

Chapter 18

HKFRS 14 “Regulatory Deferral Accounts”

Introduction	¶18-100
Recognition, measurement, impairment and derecognition.....	¶18-200
Adoption of previous GAAP accounting policies applied	¶18-210
Initial recognition and measurement	¶18-220
Measurement after recognition.....	¶18-230
Changes in accounting policies.....	¶18-240
Interaction with other HKFRSs	¶18-300
HKAS 10 “Events after the Reporting Period”	¶18-310
HKAS 12 “Income Taxes”	¶18-320
HKAS 36 “Impairment of Assets”	¶18-330
HKFRS 3 “Business Combinations”	¶18-340
HKFRS 10 “Consolidated Financial Statements” and HKAS 28 “Investments in Associates and Joint Ventures”	¶18-350
Presentation	¶18-400
Classification of regulatory deferral account balances.....	¶18-410
Classification of movements in regulatory deferral account balances.....	¶18-420
Earnings per share	¶18-430
Disclosures	¶18-500
Comparison with International Accounting Standards.....	¶18-600

¶18-100 Introduction

HKFRS 14 “Regulatory Deferral Accounts” was issued by the HKICPA in February 2014. HKFRS 14 is an interim Standard and will be superseded by the finalisation of the IASB’s more comprehensive rate-regulated activities project.

In many countries, regulated activities (such as telephone, gas, electricity and water) are subject to rate regulation where governments are involved in regulating the supply and pricing; this can have a significant effect on the value and timing of an entity’s revenue.

Rate regulation is defined in HKFRS 14 as “a framework for establishing the prices that can be charged to customers for goods or services and that framework is subject to oversight and/or approval by a rate regulator” (Appendix A).

Rate regulation is designed to protect customers from unreasonable rates while allowing the suppliers to recover the costs through the prices (rates) the entities charge to customers for rate-regulated goods or services. Consequently, rate regulation might allow the suppliers to defer the recovery

of these amounts in order to reduce volume or purchase price variations and recognise them in separate regulatory deferral accounts.

The scope of HKFRS 14 is focused and covers only entities that (para 5):

- (a) are first-time adopters of HKFRS;
- (b) conduct rate-regulated activities; and
- (c) recognise rate-regulated assets and/or liabilities in accordance with their previous GAAP.

HKFRS 14 also permits eligible rate-regulated entities to continue recognising 'regulatory deferral account balances' in accordance with their previous GAAP in subsequent financial statements (para 6).

Entities within the scope of HKFRS 14 would be afforded an option to apply their previous GAAP accounting policies for the recognition, measurement and impairment of assets and liabilities arising from rate regulation (term 'regulatory deferral accounts balance').

'Regulatory deferral accounts balance' is in HKFRS 14 as "the amount of any expense (or income) account that would not be recognised as an asset or a liability in accordance with other HKFRSs, but that qualifies for deferral because the amount is included, or is expected to be included, by the rate regulator in establishing the price(s) that can be charged to customers" (Appendix A).

These regulatory deferral account balances, along with the associated impact on profit or loss, would be recognised and presented separately from other items in the financial statements. Thus, for those entities electing to adopt HKFRS 14, all other line items and subtotals within the financial statements would exclude the effects of regulatory deferral accounts. This would result in these entities being placed on a comparable basis with other entities that report in accordance with HKFRS but which do not apply HKFRS 14.

¶18-200 Recognition, measurement, impairment and derecognition

Under HKFRS 14 entities are allowed to recognise regulatory deferral account balances in the statement of financial position at amounts that would otherwise be recognised in the statement of profit or loss and other comprehensive income, if they do not meet the criteria to be recognised as an asset or a liability under HKFRS.

¶18-210 Adoption of previous GAAP accounting policies applied

HKFRS 14 provides a temporary exemption from complying with the requirements in other HKFRSs as well as the definitions, recognition criteria

and measurement concepts for assets, liabilities, income and expenses in the *Conceptual Framework*.

Under the exemption, an entity that has rate-regulated activities electing to apply HKFRS 14 shall develop their accounting policies under HKAS 8 “Accounting Policies, Changes in Accounting Estimates and Errors” and continue to apply its previous GAAP accounting policies for recognition, measurement, impairment and derecognition of regulatory deferral account balances (paras 9 and 11).

