STAFF PAPER

16-17 July 2015

Accounting Standards Advisory Forum

Project	**Rate-regulated Activities: Research project**
Paper topic	Developing a revenue approach

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Purpose of the paper

1. The purpose of this paper is to set out the reasons for, and ask the IASB to accept, the staff's recommendation to progress the research and development of a 'revenue-approach' model for rate-regulated activities, separately from the requirements of IFRS 15 *Revenue from Contracts with Customers*.

Background

2. In September 2014, the IASB published the Discussion Paper *Reporting the Financial Effects of Rate Regulation* (the Discussion Paper). The Discussion Paper does not include detailed accounting proposals. Instead, it explores several possible approaches that the IASB could consider when deciding how best to report the financial effects of rate regulation.

3. The feedback received through outreach activities and comment letter responses to the Discussion Paper was presented to the IASB in its February 2015 meeting.[1] The feedback demonstrates that there is strong support for developing principle-based, specific accounting requirements that will lead to the recognition of at least some regulatory deferral account balances in IFRS financial statements.

[1] Agenda Paper 9 *Initial analysis of responses to the Discussion Paper*, February 2015, available to download from http://www.ifrs.org/Current-Projects/IASB-Projects/Rate-regulated-activities/Pages/Discussion-and-papers-stage-4.aspx.

However, views are mixed about whether this should be done through a separate Standard to replace IFRS 14 *Regulatory Deferral Accounts* or through amendments to, or an Interpretation of, existing Standards.[2]

4. The strongest support from respondents is for an approach that would be based on IFRS 15, focusing on the entity's rights and obligations relating to the customers as a whole (the customer base), instead of its rights and obligations to individual customers. This is most likely to result in adjustments to the timing of recognition of a combination of revenue and costs.

5. In addition, there is strong support for identifying separately, either in the disclosure notes or as separate line items adjacent to related line items, any regulatory deferral account balances and related income statement movements that are recognised.

6. In February 2015, the IASB considered the initial analysis of responses to the Discussion Paper. The IASB asked the staff to focus the next stage of their analysis on a small number of issues, including:

   (a) how the principles of IFRS 15, in particular relating to the identification of performance obligations, could be adapted to rate-regulated activities; and

   (b) the meaning and use of 'the customer base', in particular within the context of the three-way relationship between a rate-regulated entity, the rate regulator and the end customer.[3]

7. These issues were discussed with the IASB's Consultative Group for Rate Regulation (the Consultative Group) in its meeting in March 2015, in particular

[2] In January 2014, the IASB issued IFRS 14. This Standard permits particular entities, when adopting IFRS for the first time, to continue to apply their previous GAAP accounting policies for the recognition and measurement of regulatory deferral accounts, with specified presentation and disclosure requirements. IFRS 14 is classified as a temporary Standard that will either be modified or withdrawn, depending on the outcome of the research project

[3] The issues raised are summarised in the February IASB Update, reproduced in Appendix 2 of Agenda Paper 9A *Project status and next steps*, May 2015.

through Agenda Paper 4 *What is performance?*[4] This paper is reproduced in Appendix 1. An extract from the summary note of the meeting, summarising the discussion around Agenda Paper 4, is contained in Appendix 2. The staff continue to analyse the matters raised in that meeting.

8. Our findings so far suggest that any accounting model to be developed for rate-regulated activities should be contained within a separate Standard to replace IFRS 14. In our view, trying to develop a model by amending existing Standards will introduce added complexity and uncertainty for all entities applying IFRS, not merely those with activities that are subject to defined rate regulation. This factor contributed to the IASB's decision to make IFRS 14 a self-contained, stand-alone Standard. IFRS 14 requires that an entity within its scope must apply the existing requirements of all other Standard before applying the remaining requirements of IFRS 14. Consequently, all specified requirements for reporting regulatory deferral account balances, and any exceptions to, or exemptions from, the requirements of other Standards that are related to those balances, are contained within IFRS 14 instead of within those other Standards.

Staff recommendation

9. The staff recommend that, for activities that are subject to defined rate regulation, we should look to develop an accounting model that would be contained in a separate Standard to replace IFRS 14, instead of developing amendments to, or Interpretations of, existing Standards.

