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Standard Setting Updates and Accounting Hot Topics

Will Bible

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Agenda

- New Revenue Guidance
- Accounting for Leases—Summary Update
- Cloud Computing
- Private Company Standard Setting
- Net Energy Metering and Other Trends in Ratemaking
- Other Electricity Accounting Issues of Consideration

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New Revenue Guidance

New Revenue Guidance

Early application is not permitted

Effective Date

- Public entities:
  - Annual reporting periods beginning after December 15, 2016, including interim reporting periods therein (FY 2017)
  - Early application not permitted

Transition Options

- Full Retrospective Approach
  - Restate prior periods in compliance with ASC 250
- Modified Retrospective Approach
  - Apply revenue standard to contracts not completed as of effective date and record cumulative catch up
  - Example:

cumulative catch-up

January 1, 2017 Initial Application Year	2017 Current Year	2016 Prior Year 1	2015 Prior Year 2
New contracts	New ASU		
Existing contracts	New ASU + cumulative catch up	Legacy GAAP	Legacy GAAP
Completed contracts		Legacy GAAP	Legacy GAAP

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New Revenue Guidance
Scope

- Applies to an entity's ***contracts*** with ***customers***
- Does not apply to:
  - Lease contracts (ASC 840),
  - Insurance contracts (ASC 944),
  - Certain financial instruments and other contractual rights or obligations,
  - Guarantees (other than product or service warranties), and
  - Nonmonetary exchanges whose purpose is to facilitate a sale to another party
- Some key aspects apply to transfer (sale) of nonfinancial assets

Glossary terms

Contract: An agreement between two or more parties that creates enforceable rights and obligations.

Customer: A party that has contracted with an entity to obtain goods or service that are an output of the entity's ordinary activities in exchange for consideration.

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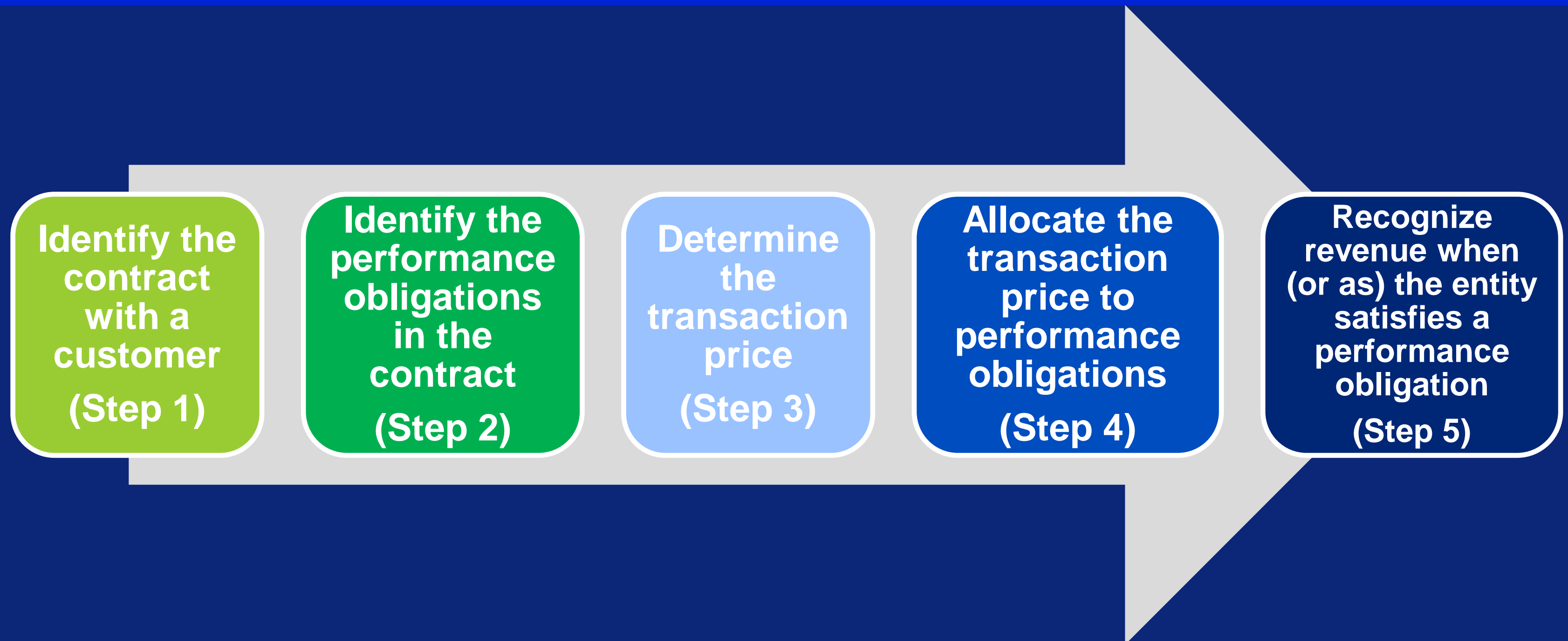
New Revenue Guidance
Overview

