STAFF PAPER

July 2015

IASB Meeting

Project	**Rate-regulated Activities**
Paper topic	Revenue requirement—illustrative example

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Introduction

1. During its consideration in May 2015 of the Agenda Papers 9A *Project status and next steps* and 9B *Developing a revenue approach*, 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.

2. 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 include 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.

3. 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.

4. In this meeting, we would like to explore further the tripartite relationships. In particular, we would like to focus on the illustrative example contained in Appendix 1. 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, and billed, 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.

5. We have set out some specific questions for the IASB in paragraph 19. IASB members are not restricted to addressing the specific questions but are encouraged to consider whether any additional adjustments may be useful in providing relevant information to users of financial statements. At this stage, we are looking for general direction from the IASB to help us to develop possible models to explore through the Discussion Paper.

6. In Appendix 2, we have provided some analysis of the issues arising in the illustrative example. We do not provide staff recommendations about how to answer the questions in paragraph 19. We will be discussing the same example with the Accounting Standards Advisory Forum (ASAF) a few days before the IASB meeting. We do not wish to pre-empt any views expressed by the ASAF members. We will give the IASB an oral update on the outcome of the ASAF discussion at the start of the IASB session in which we discuss this paper.

7. We plan to bring further papers the IASB, which will start to develop possible models that will reflect the general direction provided in the July meetings of the ASAF and IASB. The papers will include a comparison of the possible models with existing IFRS requirements and the *Conceptual Framework*. Subsequently, we will ask the IASB to express preferences for any particular model on the basis of that analysis.

Background

8. 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.

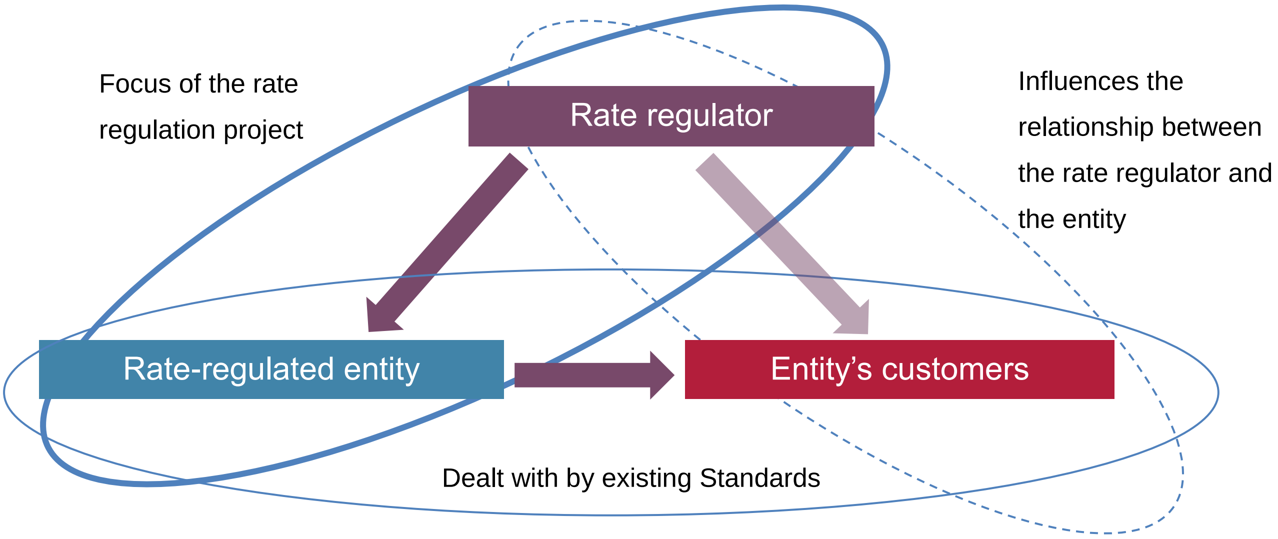
9. The strongest support expressed by respondents to the Discussion Paper was for an approach that is based on IFRS 15 *Revenue from Contracts with Customers*. The May 2015 Agenda Paper 9B sets out the reasons for the staff's recommendation to progress the development of a 'revenue-approach' model for 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 being applied to the rights and obligations created by the regulatory agreement. These include the definitions of customer and performance obligation.

