STAFF PAPER

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Accounting Standards Advisory Forum

Project	**Rate-regulated Activities**		
Paper topic	Cover note		
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Introduction

1. In its May 2015 meeting, the IASB considered the following papers, which were numbered 9A and 9B for the IASB meeting but have been renumbered as papers 8A and 8B for this ASAF meeting:
   (a) Agenda Paper 9A/8A *Project status and next steps*; and
   (b) Agenda Paper 9B/8B *Developing a revenue approach*.

2. The agenda papers are provided to the Accounting Standards Advisory Forum (ASAF) members for background information. The questions related to the advice that we are seeking from members of the ASAF are contained in this cover note.

The tripartite relationships

3. During its consideration of the Agenda Papers 9A/8A and 9B/8B, the IASB discussed implications of the tripartite relationships highlighted in the papers between:
   (a) the rate-regulated entity and its customers;
   (b) the rate-regulated entity and the rate regulator; and
   (c) the rate regulator and the rate-regulated entity’s customers.

4. The IASB noted that existing predominant practice in IFRS financial statements deals with the first of these relationships. Thus, when applying existing

Standards, an entity would use the terms and conditions in the individual contracts between the entity and its customers, which includes the regulated rate. For example, existing Standards containing requirements for revenue recognition would result in an entity recognising revenue for the goods and services provided to customers using the regulated rate.

5. The IASB tentatively decided that it should undertake standard-setting activity to address the other two relationships, but that the form of that standard-setting activity would become apparent as the project progresses. All IASB members agreed that development of a second Discussion Paper would be the fastest way to progress the project.

6. In this meeting of the ASAF, we would like to explore further the tripartite relationships. In particular, we would like to focus on the illustrative example contained in Appendix 1 of Agenda Paper 9B/8B, which is reproduced in this cover note for convenience. The example shows how the rate regulator's relationship with the entity's customers, both present and future, is reflected in the calculation of the entity's revenue requirement for the year. It shows that the amounts billable to customers do not merely reflect the value of goods or services delivered to customers during the period. Instead, the revenue requirement includes amounts for other activities, some of which are to be carried out in future periods.

Background

7. In February 2015, the IASB considered the responses received to the Discussion Paper *Reporting the Financial Effects of Rate Regulation*, which was published in September 2014.[1] The deadline for comments was 15 January 2015. The Discussion Paper and the summary of responses can be downloaded from the project page on the IASB website at http://go.ifrs.org/Rate-regulation.

8. In its May 2015 meeting, the IASB considered the agenda papers referred to in paragraph 1. The papers highlight that there was strong support from respondents

[1] The summary of responses was presented in Agenda Paper 9 *Initial analysis of responses to the Discussion Paper*, February 2015.

to the Discussion Paper for developing specific accounting requirements that will lead to the recognition of at least some regulatory deferral account balances in IFRS financial statements.

9. Most of those who support recognition consider that, on the basis of the description of the combination of rights and obligations created by defined rate regulation, there are at least some regulatory deferral account balances that do meet the definitions of assets and liabilities in the *Conceptual Framework*. Some consider that they meet the existing definitions but others suggest that the changed definitions that have been proposed in the *Conceptual Framework* project will need to be confirmed to support this view.

10. The strongest support expressed by respondents to the Discussion Paper was for an approach that would result in the development of specific accounting requirements that would modify existing Standards to recognise regulatory deferral account balances as assets and liabilities by changing the timing of recognition of revenue or a combination of costs and revenue. The strongest support from respondents was for an approach that is based on IFRS 15 *Revenue from Contracts with Customers*.

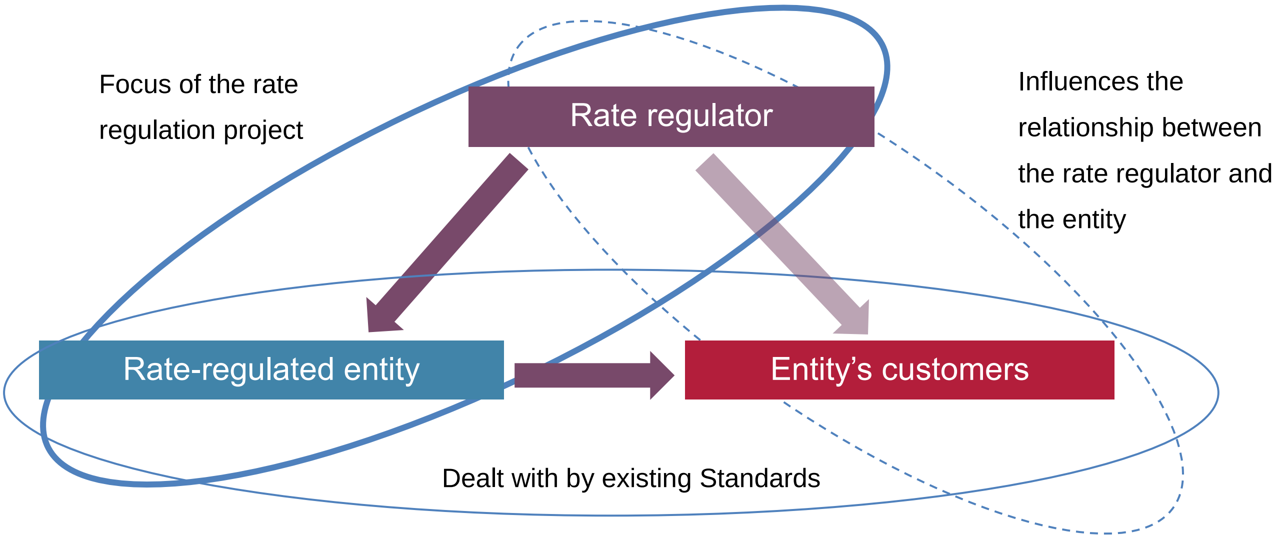
11. Agenda Paper 9B/8B sets out the reasons for the staff's recommendation to progress the research and development of a 'revenue-approach' model for rate-regulated activities separately from the requirements of IFRS 15. The paper notes that our preliminary analysis has identified that some of the definitions 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.

