KASB DISCUSSION PAPER

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Accounting Standards Advisory Forum

Project	**Rate-regulated Activities**
Paper topic	Required costs which are currently expensed

CONTACT(S)	Sungsoo Kwon	sskwon@kasb.or.kr	+82 (0)2 6050 0152
	Daehyun Kim	dhkim@kasb.or.kr	+82 (0)2 6050 0172
	Haneul Kim	hnkim@kasb.or.kr	+82 (0)2 6050 0149

Purpose of this paper

1. This paper discuses how the rate-regulated activities have financial effect on rights and obligations of the rate-regulated entity in defined rate regulation. There are two views based on the revenue approach, which have been supported by many stakeholders. By using an illustrative example, this paper will address the two views.

2. This paper provides a simple illustrative example, which relates to the rate-regulated entity's activity of purchasing raw materials. Specifically, it relates to 'required costs that are currently expensed' and is one of the entity's activity directly relevant to transferring goods or services to a customer. The issue is when the entity should recognise revenue if the revenue requirement changes due to the purchasing price change in raw materials and thus an adjustment of revenue requirement is made.

Overview

3. As mentioned above, based on the revenue approach, there are two views as follows:

   (a) **View 1**—make no adjustment to the predominant existing IFRS practice; and

   (b) **View 2**—recognise the revenue requirement as the revenue for carrying out the required rate-regulated activities during the period.

4. The two views will be assessed in the light of the *Conceptual Framework* and IFRS 15, using an illustrative example.

5. The fact patterns of the illustrative example are as follows (See also Appendix of this paper).

Fact patterns[1]

The rate regulated entity (the entity) imports natural gas from overseas and provides it to customers after going through manufacturing process. The raw material cost of natural gas is contingent on foreign exchange rate and oil price. The rate regulator approved that the revenue requirement including the raw material cost of natural gas is CU1,000 per annum. The ex-ante revenue requirement is the same from Year 1 throughout Year 5. And assume that there is no required margin. The selling price is set at CU10 as the entity forecasts that it will sell 100 units of the product per annum. For the convenience of discussion, assume that the entity does not have any transactions involving transfer of business, spin-off, discontinuation of business, etc.

Illustrative Example A: a case of asset recognition

In Year 1, the actual cost was CU1,200, which exceeds the estimated cost of CU1,000, due to the fluctuation in foreign exchange rate and oil price. The actual quantity of sold products was 90 units, which is lower than the estimated quantity of 100 units. The revenue requirement for 90 units was CU1,200.

The regulator approves that the entity increases the rate in Year 2 in order to compensate the amount that was caused by the actual cost that exceeded the estimated cost and the actual quantity that was lower than the estimated quantity. Assume that there is no difference between the actual amount and the estimated amount in terms of cost and quantity from Year 2.

Illustrative Example B: a case of liability recognition

In Year 1, the actual cost was CU800, which is lower than the estimated cost of CU1,000, due to the fluctuation in foreign exchange rate and oil price. The actual quantity of sold products was 110 units, which is higher than the estimate quantity of 100 units. The regulator approves that the rate-regulated entity decrease the rate in Year 2 to reflect the less-than-expected actual cost and the more-than-expected actual volume. Assume that there is no difference between the actual amount and the estimated amount in terms of cost and quantity from Year 2.

[1] Monetary amounts are denominated in 'currency units (CU)'.

Assessment 1— *Conceptual Framework* perspective

6. The assessment will show that **View 2** (ie recognise the revenue requirement as the revenue for carrying out the required rate-regulated activities during the period) can be supported by the *Conceptual Framework*. The assessment will be made on the basis of **three aspects relating to the definition of asset and two aspects of the definition of liability** under the *Conceptual Framework*. The five aspects are as follows:

Illustrative Example A: a case of asset recognition

(a) result from past transactions or other past event (relating to definition of asset and illustrative Example A of this paper).

(b) exercising control (relating to definition of asset and illustrative Example A of this paper).

(c) future economic benefit (relating to definition of asset and illustrative Example A of this paper).

Illustrative Example B: a case of liability recognition

(d) no practical ability to avoid (relating to definition of asset and illustrative Example B of this paper).

(e) present or conditional obligation to transfer an economic resource (relating to definition of asset and illustrative Example B of this paper).