10. The following paragraphs explain the staff's reasoning for the recommendation. The explanation is not intended to cover the staff's recommendation for what any possible model might look like. The purpose is merely to support our recommendation to develop the model separately and to confirm that we have found no support within IFRS 15 for changing the existing predominant practice applied in IFRS financial statements. In accordance with the predominant

[4] The agenda, agenda papers, recordings of the meeting sessions and the summary note of the Consultative Group's meeting can be downloaded from the project page on the IFRS website at http://www.ifrs.org/About-us/IASB/Advisory-bodies/Working-groups/Consultative-Group-for-Rate-Regulation/Pages/Consultative-Group-for-Rate-Regulation-meetings.aspx.

practice, the existing requirements of IFRS are applied without amendment for the effects of the regulatory agreement. This has resulted in revenue from customers being recognised based on the timing of the entity's right to bill customers, in accordance with the individual contracts with customers.

Reasons for the staff's recommendation

IFRS 15 focuses on revenue from contracts with customers

11. The strongest support expressed in the responses to the Discussion Paper was for developing specific IFRS requirements that focus on the acceleration/deferral of the timing of recognition of revenue or a combination of revenue and costs to reflect the effect of rate regulation on those revenues and costs. The most common suggestion is to develop an approach that is based on IFRS 15, focusing on the entity's rights and obligations relating to the customers as a whole (the customer base), instead of its rights and obligations relating to individual customers. This would lead to amendments to, or an Interpretation of, IFRS 15.

12. Our analysis so far indicates that focusing on the entity's relationship with the customer base alone, instead of with individual customers, is unlikely to result in a substantially different outcome from the existing predominant accounting practice. This is because, although the regulatory agreement is used to determine the price that is charged to customers for the distinct goods or services provided by the entity, the regulatory agreement does not override the rights and obligations created by the individual customer contracts. Merely aggregating those rights and obligations for the whole of the customer base does not change the overall effect of the individual customer contracts.

13. Instead, the regulatory agreement has a wider economic effect that creates rights and obligations for the entity that are distinguishable from the rights and obligations that it has with individual customers. These distinguishable rights and obligations are created by the regulatory agreement between the entity and the rate regulator. The rate or price used in the individual customer contracts provides the mechanism for the entity to collect the cash flows to which it is entitled in

exchange for satisfying its obligations in both the individual customer contracts and the contract with the rate regulator, that is, the regulatory agreement.

14. During the March 2015 meeting of the Consultative Group, many members suggested that the strongest evidence of what activities should lead to revenue recognition is the agreement with the rate regulator. Consequently, a focus on applying IFRS 15 merely to the contracts with customers, and thus ignoring the rights and obligations arising from the agreement with the regulator, might not present a complete picture of the entity's financial position and financial performance.

15. However, our preliminary analysis has identified that some of the definitions contained within IFRS 15, which are essential to the application of the revenue recognition requirements in the Standard, do not lend themselves to be applied to the rights and obligations created by the regulatory agreement. These include the definitions of customer and performance obligation. Identifying the performance obligations and identifying when they are satisfied by the transfer of distinct goods and services is fundamental to the timing of recognition of revenue from customers in accordance with IFRS 15. Many of the rate-regulated activities that the entity is obliged to carry out, and for which consideration is included in the 'revenue requirement', do not involve the transfer of goods or services to the individual customers or to the rate regulator. The revenue requirement is the amount of consideration to which the entity is entitled in exchange for carrying out the required rate-regulated activities during the period. Appendix 2 outlines some of the difficulties identified to date in applying IFRS 15 to the regulatory agreement.

16. Consequently, we think that substantial amendments would be needed to IFRS 15 to facilitate its application to the rights and obligations created in the regulatory agreement. In the absence of such amendments, we do not think that it is appropriate to try to develop an Interpretation of IFRS 15 to create new requirements for the effects of the regulatory agreement. Any Interpretation will be constrained by the existing requirements of IFRS 15.

Transparency and understandability

17. In our view, developing a model that is separate from, instead of creating amendments to, IFRS 15 and other existing Standards provides greater flexibility to more faithfully present the financial effects of defined rate regulation in a more transparent and understandable way.

