Deloitte.

Investments in Alternative Energy Assets

Jason Gambone
jasongambone@deloitte.com

Brent Wilberts
bwilberts@deloitte.com

Deloitte & Touche LLP

Agenda

Consolidation

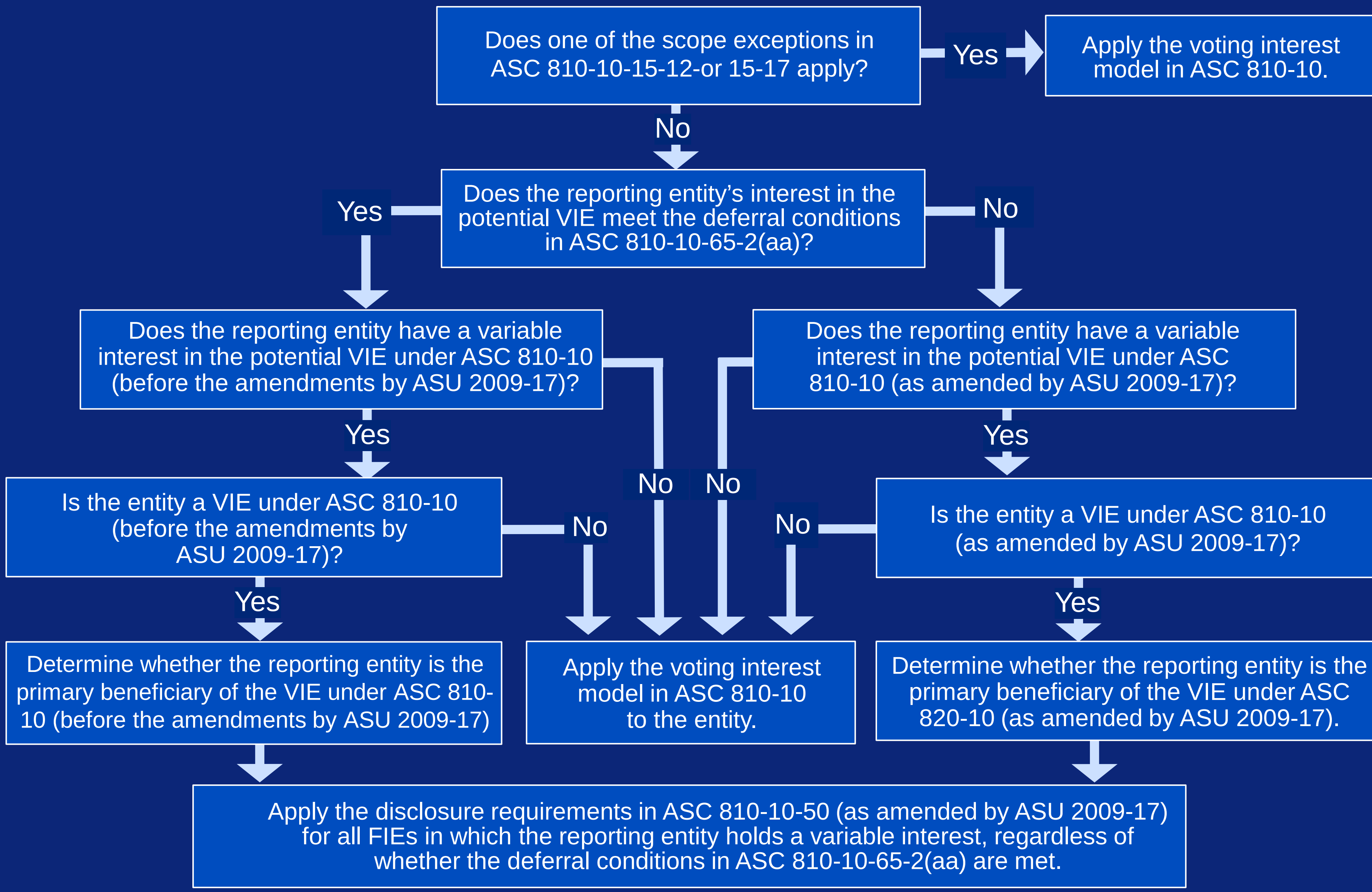
Equity Method Accounting

Joint Venture Accounting

Undivided Interests

Consolidation

Consolidation Models (Current GAAP)



ASC 810 Scope Exceptions

- Employee benefit plan subject to the provisions of Topic 712 or 715. FIN 46(R), paragraph 4]
- An investment company within the scope of Topic 946
- A governmental organization
- A legal entity that is required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7 of the Investment Company Act of 1940 (pending)

Voting Interest Model

The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree.