Such previous GAAP accounting policies may include, for example, the following practices (para B4 of Application Guidance):

- (a) recognising a regulatory deferral account debit balance when the entity has the right, as a result of the actual or expected actions of the rate regulator, to increase rates in future periods in order to recover its allowable costs (i.e. the costs for which the regulated rate(s) is intended to provide recovery);
- (b) recognising, as a regulatory deferral account debit or credit balance, an amount that is equivalent to any loss or gain on the disposal or retirement of both items of property, plant and equipment and of intangible assets, which is expected to be recovered or reversed through future rates;
- (c) recognising a regulatory deferral account credit balance when the entity is required, as a result of the actual or expected actions of the rate regulator, to decrease rates in future periods in order to reverse over-recoveries of allowable costs (i.e. amounts in excess of the recoverable amount specified by the rate regulator); and
- (d) measuring regulatory deferral account balances on an undiscounted basis or on a discounted basis that uses an interest or discount rate specified by the rate regulator.

The following are examples of the types of costs that are frequently recognised in separate regulatory deferral accounts (para B5 of Application Guidance):

- (a) volume or purchase price variances;
- (b) costs of approved ‘green energy’ initiatives (in excess of amounts that are capitalised as part of the cost of property, plant and equipment in accordance with HKAS 16 “Property, Plant and Equipment”);
- (c) non-directly-attributable overhead costs that are treated as capital costs for rate regulation purposes (but are not permitted, in accordance with HKAS 16, to be included in the cost of an item of property, plant and equipment);
- (d) project cancellation costs;
- (e) storm damage costs; and

- (f) deemed interest (including amounts allowed for funds that are used during construction that provide the entity with a return on the owner's equity capital as well as borrowings).

¶18-220 Initial recognition and measurement

An entity shall first determine the carrying amount of its assets and liabilities under HKFRS and the *Conceptual Framework*, excluding HKFRS 14. It shall then compare these amounts with the assets and liabilities determined under the entity's previous GAAP accounting policies. The differences would represent the regulatory deferral debit or credit account balances to be recognised.

The following example illustrates how an entity recognises and measures the regulatory deferral account balances separately from other HKFRSs.

Illustration 18.1

Safety Gas Inc. (SG) is a gas company in Country Z that reports under US GAAP and has a year-end of 31 December. In order to reduce price volatility in rates charged to customers, the rate regulator in Country X requires SG to recover the differences between actual and expected costs in future periods.

The deferred gas costs meet the recognition criteria for an asset under US GAAP and are presented as "Other assets and deferred costs" in the statement of financial position of SG as at 31 December 20x3. For simplicity, it is assumed that no other assets are included in the "Other assets and deferred costs" item.

Under the rate regulation and mechanisms, SG is allowed to recover the actual approved costs of gas supplies on a pass-through basis. Any net under or over-recovery of gas costs is amortised using straight-line method over 3 years.

SG adopts HKFRS in its 20x5 annual financial statements. On the date of HKFRS adoption (1 January 20x4), SG has a carrying amount of US\$12,300,000 presented as "Other assets and deferred costs" in its US GAAP statement of financial position, which relates to the net under-recovery of gas costs to be deferred over the next 3 years. However, SG has assessed that these deferred gas costs do not meet the asset recognition criteria under HKFRS. Consequently, the regulatory deferral account (debit) balance to be recognised under HKFRS 14 amounts to US\$12,300,000 (i.e. US\$12,300,000 – US\$0), which equals the difference between the deferred gas costs recognised under previous GAAP accounting policies (in this example, US GAAP) and what would have been recognised under HKFRS without adopting HKFRS 14. Annual amortisation of US\$4,100,000 (i.e. US\$12,300,000/3) would then be recognised in SG's profit or loss over the 3-year recovery period.

¶18-230 Measurement after recognition

HKFRS 14 requires that an entity that elects adopting HKFRS 14 shall continue to apply its previous GAAP accounting policies for the recognition, measurement, impairment and derecognition of regulatory deferral account balances (para 11). The entity is required to apply the accounting policies consistently in subsequent periods (para 12).

