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Accounting for Executory Long-term Power Sales Agreements (now & post-2017)

George Fackler
gfackler@deloitte.com

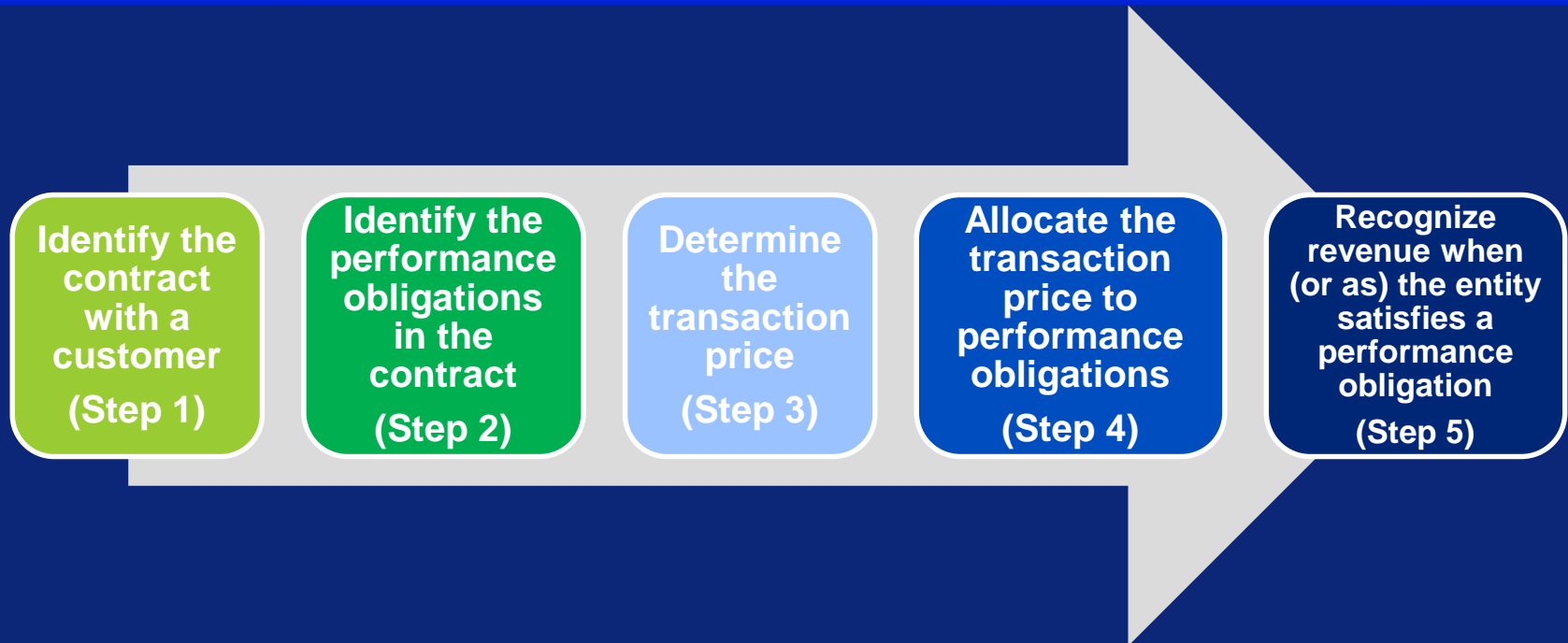
Jody Surprise
jsurprise@deloitte.com

Deloitte & Touche LLP



New Revenue Standard 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

Effective Date for the New Revenue Standard

In July, the FASB deferred for one year the effective date of the new revenue standard for both public and private entities. Early adoption as of the original effective date is allowed.

- **Public entities:**

- Annual reporting periods beginning after December 15, 2017, including interim reporting periods within those periods.
- Public entities can early adopt for annual reporting periods beginning after December 15, 2016, including interim periods

- **Private entities:**

- Annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2018.
- Nonpublic entities can also elect to early adopt the standard as of the following:
 - Annual reporting periods beginning after December 15, 2016, including interim periods
 - Annual reporting periods beginning after December 15, 2016, and interim periods within annual reporting periods beginning one year after the period of initial application of the standard

What are the Transition Options?