Control by Other than Voting Interest

- Control of the board of directors/governing body
- Notwithstanding lack of ownership of voting stock, the investor has control of sufficient proxy rights for a majority of the voting stock by agreement
- Contracts or other written agreements with other holders of voting interests that provide control
- Holding of a majority of total equity or "at risk" capital, resulting in potential influence beyond voting share percentage
- Ability to sell, lease, or otherwise dispose of the investee's assets

Variable Interest Examples

- Equity investments at risk, including
  - Mezzanine equity
  - Preferred equity
  - Preferred stock
  - Common stock
  - Partnership capital
- Investments in subordinated beneficial interests
- Any of a VIE's liabilities, including
  - Long-term debt

Variable Interest Examples

- Guarantees of the value of the assets or liabilities of a VIE, written put options on the assets of the VIE, or similar obligations
- A forward contract to sell assets that are owned by the VIE at a fixed price will usually absorb the variability in the fair value of the asset that is the subject of the contract
- Operating leases where potential VIE is lessee
- Derivatives
- PPAs

Non-Variable Interests

- Assets
- Operating leases where potential VIE is lessor

Equity Investment at Risk

- The total equity investment at risk is not sufficient to permit the legal entity to finance its activities without additional subordinated financial support provided by any parties, including equity holders.
- As a group the holders of the equity investment at risk lack certain characteristics

Leases as Variable Interests

An operating or capital lease represents an economic liability of the lessee entity (the potential variable interest entity). That is, the lessor is exposed to the lessee entity's ability to pay under the terms of the lease agreement. Therefore, a lessor's interest in a lease generally is a variable interest in the lessee entity. Contingent rentals may increase the lessor's exposure to variability in the results of the entity. For example, contingent rentals based on the lessee entity's sales would result in the lessor’s absorbing or receiving additional variability in the results of the entity.

VIE Consolidation

- A reporting entity with a variable interest in a VIE shall assess whether the reporting entity has a controlling financial interest in the VIE and, thus, is the VIE’s primary beneficiary. A reporting entity shall be deemed to have a controlling financial interest in a VIE if it has both of the following characteristics:
  - a. The power to direct the activities of a VIE that most significantly impact the VIE’s economic performance
  - b. The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

VIE Reconsideration Events

- The legal entity's governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the legal entity's equity investment at risk
- The equity investment or some part thereof is returned to the equity investors, and other interests become exposed to expected losses of the legal entity
- The legal entity undertakes additional activities or acquires additional assets, beyond those that were anticipated

Control of Partnerships

- Prior to the eventual adoption of ASU 2015-02, the general partners in a limited partnership are presumed to control that limited partnership regardless of the extent of the general partners' ownership interest in the limited partnership

ASU 2015-02

- Removes the presumption of GP control
- All entities need to re-consider their consolidation conclusions
- Transition dates
  - Public companies - Annual and interim periods beginning after 12/15/15
  - Private companies – Annual periods beginning after 12/15/16 and interim periods after 12/15/17

ASU 2015-02 *(cont.)*

- LPs will be VIEs, unless the limited partners have either substantive kick-out or participating rights. Although more partnerships will be VIEs, it is less likely that a GP will consolidate an LP.
- The ASU amends the effect that fees paid to a decision maker or service provider have on the consolidation analysis. Specifically, it is less likely that the fees themselves would be considered a variable interest, that an entity would be a VIE, or that consolidation would result.

ASU 2015-02 *(cont.)*

- The ASU significantly amends how variable interests held by a reporting entity's related parties or de facto agents affect its consolidation conclusion. Specifically, the ASU will result in less frequent performance of the related-party tiebreaker (and mandatory consolidation by one of the related parties) than under current U.S. GAAP.