Core principle: Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration the entity expects to be entitled in exchange for those goods or services



This revenue recognition model is based on a control approach which differs from the risks and rewards approach applied under current U.S. GAAP

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Step 1 | Step 2 | Step 3 | Step 4 | Step 5

New Revenue Guidance
Step 1: Identifying the contract

A legally enforceable contract (oral or implied), but must meet all of the following requirements:

- The parties have approved the contract and are committed to perform
- The entity can identify each party's rights regarding goods or services
- The entity can identify the payment terms for the goods or services to be transferred
- The contract has commercial substance
- It is probable the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer

A contract will not be in the scope if:

The contract is wholly unperformed **AND** Each party can unilaterally terminate the contract without compensation

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New Revenue Guidance

Step 2: Identifying performance obligations

The ASU defines a **performance obligation** as a promise to transfer to the customer a good or service (or a bundle of goods or services) that is **distinct**.

A series of goods or services with the same pattern of transfer may be a single obligation

Identify all (explicit or implicit) promised goods and services in the contract

Are promised goods and services distinct from other goods and services in the contract?

CAPABLE OF BEING DISTINCT

Can the customer benefit from the good or service on its own or together with other readily available resources?

AND

DISTINCT WITHIN CONTEXT OF CONTRACT

Is the good or service separately identifiable from other promises in the contract?

YES

Account for as a performance obligation

NO

Combine 2 or more promised goods or services & reevaluate

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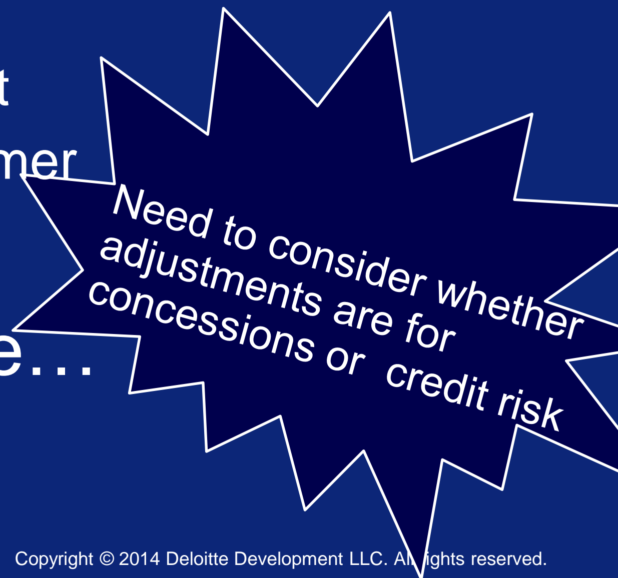
New Revenue Guidance
Step 3: Determine the transaction price

Principle: The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer (which excludes estimates of variable consideration that are constrained).