Retrospective Approach

(Full retrospective application – restate prior periods)

- Must consider requirements in ASC 250
- What practical expedients are available?
 - Completed contracts that began and ended during same annual reporting period do not need to be restated
 - For completed contracts with variable consideration, entity can use transaction price when the contract is completed rather than estimating the variable amount
 - For periods presented before adoption, entity is not required to disclose (1) amount of transaction price allocated to remaining performance obligations and (2) explanation of when the related revenue is expected to be recognized
- If an entity elects to apply one or more of the practical expedients above, how must they be applied?
 - Must be applied consistently to all reporting periods presented
 - Must disclose (1) that it has used the expedient(s) and (2) a qualitative assessment of the estimated effect of applying the expedients

What are the Transition Options? (cont.)

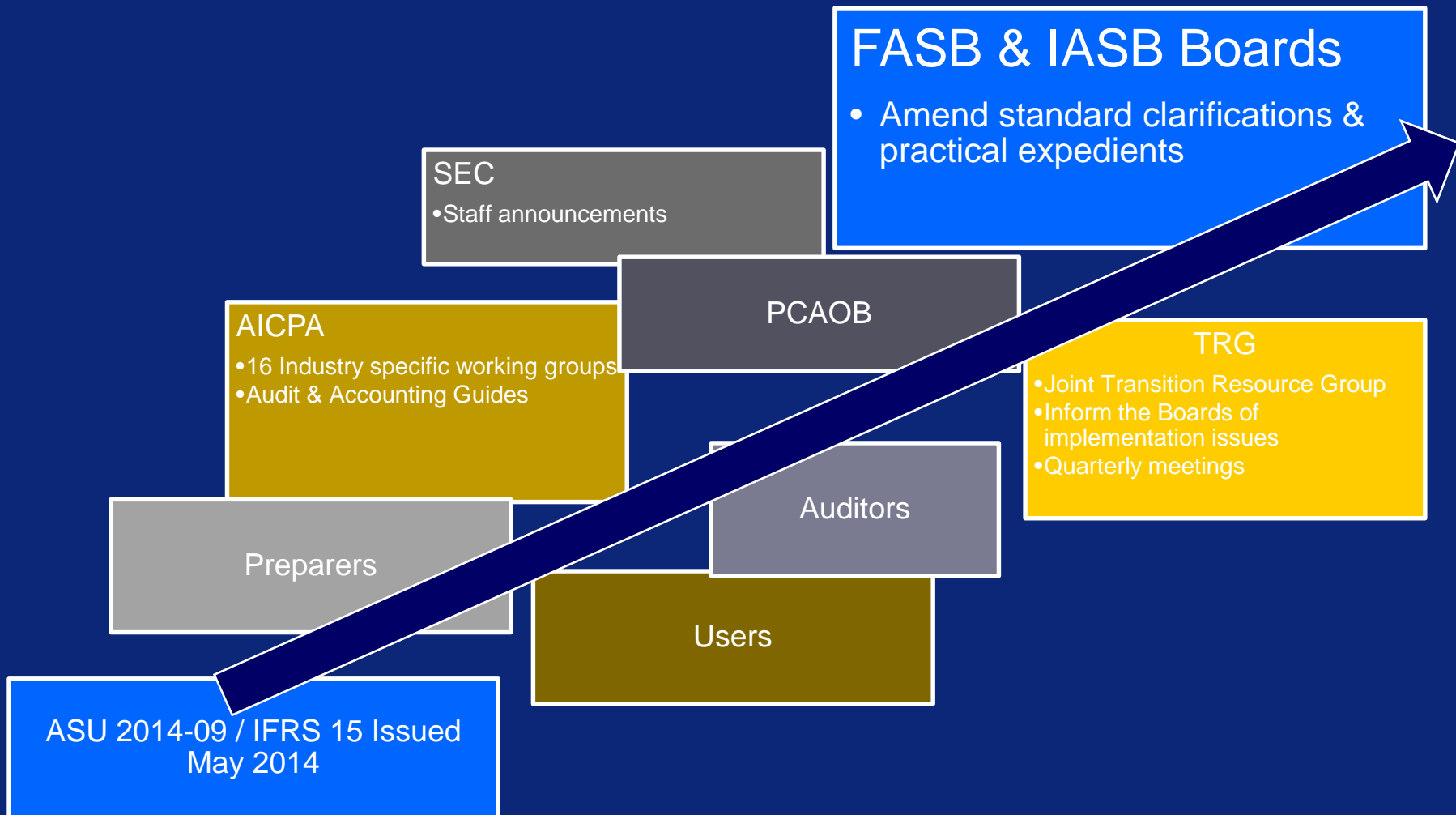
Modified Retrospective Approach

- Apply new revenue guidance to contracts not completed as of date of initial application date and record cumulative catch up to opening retained earnings
 - What is required to be disclosed in the year of adoption?
 - The amount by which each financial statement line item is affected in the current period by the application of the ASU as compared with guidance in effect before the change
 - An explanation of the reasons for any such significant changes



January 1, 2018 Initial Application Year	2018 Current Year	2017 Prior Year 1	2016 Prior Year 2
New contracts	New ASU	N/A	N/A
Existing contracts	New ASU + cumulative catch up	Legacy GAAP	Legacy GAAP
Completed contracts	N/A	Legacy GAAP	Legacy GAAP

Implementation Efforts – Key Participants



Power & Utility Task Force Focus Areas

Focus Areas	Considerations
Tariff-based sales	<ul style="list-style-type: none">• Scope clarification• Carve out of alternative revenue programs
Variable consideration	<ul style="list-style-type: none">• Application of constraint guidance• Different pricing profiles for same service (e.g. step vs. strip pricing)
Contract modifications including blend-and-extend	<ul style="list-style-type: none">• Financing element present?• Partial terminations
Bundled arrangements (e.g. PPAs)	<ul style="list-style-type: none">• Identification of separate POs• Timing of revenue (customer control)
Sales of non-financial assets	<ul style="list-style-type: none">• Replacing real estate sale rules• Partial sales – unit of account?
Contributions in aid of construction	<ul style="list-style-type: none">• Revenue vs. offset to PP&E

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

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.

Scope *(cont.)*

Case Study: Contract with a customer that is partially within the scope of the new standard.