Illustration 18.2

Refer to Illustration 18.1 above, the following table shows the effects of variations in the gas cost on SG's rate-regulated activities and the regulated deferral account (debit)/credit balance over the 3 years as at 31 December 20x4, 20x5 and 20x6:

	20x4	20x5	20x6
	US\$'000	US\$'000	US\$'000
Amounts charged to customers in the year for gas supplies based on regulated rates	81,400	99,800	96,000
Recovery in prior years	—	(4,100)	(2,400)
Net amounts charged to customers in the year	81,400	95,700	93,600
Actual gas supply costs in the year	<u>93,700</u>	<u>100,800</u>	<u>85,500</u>
Regulatory deferral account (debit)/credit balance	<u>(12,300)</u>	<u>5,100</u>	<u>8,100</u>

It may be noted in the table above that:

- (a) The regulatory deferral account (debit)/credit balance represents the net amount of (under)/over recovery of gas supply costs.
- (b) The under-recovery of gas supply costs results in a regulatory deferral debit balance of US\$12,300,000 was recognised as at 1 January 20x4 on adopting HKFRS 14. The annual amortisation charge for this regulatory deferral debit balance over the next 3 years would be US\$4,100,000 (i.e. US\$12,300,000/3). In the year 20x4, the over-recovery of gas supply costs of US\$5,100,000 results in a regulatory deferral credit balance which would also be amortised over 3 years, with an annual credit of US\$1,700,000 (i.e. US\$5,100,000/3).

Illustration 18.3

Refer to Illustration 18.2 above, the table below shows the movements in the net regulatory deferral account debit/(credit) balances over the three-year recovery period ended 31 December 20x4, 20x5 and 20x6:

	20x4	20x5	20x6
	<i>US\$'000</i>	<i>US\$'000</i>	<i>US\$'000</i>
Balance as at 1 January	–	12,300	3,100
Net under-recovery of gas supply costs in the year	12,300		
Net over-recovery of gas supply costs in the year		(5,100)	(8,100)
Amortisation of under-recovery of gas supply costs arising in the year 20x5		(4,100)	(4,100)
Amortisation of over-recovery of gas supply costs arising in the year 20x5			1,700
Net movement	<u>12,300</u>	<u>(9,200)</u>	<u>(10,500)</u>
Balance as at 31 December	<u>12,300</u>	<u>3,100</u>	<u>(7,400)</u>

It may be noted in the table above that:

- (a) Similar process applies in accounting for the regulatory deferral account balances in subsequent years.
- (b) The net movement in the regulatory deferral account debit/(credit) balances would be recognised in SG's profit or loss.

¶18-240 Changes in accounting policies

HKFRS 14 prohibits an entity from changing its accounting policies in order to start recognising regulatory deferral account balances upon initial application of HKFRS 14 and to changes made in subsequent reporting periods if the entity has not recognised such balances under its previous GAAP (paras 13 and 15).

Changes in accounting policies for regulatory deferral account balances are permitted only in limited circumstances. HKFRS 14 specifically states that an entity may only change its accounting policies for the recognition, measurement, impairment and derecognition of regulatory deferral account balances only if the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs (para 13). The entity shall judge relevance and reliability* using the criteria in paragraph 10 of HKAS 8 (para 13).

*(*Note: The term “faithful representation” is used in the Conceptual Framework and it encompasses the main characteristics that the previous Framework called “reliability”. The requirement in para 13 of HKFRS 14 is based on the requirements of HKAS 8, which retains the term “reliable”.)*

¶18-300 Interaction with other HKFRSs

Other HKFRSs (HKFRS other than HKFRS 14) generally apply to regulatory deferral account balances in the same way as they apply to assets, liabilities, income and expenses that are recognised in accordance with other HKFRSs. The only specific exceptions, exemptions or additional requirements related to the interaction of HKFRS 14 with other HKFRSs are contained within HKFRS 14 (para 16).

¶18-310 to ¶18-350 outline how some other HKFRSs interact with the requirements of HKFRS 14 and clarify specific exceptions to, and exemptions from, other HKFRSs and additional presentation and disclosure requirements that are expected to be applicable.