Transaction price shall include…

- Fixed consideration
- Variable consideration (estimated and potentially constrained)
- Noncash consideration
- Adjustments for significant financing component
- Adjustments for consideration payable to customer



Transaction price does NOT include…

- Effects of customer credit risk

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New Revenue Guidance
Step 3:
Determine the transaction price

When accounting for variable consideration an entity shall…

- Estimate using expected value (probability weighted) or most likely amount methods
- Subject to the following “constraint”:
  - Include some or all of the amount of variable consideration in the transaction price to the extent that it is probable that a subsequent change in the estimate would not result in a significant revenue reversal
  - Consider the following factors in assessing whether the estimated transaction price is subject to significant revenue reversal:
    - Highly susceptible to factors outside entity’s influence
    - Uncertainty not expected to be resolved for a long time
    - Entity’s experience is limited
    - Entity typically offers broad range of price concessions/payment terms
    - Large number of broad range possible outcomes

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Step 1 | Step 2 | Step 3 | Step 4 | Step 5

New Revenue Guidance
Step 4: Allocate the transaction price

- Allocate transaction price on a relative standalone selling price basis (estimate standalone selling price if not observable)
  - The expected cost-plus margin method, adjusted market assessment method, or residual method (only if price is highly variable or uncertain) are acceptable
- Allocate consideration (and changes) in the transaction price to all performance obligations (based on initial allocation) unless a portion of (or changes in) the transaction price relate entirely to one (or more) obligations and certain criteria are met
- Do not reallocate for changes in standalone selling prices
- If certain criteria are met, a discount or variable consideration may be allocated to one or more, but not all, of the performance obligations in a contract.

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New Revenue Guidance
Step 5: Recognizing Revenue

Evaluate if control of good or service transfers over time, if not then transfers at a point in time

An entity satisfies a performance obligation over time if…

The customer receives and consumes the benefit as the entity performs. (e.g., cleaning service)

OR

Performance creates or enhances a customer controlled asset. (e.g., home addition)

OR

Performance does not create an asset with an alternative use and the entity has both an enforceable right to payment for performance completed to date and expects to fulfil contract as promised.

Measure progress toward completion using input/output methods

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New Revenue Guidance
Step 5: Recognizing Revenue

For performance obligations satisfied at a point in time, indicators that control transfers include, but are not limited to, the following:

- The entity has a present right to payment
- The customer has legal title
- The entity has transferred physical possession
- The customer has the significant risks and rewards of ownership
- The customer has accepted the asset

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New Revenue Guidance

Contract Costs

Costs to obtain a contract

- Capitalize costs of obtaining a contract if they are incremental and expected to be recovered (e.g., sales commissions)
  - 1 year practical expedient

Costs to fulfill a contract

- Recognize assets in accordance with other Topics (inventory, PP&E, software, etc.), otherwise capitalize costs that:
  - Relate directly to the contract (or specific anticipated contract);
  - Generate/enhance a resource that will be used to satisfy obligations in the future; and
  - Are expected to be recovered
- Costs that relate to satisfied performance obligations (or partially satisfied performance obligations) must be expensed when incurred

Impairment – Recognize immediately if costs deemed not recoverable

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New Revenue Guidance

Selection of Potential Industry Issues

Step 1: Identifying the contract with the customer

- Tariff based customers
- Tax equity deals
- Alternative revenue arrangements
- Revenue subject to refund
- Principal / Agent considerations for ISO and Auction transactions

Step 2: Identify the performance obligations

- Firm and interruptible capacity
- Bundled energy arrangements

Step 3: Determine transaction price

- Determining whether blend-and-extend contract modifications result in financing elements that must be accounted for separately
- Indexation

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New Revenue Guidance
Industry Issues

Step 4: Allocate transaction price to performance obligations

- Recognition under step price arrangements
- On-peak vs. Off-peak deliveries
- Accounting for options

Step 5: Recognize revenue as performance obligation is satisfied

- Recognition of revenue associated with RECs
- Implications of the removal of specialized Real Estate sales rules

AICPA Task Force

- By industry

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Accounting for Leases—Summary Update