18. Respondents to the Discussion Paper confirmed that users of financial statements are interested in information that enables them to predict the effects of the rate regulation on the timing of revenue and cash flows of the entity. Regulatory balances arise because of a variety of rights and obligations created by the regulatory agreement. Different rights and obligations can have different effects on the timing of revenue and cash flows. Developing a separate model that focuses more explicitly on the financial effects of the rate regulation will, in our view, enable the model to more clearly identify the nature and cause of any regulatory balances recognised.

19. This separate identification of the nature of regulatory balances will provide information that users of financial statements have told us is relevant and useful for their analysis of the financial statements of rate-regulated entities. This separate identification is also compatible with the support expressed by many respondents to the Discussion Paper for identifying separately, either in the disclosure notes or as separate line items adjacent to related line items, any regulatory deferral account balances and related income statement movements that are recognised.

20. In addition, we think that developing requirements through a separate Standard would more readily facilitate the development of clearer and stronger scoping requirements to prevent other entities from analogising to rate regulation in order to smooth their results.

Consistency with the US GAAP approach

Applying the requirements applicable to unregulated entities before making adjustments for specified regulatory requirements

21. An advantage of developing a model for rate-regulated activities that would be separate from existing Standards, instead of developing a model by amending existing Standards, is that this would be consistent with the approach used in US GAAP.

22. The relevant US Standard, Topic 980 *Regulated Operations*, requires that entities with activities within its scope should first apply the requirements of US GAAP that are applicable to unregulated entities. Topic 980 then specifies that its requirements only apply to those situations within its scope in which the relevant accounting requirements of the rate regulation conflict with the requirements of US GAAP that are applicable to unregulated entities. Consequently, the requirements of Topic 980 are considered to 'overlay' the requirements of general US GAAP.

23. Topic 980 focuses on the recognition of regulatory assets and regulatory liabilities in specified situations in which the actions of a rate regulator create economic rights and obligations for the entity that should be recognised in the financial statements. Topic 980 notes that only when a regulatory accounting order specifies how a cost will be handled for rate-making purposes would it have an economic effect that would justify deviation from the GAAP applicable to business entities in general.

Topic 980 changes the timing of recognition of a combination of revenue and costs

24. Although many people describe the US GAAP approach as a 'cost-deferral model', this is not an accurate depiction, because Topic 980 focuses more on the rights and obligations created by the rate regulation. Consequently, the requirements of Topic 980 focus mainly on when to recognise, and how to measure, regulatory assets and regulatory liabilities and whether to present them as separate assets/liabilities or to include them in the carrying amount of other assets.

25. Some sub-sections of Topic 980 provide guidance about the other side of the entry, that is, how to present the adjusting entry in the statement of profit or loss. Some of these sub-sections deal with the capitalisation of all or part of an incurred cost that would otherwise be charged to expenses; the effect is to reduce the amount of costs recognised as expenses in profit or loss. However, other sub-sections of Topic 980 provide some specific guidance that either permits or requires an entity to adjust income when recognising a regulatory asset or regulatory liability. The common examples include:

(a) **Over-recovery of past costs**: a regulatory liability is recognised through an adjustment to *either* revenue or expenses (sub-section 405 *Liabilities*).

(b) **Pre-funding of future expected costs**: a regulatory liability is recognised because revenue is not recognised for the relevant amount (sub-section 405).

(c) **A gain or other reduction of net allowable costs is to be given to customers over future periods**: a regulatory liability is recognised because the gain or other reduction of allowable costs is not recognised as income of the current period (sub-section 405).

(d) **Alternative revenue programmes**: a regulatory asset (or liability) is recognised through an adjustment to revenue. The revenue adjustment is presented separately from the amount of revenue from customers (sub-section 605).

26. Sub-section 605 of Topic 980 notes two common types of alternative revenue programs, which are termed Type A and Type B.

(a) **Type A**—adjust billings for the effects of weather abnormalities or broad external factors (these typically involve variances from estimated amounts) or to compensate the entity for demand-side management initiatives (for example, no-growth plans and similar conservation efforts).

(b) **Type B**—provides for additional billings (incentive awards) if the utility achieves specified objectives, such as reducing costs, reaching specified milestones, or demonstrably improving customer service.