¶18-310 HKAS 10 “Events after the Reporting Period”

An entity may need to use estimates and assumptions in the recognition and measurement of its regulatory deferral account balances. Hence, for events that occur between the end of the reporting period and the date when the financial statements are authorised for issue, HKAS 10 shall be applied to identify whether those estimates and assumptions should be adjusted for in the regulatory deferral account balances at the end of the reporting period in order to reflect those events (para B8 of Application Guidance).

¶18-320 HKAS 12 “Income Taxes”

HKFRS 14 requires an entity to present the deferred tax asset (liability) arising on recognition of regulatory deferral account balances either (para B11 of Application Guidance):

- (a) with the line items that are presented for the regulatory deferral account debit balances and credit balances; or
- (b) as a separate line item alongside the related regulatory deferral account debit balances and credit balances.

This differs from the general HKAS 12 presentation and disclosure requirements of combining all deferred tax asset (liability) balances.

Similarly, when an entity recognises the movement in a deferred tax asset (liability) arising on recognition of deferral account balances, the entity shall not include the movement in that deferred tax amount within the tax expense (income) line item that is presented in the statement(s) of profit or

loss and other comprehensive income in accordance with HKAS 12. The movement shall be presented either (para B12 of Application Guidance):

- (a) with the line items that are presented in the statement(s) of profit or loss and other comprehensive income for the movements in regulatory deferral account balances; or
- (b) as a separate line item alongside the related line items that are presented in the statement(s) of profit or loss and other comprehensive income for the movements in regulatory deferral account.

¶18-330 HKAS 36 “Impairment of Assets”

HKFRS 14 requires an entity to continue to apply its previous GAAP accounting policies for the identification, recognition, measurement and reversal of any impairment of its recognised regulatory deferral account balances (para B15 of Application Guidance). Consequently, HKAS 36 does not apply to the separate regulatory deferral account balances recognised.

However, HKAS 36 might require an entity to perform an impairment test on a cash-generating unit (CGU) that includes regulatory deferral account balances. The test might be required because the CGU contains goodwill, or because one or more of the impairment indicators have been identified as relating to the CGU. In such situations, paragraph B16 of Application Guidance provides that an entity shall apply the requirements of paragraphs 74 to 79 of HKAS 36 to decide whether any of the regulatory deferral account balances recognised are included in the carrying amount and recoverable amount of the CGU for the purpose of the impairment test. Thus, if the regulatory deferral account balances are included in the carrying amount of a CGU, they need also be included in the recoverable amount of the CGU.

¶18-340 HKFRS 3 “Business Combinations”

The core principle of HKFRS 3 is that an acquirer of a business recognises the assets acquired and the liabilities assumed at their acquisition-date fair values. HKFRS 3 allows a limited number of exceptions to this general principle. Para B18 of Application Guidance provides an additional exception.

Para 11 and 12 of HKFRS 14 require an entity to continue to apply its previous GAAP accounting policies for the recognition and measurement of regulatory deferral account balances. Consequently, when an entity that has applied HKFRS 14 acquires a business, it shall apply, in its consolidated financial statements, its accounting policies to the acquiree’s regulatory deferral account balances at the date of acquisition. The acquiree’s regulatory deferral account balances are recognised in the consolidated financial statements of the acquirer in accordance with the acquirer’s policies, irrespective of whether the acquiree recognises those balances in its own financial statements (para B18 of Application Guidance).

¶118-350 HKFRS 10 “Consolidated Financial Statements” and HKAS 28 “Investments in Associates and Joint Ventures”

HKFRS 10 and HKAS 28 require the use of uniform accounting policies for like transactions and other events in similar circumstances, in preparing consolidated financial statements by the parent and entity’s financial statements of the investing entity in applying the equity method.

Consequently, if a parent recognises regulatory deferral account balances in its consolidated financial statements in accordance with HKFRS 14, it shall apply the same accounting policies to the regulatory deferral account balances arising in all of its subsidiaries. This shall apply irrespective of whether the subsidiaries recognise those balances in their own financial statements (para B23 of Application Guidance).

Similarly, adjustments shall be required to bring the associate’s or joint venture’s accounting policies for the recognition, measurement, impairment and derecognition of regulatory deferral account balances confirm to those of the investing entity in applying the equity method (para B24 of Application Guidance).

