

KASB DISCUSSION PAPER

29 September 2016

Accounting Standards Advisory Forum

Project	Rate-regulated Activities
Paper topic	Required costs which will be expensed in future periods

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

This paper has been prepared for discussion at a public meeting of the Accounting Standards Advisory Forum (ASAF) and does not represent the views of the International Accounting Standards Board (the Board) or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of those Standards. Technical decisions are made in public and reported in an IASB® Update.

Purpose of this paper

1. This paper addresses issues assuming that View 2 as described in the previous Agenda Papers (ie Agenda Papers 3Ba and 3Bb) is taken. Two views (View 2A and View 2B) will be discussed by using an illustrative example.
2. The illustrative example in this paper relates to the activities that are required to be performed as a promise with regulators, which are indirectly relevant to transferring goods or services to customers, whereas the illustrative example in Agenda Paper 3Bb related to the activities performed directly relevant to transferring goods or services to customers.

Overview

3. The illustrative example in this paper is a simplified version of the illustrative case of construction work provided in the agenda paper for the May 2015 IASB meeting. Construction work is one of the obligations required by the regulatory agreement between the rate regulator and the rate-regulated entity; and an obligation to maintain readiness of a related asset to produce goods or services to customers.
4. The rate-setting mechanism in the regulatory agreement reflects the amount to construct or purchase the related asset (ie acquired cost) in the rate as revenue requirement. And the rate-regulated entity recognises depreciation expenses of the related asset over the useful life of the related asset.
5. In practice, the acquired cost, partly or wholly, is often reflected in the rate before the completion of acquiring the asset for the purpose of funding the purchase. In this case, there are three different timings to consider: (i) billing to customers; (ii) completion of the related asset

6. purchase; (iii) the use of the related asset, as part of the activity to provide goods or services to customers. These timing differences raise an issue about the timing of revenue recognition relating to the revenue requirement adjustment.
7. As mentioned above, assuming View 2 is taken, there are two views on this issue.
 - (a) **View 2A**—The rate-regulated entity recognises revenue when it satisfies the performance obligation to the rate regulator; and
 - (b) **View 2B**—The rate-regulated entity recognises revenue only when it satisfies the performance obligation to the customer.
8. The two views will be assessed in the light of IFRS 15, using an illustrative example.
9. The fact patterns of the illustrative example are as follows. (See Appendix of this paper for more detailed information.)

Fact patterns¹

In Year 3², the rate regulator approved a plan for the entity to build a new natural gas plant to expand its capacity to distribute natural gas. 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 also approved that the rate reflects the construction cost of CU500, to help fund the construction. The construction commenced in Year 3 and is expected to be completed in Year 4. The entity spends CU500 during Year 4, which is capitalised in accordance with IAS 16. The depreciation expense of the plant will be recognised from Year 5 over its useful life of 10 years with the straight line method.

Assessment—IFRS 15 perspective

View 2A

10. In **View 2A**, the rate regulator represents collective customers and enters into the agreement with the rate-regulated entity in the capacity of collective customers. In this sense, the performance obligation established in the regulatory agreement is the performance obligation of the rate-regulated entity to the customer. Also, the performance obligation in the regulatory agreement

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

² Assume that fact patterns of Year 1 and Year 2 are the same as those in Illustrative Example A of Agenda Paper 3Bb.

includes incidental activities to the main activity of providing goods or services to customers, such as maintaining readiness of the related asset to produce goods or services.

11. In the illustrative example, the rate-regulated entity was required to construct a PPE by the regulatory agreement and thus billed CU 500 as part of revenue requirement in Year 3 to fund the construction. The amount collected in Year 3 is recognised as liability (ie unearned revenue) because the entity has not satisfied the obligation to construct the PPE.
12. The entity recognises CU500 as revenue in Year 4 because it has completed its construction of the PPE and thus satisfied the distinctive performance obligation described in IFRS 15.
13. In View 2A, the obligation to construct a PPE (ie indirect obligation) as well as the obligation to transfer natural gas to customers (ie direct obligation) is considered as distinctive performance obligation for revenue recognition (ie a separate unit of performance obligation).
14. Accordingly, the rate-regulated entity recognises revenue when it satisfies the performance obligation established in the regulatory agreement even before the entity has transferred goods or services to customers.

View 2B

15. In **View 2B**, an input activity, the activity to construct a plant as a promise with the rate regulator, should be combined with the output activity (ie to transfer natural gas to customers) as a 'bundle of goods or services' and these two activities are 'highly interdependent or highly interrelated'. Therefore, the rate-regulated entity should not identify the obligation to construct a plant as a distinct performance obligation and thus recognises its revenue when it satisfies the ultimate performance obligation to transfer natural gas to customers.
16. The plant is used for satisfying the performance obligation to transfer natural gas to customers, as depreciation expense is incurred. Accordingly, the rate-regulated entity recognises its revenue in correspondence with the depreciation amount over the useful life of the plant (ie for 10 years starting from Year 5).
17. Consequently, the entity recognises revenue annually by allocating the revenue requirement collected in Year 3 (ie CU 500) in correspondence to the depreciation expense of the PPE starting from Year 5 for 10 years onwards.

KASB's view

18. The KASB supports View 2B because View 2B would be more consistent with the requirements of IFRS 15. Also, View 2B would be better than View 2A in that it would not undermine the comparability among non-regulated entities and rate-regulated entities for the purpose of presenting revenue.