7. The assessment will be performed below on Illustrative Example A (Assessment 1.1) and Illustrative Example B (Assessment 1.2), respectively.

Assessment 1.1— Illustrative Example A: a case of asset recognition

Result from past transactions or other past event

8. The fact patterns of the illustrative example above (See also Appendix of this paper) show that providing natural gas to customers is a past transaction. And the adjustment of revenue requirement (ie CU300) in Year 2 is a result from this transaction. The revenue requirement adjustment is due to the purchasing price increase in raw materials (ie CU200) and the difference between the actual volume and estimated volume (ie CU 100).

Exercising control

9. The rate-regulated entity has an exclusive right to collect the revenue requirement relating to the required cost (ie raw material cost) in the environment of defined rate regulation where there is

no effective competition. And the identified revenue requirement adjustment (ie CU300) is ensured by a regulatory agreement or related law. Accordingly, the revenue requirement adjustment (ie CU300) is an asset that is controlled by the rate-regulated entity.

Future economic benefit in terms of definition of an asset

10. The revenue requirement adjustment (ie CU300) is the amount that will be reflected in the future rate and be collected from customers in the future periods. In other words, there will be future economic benefit to the rate-regulated entity in Year 2.

Assessment 1.2— Illustrative Example B: a case of liability recognition

No practical ability to avoid

11. As the rate-regulated entity billed to the customer more than the revenue requirement in Year 1 (ie CU 300), the rate for the customer in Year 2 is decreased to reflect the amount that exceeds the revenue requirement in Year 1. The rate in Year 2 is determined by deducting the revenue requirement adjustment (ie CU 300) from the revenue requirement in Year 2 calculated on the assumption that there is not unexpected event.

12. The rate-regulated entity has an obligation to continue to provide natural gas to customers at a rate set by the regulator and it should abide by the regulatory agreement or law that enforces the performance of specific activities. Accordingly, the revenue requirement adjustment in Year 1 (ie CU 300) is similar to unearned revenue. The obligation to transfer natural gas is unavoidable by the rate-regulated entity.

Present or conditional obligation to transfer an economic resource

13. The rate-regulated entity has to decrease the rate in Year 2 by the revenue requirement adjustment amount (ie CU 300) in Year 1. In effect, this means that the entity received the revenue requirement of Year 2 in Year 1. In other words, the entity received, in advance, a part of the consideration in return for the goods or services that is to be provided in Year 1. Since the entity does not return this revenue requirement adjustment (ie CU 300) in Year 1 to customers but assumes the obligation to provide natural gas in Year 2, it should recognise such obligation to provide goods or services as non-financial liability. Accordingly, this adjustment meets the definition of liability.

Assessment 2—IFRS 15 perspective

Timing of revenue recognition for unbilled revenue requirement: Two views

14. For the purpose of discussing revenue recognition for unbilled revenue requirement, View 1 and View 2 can be rephrased as follows:

- **View 1—**Recognise in **Year 2** the revenue requirement adjustment (ie CU 300) that is not reflected in the contract with customers in Year 1 because such revenue requirement will be billed to, and collected from, customers in Year 2; and

- **View 2—**Recognise in **Year 1** the revenue requirement that is not reflected in the contract with customers in Year 1 because such revenue requirement is the consideration for transferring goods or services to customers in Year 1.

15. In View 1, the revenue requirement adjustment (ie CU300) in Year 1 should be recognised as revenue in Year 2 because it will be reflected in the rate in Year 2 and thus is collectible from customers. The revenue requirement adjustment (ie CU 300) is a consideration for satisfying the performance obligation relating to the contract with customers in Year 2.

16. In View 2, the revenue requirement adjustment (ie CU300) in Year 1 is, by nature, the variable consideration described in IFRS 15 and the rate-regulated entity has satisfied its performance obligation in return for the revenue requirement including the adjustment in accordance with the regulatory agreement in Year 1. Although the revenue requirement including the adjustment in Year 1 is not an explicit variable consideration in the contract with the customers, it is a variable consideration for the performance obligation satisfied in accordance with the regulatory agreement in Year 1.