10. 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. As demonstrated in the illustrative example that is the focus of this paper, 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 the May 2015 Agenda Paper 9B outlines some of the difficulties identified to date in applying IFRS 15 to the regulatory agreement.

The tripartite relationships

11. As noted in paragraphs 1—2, 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 interdependent.

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



12. 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.

13. 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.

14. Although the right to consideration is created by the regulatory agreement, it is not the rate regulator that is obliged to pay the consideration to the entity. 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.

15. We are not suggesting that we need an accounting model for the relationship between the rate regulator and the entity's customers. This relationship influences the rate regulator's decisions about how to structure the regulatory agreement with the entity but does not, of itself, create any rights or obligations for which an accounting model is needed. In the illustrative example, when the rate regulator confirms that the CU2 million costs incurred to repair the flood damage in 20X4 will be recovered through bills to customers in 20X6, the rate regulator will have considered the ability of customers to pay the amount in 20X6.

16. In this paper, we are trying to identify what accounting model would best reflect the relationship between the rate regulator and the entity. As noted earlier, the definitions and specific requirements of IFRS 15 are focused on the relationship between the entity and its customers. We are looking to develop a model that is based on the principles of IFRS 15 but which reflects the effects of the rate regulator's relationship with the entity on the contract between the entity and its customers. In particular, we are looking to identify how the relationship between the rate regulator and the entity affects the rate charged to customers in such a way that rate does not faithfully reflect the value of the goods or services transferred to customers during the reporting period.

Questions for the IASB

17. An illustrative example is set out in the Appendix in the following paragraphs. We would like the IASB to consider the fact pattern, together with some additional assumptions outlined in paragraphs 20–27. 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 to customers 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) repair of the entity's own assets;
    (b) funding of research activities; and
    (c) funding of construction of the entity's own assets.

19. We seek the IASB members' views on 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. IASB 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. At this stage, we are looking for general direction from the IASB to help us to develop possible models to explore through the Discussion Paper. We plan to bring further papers to the IASB, which will analyse the possible models within the context of existing IFRS requirements and the *Conceptual Framework*. We will ask the IASB to express preferences for any particular model on the basis of that analysis.

Questions for the IASB

Questions to consider include:

Flood damage costs—should Entity W:

(a) defer the recognition of the CU2 million costs incurred until it recovers the amount through bills to customers in 20X6, which is recognised as revenue in 20X6?

(b) recognise the CU2 million costs incurred as an expense in 20X4 and also recognise CU2 million income in 20X4 in order to recognise Entity W's right to recover this amount through bills to customers in 20X6? 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 between the CU1.5 million funding billed to customers and recognised as revenue in 20X4 compared to the CU250,000 research expenditure that was recognised as an expense 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 shortfall between the CU8 million funding billed to customers and recognised as revenue in 20X4 compared to the actual construction costs of CU4.5 million incurred until Entity W carries out the future construction activities?

(b) defer the recognition of the whole of the CU8 million funding billed to customers and recognised as revenue in 20X4 until Entity W completes the construction of the new water plant and brings it into use to provide water services to customers? If yes, over what period should this income be recognised in profit or loss; immediately or over the useful economic life of the asset?

(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?

Appendix 1: 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
Estimated volume of water to be transferred to customers	500,000 units	
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 CU500,000 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. For simplicity, please ignore the time value of money.

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**
Volume of water to be transferred to customers (Units)	500,000	500,000

22. In accordance with the existing predominant practice in IFRS, the revenue for the period recognised in Entity W's financial statements is the total amount that is billable to customers in accordance with the contracts between the entity and its customers (CU95.5 million). This amount 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).