Question for ASAF members

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

APPENDIX— Illustrative example of non-currently contributed cost: comparison of View 2 A and View 2 B³

Fact patterns⁴

In Year 3, the rate regulator approved a plan for the entity to build a new natural gas plant to expand its capacity to distribute natural gas. 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 also approved that the rate reflects the construction cost of CU500, to help fund the construction. The construction commenced in Year 3 and is expected to be completed in Year 4. The entity spends CU500 during Year 4, which is capitalised in accordance with IAS 16. The depreciation expense of the plant will be recognised from Year 5 over its useful life of 10 years with the straight line method.

CU

	Y1	Y2	Y3	Y4	Y5
Original Revenue Requirement	1,000	1,000	1,000	1,000	1,000
<i>Cash flow for activities</i>	-	-	-	-	-
Volume difference	(100)	100	-	-	-
Cost difference	(200)	200	-	-	-
Construction work	-	-	500	(500)	-
Amounts billed to customers	900	1,300	1,500	1,000	1,000
View 2A Adjusted Revenue	1,200	1,000	1,000	1,500	1,000
View 2B Adjusted Revenue	1,200	1,000	1,000	1,000	1,050

* Depreciation of the new plant starts from Year 5 to Year 14.

Journal entries of funding the construction of the entity's own assets

View 2A	View 2B
<p>Year 3</p> <p>DR Revenue CU500 CR Regulatory liability CU500</p> <p><i>The entity recognises a regulatory liability as it receives prepayment from customers for the construction work that it expects to carry out in the future.</i></p>	<p>Year 3</p> <p>DR Revenue CU500 CR Regulatory liability CU500</p> <p><i>The entity has received funding for the construction of an additional plant. The funded amount lowers the rate for customers, which will be payable by customers to the entity for the transfer of natural gas in the future.</i></p>

³ Monetary amounts are denominated in 'currency units (CU)'.

⁴ Assume that fact patterns of Year 1 and Year 2 are the same as those of Illustrative Example A of Agenda Paper 3Bb.

View 2A	View 2B
<p>Year 4</p> <p>DR PP&E CU500 CR Payables CU500</p> <p><i>The construction costs are capitalised as property, plant and equipment.</i></p> <p>DR Regulatory liability CU500 CR Revenue CU500</p> <p><i>By completing the construction of a new plant,.it performed the obligation under the regulatory agreement with the regulator as representative of collective customers.</i></p>	<p>Year 4</p> <p>DR PP&E CU500 CR Payables CU500</p> <p><i>The construction costs are capitalised as property, plant and equipment.</i></p>
<p>Year 5 onwards</p> <p>DR Depreciation expense CU50 CR PP&E CU50</p> <p><i>To recognise the depreciation charge for the year, based on the total cost of construction of CU500.</i></p>	<p>Year 5 onwards</p> <p>DR Depreciation expense CU50 CR PP&E CU50</p> <p><i>To recognise the depreciation charge for the year, based on the total cost of construction of CU500</i></p> <p>DR Regulatory liability CU50 CR Revenue CU50</p> <p><i>The entity has billed less for the services transferred to customers during the year because the consideration has been received in Year 3.</i></p> <p><i>(Acquiring the related asset is part of input operating activity and the performance obligation to customers is completed when the output is transferred to customers.</i></p>

(a) View 2A

Year 3

CU			
Statement of financial positions			
Contract asset(Receivables)	1,500	Contract liability(Payables) Regulatory liability	1,000 500
Statement of profit or loss			
Cost of sales	1,000	Revenue	1,000

Year 4

Statement of financial positions			
Cash	500 ¹	Contract liability(Payables)	1,500 ²

Contract asset(Receivables)	1,000
PP&E	500

Statement of profit or loss

Cost of sales	1,000	Revenue	1,500 ³
---------------	-------	---------	--------------------

(Footnote 1) CU500 is a cash inflow of CU1,500 resulting from collecting receivables minus a cash outflow of CU1,000 resulting from settling payables. CU500 is carried forward to Year 4.

(Footnote 2) CU1,500 is the sum of the payable (ie CU1,000) for purchasing raw materials and the payable (ie CU500) for purchasing the PP&E.

(Footnote3) CU1,500 is the sum of the contract revenue (ie CU1,000), which is billed to customers for providing goods or services in Year 4, and revenue requirement adjustment (ie CU500).

Year 5

Statement of financial positions

Contract asset(Receivables)	1,000	Contract liability(Payables)	1,000
PP&E	500		
Accumulated amount of depreciation	(50)		

Statement of profit or loss

Cost of sales	1,000	Revenue	1,000
Depreciation	50		

(b) View 2B

Year 3

CU

Statement of financial positions

Contract asset(Receivables)	1,500	Contract liability(Payables)	1,000
		Regulatory liability	500

Statement of profit or loss

Cost of sales	1,000	Revenue	1,000
---------------	-------	---------	-------

Year 4

Statement of financial positions

Cash	500 ¹	Contract liability(Payables)	1,000
Contract asset(Receivables)	1,000	Regulatory liability	500
PP&E	500		

Statement of profit or loss

Cost of sales	1,000	Revenue	1,000
---------------	-------	---------	-------

(Footnote 1) CU500 is a cash inflow of CU1,500 resulting from collecting the receivables in Year 3 minus a cash outflow

of CU1,000 resulting from settling the payables. CU500 is carried forward to Year 4.

Year 5

Statement of financial positions

Contract asset(Receivables)	1,000	Contract liability(Payables)	1,000
PP&E	500	Regulatory liability	450
Accumulated amount of depreciation	(50)		

Statement of profit or loss

Cost of sales	1,000	Revenue	1,050 ¹
Depreciation	50		

(Footnote 1) CU1,050 is the sum of contract revenue (ie CU1,000) and revenue requirement adjustment (ie CU50).