17. Accordingly, as mentioned in Agenda Paper 3Ba, revenue for this adjusted consideration (ie CU 1,200) can be recognised as revenue in Year 1. This is because it is a consideration in return for satisfying the performance obligation in Year 1 regardless of the fact that this adjusted consideration is not contractually billable in Year 1, but is contractually billable in Year 2 by adjusting the amount of consideration in the contract. This rationale can be analogised to the requirement for progressive revenue recognition over time in IFRS 15.

Question for ASAF members
1. Do you have any comments on the illustrative example in the appendix of this paper?

APPENDIX— Illustrative examples of currently contributed and expensed cost: comparison of View 1 and View 2[2]

Fact patterns

Common fact patterns

The rate regulated entity (the entity) imports natural gas from overseas and provides it to customers after going through manufacturing process. The raw material cost of natural gas is contingent on foreign exchange rate and oil price. The rate regulator approved that the revenue requirement including the raw material cost of natural gas is CU1,000 per annum. The ex-ante revenue requirement is the same from Year 1 throughout Year 5. And assume that there is no required margin. The selling price is set at CU10 as the entity forecast that it will sell 100 units of the product per annum. For the convenience of discussion, assume that the entity does not have any transactions involving transfer of business, spin-off, discontinuation of business, etc.

Illustrative Example A: a case of asset recognition

In Year 1, the actual cost was CU1,200, which exceeds the estimated cost of CU1,000, due to the fluctuation in foreign exchange rate and oil price. The actual quantity of sold products was 90 units, which is lower than the estimated quantity of 100 units. The revenue requirement for 90 units was CU1,200.

The regulator approves that the entity increases the rate in Year 2 in order to compensate the amount that was caused by the actual cost that exceeded the estimated cost and the actual quantity that was lower than the estimated quantity. Assume that there is no difference between actual amount and estimated amount in terms of cost and quantity from Year 2.

Illustrative Example B: a case of liability recognition

In Year 1, the actual cost was CU800, which is lower than the estimated cost of CU1,000, due to the fluctuation in foreign exchange rate and oil price. The actual quantity of sold products was 110 units, which is higher than the estimate quantity of 100 units. The regulator approves that the rate-regulated entity decrease the rate in Year to reflect the less-than-expected actual cost and the more-than-expected actual volume. Assume that there is no difference between actual amount and estimated amount in terms of cost and quantity from Year 2.

[2] Monetary amounts are denominated in 'currency units (CU)'.

Illustrative Example A

		CU
	Y1	**Y2**
Original Revenue Requirement	1,000	1,000
Cash flow for activities	-	-
Volume difference	**(100)**	**100**
Cost difference	**(200)**	**200**
Amounts billed to customers	900	1,300
	(CU10*@90)	(CU13*@100)
View 1 Adjusted Revenue	**900**	**1,300**
View 2 Adjusted Revenue	**1,200**	1,000

Journal entries of raw material costs variances and volume difference under View 1 and View 2

View 1	View 2
Year 1 DR Receivables CU900 CR Revenue CU900 *The CU900 is billed to customers and recognised as revenue in Year1.* *< No adjustment>*	**Year 1** DR Receivables CU900 CR Revenue CU900 *CU900 is billed to customers and recognised as revenue in Year1.* DR Regulatory asset CU300 CR Revenue CU300 *The entity has a right to recover CU200 of raw materials cost that was incurred and to adjust CU100 of the revenue requirement for the volume difference in Year1 through future billing to customers.*
Year 2 DR Receivables CU1,300 CR Revenue CU1,300 *The CU1,300 is billed to customers and recognised as revenue in Year 2.* *< No adjustment>*	**Year 2** DR Receivables CU1,300 CR Revenue CU1,000 CR Regulatory asset CU300 CU1,300 is the amount billed to customers. CU 1,000 is the amount of the required revenue in Year 2 . CU300 , which was recognised as regulatory asset in Year 1, is transferred to receivable and collected from customers in Year 2.

(a) View 1

Year 1

CU

Statement of financial positions

Contract asset(Receivables)	900	Contract liability(Payables)	1,200

Statement of profit or loss

Cost of sales	1,200	Revenue	900

Year 2

Statement of financial positions

Contract asset(Receivables)	1,300	Contract liability(Payables)	1,000

Statement of profit or loss

Cost of sales	1,000	Revenue	1,300

(b) View 2

Year 1

Statement of financial positions

Contract asset(Receivables)	900	Contract liability(Payables)	1,200
Regulatory asset	300		

Statement of profit or loss

Cost of sales	1,200	Revenue	1,200[1]

(Footnote 1) CU1,200 is the sum of CU900, which is revenue from the contract with customers and CU300, which is the revenue requirement adjustment in Year 1.