23. The CU2.75 million reconciling balance between the estimated and actual cost 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
Costs recovered from customers during the period but not yet incurred	**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 recognised as expenses 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 will bill customers CU1.5 million per annum for three years, starting in 20X4, in order to fund a research project. Failure to meet the rate regulator's required target for the results of the project by the end of 20X6 will result in the reduction of future revenue requirements to 'refund' all or part of the funding. In setting the funding level, the rate regulator has assessed available technical and market evidence and determined that the required target is achievable within the estimated cost being funded through the revenue requirement.

26. 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, but is not committed, 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 × CU1.5 million). At this time, the criteria for capitalising the expenditure as development costs have not been met.

27. 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.

Appendix 2: Comments on possible accounting approaches

28. The illustrative example highlights three items for which the amounts billed to customers do not directly relate to the transfer of distinct goods or services to customers during the period. The three items are:
    (a) repair of the entity's own assets
    (b) funding of research activities; and
    (c) funding of construction of the entity's own assets.

29. For each of the three items, the questions for the IASB in paragraph 19 provide three options:
    (a) accelerate or defer revenue/income;
    (b) accelerate or defer related costs; or
    (c) make no adjustment to the existing predominant existing IFRS practice.

30. Using the existing predominant IFRS practice, Entity w recognises revenue based on the contracts with customers, which reflects the volume of units of water that are passed through the customers' meters and the regulated rate per unit charged by the entity. In accordance with this treatment, entity W recognises revenue of CU99.5 million for the year 20X4. In addition, Entity W has recognised all costs incurred in profit or loss, except for the construction costs of CU4.5 million during 20X4, which have been capitalised in accordance with IAS 16 *Property, Plant and Equipment*.

Repair of the entity's own assets

31. This is perhaps the most straightforward of the items being discussed, because there is a linear relationship between the costs incurred and the amounts billed to customers through the revenue requirement.

32. The fact pattern notes that the regulatory agreement includes a clause that confirms that Entity W has the right 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. In addition, the rate regulator has confirmed that these additional costs will be included in the calculation of the revenue requirement for 20X6.

Questions for the IASB

Questions to consider include:

Flood damage costs—should Entity W:

(a) defer the recognition of the CU2 million costs incurred until it recovers the amount through bills to customers in 20X6, which is recognised as revenue in 20X6?

(b) recognise the CU2 million costs incurred as an expense in 20X4 and also recognise CU2 million income in 20X4 in order to recognise Entity W's right to recover this amount through bills to customers in 20X6? 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?

Existing accounting

33. Retaining the existing predominant practice used in IFRS financial statements results in the recognition the repair cost of CU2 million in 20X4. Entity W would not recognise the additional CU2 million revenue until it is included in the revenue requirement and billed to customers in 20X6. In 20X4, Entity W makes the following journal entries:

DR Repair costs (profit or loss (P+L))	CU2 million	
CR Payables/cash		CU2 million

To recognise the flood damage repair costs when incurred.

34. In 20X6, Entity W makes the following journal entries:

DR Receivables/cash	CU2 million	
CR Revenue from customers (P+L)		CU2 million

The CU2 million is included in the total amount billed to customers and recognised as revenue in 20X6.

35. Those who do not support making adjustments to these entries, which are the same as the entries that would be made in the absence of the rate regulation, argue that the need to repair the flood damage is a normal part of the entity's activities. In the absence of the rate regulation, Entity W would still incur the same costs in order to continue to supply water to its customers. The entity would then look to increase its selling price to recover the costs in due course.

36. Those who support making adjustments to reflect the effects of the rate regulator's relationship with the entity argue that the CU99.5 million billed and recognised as revenue in 20X4 does not faithfully represent the performance of the entity during the year. In this case, they argue that Entity W has not merely satisfied its performance obligation to transfer 500,000 units of water to customers in exchange for consideration of CU99.5 million. They argue that Entity W has satisfied an additional 'performance obligation' that is contained in the regulatory agreement; it has carried out the work necessary to fulfil its regulatory obligation to minimise disruption to services by quickly repairing the damage caused by the flood. As a result, Entity W has a right to receive additional consideration of CU2 million. This is a present right, created as a result of the work completed during the year.