Leases: Summary

Timeline: May 2013 to present

- Exposure draft issued
- Numerous comments received
- Re-deliberations continue

Scope: generally the same as current standard

Overview

- Most leases on balance sheet (similar to today's capital leases)
- Introduces the right-of-use (ROU) asset approach under which a lessee records
- Dual model expense (FASB) versus single model expense (IASB)

Next steps

- Balance sheet and cash flow statement presentation
- Subleases
- Cost-benefit, transition & effective date
- Sale and leaseback transactions

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Customer's Accounting for Fees in a Cloud Computing Arrangement

Background

What is a Cloud Computing Arrangement?

- Clouds can take various forms, from a singe software application to outsourcing of an entity's IT infrastructure
- Over the past several years, cloud computing has revolutionized the business and technology landscape, offering more flexible and lower-cost IT solutions that allow businesses to outsource their traditional ERP systems or any other on-site application to an off-site, on-demand solution
- Cloud arrangements can be structured in various ways, including:
  - Public clouds
  - Private clouds
  - Community clouds
  - Hybrid clouds

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Background

- Issue:
  - Current GAAP does not provide explicit guidance on how customers should account for fees in a cloud computing arrangement
  - Various costs to consider
    - Web site development
    - Development or acquisition of software
    - Infrastructure purchases
    - Contract & acquisition
    - Maintenance for ongoing services
- Diversity in practice exists in accounting for these arrangements
- Companies have been analogizing to various literature:
  - ASC 350-40 (internal use software)
  - ASC 360 (dedicated server or other equipment)
  - ASC 840 (operating vs. capital leases)
  - ASC 985-20 (costs of software to be sold)

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FASB Update

- Added to technical agenda on April 28, 2014, and discussed at the June 18, 2014 FASB Meeting
- Project taken up by FASB under the Simplification Initiative
- Exposure Draft issued August 20, 2014, with comment deadline of November 18, 2014
- Proposed effective date:
  - Public Entities – effective for annual periods, including interim periods within those annual periods, beginning after December 15, 2015.
  - Other Entities – effective for annual periods beginning after December 15, 2015, and interim periods in annual periods beginning after December 15, 2016
- Reporting entities may elect retrospectively or prospectively

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Exposure Draft Highlights

- Adds guidance to ASC 350-40
- Based on the proposed ASC 350-40-15-4C, it is anticipated that many of the cloud arrangements would fall under the service contract model; however, the ED does not give clarity on how to account for service contracts
- ASC 350-40-15-4A provides clarification on when an arrangement has an internal-use software element
- Companies must continue to analogize to other guidance to assess overall accounting for a cloud computing arrangement:
  - Need to consider if software will be sold, leased, or marketed (ASC 985-20), or if the software is for internal use (ASC 350-40)
  - Web Site Development—ASC 350-50 provides guidance on capital vs. expense for each of the stages of development
  - Contract Acquisition Costs – SEC has stated “expensing customer or contract acquisition is almost always acceptable,” but also need to consider ASC 310-20 or ASC 605-20
  - Maintenance Costs – Generally expensed (ASC 350-40 and ASC 985-20)

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Private Company Standard Setting

Private Company Standard Setting

Overview

Agenda topic	Status
Framework and scope:	
Private Company Decision-Making Framework	Final version issued in Dec 2013
Definition of a Public Business Entity	Final ASU issued in Dec 2013
Alternatives:	
Subsequent Accounting for Goodwill	Final ASU issued Jan 2014
Interest Rate Swaps – simplified hedge accounting	Final ASU issued Jan 2014
VIE Consolidation Exception	Final ASU issued Jan 2014
Intangible Assets	PCC to redeliberate

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Private Company Standard Setting

Definition of a Public Business Entity

ASU 2013-12 defines a public business entity as an entity that meets any of the following criteria:

a. Required by the SEC to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
b. Required by the Securities Exchange Act of 1934, as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
c. Required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
d. Has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
e. Has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