ASU 2015-02 *(cont.)*

- For entities other than limited partnerships, the ASU clarifies how to determine whether the equity holders (as a group) have power over the entity (this will likely result in a change to current practice). The clarification could affect whether the entity is a VIE.

ASU 2015-02 *(cont.)*

- Unless it is exempt, a reporting entity is required to apply either the VIE model or the voting interest entity model in performing its consolidation assessment. To determine which model to apply, the reporting entity evaluates whether any of the three conditions in ASC 810-10-15-14 are present. If so, it applies the VIE model.

ASU 2015-02 *(cont.)*

- Amendments to 810-10-15-14 regarding the power to direct activities
- 2 models for this evaluation –
  a) LP model and b) corporation model

ASU 2015-02 LP Model

- LP considered a VIE unless substantive kick out rights exist
- Kick out rights – Not a VIE and evaluate for power
- No Kick Out rights – VIE and evaluate for consolidation + must provide VIE disclosures

ASU 2015-02 Corporate Model

- 2 Step process
  - Step 1) Evaluate if equity holders have power over the most significant activity of the entity through their equity interests (voting rights)
  - Step 2) Evaluate if a single equity holder has the unilateral ability to remove the decision maker or participate in the activities that most significantly affect the entity’s economic performance
- If no, to both questions, the entity is a VIE

ASU 2015-02 Consolidation of LPs

- If a VIE, perform primary beneficiary analysis
  - Power to direct activities
    - Evaluate economic exposure
  - Obligation to absorb losses of, or the right to receive the benefits from, the VIE that could potentially be significant to the VIE
  - Do not consider fee arrangements
- If not a VIE, no changes to GAAP, ownership, directly or indirectly, of more than 50% of the o/s voting shares results in consolidation

Equity Method Accounting

Basic Principle

- If consolidation is not appropriate, investments may qualify for the equity method of accounting
- Equity method accounting applies to investments in common stock or in-substance common stock that give the investor significant influence over operating or financial policies
- In-substance common stock is an investment that exhibits the same characteristics of risk and reward as that of the investee’s common stock
  - Convertible debt
  - Preferred equity
  - Options or warrants

Significant Influence

- Significant influence is presumed (by US GAAP) at 20% or greater investment in common stock
- May have greater than 20% ownership and not have significant influence
  - Opposition by investee
  - Contractual agreement surrendering rights
  - Concentrated ownership that operates the entity independently
  - Lack of board representation

Significant Influence

- Significant influence may also be obtained outside of investment percentage
  - Board representation
  - Participation in management decisions
  - Ability to make management changes
  - Agreement to purchase additional equity
  - Significant intercompany transactions
  - Technology dependence
- Many agreements associated with alternative energy projects could provide significant influence

Application of Equity Method

- Record investment at cost
  - Should include all direct costs of the investment
  - What about differences between cost and fair value (i.e. basis difference)?
    - Basis difference accounted for as if the investor consolidates the investee (current GAAP)
- Carrying amount of investment is adjusted based on the investor’s share of earnings or losses
  - There are several acceptable methods afforded by GAAP, which should be applied based on the facts and circumstances of each investment

Basis Differences

- Investor A acquires 30% equity interest in Investee B for $300 million. Fair value of B's net assets is determined to be $1.2 billion
  - What is the basis difference to be considered at the initial investment?
    - $60 million
  - Assume A attributes this basis difference to the fair value of property owned by B that has an EUL of 20 years; what is the annual effect on A's equity earnings?
    - $3 million (less than 30% of B's profit or loss)

Percentage of Ownership

- Recognizes the investor's share of investee earnings or loss based on their percentage ownership, as adjusted for the following
  - Elimination of intra-entity profits and losses until realized as if investee were consolidated
  - Capital transactions with the investor
  - Amortization of basis differences, if appropriate
  - Other comprehensive income
- If the investee prepares non-US GAAP financial information, the investor must record the appropriate adjustments

Application of Percentage of Ownership

- Investor A acquires 30% equity interest in Investee B for $300 million. A has rights to profits and losses commensurate with ownership and applies equity method accounting. B records $60 million of income in 201X.
  - What is A's equity income?
    - $18 million
  - What is the investment balance?
    - $318 million
- If in the same year B distributes $30 million to A?
  - Investment reduced to $288 million.

