A/c Cr.	500
(Being regulatory Income/Expense transferred to Profit and loss.)		

Year 2013-14

5. The above interest expense is recouped by way of higher depreciation for the tariff fixation purposes for the year 2013-14. The depreciation is charged over the life specified in the tariff regulations (assumed to be 10 years in this case). The recoument of depreciation is recognised as a realisation of regulatory asset with a corresponding debit to the statement of profit and loss.

31.3.2013	Regulatory Expense Dr.	50
	Regulatory Asset A/c Cr.	50
(Being decrease in tariff compensated by regulatory expense)		

Accounting for Rate Regulated Activities

XYZ Ltd.

Statement of Profit and Loss for the period ended 31.3.2013

(Figures other than the above have been assumed).

Particular	Amount (₹ crore)
Sales	12000
Other Income	1600
Total Income	13600
Raw Material Consumed	6800
Increase/decrease of WIP and FG	1200
Employee Benefits	1250
Finance Cost (Interest for the abnormal suspension)	500
Depreciation/Amortization	750
Total Expenses	10500
Profit before Tax (PBT) and Rate Regulated Activities (RRA)	3100
(Add) Regulatory Income/Expense	500
PBT	3600
Less: Tax Expense*	
Current Tax (3100@35%)	(1085)
Deferred Tax other than RRA	(100)
Deferred Tax expense pertaining to RRA (500@35%)	(175)
Profit After Tax (PAT)	2240

* Tax rate assumed to be 35%.

Extract of Balance Sheet of XYZ Ltd. as on 31.3.2013.

Assets	Amount (₹ crore)
Non-current Assets	
Other non-current assets- Regulatory Asset	450
Current assets	
Other current assets- Regulatory Asset	50
TOTAL	500

Example 4 – Rate Regulatory Asset

XYZ Ltd. is an entity engaged in distribution of power. The relevant tariff regulations permit inclusion of certain expenses for fixing the future tariff. Such expenses otherwise are required to be recognised in the statement of profit and loss.

During the year 2013-14, XYZ Ltd. incurred a sum of ₹ 100 crore towards additional ex-gratia payment to its employees due to change in the relevant law. As per the regulations governing the tariff charged by the XYZ Ltd. from its customers, the said additional expense is permissible as 'truing up adjustment' in the future tariff. Accordingly, the additional expenditure incurred by XYZ Ltd. is considered to be a regulatory asset by the company.

During the year 2014-15, the regulator in accordance with the tariff regulation adjusts (increase) the tariff to be charged by XYZ Ltd from its customers at by ₹ 10 per unit for increase in employee benefits incurred in the previous year, i.e. 2013-14. During the year 2014-15, XYZ Ltd. billed 56,00,000 units to its customers.

Following accounting entries should be passed by XYZ Ltd. during the period 2013-14 and 2014-15.

Year 2013-14

- At the time when the additional employee benefits expenses are incurred:

		Amount (₹ in crores)
2013-14	Employee Benefit Exp. A/c Dr.	100
	Employee Benefits Payable A/c Cr.	100
(Being additional employee benefit expenses incurred)		

- At the end of the reporting period, employee benefit expense is recognised in the statement of profit and loss:

31.2.2014	Profit and Loss A/c Dr.	100
	Employee Benefit Exp. A/c Cr.	100
(Being additional employee benefit expenses transferred to profit and loss)		

Accounting for Rate Regulated Activities

3. As the tariff regulations permit inclusion of additional employee benefit expenses in the tariff determination, on the reporting date the same would be recognised as a regulatory asset:

31.3.2014	Regulatory Asset A/c Dr.	100
	Regulatory Income/Expense A/c Cr.	100
(Being regulatory asset recognised)		

4. Transfer of Regulatory Income/ Expense to Profit and loss A/c.

31.3.2014	Regulatory Income/Expense Dr.	100
	Profit and Loss A/C Cr.	100
(Being Regulatory Income/Expense transferred to Profit and Loss.)		

Year 2014-15

5. As during the year, ₹5.60 crores are recovered by the entity through increased revenue, the following entry for amortisation of regulatory asset is passed by XYZ Ltd:

31.3.2015	Regulatory Income/Expense A/c Dr.	5.60
	Regulatory Asset A/c Cr.	5.60
(Being increase in revenue adjusted against the regulatory asset)		

6. Transfer of Regulatory Income/ Expense to Profit and loss A/c.

31.3.2015	Profit and Loss A/c Dr.	5.60
	Regulatory Income/Expense A/c Cr.	5.60
(Being Regulatory Income/Expense transferred to Profit and Loss.)		

XYZ Ltd.
Statement of Profit and Loss the period ended 31.3.2014
 (Figures other than the above have been assumed).

Particular	Amount (₹ crore)
Sales	11900
Other Income	100
Total Income	12000
Raw Materials Consumed	6800
Increase/decrease of WIP and FG	1200
Employee Benefits (including additional expense)	1150
Depreciation/Amortization	750
Other Expenses	100
Total Expenses	10000
Profit Before Tax (PBT) and Rate Regulated Activities (RRA)	2000
(Add) Regulatory Income/Expense	100
PBT	2100
Less: Tax Expense*	
Current Tax (2000 @35%)	(700)
Deferred Tax other than RRA	(100)
Deferred Tax expense pertaining to RRA (100@35%)	(35)
Profit After Tax (PAT)	1265

* Tax rate assumed to be 35%.

Extract of Balance Sheet of XYZ Ltd. as on 31.3.2014.

Assets	Amount (₹ crore)
Current Assets	
Other Current Assets (Regulatory Asset)	100
TOTAL	100

Accounting for Rate Regulated Activities

Year 2014-15

XYZ Ltd.

Statement of Profit and Loss for the period ended 31.3.2015.

(Figures other than the above have been assumed).

Particular	Amount (₹ crore)
Sales (including increased revenue due to tariff adjustment)	11905.60
Other Income	100.00
Total Income	12005.60
Raw Materials Consumed	6800.00
Increase/decrease of WIP and FG	1200.00
Employee Benefits	1150.00.
Depreciation/Amortization	750.00
Other Expenses	100.00
Total Expenses	10000.00
Profit Before Tax (PBT) and Rate Regulated Activities (RRA)	2005.60
(Less) Regulatory Income/Expense	(5.60)
PBT	2000.00
Less: Tax Expense*	
Current Tax (2005.60 @35%)	(701.96)
Deferred Tax other than RRA	(100.00)
Deferred Tax saving pertaining to RRA (5.60@35%)	1.96
Profit After Tax (PAT)	1200.00

* Tax rate assumed to be 35%.

Extract of Balance Sheet of XYZ Ltd. as on 31.3.2014.

Assets	Amount (₹ crore)
Non-current Assets	
Other non-current assets (Regulatory Asset)	94.40
TOTAL	94.40