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Private Company Standard Setting
Goodwill

An entity that elects simplified goodwill accounting:

- Amortizes goodwill over 10 years or less than 10 years if the entity can demonstrate that another useful life is more appropriate
- Tests goodwill for impairment only when a triggering event occurs instead of having to perform the test annually (or more frequently if indicators of impairment exist), as is required currently
- Tests goodwill for impairment at either the entity level or the reporting unit level, applying only Step 1
- Is subject to incremental disclosure requirements

- Effective for years beginning after 12/15/14 (early adoption permitted)
- Prospectively applied to existing and future goodwill balances

Note*: The FASB has separately added a project to its agenda to simplify the accounting for goodwill for all entities.*

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Private Company Standard Setting
Interest Rate Swaps

An entity that elects simplified hedge accounting:

- Continues to account for the interest rate swap and the variable-rate debt separately on the face of the balance sheet
- Assumes no hedge ineffectiveness in the hedging relationship (i.e., effectively show just a fixed amount of interest in the income statement)
- Measures the interest rate swap at its settlement value rather than its fair value
- Is subject to hedge documentation requirements (but is allowed more time)
- Elects on an individual instrument basis, assuming qualifying criteria are met

- Effective for years beginning after 12/15/14 (early adoption permitted)
- Applied using either a modified or full retrospective approach; existing swaps may qualify for simplified hedge accounting upon adoption

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Private Company Standard Setting
VIE Consolidation Exception

An entity that elects the exception to VIE consolidation guidance:

- Opts out of applying ASC 810 VIE guidance to determine whether a lessor entity shall be subject to consolidation and instead apply the ASC 810 'voting interest model' if all of the following criteria are met:
  - Private company and legal entity under common control
  - Private company has a lease arrangement with legal entity
  - Substantially all activities between private company and legal entity are related to leasing activities of the legal entity
  - If "the private company lessee explicitly guarantees or provides collateral for any obligation of the lessor entity related to the asset leased by the private company, then the principal amount of the obligation at inception of such guarantee or collateral arrangement does not exceed the value of the asset leased by the private company from the lessor entity."

- Effective for years beginning after 12/15/14 (early adoption permitted)
- Applied using a full retrospective approach

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Net Energy Metering and Other Trends in Ratemaking

Behind the Meter Innovation is Growing Rapidly

- Emerging behind the meter services include
  - Distributed solar
  - Fuel cells
  - Small scale natural gas generation
  - Electricity storage
  - Microgrids
  - Energy management hardware and software

Recent trends of new market entrants

- Changing role of new market entrants
- Maturity curve of new technologies
- Solutions to the solar affordability barrier

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Rate Design:
A Regulatory Afterthought

- “Revenue Requirement” has been the main focus in traditional vertical monopoly regimes and now in competitive regimes for delivery rates
- Historically embedded rate design features perpetuate divergence from cost of service study indications
- There is an enduring cross-subsidy temptation
- The politics of price signals – “dangerous knowledge”
  - Traditional “cost of service” misprices surplus & shortage

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New Tensions In The Rate Design Process: Competitive Markets & New Policy Goals

- State-level energy efficiency and load reduction goals
- Renewable portfolio standards and net metering
- Movement to competitive markets by states with one-third of total national load removes most cross-subsidy from supply, leaving less room for overall cross-subsidy through delivery rates
- Many competitive states have not significantly altered process – similar complexity & resources for delivery-only rates
- Diversity of residential retail products in competitive states may invite regulatory intervention to limit offerings

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Unintended Consequences:
Policies & Practices In Conflict

- Electric plug-in vehicles: Volumetric & non-TOU rate designs and inverted pyramid may discourage use
- Net metering that includes delivery may encourage rooftop solar but shifts distribution costs to others
- Conventional rate design limits the use and value of smart meters being deployed pursuant to other policies – such as pre-pay, demand response and time-of-use
- Disconnect between gas & electric rate design may send wrong price signals for distributed generation

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Distributed Generation (DG)