12. Identifying the performance obligations and identifying when they are satisfied by the transfer of distinct goods and services is fundamental to the timing of the 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 of Agenda Paper 9B/8B outlines some of the difficulties identified to date in applying IFRS 15 to the regulatory agreement.

The tripartite relationships

13. As noted in paragraphs 3—4, a major issue that we have to deal with is that there is a tripartite relationship between the rate-regulated entity and its customers, the entity and the rate regulator, and the rate regulator and the entity's customers. These relationships are inter-dependent.



14. IFRS 15 focuses on the relationship that is formalised in the contracts between the entity and its customers. The contracts identify what goods and services the entity delivers to its customers. The contracts also identify the rate that the entity can use to charge its customers for the goods and services that are delivered. However, the rate that is used to charge customers does not merely reflect the value of the goods and services delivered in the period. The rate reflects the amount of the 'revenue requirement', which is determined by the rate regulator. The revenue requirement is made up of a variety of items, not all of which relate directly to the delivery of the goods and services to customers during the period. The interaction between the rate regulator and the rate used in the contracts between the entity and its customers was not envisaged when IFRS 15 was developed.

15. In defined rate regulation, the regulatory agreement between the entity and the rate regulator obliges the entity to carry out specified activities in exchange for the right to receive a determinable amount of consideration. The revenue requirement reflects the determinable amount of consideration to which the entity is entitled. The amount of consideration includes both a right to recover specified costs plus a right to make a return on the entity's investments in the assets used to provide the regulated goods or services. The regulatory agreement will include a formula for the calculation of the revenue requirement.

16. Although the right to consideration is created by the regulatory agreement, it is not the rate regulator that is obliged to pay it. Instead, the rate regulator takes into account his or her relationship with the entity's customers when determining both the amount of consideration and its timing. For this purpose, the rate regulator considers not just the existing customers but also how the total population of customers is likely to change over time. The rate regulator's consideration of this population of customers is then reflected in both the regulatory agreement and, through the regulated rate, the entity's contracts with its customers.

Questions for the ASAF

17. The illustrative example from Appendix 1 of Agenda Paper 9B/8B is reproduced in the following paragraphs. We would like members of the ASAF to consider the fact pattern, together with some additional assumptions outlined in paragraphs 21—26. At this stage, we are looking for initial views and suggestions for addressing the timing of recognition of costs and revenue in the financial statements. These initial suggestions will help provide direction to the IASB staff for developing an accounting model to provide users of financial statements with more relevant information about the effects of the relationship between the entity and the rate regulator.

18. The illustrative example highlights three items for which the revenue requirement has been, or will be, adjusted to reflect activities of the entity that do not directly relate to the delivery of units of water during the period. Each of the three items highlight a mismatch in the timing of recognition in profit or loss between the

revenue billed to customers and the related costs being incurred. The three items are:

(a) funding of research activities;

(b) funding of construction of the entity's own assets; and

(c) repair of the entity's own assets.

19. We seek the ASAF members' views about whether, for each of the three items, the financial effects of the rate regulator's relationship with the entity may be better reflected in IFRS financial statements by adjusting the timing of recognition of revenue, costs or a combination of revenue and costs. ASAF members are not restricted to addressing the specific questions below but are encouraged to consider whether any additional adjustments may be useful in providing relevant information to users of financial statements.

Questions for the ASAF

Questions to consider include:

Flood damage costs—should Entity W:

(a) defer the recognition of the costs until it recovers the amount through bills to customers in 20X6, which is recognised as revenue in 20X6?

(b) recognise its right to recover the amount expensed through profit or loss in 20X4 through bills to customers in 20X6 by recognising income during 20X4? If so, should this income be described as 'revenue' or some other form of income?

(c) make no adjustment to the existing predominant practice, which is to recognise the CU2 million costs in profit or loss in 20X4 and recognise the related amounts billed to customers in 20X6 as revenue in 20X6?