37. Many argue that this CU2 million should be recognised as an asset in the statement of financial position of Entity W, because it meets the definition of an asset in the *Conceptual Framework*, ie it is a present economic resource controlled by the entity as a result of past events. If this is accepted, the question then becomes what type of asset it is and what is the corresponding entry in the accounts.

38. Many argue that it has characteristics of a financial asset, although most accept that it does not meet the strict definition of a financial asset in paragraph 11 of IAS 32 *Financial Instruments: Presentation*. It is clearly not cash, or an equity instrument or a contract that will or may be settled in the entity's own equity instruments. It is not yet a contractual right between the entity and the customer, because the entity will not be able to bill the customer until 20X6 and the customer has no obligation to pay until it has been billed.

39. It is a right that arises because of the regulatory agreement between the entity and the rate regulator. Some may argue that this creates a contractual right to receive cash and, therefore meets the financial asset definition in paragraph 11(c)(i) of IAS 32. Others suggest that it does not meet the definition in IAS 32 because it is not a right to receive cash now. Instead, it is a 'regulatory right' to receive cash in the future. Until it becomes billable, it is not a financial asset.

40. If Entity W's right to bill customers CU2 million to recover the costs it has incurred in carrying out its regulatory obligation to restore services by repairing the flood damage is recognised as a 'regulatory asset', then we need to consider the other side of the double entry. The question in paragraph 32 asks whether this should be a credit to income (either as 'revenue' or given another name) or to expenses.

41. If the credit is to expenses, this has the effect of negating the costs of the flood during the year 20X4 and so there would be no amount recognised in profit or loss to reflect that the flood had happened. Instead, the cost of repairing the flood damage will be recognised in profit or loss in 20X6, when the regulatory asset is recovered through the increased rate billed to customers. Assuming that Entity W initially makes the journal entries in paragraph 33, Entity W would make the following additional journal entries:

In 20X4:

DR Regulatory asset		CU2 million	
	CR Repair costs (P+L)		CU2 million

To defer the recognition of the repair costs and recognise the regulatory asset.

In 20X6:

DR Repair costs (P+L)		CU2 million	
	CR Regulatory asset		CU2 million

To recognise the repair costs in the same period that the regulatory asset is recovered through the amounts billed to customers.

42. Alternatively, if the credit is to income, the flood damage expense will remain in profit or loss in 20X4. This, some argue, provides a more faithfully representative picture of the events and activities of the year. Others argue that 'grossing up' both income and expense is unhelpful and eliminating the cost is preferable.

43. Assuming that Entity W initially makes the journal entries in paragraph 33, Entity W would make the following additional journal entries:

In 20X4:

DR Regulatory asset		CU2 million	
	CR Revenue OR 'regulatory adjustment' (P+L)		CU2 million

To recognise the additional consideration that Entity W has a right to *receive in exchange for repairing the storm damage.*

In 20X6:

DR Revenue OR 'regulatory adjustment' (P+L) CU2 million

CR Regulatory asset CU2 million

To recognise that the regulatory asset that is recovered through the amounts billed to customers in 20X6 relates to the consideration already recognised in 20X4, when the repair work was performed.

44. If the credit is to 'income' in profit or loss, there is a question about whether the adjustment should be to the 'top line' revenue number, or to another income line. Some argue that the adjustment should be to a separate line, because the top line revenue amount should be the amount billed/billable to customers in accordance with IFRS 15. In this case, the repair of the flood damage does not transfer goods or services directly to the customers, as required in the definition of a performance obligation in IFRS 15.

Funding of research activities

45. Through the revenue requirement, the rate regulator has established a schedule of cash collection for Entity W to fund research work to reduce the environmental impact of the chemicals that it uses in its water treatment plant. The rate regulation does not specify what costs the entity must incur and when those costs should be incurred. Instead, the rate 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.