- What Is DG?
  - Small-scale, on-site power generation located at or near customers’ homes or business
  - Common examples include solar panels, energy storage devices, fuel cells, micro turbines, small wind turbines, and combined heat and power systems
- Why Is It Growing?
- Net Metering Considerations
  - Customers receiving a retail offset is the same economically as if the customers had sold their power back to the utility at the full retail rate

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Some Other Recent Trends in Ratemaking

- Capital spend and low /no sales growth driving sizable rate increases
- Slow economic recovery results in reluctance to impose major rate increases on customers
- ROEs are declining
- Disallowances are more prevalent
- Early retirement of meters and generating facilities
- “Kick the can down the road” is more prevalent

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Ratemaking Trends *(cont.)*

- Some actions to keep rates down reduce earnings
  - Lower ROE
  - Assume higher sales growth for test year
  - Disallow or “cap” new plant investment amount
  - Reduce various test year costs (for example by assuming efficiencies or not allowing some elements of costs)

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Ratemaking Trends *(cont.)*

- Other actions to keep rates down potentially do not reduce earnings
  - Reduce depreciation rates prospectively
  - Refund accumulated cost of removal
  - Refund “excess” accumulated depreciation
  - Stepped rate increases for large capital project
  - Permission to defer certain costs until the next rate case
  - “Flow through” ratemaking for certain tax temporary differences
  - Use a policy for timing of including certain costs in rates more slowly than under GAAP

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Overview of Accounting Implications

- Some decisions in a rate order require careful consideration, such as:
  - Cost deferrals for major newly completed plant (phase-in plans)
  - Disallowances for recently completed plant or caps for plants under construction
  - Depreciation adjustments
  - Abandonment considerations
  - Deferral of various test year costs to a future rate case
  - Full rate of return allowed on cost deferrals

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Other Electricity Accounting Issues of Consideration

NPNS for Electricity Forwards in Nodal Markets

- Diversity in views around application of NPNS to forward purchases that deliver to a hub
- Spot market used to “transmit” the power from hub to customer load zone
- Spot sale at hub and spot purchase at load zone
- LMP differential = cost of transmission
- Is spot sale at hub a net settlement of the forward contract?
- If so, NPNS would appear to be precluded
- U.S. GAAP does not contemplate nodal markets
- Diversity in practice exists (EEI survey performed in September 2013)

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NPNS for Electricity Forwards in Nodal Markets

- Issue discussed with SEC staff on a no-name basis
- Industry has prepared a position paper that presents alternative views and asks SEC "not to object" to NPNS
- Key arguments include:
  - Physical grid and related physics haven't changed
  - No other way to transmit in a nodal market
  - Spot activity is balanced therefore this is not a net settlement
  - ISO/RTO is an agent acting as a common carrier – nodal price difference = charge for transmission service
- SEC staff has submitted our issue to the EITF and asked them to address it

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Impact of Selling Excess Power

- Over the last few years, many utilities entered into long-term renewable electricity purchase contracts for the following reasons:
  - State mandates
  - Lack of sufficient sources of renewable energy
  - Banks requiring long-term PPAs in place to fund new projects
  - Regulators allowing recovery of the cost of power obtained under PPAs
- Many states have delayed or relaxed their requirements resulting in many utilities have excess renewable energy in 2014, 2015, and 2016
- To minimize the overall cost of power to the rate payers, utilities are selling the excess renewable energy into the spot or forward market

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Impact of Selling Excess Power

- Does selling excess power taint normal?
- Is selling excess power on a forward basis more problematic than selling in the spot market?
- Is the analysis different for a “capacity” contract (i.e. 10(b)(4)) as compared to a “regular” contract (i.e. 10(b)(1))?
- Is the company required by their regulator to sell excess power in order to maximize cost savings?
- If selling the excess power does not taint normal, can a forward sales contract to sell that excess power qualify for the normal exemption?
- Does entering into the offsetting contract preclude application of the exemption to other contracts entered into by the company?

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Questions?

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