Research costs—should Entity W:

(a) defer the recognition of revenue/income equal to the CU1.25 million shortfall in the CU1.5 million funding included in the 20X4 revenue requirement compared to CU250,000 research expenditure expensed in the 20X4 profit or loss until Entity W carries out the pre-funded activities?

(b) recognise an expense to create a provision for CU1.25 million shortfall in the research costs that it is expected to incur to match the funding provided through the revenue requirement in 20X4?

(c) make no adjustment to the existing predominant practice, which is to recognise the CU1.5 million billed as revenue in profit or loss in 20X4 and recognise the CU250,000 research costs incurred as an expense in 20X4?

Construction costs—should Entity W:

(a) defer the recognition of revenue/income equal to the CU3.5 million (CU8 million-4.5 million) shortfall in the amount of funding included in the revenue requirement compared to the actual construction costs incurred until Entity W carries out the future construction activities?

(b) defer the recognition of the whole of the CU8 million funding received from customers during 20X4 until Entity W completes the construction of the new water plant and brings it in to use to provide water services to customers?

(c) make no adjustment to the existing predominant practice, which is to capitalise the CU4.5 million costs in property, plant and equipment in 20X4 and recognise the CU8 million included in bills to customers as revenue in 20X4?

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:

		CU'000[2]	**CU'000**
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 CU1.5 million 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 CU8 million 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 CU 500,000 and additional repairs and maintenance costs of CU1.5 million. The rate regulator has confirmed that these additional costs will be included in the calculation of the revenue requirement for 20X6.

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

Additional information/assumptions

20. In addition to the information provided in the illustrative example, please use the additional information and assumptions contained in the following paragraphs in your analysis.

21. The actual results for the 20X4 year are all in line with the estimates used in determining the revenue requirement, except as noted in the illustrative example. The entity delivered 500,000 units to customers during 20X4, which is in line with the estimate used by the rate regulator in calculating the price per unit. The comparison between the estimated and actual amounts is summarised in the following table.

Comparison of actual vs estimated amounts	**Estimate CU'000**	**Actual CU'000**
Regulatory depreciation of the regulatory asset base (RAB)	50,000	50,000
Fixed costs:	24,000	24,000
Variable costs:	12,000	12,000
Exceptional flood damage	0	2,000
Research into environmentally-friendly water treatment processes	1,500	250
Construction of new water treatment plant	8,000	4,500
Total costs	**95,500**	**92,750**
Allowable rate of return on the RAB	4,000	4,000
Reconciling balance	0	2,750
Revenue billable/billed to customers (500,000 units x CU0.199)	**99,500**	**99,500**

22. In accordance with the existing predominant practice in IFRS, the revenue for the period recognised in Entity W's financial statements is calculated using the quantity of units of water delivered to customers during the period (500,000 units) multiplied by the regulated rate per unit (CU0.199); that is the amounts billable to customers in accordance with the contracts between the entity and its customers (CU95.5 million).

23. The CU2.75 million reconciling balance between the estimated and actual amounts is made up as follows:

Reconciling balance	**CU'000**
Exceptional flood damage costs incurred	(2,000)
Difference between actual expenditure incurred on research into environmentally-friendly water treatment processes compared to the funding included in the revenue requirement	1,250
Difference between actual expenditure incurred on construction of new water treatment plant compared to the funding included in the revenue requirement	3,500
Reconciling balance	**2,750**

24. The regulatory agreement includes a clause that confirms that Entity W will be able to recover, through future revenue requirements, all costs that are reasonably incurred in repairing unavoidable damage to the network, such as that caused by the unexpected flooding during 20X4. The CU2 million flood damage costs incurred during 20X4 were expensed in full in profit or loss because they related fully to clean-up and repair costs, with no enhancement of the network.

25. As noted in Note 1 to the illustrative example, Entity W incurred research costs of CU250,000 for which it has received funding of CU1.5 million during the year. The CU250,000 was recognised as an expense in profit or loss in accordance with IAS 38 *Intangible Assets*. Entity W expects to incur further costs of CU4.25 million during 20X5 and 20X6, which equals the total amount of funding to be provided through the revenue requirement (3 x CU1.5 million). At this time, the criteria for capitalising the expenditure as development costs have not been met

26. As noted in Note 2 to the illustrative example, the revenue requirement for 20X4 includes an amount of CU8 million and will include a further CU8 million in 20X5 (CU16 million in total) to help fund the construction of a new water treatment plant to expand the capacity of the network. Construction commenced in March 20X4 and is expected to be completed during 20X5. Entity W incurred construction costs of CU4.5 million during 20X4, which have been capitalised in accordance with IAS 16 *Property, Plant and Equipment*. Entity W expects to spend a further CU16.5 million during 20X5 (CU21 million in total), which will again be capitalised in accordance with IAS 16. The CU5 million shortfall in funding (total expenditure of CU21 million compared to the CU8 million funding in each of 20X4 and 20X5) will be added to the RAB. The rate regulator has confirmed that this will be recovered through the regulatory depreciation commencing in 20X6, together with the allowed rate of return.