Questions for the IASB

Questions to consider include:

Research costs—should Entity W:

(a) defer the recognition of revenue/income equal to the CU1.25 million shortfall between the CU1.5 million funding billed to customers and recognised as revenue in 20X4 compared to the CU250,000 research expenditure that was recognised as an expense 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?

Existing accounting

46. Retaining the existing predominant practice used in IFRS financial statements results in the recognition of the CU0.25 million research costs incurred in 20X4 as an expense. Entity W recognises the CU1.5 million funding, which is billed to customers, as revenue in 20X4. As a result, Entity W makes the following journal entries:

DR Research expense (profit or loss (P+L))	CU0.25 million	
CR Payables/cash		CU0.25 million

To recognise the research costs when incurred.

DR Receivables/cash	CU1.5 million	
CR Revenue from customers (P+L)		CU1.5 million

The CU1.5 million is included in the total amount billed to customers and recognised as revenue in 20X4.

47. Those who do not support making adjustments to these entries, which are the same as the entries that would be made in the absence of the rate regulation, argue that the entity's performance obligation is to transfer water services to the customers. The regulatory obligation to carry out additional research to reduce the environmental impact of carrying out those services could be applied to any type of entity, even in the absence of rate regulation. In such circumstances, the entity would try to recover the cost of its regulatory obligations through rate increases. They argue further that the contractual price that customers have agreed to pay is the regulated rate, and that it is not relevant how the rate is determined. Consequently, it is appropriate to recognise revenue at an amount equal to the regulated rate multiplied by the volume of units of water transferred to the customers.

48. As noted in paragraph 36, those who support making adjustments to reflect the effects of the rate regulator's relationship with the entity argue that the CU99.5 million billed and recognised as revenue in 20X4 does not faithfully represent the performance of the entity during the year. In this case, they argue that Entity W has received consideration of CU1.5 million in exchange for carrying out research work, but that Entity W has not satisfied its performance obligation to the rate regulator to carry out the work.

49. In this case, the research activity does not transfer goods or services directly to the customer and does not, therefore, fit within the definition of a performance obligation in IFRS 15.[3] However, the CU1.25 million does, it is suggested, represent the entity's obligation to perform a future regulated activity for which the entity has already received consideration through the amounts billed to customers during 20X4. If the entity does not perform the future activity, it will not achieve the required target to keep the funding, which will be returned to customers through future rate reductions.

50. Assuming that Entity W initially makes the journal entries in paragraph 46, those who support the deferral of income suggest that the credit balance is similar to a 'contract liability' in IFRS 15. Consequently, they would create a 'regulatory liability' by deferring the recognition of income (whether called revenue or something else) amounting to CU1.25 million. In this case, Entity W would make the following additional journal entries in 20X4:

DR Revenue OR 'regulatory adjustment' (P+L)	CU1.25 million	
CR Regulatory liability		CU1.25 million

To recognise that Entity W has received a prepayment for the research work that it expects to carry out in the future.

51. An alternative adjustment is to increase the amount of the research cost expense recognised in profit or loss from the CU0.25 million cost incurred to a total of CU1.5 million. This would require the creation of a provision for the additional CU1.25 million expected to be incurred in the future. In addition to the making

[3] Appendix A of IFRS 15 defines a contract liability as '[a]n entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer'.

the journal entries in paragraph 46, Entity W would make the following journal entries in 20X4:

DR Research costs (P+L)	CU1.25 million	
CR Provision for future research costs		CU1.25 million

To create a provision for the additional research costs that Entity W expects to incur in the future.

52. The fact pattern in paragraph 26 notes that although Entity W expects to spend the additional CU1.25 million, it is not committed to doing so. This brings into doubt whether a provision should be recognised for the additional expenditure at the end of 20X4. Some argue that there is no unavoidable obligation to spend the additional CU1.25 million.