27. Paragraph 980-605-25-3 of Topic 980 notes that both types of programme enable the entity to adjust rates '*in response to past activities or completed events*'. Once the specific events that trigger the additional revenues have been completed, the entity recognises the additional revenue, subject to specified conditions.

28. When developing Topic 606 *Revenue from Contracts with Customers*, the FASB decided that alternative revenue programmes are contracts between an entity and a regulator of utilities, not a contract between the entity and a customer within the scope of Topic 606.[5] Consequently, the FASB decided to keep the existing requirements for alternative revenue programmes in Topic 980, instead of dealing with them in Topic 606.

29. The decision of the FASB on this issue is consistent with our preliminary analysis of the applicability of IFRS 15 to the regulatory agreement (see paragraph A6(a) of Appendix 3).

30. Consistently with the decision that alternative revenue contracts are outside the scope of Topic 606 because they are created by contracts between an entity and a regulator of utilities, not a contract between the entity and a customer, the FASB also decided to amend the previous presentation requirements in Topic 980. The amendments require that an entity must present revenue arising from the regulatory assets/liabilities recognised as a result of the alternative revenue programmes on the face of the statement of comprehensive income, separately from revenues arising from contracts with customers.

Clarity in applying existing IFRS

31. In the absence of specific guidance for rate-regulated activities, most rate-regulated entities do not recognise regulatory deferral account balances in accordance with the predominant practice that has developed in IFRS financial statements. Instead, existing Standards are applied without modification for the

[5] Topic 606 was issued in May 2014 as a converged Standard with IFRS 15.

effects of the regulatory agreement. This has resulted in revenue from customers being recognised based on the timing of the entity's right to bill customers, in accordance with the individual contracts with customers. Responses to the Discussion Paper suggest that this predominant practice may not provide the most appropriately faithful presentation of an entity's rights and obligations, because it may not reflect the interaction of the regulatory agreement and the individual contracts with customers.

32. Entities with activities that are subject to defined rate regulation are preparing for the transition to IFRS 15 from the existing revenue Standards, IAS 18 *Revenue* and IAS 11 *Construction Contracts*. We are aware that some of these entities are unclear about whether the requirements of IFRS 15 are sufficiently different from those of the predecessor Standards to result in changes to their existing revenue recognition accounting policies in such a way that it would allow them to reflect the effects of the regulatory agreement through the requirements of IFRS 15.

33. On the basis of our analysis to date, the staff have concluded that the transition from IAS 18 and IAS 11 to IFRS 15 should not affect the existing predominant practice outlined in paragraph 31, that is, revenue recognised in accordance with IFRS 15 is based on the rights and obligations created by the individual contracts with customers. This means that the timing of recognition of revenue is not affected by the requirements of the regulatory agreement. This is because, like IAS 18 and IAS 11, IFRS 15 focuses on the rights and obligations created by the contracts between the entity and its customers.

34. The regulatory agreement is a contract between the entity and the rate regulator, which is related to, but separate from, the individual contracts between the entity and its customers. The regulatory agreement creates different rights and obligations for the entity that are distinguishable from the rights and obligations that it has with individual customers. It is these distinguishable rights and obligations that should be the focus of any model to be developed for activities that are subject to defined rate regulation.

35. The relationship between the rights and obligations arising from the individual contracts and those arising from the contract with the rate regulator is complex. Trying to deal with these complexities through amendments to, or an

interpretation of, IFRS 15 is likely to create confusion, uncertainty, and unintended consequences for all entities that are trying to make the transition to, and subsequently apply, IFRS 15. This includes entities that are not subject to defined rate regulation as well as those that have activities that are.

36. We think that developing a model to address the financial effects of rate regulation through a separate Standard will help to clarify that IFRS 15 should be used to account for the contracts between the entity and its customers. The regulated rate should be applied to the distinct goods or services delivered, in accordance with the existing predominant practice in IFRS. The effects of the regulatory agreement can then be identified and dealt with separately to aid understanding and clarity.

Question for the IASB

Question
Do you agree with the staff recommendation that, for activities that are subject to defined rate regulation, we look to develop an accounting model that is contained in a separate Standard to replace IFRS 14, instead of developing amendments to, or Interpretations of, existing Standards, in particular IFRS 15?