- ABC Wind Farm enters into a power purchase agreement (“PPA”) to sell 100% of the electricity output and the associated renewable energy certificates (“RECs”) to a regulated utility. ABC’s accounting policy is that RECs are not considered output of its wind facility. The electricity element of the PPA is accounted for as a lease.

Discussion Topic: How should ABC Wind Farm account for its sale of electricity and REC’s under its PPA?

Step 1

Step 2

Step 3

Step 4

Step 5

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

Collectibility threshold

A contract will not be in the scope if:

The contract is wholly unperformed

AND

Each party can unilaterally terminate the contract without compensation



Contract Modifications

Guidance on accounting for contract modifications under current U.S. GAAP does not exist for most industries and arrangements; therefore, practice is mixed with regard to how entities account for contract modification.

- Under the new standard, a contract modification is accounted for as a separate contract if:
 - The modification promises distinct goods or services; and
 - The price of the contract increases by an amount of consideration that reflects the standalone selling price of the additional promised goods or services.
- A modification that is not a separate contract is evaluated and accounted for either as:
 - A termination of the original contract and the creation of a new contract, if the goods or services are distinct from those transferred before the modification;
 - A cumulative adjustment to contract revenue, if the remaining goods and services are not distinct and are part of a single performance obligation that is partially satisfied; or
 - A combination of the preceding two approaches.



Contract Modifications

Case Study

Company A has an existing agreement for the sale of electricity to Company B with a contract price of \$40 MWh for annual quantities of 100,000 MWh for a 10 year term. The seller of electricity concluded that its obligation to sell electricity is a single performance obligation that is satisfied over time.

Three years into the agreement, the parties enter into a contract modification to the existing arrangement, which extended the contract term for five additional years beyond the original term with annual 100,000 MWh delivered at a price of \$55 MWh during years 11 through 15.

Discussion Topic: How should the Company A account for the contract modification?

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



YES

Account for as a performance obligation

NO

Combine 2 or more promised goods or services & reevaluate



Performance Obligation (*cont.*)

Case Study

Company A sells electricity and RECs to Company B under a 10 year PPA. The PPA does not contain a lease and that the electricity and REC are not accounted for as derivatives (i.e. the PPA is subject to the scope of the new revenue standard).