¶118-400 Presentation

One key aspect of HKFRS 14 is the requirements of presenting the regulatory deferral account balances, and the net movements in the balances on separate line items in the statement of financial position and statement of profit or loss and other comprehensive income.

¶118-410 Classification of regulatory deferral account balances

HKFRS 14 requires an entity to present as separate line items in the statement of financial position for (para 20):

- (a) the total of all regulatory deferral account debit balances; and
- (b) the total of all regulatory deferral account credit balances.

When current and non-current assets, and current and non-current liabilities, are presented as separate classifications in an entity’s statement of financial position, the totals of regulatory deferral account balances shall not be classified as current or non-current. Instead, the separate line items required by paragraph 20 above are distinguished from the assets and liabilities that are presented in accordance with other HKFRSs by the use of sub-totals, which are drawn before the regulatory deferral account balances are presented (para 21).

Illustration 18.4

An illustration of presenting the regulatory deferral account debit balances and credit balances and any related deferred tax asset (liability) as separate line items in the statement of financial position is provided in the Illustrating Examples of HKFRS 14, and is reproduced with slight modifications as follows:

XYZ Group — Statement of financial position as at 31 December 20x7

	20x7 \$'000	20x6 \$'000
Assets		
Non-current assets		
Property, plant and equipment	350,700	360,020
Goodwill	80,800	91,200
Other intangible assets	227,470	227,470
Investments in associates	100,150	110,770
Investments in equity instruments	129,790	146,460
	<u>888,910</u>	<u>935,920</u>
Current assets		
Inventories	135,230	132,500
Trade receivables	91,600	110,800
Other current assets	25,650	12,540
Cash and cash equivalents	212,160	220,570
	<u>464,640</u>	<u>476,410</u>
Total assets	1,353,550	1,412,330
Regulatory deferral account debit balances and related deferred tax asset	<u>112,950</u>	<u>111,870</u>
Total assets and regulatory deferred account balances	<u>1,466,500</u>	<u>1,524,200</u>
Equity and liabilities		
Equity attributable to owners of the parent		
Share capital	650,000	600,000
Retained earnings	243,500	164,500
Other components of equity	10,200	21,200
	<u>903,700</u>	<u>785,700</u>
Non-controlling interests	<u>70,050</u>	<u>45,800</u>
Total equity	<u>973,750</u>	<u>831,500</u>

Non-current liabilities		
Long-term borrowings	120,000	160,000
Deferred tax	28,800	26,040
Long-term provisions	28,850	52,240
Total non-current liabilities	<u>177,650</u>	<u>238,280</u>
Current liabilities		
Trade and other payables	87,140	111,150
Short-term borrowings	80,000	200,000
Current portion of long-term borrowings	10,000	20,000
Current tax payable	35,000	42,000
Short-term provisions	5,000	4,800
Total current liabilities	<u>217,140</u>	<u>377,950</u>
Total liabilities	<u>394,790</u>	<u>616,230</u>
Total equity and liabilities	<u>1,368,540</u>	<u>1,447,730</u>
Regulatory deferral account credit balances	<u>97,960</u>	<u>76,470</u>
Total equity, liabilities and regulatory deferral account credit balances	<u>1,466,500</u>	<u>1,524,200</u>

¶18-420 Classification of movements in regulatory deferral account balances

HKFRS 14 requires an entity to present the net movement in all regulatory deferral account balances for the reporting period that relate to items recognised in other comprehensive income (para 22). Separate line items are used for the net movement related to items that, in accordance with other HKFRSs (para 22):

- (a) will not be reclassified subsequently to profit or loss; and
- (b) will be reclassified subsequently to profit or loss when specific conditions are met.

Similarly, HKFRS 14 requires an entity to present a separate line item in profit or loss, for the remaining net movement in all regulatory deferral account balances for the reporting period, excluding movements that are not reflected in profit or loss, such as amounts acquired (para 23). This separate line item shall be distinguished from the income and expenses that are presented in accordance with other HKFRSs by the use of a sub-total, which is drawn before the net movement in regulatory deferral account balances.

¶18-430 Earnings per share

For basic and diluted earnings per share presented in accordance with HKAS 33 "Earnings per Share", HKFRS 14 also requires an entity to present additional basic and diluted earnings per share amounts, excluding the net movement in the regulatory deferral account balances with equal prominence (para B14 of Application Guidance).