Funding of construction of the entity's own assets

53. Through the revenue requirement, the rate regulator has established a schedule of cash collection for Entity W to fund the construction of a new water treatment plant. Instead of requiring the entity to seek funding from lenders or investors, the rate regulator has determined, based on his knowledge and assessment of the population of customers and the cost of borrowing, that the entity's customers should provide some funding in advance of construction activity, with some being collected in arrears.

54. As noted in paragraph 27, the total cost of construction is expected to be CU21 million, with CU4.5 million incurred in 20X4 and the remainder to be incurred in 20X5. Entity X has billed CU8 million in 20X4, and will bill a further CU8 million in 20X5. The additional CU5 million will be added to the regulatory asset base (RAB). The depreciation of this amount will then be recovered through the revenue requirement in 20X6 and later years. In addition, Entity W, from 20X6 onwards, will earn a return on the reducing balance within the RAB.

55. This pattern of funding creates a difference between the amount of construction costs being capitalised into the RAB and those capitalised in the IFRS financial statements.

    (a) In the regulatory accounts—the construction costs of CU4.5 million and CU11.5 million (a total of CU16 million) will be recognised as expenses in 20X4 and 20X5 respectively, with CU5 million being capitalised into the RAB in 20X5.

(b) In the IFRS accounts—the construction costs of CU4.5 million and CU16.5 million (a total of CU21 million) will be capitalised into property, plant and equipment in 20X4 and 20X5 respectively, with no costs recognised in profit or loss account, in accordance with IAS 16. The costs will subsequently be recognised through depreciation starting in 20X6.

Questions for the IASB
Questions to consider include: **Construction costs**—should Entity W: (a) defer the recognition of revenue/income equal to the CU3.5 million shortfall between the CU8 million funding billed to customers and recognised as revenue in 20X4 compared to the actual construction costs of CU4.5 million incurred until Entity W carries out the future construction activities? (b) defer the recognition of the whole of the CU8 million funding billed to customers and recognised as revenue in 20X4 until Entity W completes the construction of the new water plant and brings it into use to provide water services to customers? If yes, over what period should this income be recognised in profit or loss; immediately or over the useful economic life of the asset? (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?

Existing accounting

56. Retaining the existing predominant practice used in IFRS financial statements results in the CU4.5 million of construction costs incurred in 20X4 being capitalised as property, plant and equipment. Entity W recognises the CU8 million funding, which is billed to customers, as revenue in 20X4. As a result, Entity W makes the following journal entries in 20X4:

DR Property, plant and equipment	CU4.5 million	
CR Payables/cash		CU4.5 million

To recognise the construction costs as property, plant and equipment when incurred.

DR Receivables/cash CU8 million

CR Revenue from customers (P+L) CU8 million

The CU8 million is included in the total amount billed to customers and recognised as revenue in 20X4.

57. Those who do not support making adjustments to these entries, which are the same as the entries that would be made in the absence of the rate regulation, argue that the entity's performance obligation is to transfer water services to the customers. Entity W could have made the decision to construct an additional water treatment plant to satisfy an anticipated future increase in demand, even in the absence of rate regulation. In such circumstances, the entity would try to recover the cost of its construction as quickly as possible through rate increases. They argue further that the contractual price that customers have agreed to pay is the regulated rate, and that it is not relevant how that the rate is determined. Consequently, it is appropriate to recognise revenue at an amount equal to the regulated rate multiplied by the volume of units of water transferred to the customers.

58. As noted in paragraph 36, those who support making adjustments to reflect the effects of the rate regulator's relationship with the entity argue that the CU99.5 million billed and recognised as revenue in 20X4 does not faithfully represent the performance of the entity during the year.

59. In 20X4, Entity W has again received funding in advance of carrying out the required regulated activity. In the previous example of research activities, some may have supported the view that the recognition of the pre-funded amount as income in profit or loss should be deferred until the entity carries out the research work (and recognises the related cost in profit or loss). In this case, the regulated activity is to construct a water treatment plant, the cost of which is recognised as the entity's own asset in accordance with IAS 16. The cost will subsequently be recognised as an expense in profit or loss through the depreciation charge.