Appendix 1: Contents of Consultative Group Agenda Paper 4A *What is performance*?, March 2015

A1. The following paragraphs reproduce the contents of Agenda Paper 4A *What is performance*?. This paper was discussed by the IASB's Consultative Group for Rate Regulation, at their meeting on 4 March 2015. The note summarising the discussion is reproduced in Appendix 2.

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Agenda ref **4**

STAFF PAPER

4 March 2015

Rate-regulated Activities
Consultative Group meeting

Project	**Rate-regulated Activities: Research project**		
Paper topic	What is performance?		
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Introduction

1. Paragraph 5.34 of the Discussion Paper *Reporting the Financial Effects of Rate Regulation* (the Discussion Paper) summarised four possible accounting approaches for reporting the financial effects of rate regulation. Paragraph 61 of the Appendix to Agenda Paper 2 *Initial analysis of responses to the Discussion Paper* notes that the strongest support is for the approach that would recognise the financial effects of rate regulation through specific IFRS requirements. Most supporters of this approach favoured adjusting the timing of recognition of revenue or of a combination of revenue and costs.

2. The most common suggestion made for how to develop an accounting approach is to develop specific IFRS requirements using the principles contained in IFRS 15 *Revenue from Contracts with Customers*. Several respondents note that the rate-setting mechanism and adjustments to the revenue requirement focus

primarily on determining the amount of consideration to which the entity is entitled in exchange for performing its rate-regulated activities. Consequently, it seems logical to focus any accounting requirements on revenue recognition and measurement.

3. Several respondents note, in addition, that the combination of an adjustment to the timing of revenue recognition and the deferral of cost recognition are not incompatible with the principles of IFRS 15. Using the requirements of IFRS 15, an entity recognises particular contract costs as an asset if specified conditions are met.

Purpose of this paper

4. The purpose of this paper is to explore some of the issues that are likely to need more detailed analysis and evidence-gathering before asking the IASB to consider whether, and if so how, it might adapt the principles in IFRS 15 to reflect the financial effects of rate regulation.

5. The purpose of the discussion at this meeting is to gather the initial views of the Consultative Group about how we might be able to analyse different types of rate-regulated activities within the context of the revenue recognition principles in IFRS 15.

Recognising revenue in accordance with IFRS 15

6. Paragraph 31 of IFRS 15 states:

> An entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (ie an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.

7. Appendix A of IFRS 15 defines a performance obligation as:

> A promise in a **contract** with a **customer** to transfer to the customer either:

(a) A good or service (or bundle of goods or services) that is distinct; or

(b) A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

8. In addition, Appendix A of IFRS 15 contains the following definitions:

Contract: An agreement between two or more parties that creates enforceable rights and obligations.

Customer: A party that has contracted with the entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

9. Paragraphs 24-25 of IFRS 15 provide additional guidance about distinguishing performance obligations involving transfers to customers from other promises in contracts with customers that do not lead to revenue recognition.

Promises in contracts with customers

24 A contract with a customer generally explicitly states the goods or services that an entity promises to transfer to a customer. However, the performance obligations identified in a contract with a customer may not be limited to the goods or services that are explicitly stated in that contract. This is because a contract with a customer may also include promises that are implied by an entity's customary business practices, published policies or specific statements if, at the time of entering into the contract, those promises create a valid expectation of the customer that the entity will transfer a good or service to the customer.

25 Performance obligations do not include activities that an entity must undertake to fulfil a contract unless those activities transfer a good or service to a customer. For example, a services provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the customer

> as the tasks are performed. Therefore, those setup activities are not a performance obligation.

What activities represent performance obligations in defined rate regulation?

10. Section 4 and Appendix B of the Discussion Paper provide background information about the revenue requirement and the rate-setting mechanism. This information highlights that the revenue requirement typically reflects the expected performance of activities that are both directly related to providing the goods or services that are delivered and billed to the customers and other indirect activities required by the rate regulation. In some cases, the rate regulator will take into account the cash flow needs of the entity (and/or the customers) when establishing the revenue requirement for the period. Consequently, the revenue requirement may not reflect merely the performance of the current period, but also includes adjustments related to performance of other periods, which could be both past and future periods.