Illustration 18.5

An illustration of presenting the net movement in regulatory deferral account balances as separate line items in the statement of profit or loss and other comprehensive income is provided in the Illustrating Examples of HKFRS 14, and is reproduced with slight modifications as follows:

XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20x7

(illustrating the presentation of profit or loss and other comprehensive income in one statement and the classification of expenses within profit or loss by function)

	20x7	20x6
	\$'000	\$'000
Revenue	390,000	358,784
Cost of sales	<u>(237,062)</u>	<u>(230,000)</u>
Gross profit	152,938	128,784
Other income	44,247	16,220
Distribution costs	(9,000)	(13,700)
Administrative expenses	(20,000)	(31,500)
Other expenses	(2,100)	(1,200)
Finance costs	(8,000)	(7,500)
Share of profit of associates	<u>35,100</u>	<u>15,100</u>
Profit before tax	193,185	106,204
Income tax expense	<u>(43,587)</u>	<u>(44,320)</u>
Profit for the year before net movements in regulatory deferral account balances	149,598	61,884
Net movement in regulatory account balances related to profit or loss and the related deferred tax amount	(27,550)	3,193
Profit for the year and net movements in regulatory deferral account balances	122,048	65,077

Other comprehensive income: Items that will not be reclassified to profit or loss:		
Remeasurement of defined benefit pension plans	(7,938)	(3,784)
Net movement in regulatory account balances related to other comprehensive income	7,140	4,207
Other comprehensive income for the year, net of income tax	(798)	423
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	121,250	65,500
Profit and net movements in regulatory deferral account balances attributable to:		
Owners of the parent	97,798	51,977
Non-controlling interests	24,250	13,100
	<u>122,048</u>	<u>65,077</u>
Total comprehensive income attributable to:		
Owners of the parent	97,000	52,400
Non-controlling interests	24,250	13,100
	<u>121,250</u>	<u>65,500</u>
Earnings per share		
Basic and diluted	0.61	0.35
Basic and diluted including net movement in regulatory deferral account balances	0.46	0.30

¶18-500 Disclosures

HKFRS 14 requires an entity that elects to apply HKFRS 14 to disclose information that enables users to assess (para 27):

- the nature of, and the risks associated with, the rate regulation that establishes the price(s) that the entity can charge customers for the goods or services it provides; and
- the effects of that rate regulation on the entity's financial position, financial performance and cash flows.

The major disclosure requirements include:

- (a) a brief description of the nature and extent of the rate-regulated activity and the nature of the regulatory rate-setting process (para 30(a));
- (b) an explanation of how the future recovery or reversal of each class (i.e. each type of cost or income) of regulatory deferral account balance is affected by risks and uncertainty, such as demand risk (e.g. changes in consumer attitudes, the availability of alternative sources of supply or the level of competition) and regulatory risk (e.g. the submission or approval of a rate-setting application or the entity's assessment of the expected future regulatory actions) (para 30(c));
- (c) the basis on which regulatory deferral account balances are recognised and derecognised, and how they are measured on initial recognition and subsequently (para 32); and
- (d) for each type of rate-regulated activity, a reconciliation of the carrying amount of each class of regulatory deferral account balance at the beginning and the end of the period (para 33(a)).

Further, HKFRS 14 requires that the description of the rate-regulated activity and the nature of the regulatory rate-setting process as well as the explanation of the future recovery or reversal of each class of regulatory deferral account balance shall be provided in the financial statements either directly in the notes or incorporated by cross-reference to some other statement that is available to users of the financial statements (e.g. management summary or risk report) (para 31).

When an entity provides disclosures in accordance with HKFRS 12 "Disclosure of Interests in Other Entities" for an interest in a subsidiary, associate or joint venture that has rate-regulated activities and for which regulatory deferral account balances are recognised, the entity is required to disclose separately the amounts included for the regulatory deferral account debit and credit balances and the related net movement for the interests disclosed (para 35).

¶18-600 Comparison with International Accounting Standards

HKFRS 14 is based on IFRS 14 "Regulatory Deferral Accounts". There are no major textual differences between the two accounting standards. Compliance with HKFRS 14 will ensure compliance with IFRS 14.