60. This raises an additional issue about how much of the income from amounts billed to customers should be deferred into a later period. If the regulated activity for which the entity is receiving consideration through the revenue requirement is the construction of the water treatment plant, it can be argued that the entity could recognise the CU4.5 million that covers the costs incurred as income in 20X4,

with CU3.5 million deferred until 20X5. This would mean that Entity W would make the following journal entries in 20X4, in addition to those in paragraph 56:

DR Revenue OR 'regulatory adjustment' (P+L)	CU3.5 million	
CR Regulatory liability		CU3.5 million

To recognise that Entity W has received a prepayment for the construction work that it expects to carry out in the future.

61. However, if this is the accepted treatment, then it could also be argued that in 20X5, the entity could (or should) recognise income of CU16.5 million to reflect its completion of the water treatment plant. This would then involve the recognition of a 'regulatory asset' of CU5 million at the end of 20X5 to reflect the fact that only a total of CU16 million has been billed up to the end of 20X5 but the entity has a right to recover the remaining CU5 million. This would lead to the following journal entries in 20X5:

DR Property, plant and equipment	CU16.5 million	
CR Payables/cash		CU16.5 million

To recognise the construction costs as property, plant and equipment when incurred.

DR Receivables/cash	CU8 million	
CR Revenue (P+L)		CU8 million

The CU8 million is included in the total amount of billed to customers and recognised as revenue in 20X5.

DR Regulatory asset	CU5 million	
CR Revenue OR 'regulatory adjustment' (P+L)		CU5 million

To recognise that Entity W has a right to recover the additional CU5 million construction cost that was incurred in 20X5 through future bills to customers.

62. An alternative argument is that the entity should defer the recognition of the full CU8 million funding for the construction of the water treatment plant in 20X4 and defer a further CU8 million in 20X5. The amounts already collected could then be released to profit or loss on a systematic basis starting in 20X6, when the water treatment plant starts to be depreciated in accordance with IAS 16.

63. Supporters of this view argue that the customers are being used as a source of finance by prepaying for future services. The funding received from customers

should, therefore, be treated in the same way as finance obtained from another 'lender'. The customers will recover their funding by paying a lower rate for the water services that they will receive from 20X6 onwards. The lower rate will reflect the fact that the revenue requirement for the years 20X6 onwards will not contain any amount that relates to the CU16 million that has already been recovered in 20X4 and 20X5.

64. This treatment would result in the following journal entries, in addition to those made in paragraph 56:

In 20X4

DR Revenue OR 'regulatory adjustment' (P+L)	CU8 million	
CR Regulatory liability		CU8 million

To recognise that Entity W has received funding for the construction of the additional water treatment plant. This contribution to the cost of construction will be reflected in lower rates, which will be payable by customers to Entity W for the transfer of water services in the future.

In 20X5

DR Receivables/cash	CU8 million	
CR Revenue from customers (P+L)		CU8 million

The CU8 million is included in the total amount billed to customers and recognised as revenue in 20X5.

DR Property, plant and equipment	CU16.5 million	
CR Payables/cash		CU16.5 million

To recognise the construction costs as property, plant and equipment when incurred.

DR Revenue OR 'regulatory adjustment' (P+L)	CU8 million	
CR Regulatory liability		CU8 million

To recognise that Entity W has received funding for the construction of the additional water treatment plant. This contribution to the cost of construction will be reflected in lower rates, which will be payable by customers to Entity W for the transfer of water services in the future.

In 20X6 onwards

DR Depreciation expense (P+L)	CUx million	
CR Property, plant and equipment		CUx million

To recognise the depreciation charge for the year, based on the total cost of construction of CU21 million.

DR Regulatory liability CUx million

CR Revenue OR 'regulatory adjustment' (P+L) CUx million

To recognise that Entity W has billed less for the water services transferred to customers during the year because part of the consideration has been received in 20X4 and 20X5.