STAFF PAPER

July 2015

IASB Meeting

Supplement to illustrate the outcome of the journal entries in Appendix 2 of Agenda Paper 9

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

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Purpose of this paper

1. In response to a request by an IASB member and questions raised at the Accounting Standards Advisory Forum (ASAF) meeting on 17 July 2015, this paper provides a summary of the outcomes of the journal entries contained in Appendix 2 of Agenda Paper 9. This paper highlights the effects of the journal entries in the statement of profit or loss (see paragraphs 9, 10 and 14).

2. In addition to the demonstrating the impact of the journal entries in the year 20X4, which is the only year for which full information is provided in Agenda Paper 9, we think it is more helpful to roll forward the example for the next two years, 20X5 and 20X6. This is because the possible adjustments made in 20X4 to reflect the rate regulator's relationship with the entity will reverse in part or in full during 20X5 and 20X6.

Background

3. Appendix 1 of Agenda Paper 9 sets out a numerical example, which shows how the rate regulator's relationship with the entity and its 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.

4. 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.

5. For each of the three items, the questions for the IASB in paragraph 19 of Agenda Paper 9 provide three options:
   - accelerate or defer revenue/income;
   - accelerate or defer related costs; or
   - make no adjustment to the existing predominant existing IFRS practice.

6. Appendix 2 of Agenda Paper 9 provides some analysis of the illustrative example, which indicates the journal entries that reflect the existing predominant practice. In addition, Appendix 2 indicates the journal entries that could be applied to accelerate or defer revenue/income or costs.

7. To reduce the volume of additional information presented in this paper, we have made the following simplifying assumptions to roll forward the example to 20X5 and 20X6:
   (a) The estimated and actual volume of water transferred to customers in each of 20X5 and 20X6 is the same as in 20X4; that is 500 million units.[1]
   (b) The research and construction costs expected to be incurred in 20X5 and 20X6, as described in paragraph 26 of Agenda Paper 9 are incurred as expected and the rate regulator, in 20X6, confirms that Entity W has achieved the required target to retain the CU4.5 million billed to customers in 20X4 through 20X6.

[1] Appendix 1 of Agenda Paper 9 erroneously notes that Entity W sells 500,000 units at CU0.199 per unit. The correct volume is 500 million units, which results in the amount billed to customers of CU99.5 million.

(c) The estimated costs included in the calculation of the revenue requirement in 20X5 is the same as in 20X4; that is CU95.5 million,. In 20X6, the estimated costs are again as the same as in 20X4 and 20X5, except for the amounts related to the flood damage repair and the construction of the water treatment plant, as specified in this paper.

8. To reduce the volume of information needed to explain the outcomes, this paper looks at each of the three items in isolation. This means that any changes to the revenue requirement or to the actual costs incurred related to items other than one in focus, are not reflected. This allows the full impact of each individual item to be seen, without the effect being diluted by other parts of the fact pattern.

Flood damage repair

9. In 20X4, Entity W incurs repairs cost that are CU2 million higher than the estimate used in the 20X4 revenue requirement calculation. The rate regulator includes the CU2 million in the calculation of the 20X6 revenue requirement. The following tables demonstrate the effects of the three options presented in the question in paragraph 19 of Agenda Paper 9.

Flood damage 20X4

	(c) No adjustment	(a) Adjust costs	(b) Adjust revenue
	CU million	**CU million**	**CU million**
Revenue (billed/billable)	99.50	99.50	99.50
Adjustment	0.00	0.00	2.00
	99.50	**99.50**	**101.50**
Costs (95.5+2)	97.50	97.50	97.50
Adjustment	0.00	(2.00)	0.00
	97.50	**95.50**	**97.50**
Profit	2.00	4.00	4.00

Flood damage20X5

	(c) No adjustment	(a) Adjust costs	(b) Adjust revenue
	CU million	**CU million**	**CU million**
Revenue (billed/billable)	99.50	99.50	99.50
Adjustment	0.00	0.00	0.00
	99.50	**99.50**	**99.50**
Costs	95.50	95.50	95.50
Adjustment	0.00	0.00	0.00
	95.50	**95.50**	**95.50**
Profit	4.00	4.00	4.00

Flood damage 20X6

	(c) No adjustment	(a) Adjust costs	(b) Adjust revenue
	CU million	**CU million**	**CU million**
Revenue (billed/billable) (99.5+2)	101.50	101.50	101.50
Adjustment	0.00	0.00	(2.00)
	101.50	**101.50**	**99.50**
Costs	95.50	95.50	95.50
Adjustment	0.00	2.00	0.00
	95.50	**97.50**	**95.50**
Profit	6.00	4.00	4.00
Total profit for 3 years	**12.00**	**12.00**	**12.00**

Research project

10. In 20X4, Entity W incurred research costs of CU250,000 for which it has received funding of CU1.5 million during the year. Through the revenue requirement, Entity W receives further funding of CU1.5 million in each of 20X5 and 20X6. As expected, Entity W incurs a further CU4.25 millions costs in 20X5 and 20X6, of which CU2.25 million is incurred in 20X5 and the remaining CU2 million in 20X6. The following tables demonstrate the effects of the three options presented in the question in paragraph 19 of Agenda Paper 9.