11. Several respondents note that the direct and indirect activities can create different types of obligations, only some of which involve the transfer to the customers of distinct goods or services. Some of these respondents suggest that it is particularly important to assess whether revenue should be recognised only for goods or services delivered to the customers. Some indirect activities may not be directly linked to the satisfaction of performance obligations to the customers and should, therefore, not result in the recognition of revenue, even if they directly affect an entity's current right to the revenue requirement.

12. Some respondents suggest that, in cases in which the rate-adjustment 'de-couples' or shifts volume or demand risk away from the entity to the customers, this may suggest that the service performed is not directly related to the volume of the activity. For example, the Autorité des Normes Comptables (ANC) suggests that:

> . . . For an energy distribution company, under DRR [defined rate regulation], the key service promised is the availability of the network.

13. We would like to explore, with the Consultative Group, whether it is possible to distinguish between types of activities/service promises that could or should result in revenue recognition, and other activities that the entity must undertake to fulfil its regulatory obligations but that do not support the recognition of revenue. To assist with this discussion, we have set out a short illustrative example, which contains some activities that we understand may be required by rate regulation and would typically be included in the calculation of the revenue requirements. These are for illustrative purposes only. We are also interested in other types of activities that the members of the Consultative Group can identify and would like to discuss.

Questions for the Consultative Group

Using the following example, and any other examples that you would like to introduce, how would you distinguish between the activities that you think involve the transfer to the customers of distinct goods or services and those that may not be directly linked to the satisfaction of performance obligations to the customers? Please explain the reasons for your answer.

14. The following illustrative example provides very simplified information. It is not intended to provide a comprehensive example of the rate regulation or the calculation of the revenue requirement. It is merely designed to provide a basis for discussion about the nature of the activities required. The focus of the discussion should be about whether each activity could or should be considered to relate to the satisfaction of performance obligations to the customers.

Illustrative example

Entity W provides household water services (provision of clean water and removal of waste water) to 200,000 customers in its local jurisdiction. It is the only provider of such services in that jurisdiction and is subject to defined rate regulation.

The rate regulator has established that its revenue requirement for the year ended 31 December 20X4 is made up as follows:

	CU000[6]	CU000
Regulatory depreciation of the regulatory asset base (RAB)		50,000
Allowable rate of return on the RAB		4,000
Fixed costs:		
Labour	16,000	
Repairs and maintenance (minimum level)	5,000	
Other fixed overheads	3,000	
		24,000
Variable costs:		
Waste water treatment	10,000	
Other variable overheads	2,000	
		12,000
Funding for development of environmentally-friendly water treatment processes[1]		1,500
Construction of new water treatment plant[2]		8,000
Total revenue requirement		99,500
Rate per unit to charge to customers (CU99.5m / 500,000 units)	CU0.199	

Notes

1. The rate regulator has allocated CU1.5m per annum for three years to the revenue requirement, starting in 20X4, for Entity W to carry out research and development work to reduce the environmental impact of the chemicals that it uses in its water treatment plant. The regulator has set a quantifiable target for the reduction, to be achieved by the end of 20X6. Failure to meet the target will result in the reduction of future revenue requirements to 'refund' all or part of the funding. Entity W commenced work on the project in March 20X4 and expects to achieve the target reduction within the allocated time frame. During 20X4, Entity W incurred costs on the project of CU250,000, which have been recognised as expenses (as research costs) in the period.
2. During 20X3, the rate regulator approved plans for Entity W to build a new water treatment plant to expand its capacity to process waste water. The expansion is required because the local government plans to build a new town within the jurisdiction to deal with an expected population increase related to the development of new industrial and business parks. The rate regulator has allocated CU8m per annum for two years to the revenue requirement, starting in 20X4, to help fund the construction, which commenced in March 20X4 and is expected to be completed during 20X5.

Additional note:
During 20X4, there was major unexpected flooding in the jurisdiction. As a result, Entity W incurred additional clean-up (water treatment costs) of CU0.5m and additional repairs and maintenance costs of CU1.5m. The rate regulator has confirmed that these additional costs will be included in the calculation of the revenue requirement for 20X6.

[6] In this Staff Paper, currency amounts are denominated in 'currency units' (CU).

Appendix 2: Extract from the *Summary of the 4 March 2015 meeting of the IASB's Consultative Group for Rate Regulation*

What is performance?