Year 2

Statement of financial positions

Contract asset(Receivables)	1,300	Contract liability(Payables)	1,300[1]

Statement of profit or loss

Cost of sales	1,000	Revenue	1,000[2]

(Footnote 1) CU1,300 is the sum of CU 300, which is the unsettled amount, and CU1,000, which is the payables for purchasing raw materials.

(Footnote 2) CU1,300 billed to customers is the sum of the contract revenue (ie CU1,000) for providing natural gas and the revenue requirement adjustment (ie CU300), which is the collection of the regulatory asset in Year 1.

Illustrative Example B

CU

	Y1	Y2
Original Revenue Requirement	1,000	1,000
Cash flow for activities	-	-
Volume difference	**100**	**(100)**
Cost difference	**200**	**(200)**
Amounts billed to customers	1,100	700
View 1 Adjusted Revenue	**1,100**	**700**
View 2 Adjusted Revenue	**800**	1,000

Journal entries of raw material costs variances and volume difference under View 1 and View 2

View 1	View 2
Year 1 DR Receivables CU1,100 CR Revenue CU1,100 *The CU1,100 is billed to customers and recognised as revenue in Year 1.* *< No adjustment>*	**Year 1** DR Receivables CU1,100 CR Revenue CU1,100 *CU1,100 is the total amount billed to customers. But the customers are over-billed for the revenue requirement in Year 1 and thus the adjustment entry is made as below.* DR Revenue CU300 CR Regulatory liability CU300 *The entity does not return this revenue requirement adjustment(ie CU300) in Year 1 to customers but assumes the obligation to provide natural gas in Year 2. The entity recognises such obligation to provide natural gas as non-financial liability.*
Year 2 DR Receivables CU700 CR Revenue CU700 *The CU700 is billed to customers and recognised as revenue in Year 2.* *< No adjustment>*	**Year 2** DR Receivables CU700 DR Regulatory liability CU300 CR Revenue CU1,000 *The over-billed amount in Year 1 leads to charging customers less amount for Year 2, which is CU700. The over-billed amount in Year 1 is an unearned revenue for providing goods in Year 2. The entity thus recognises revenue when it completes the*

View 1	View 2
	provision of natural gas.

(a) View 1

Year 1

CU

Statement of financial positions			
Contract asset(Receivables)	1,100	Contract liability(Payables)	800

Statement of profit or loss			
Cost of sales	800	Revenue	1,100

Year 2

Statement of financial positions			
Contract asset(Receivables)	700	Contract liability(Payables)	1,000

Statement of profit or loss			
Cost of sales	1,000	Revenue	700

(a) View 2

Year 1

CU

Statement of financial positions			
Contract asset(Receivables)	1,100[1]	Contract liability(Payables)	800
		Regulatory liability	300

Statement of profit or loss			
Cost of sales	800	Revenue	800

(Footnote 1) The total amount billed to customers (ie CU1,100) is the sum of the contract revenue from customers for providing natural gas in Year 1 (ie CU800) and the advanced receipt for providing natural gas in Years 2 (ie CU300), which is a regulatory liability recognised in the expectation that the future rate will be decreased due to overbilling.

Year 2

Statement of financial positions			
Contract asset(Receivables)	1,000[1]	Contract liability(Payables)	1,000[2]

Statement of profit or loss			
Cost of sales	1,000	Revenue	1,000[3]

(Footnote 1) CU1,000 is the sum of the balance (ie CU300) after settling the payable by using a part of the amount collected in Year 1 (ie CU1,100) and the amount billed to customers in Year 2 (ie CU700)

(Footnote 2) CU1,000 is the sum of the unsettled amount (ie CU300) of the contract liability (payables) that was recognised as the regulatory liability in Year 1 and the amount payable for purchasing raw materials in Year 2 (ie CU700).

(Footnote 3) CU 1,000 is the revenue from contract with customers (ie CU1,300) in Year 2 minus the revenue requirement adjustment (ie CU300), which is the regulatory liability in Year 1.