		Research costs 20X4	
	(c) No adjustment	(b) Adjust costs	(a) Adjust revenue
	CU million	**CU million**	**CU million**
Revenue (billed/billable)	99.50	99.50	99.50
Adjustment	0.00	0.00	(1.25)
	99.50	**99.50**	**98.25**
Costs (95.5-1.25)	94.25	94.25	94.25
Adjustment	0.00	1.25	0.00
	94.25	**95.50**	**94.25**
Profit	5.25	4.00	4.00

		Research costs 20X5	
	(c) No adjustment	(b) Adjust costs	(a) Adjust revenue
	CU million	**CU million**	**CU million**
Revenue (billed/billable)	99.50	99.50	99.50
Adjustment	0.00	0.00	0.75
	99.50	**99.50**	**100.25**
Costs (95.5+0.75)	96.25	96.25	96.25
Adjustment	0.00	(0.75)	0.00
	96.25	**95.50**	**96.25**
Profit	3.25	4.00	4.00

		Research costs 20X6	
	(c) No adjustment	(b) Adjust costs	(a) Adjust revenue
	CU million	**CU million**	**CU million**
Revenue (billed/billable)	99.50	99.50	99.50
Adjustment	0.00	0.00	0.50
	99.50	**99.50**	**100.00**
Costs (95.5+0.5)	96.00	96.00	96.00
Adjustment	0.00	(0.50)	0.00
	96.00	**95.50**	**96.00**
Profit	3.50	4.00	4.00
Total profit for 3 years	**12.00**	**12.00**	**12.00**

Construction work

11. In 20X4, the revenue requirement includes an amount of CU8 million in each of 20X4 and 20X5 (CU16 million in total) to help fund the construction of a new water treatment plant to expand the capacity of the network. Entity W incurred construction costs of CU4.5 million during 20X4, which have been capitalised in accordance with IAS 16 *Property, Plant and Equipment*. Costs incurred provide a reasonable measure of the stage of completion of the construction work.

12. As expected, Entity W spends a further CU16.5 million during 20X5 (CU21 million in total), which is again capitalised in accordance with IAS 16. The rate regulator has confirmed that 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 at the end of 20X5. This CU5 million will be recovered through the regulatory depreciation commencing in 20X6, together with the allowed rate of return. The CU16 million already recognised through the revenue requirement in 20X4 and 20X5 will not be included in the RAB because it has already been recovered from customers.

13. The following additional information demonstrates the effects in 20X6:
    (a) The CU5 million added to the RAB will be depreciated over 12.5 years, which results in a regulatory depreciation charge of CU0.4 million in 20X6.
    (b) The rate regulator includes an additional return of CU0.2 million in the revenue requirement in 20X6, to reflect the additional investment of CU5 million included in the RAB.
    (c) Entity W depreciates the water treatment plant over 12.5 years in accordance with IAS 16, resulting in a depreciation charge of CU1.7 million in profit or loss for 20X6.

14. The following tables demonstrate the effects of the three options presented in the question in paragraph 19 of Agenda Paper 9. For option (a)—adjust revenue underspend, it is assumed that the revenue recognised reflects the value of the construction activity completed during the period. As a result, revenue equal to the CU4.5 million costs incurred in included in revenue, with the recognition of a regulatory liability for the CU3.5 million underspend. If this treatment is applied

in 20X5, it seems logical to conclude that the full CU8.5 million costs incurred to complete the construction should be recognised in revenue. If so, this would result in a regulatory asset of CU5 million, representing the additional construction costs to be recovered in future years through the regulatory depreciation to be included in the revenue requirement from 20X6 onwards.

		Construction 20X4	
	(c) No adjustment	(a) Adjust revenue (underspend)	(b) Adjust revenue (all spend)
	CU million	**CU million**	**CU million**
Revenue (billed/billable)	99.50	99.50	99.50
Adjustment	0.00	(3.50)	(8.00)
	99.50	**96.00**	**91.50**
Costs (95.5-8[2])	87.50	87.50	87.50
Adjustment	0.00	0.00	0.00
	87.50	**87.50**	**87.50**
Profit	12.00	8.50	4.00
		Construction 20X5	
	(c) No adjustment	(a) Adjust revenue (underspend)	(b) Adjust revenue (all spend)
	CU million	**CU million**	**CU million**
Revenue (billed/billable)	99.50	99.50	99.50
Adjustment	0.00	8.50	(8.00)
	99.50	**108.00**	**91.50**
Costs (95.5-8*)	87.50	87.50	87.50
Adjustment	0.00	0.00	0.00
	87.50	**87.50**	**87.50**
Profit	12.00	20.50	4.00
		Construction 20X6	
	(c) No adjustment	(a) Adjust revenue (underspend)	(b) Adjust revenue (all spend)
	CU million	**CU million**	**CU million**
Revenue (billed/billable)[Note 1]	92.10	92.10	92.10
Adjustment	0.00	(0.40)	1.30
	92.10	**91.70**	**93.40**
Costs [Note 2]	89.20	89.20	89.20
Adjustment	0.00	0.00	0.00
	89.20	**89.20**	**89.20**
Profit	2.90	2.50	4.20
Total profit for 3 years	**26.90**	**31.50**	**12.20**

[2] construction costs incurred are capitalised; they are not included in expenses recognised in profit or loss.

1. The revenue requirement for 20X6 is calculated as follows:

	CU million
Calculation as per 20X4 and 20X5	99.5
Construction funding no longer included	(8)
Regulatory depreciation	0.4
Additional return on the RAB	0.2
Revenue requirement 20X6	**92.1**

2. The cost recognised in profit or loss in 20X6 is calculated as follows:

	CU million
Calculation as per 20X4 and 20X5	87.5
IAS 16 depreciation	1.7
Costs 20X6	**89.2**