17. Ms Pike explained that a number of respondents to the Discussion Paper suggested that the principles of IFRS 15 might be used as a starting point to develop an accounting model to account for rate-regulated activities. AP 4 outlines some of the issues that would need to be addressed if the principles of IFRS 15 were to be used in such a model, including the nature of the entity's obligations to perform different activities, whether those activities transfer goods or services to customers and the identity of 'the customer'. In particular, members emphasised the need to focus on the three-way relationship between the entity, the rate regulator and the recipients of the rate-regulated goods or services.

18. Although IFRS 15 focuses on the relationship between the entity and the recipients of the goods and services, it was noted that there is no explicit barrier to considering the three-way relationship. The more problematic issue is that IFRS 15 focuses on exchange transactions in which performance obligations are satisfied through the transfer of goods or services. Rate regulation typically identifies a revenue requirement that provides the entity with consideration for performing a variety of activities, not all of which relate directly to the transfer of goods and services to customers.

19. Many members suggested that the strongest evidence of what activities should lead to revenue recognition is the agreement with the rate regulator. Although the rate regulator does not typically pay for the activities performed, the customers who receive the rate-regulated goods or services are aware that the rate regulator will establish the rates and the terms and conditions to which the customers and the entity are bound. Paragraph 24 of IFRS 15 acknowledges that performance obligations are not limited to explicit promises in the contract. Instead, performance obligations may include implicit contractual terms, which members suggest include the requirements established by the rate regulation.

20. Members suggested that for many rate-regulated entities, performance not only involves the delivery of goods or services; performance also requires the entity to stand ready to deliver goods or services when the customer requires them. In other words, the revenue-generating performance could be viewed as the

carrying out of all the activities necessary to provide continuous access to the service, which involves the activities needed to maintain the infrastructure, as well as the delivery of the service itself.

21. IASB member Mary Tokar noted that the comments made by members on this issue suggested that a possible approach would be to look at the rate regulation as the 'customer contract' and determine performance on the basis of the wider activities that form the basis of the 'revenue requirement'. The relationship with the individual customers would then be regarded merely as the mechanism for collecting cash, instead of being used to determine when revenue should be recognised. Ms Tokar observed that this approach could lead to a different result than the traditional 'cost deferral' view adopted for the recognition of many regulatory deferral account balances in accordance with IFRS 14 or other GAAPs.

22. Members responded that any financial reporting outcome would still need to link revenue recognition to performance that has taken place in the past, ie by the reporting date. Some members noted that, in some cases, the regulated rate currently being charged to customers includes an amount that is being collected to pre-fund specified future activities. For regulatory purposes, this would be treated as deferred revenue and would be recognised as a regulatory liability until the specified activities are carried out.

23. This led to further discussion around how to define performance within the context of the overall obligations of the entity, as established by the terms and conditions of the regulatory agreement. This, members suggested, would need to involve a determination about how much to aggregate or disaggregate those obligations, to identify the timing of the recognition of revenue. For example, should performance:

    (a) include only the physical delivery of goods or services to customers; or

    (b) should it also include the performance of activities that satisfy the stand-ready obligation to maintain the network. so that customers always have access to the service on demand; or

    (c) should it also include the activities required to enhance and 'future-proof' the network to ensure the continuing access to, and availability of, the service?

24. One member noted the importance of paragraph 25 of IFRS 15, which highlights that performance obligations do not include activities that an entity must undertake to fulfil a contract unless those activities transfer a good or service to a customer. In many cases, the requirements of the rate regulation and the calculation of the revenue requirement make the boundary unclear between the activities that deliver goods and services, and those that the entity must undertake to support its ability to deliver goods and services unclear. The same member suggested that identifying this boundary will be challenging, but it would be critical to the project if a model is developed based on the principles of IFRS 15.

25. Another member suggested looking at the rights and obligations of the entity at the expiry or termination of the regulatory period. The terms of any balancing or compensatory payments may help to identify what the regulator considers to be performance, for which the entity is entitled to consideration.

Appendix 3: Preliminary findings of our further research—difficulties in applying IFRS 15 to the regulatory agreement

A2. As noted in paragraph 15 of this paper, our preliminary analysis has identified that some of the definitions contained within IFRS 15, which are essential to the application of the revenue recognition requirements in the Standard, do not lend themselves to be applied to the rights and obligations created by the regulatory agreement. This Appendix outlines some of the difficulties in applying IFRS 15 to the regulatory agreement that have been identified to date.