Control of the electricity transfers to Company B upon delivery of the electricity. Control of the RECs transfers upon the completion of the transfer of the REC's from Company's A's account to Company B's account. The transfer of RECs occurs upon certification, which typically happens in the month following the sale of the electricity. Assume that Company A and B also frequently transact in the sale of electricity and RECs on a standalone basis.

Discussion Topic: How many performance obligations are included in the PPA?

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

Need to consider whether adjustments are for concessions or credit risk



Variable Consideration

Current U.S. GAAP:

- The seller's price must be fixed or determinable for revenue to be recognized. Revenue related to variable consideration generally is not recognized until the uncertainty is resolved.

New Standard:

- An entity needs to determine the transaction price, which is the amount of consideration it expects to be entitled, including an estimate of variable consideration. The estimate of variable consideration should be based on the Company's policy established for either the expected value (probability weighted) or most likely amount.
 - An entity should recognize an amount within the transaction price only if it is "probable" that a subsequent change in the estimate would not result in a significant reversal.
 - Management will need to determine if there is a portion of the variable consideration (minimum amount) that would not result in a significant revenue reversal and that should be included in the transaction price. This will need to be reassessed at each reporting period

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.



Allocating the Transaction Price *(cont.)*

Case Study:

Company A sells 100 MW of electricity during each hour and the associated RECs (one REC for each MWh) to Company B at a bundled price of \$50/MWh. The total monthly transaction price equals \$3.6 million (100 MW * 24 hours * 30 days * \$50/MWh). Assume neither electricity or RECs are accounted for as derivatives. Company A sells electricity and RECs on a standalone basis for \$45/MWh and \$15/REC, respectively. These products are separately identified within the agreement and are distinct and accounted for as separate performance obligations.

Discussion Topic: How should Company A allocate the transaction price to the performance obligations?



Step 1

Step 2

Step 3

Step 4

Step 5

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



Step 1

Step 2

Step 3

Step 4

Step 5

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

Recognizing Revenue Case Study

Company A executes a PPA for the sale of 100,000 MWh per year over a 10 year term at prices that reflect the forward market price of electricity at contract inception as follows:

- Years 1-3 \$45/MWh
- Years 4-6 \$50/MWh
- Years 7-10 \$55 MWh

Company A concludes the promise to sell electricity represents one performance obligation that will be satisfied over time.

Discussion Topics:

1. How should Company A recognize revenue under its PPA?
2. What if the price escalation included in the contract does not reflect the value to be delivered to the customer each year?

Revenue Recognition – Preparing for the Change

The following summarizes some important near-term actions and decisions which companies will likely need to undertake

Near-Term Actions

- Analyze impact of standards on business units and revenue streams
- Develop project plan and roadmap
- Analyze pro forma effect on financial statements
- Determine and resolve specific accounting and tax issues
- Design system solutions, where needed
- Evaluate impact on periodic financial processes

Important Decisions

- Transition method
- Contract vs. portfolio approach
- System solutions
- Accounting policy choices

Key Stakeholders and Required Activities

New standard may require broad project plans covering the following:

	Activity	
Technical Accounting	<ul style="list-style-type: none"> • Assessment (“sprint”) effort • Scenario Documentation • Business Requirements • Accounting Policy Documentation • Finalize Transition Plan 	<ul style="list-style-type: none"> • Auditor Concurrence on Accounting Policies and Scenarios • User Acceptance Testing • Prepare Draft Disclosures • Draft Financial Statements
Data and Systems Development	<ul style="list-style-type: none"> • Systems Design and Architecture • Systems Solution Development • Systems Testing 	<ul style="list-style-type: none"> • Development and Stabilization • Post Implementation Review
Process/Close and Report	<ul style="list-style-type: none"> • Reporting Controls / Reconciliation • Monthly Close Process 	<ul style="list-style-type: none"> • Controls Implementation Review • Draft Reporting Process Development
Readiness and Training	<ul style="list-style-type: none"> • Design and Develop Training Program 	<ul style="list-style-type: none"> • Roll Out Training
Tax	<ul style="list-style-type: none"> • Evaluate Tax Reporting Requirements • Tax Reporting Implementation 	<ul style="list-style-type: none"> • Tax Planning / Reporting Process Enhancements
Program Management	<ul style="list-style-type: none"> • Form Implementation Team • Communicate to Audit Committee 	<ul style="list-style-type: none"> • Update Stakeholders/Audit Committee





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