A3. Section 4 and Appendix B of the Discussion Paper provide information about how the rate-setting mechanism establishes the 'revenue requirement', that is, the total consideration to which the entity is entitled in exchange for carrying out the specified rate-regulated activities. The Discussion Paper demonstrates that the regulatory agreement establishes the entity's obligations to carry out a variety of activities and establishes the amount of consideration that the entity is entitled to receive in exchange for satisfying those obligations. The regulatory agreement also establishes the timing of the entity's right to bill customers for that consideration, which is the reflected in the terms and conditions of the individual contracts.

A4. In the absence of specific guidance for rate-regulated activities, most rate-regulated entities do not recognise regulatory deferral account balances, in accordance with the predominant practice that has developed in IFRS financial statements.[7] Instead, existing Standards are applied, without modification for the effects of the regulatory agreement. This has resulted in revenue from customers being recognised based on the timing of the entity's right to bill customers, in accordance with the individual contracts with customers.

A5. The responses to the Discussion Paper suggest that this predominant practice may not provide the most appropriately faithful presentation of an entity's rights and obligations, because of the interaction of the regulatory agreement and the individual contracts with customers. During the discussions with the

[7] This predominant practice is applied by most entities that adopted IFRS before the issue of IFRS 14 *Regulatory Deferral Accounts* in January 2014. Entities that adopt IFRS after this time may, subject to specified conditions, be able to apply IFRS 14 to retain their previous accounting policies that result in the recognition of regulatory balances.

Consultative Group in March 2015, many members suggested that the strongest evidence of what activities should lead to revenue recognition, or modifications to the timing of revenue recognition, is the agreement with the rate regulator.

A6. However, during the discussions with the Consultative Group and our subsequent research, we have identified several difficulties in trying to use IFRS 15 to reflect the entity's rights and obligations created by the regulatory agreement. In particular, we have identified that several of the definitions contained in IFRS 15, which are essential to the application of the revenue recognition requirements in the Standard, do not seem to lend themselves to be applied to the rights and obligations created by the regulatory agreement. For example:

(a) IFRS 15 defines a customer as a 'party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration'. Some stakeholders suggest that the rate regulation is, in effect, a contract between the entity and the rate regulator and that the rate regulator can be viewed as a customer for the purpose of applying IFRS 15. However, it is unlikely that the rate regulator can be classed as a customer, because the rate regulator rarely pays consideration to the entity in exchange for the regulated activities performed. Instead, the rate regulation creates a form of tripartite arrangement in which the customers are required to provide the consideration.

(b) IFRS 15 defines performance obligations as 'promises in the contract to transfer distinct goods or services to the customer'. The rate regulation requires the entity to perform a variety of activities in exchange for consideration, but not all of these result in the transfer of distinct goods or services to customers or the rate regulator. We need to consider whether we should define performance obligations in a different way from IFRS 15 to identify how to allocate the consideration receivable for the different activities. We also need to consider, when recognising amounts as 'revenue' or 'other income', whether to distinguish between amounts that relate to transfers of goods and services and those that relate to other types of activities.

A7. In addition, IFRS 15 requires revenue to be recognised when or as the entity satisfies a performance obligation by transferring distinct goods or services to customers. As noted above, we have a challenge in determining how to define a performance obligation within the context of defined rate regulation. If we decide to allocate part of the consideration receivable from customers to the wider activities that do not directly result in a transfer to customers, we will need to establish criteria for identifying when performance occurs and, if it occurs over time, how to measure the stage of completion.

Conclusion

A8. As noted in paragraph 11 of this paper, the strongest support from respondents to the Discussion Paper is for an approach that would be based on IFRS 15. However, the difficulties outlined in this Appendix suggest that trying to make amendments to the existing requirements of IFRS 15 so that they lend themselves more readily to accounting for the rights and obligations contained in the regulatory agreement will be problematic. Consequently, we think that it will be more effective to look to develop an accounting model for rate-regulated activities that is specifically tailored to the rights and obligations contained in the regulatory agreement.