Application of Percentage of Ownership

- Assume the same facts as prior slide, except
  - A buys power generated by B for $10 million, at $2 million profit to B
  - A recognizes a basis difference at inception based on facts of earlier example
- What is A's equity income?
  - $15 million ($60 * 30% = $18 - $3 = $15)
  - Why wouldn't intra-entity elimination be necessary?
    - Intra-entity profit or loss is eliminated only on assets remaining on books

Applicability to Alternative Energy

- Application of the conventional equity method (percentage of ownership) of accounting for alternative energy investments may not be appropriate in all circumstances

- Investee’s capital structure provides different rights and priorities to its owners or ownership percentages are not specified

Alternatives to Percentage of Ownership

- Modified percentage of ownership
  - Percentage of project lifetime earnings expected to be realized by the investor, multiplied by project’s current period earnings (adjusted to remove book depreciation)
- Hypothetical liquidation at book value (HLBV)
  - Balance sheet approach which allocates pre-tax earning or loss based upon the amount each investor would receive if the investee was liquidated at the measurement date
  - Generally not appropriate when the percentage of ownership approach may be applied

Alternatives to Percentage of Ownership

- Modified equity method
  - Recognition of earnings or losses based upon the stated percentage of cash distributions
  - May be relevant for investments which flow-through tax benefits to investors, have a stable percentages of cash distributions, and have stable project operations
- ASC 970-323 Real Estate Ventures
  - investor's share of net income or loss, is based on how an increase or decrease in net assets of the venture will affect cash payments to the investor over the life of the venture and on its liquidation

Alternatives to Percentage of Ownership

- Effective yield
  - Amortization of the initial cost of the investment based on the IRR and recognition of tax credits as they are allocated
  - Applied to investments in qualified affordable housing projects
- Proportional amortization
  - Introduced in ASU 2014-01 to address investments in qualified affordable housing projects, this method amortizes the initial investment in proportion to the tax credits and other tax benefits received by the investor

Accounting for Losses

- Investor should not recognize losses in excess of the amount of its equity method investment (including loans and advances)
  - There is an exception if the investor has guaranteed obligations of the investee or is otherwise committed (legally or otherwise) to provide further financial support
- Amount of Losses to Recognize (EITF 99-10)
  - Based on ownership level (including loans) to which equity method losses are being applied or
  - Based on change in investor's claim on investee's book value

Fair Value Option

- May be applied to equity method investments
  - Applied by instrument
  - Irrevocable
  - Must be applied to the entire instrument
- May eliminate the operational challenges of applying equity method accounting
  - Could simplify accounting for investments with embedded put and call options
- May result in valuation challenges and periodic volatility
- Requires additional disclosures

Change in Ownership or Influence

- If a cost method investment qualifies for equity method accounting because of a change in ownership interest or significant influence, results of operation and retained earnings should be retroactively adjusted as if the equity method were applied since the investment inception
- An investment that no longer qualifies as an equity method investment shall discontinue accruing its share of earnings or losses
  - Investment shall not be adjusted as a result of discontinuation of equity method accounting

Impairment Considerations

- Basic principle
  - When an asset's carrying value is not recoverable
- NOT the same as long-lived asset impairment
  - Undiscounted cash flows of asset
- Requires an assessment of the fair value of the investment to the carrying value
  - For alternative energy generating facilities, fair value is often measured using the discounted cash flow approach
  - Must consider whether the decline in fair value is temporary or other-than-temporary

Impairment Considerations

- Impairment should be recognized when there is a loss in value of an investment that is other-than-temporary
- Impairment indicators
  - A series of (unplanned) operating losses
  - Modification to PPA or other contracts
  - Legislative or regulatory actions
  - Changing market factors (such as the price of power)
- Investor should not test an investee's underlying assets

Other-Than-Temporary

- How to evaluate whether an impairment is other-than-temporary (SAB Topic 5M)
  – Length of time and extent fair value is below carrying value
  – Financial condition and near-term prospects
  – Intent and ability to hold the investment
  – Changes in technology
  – Macroeconomic trends
  – Capital strength of the investee
  – Cessation of support or commitment by other investors

Impairment

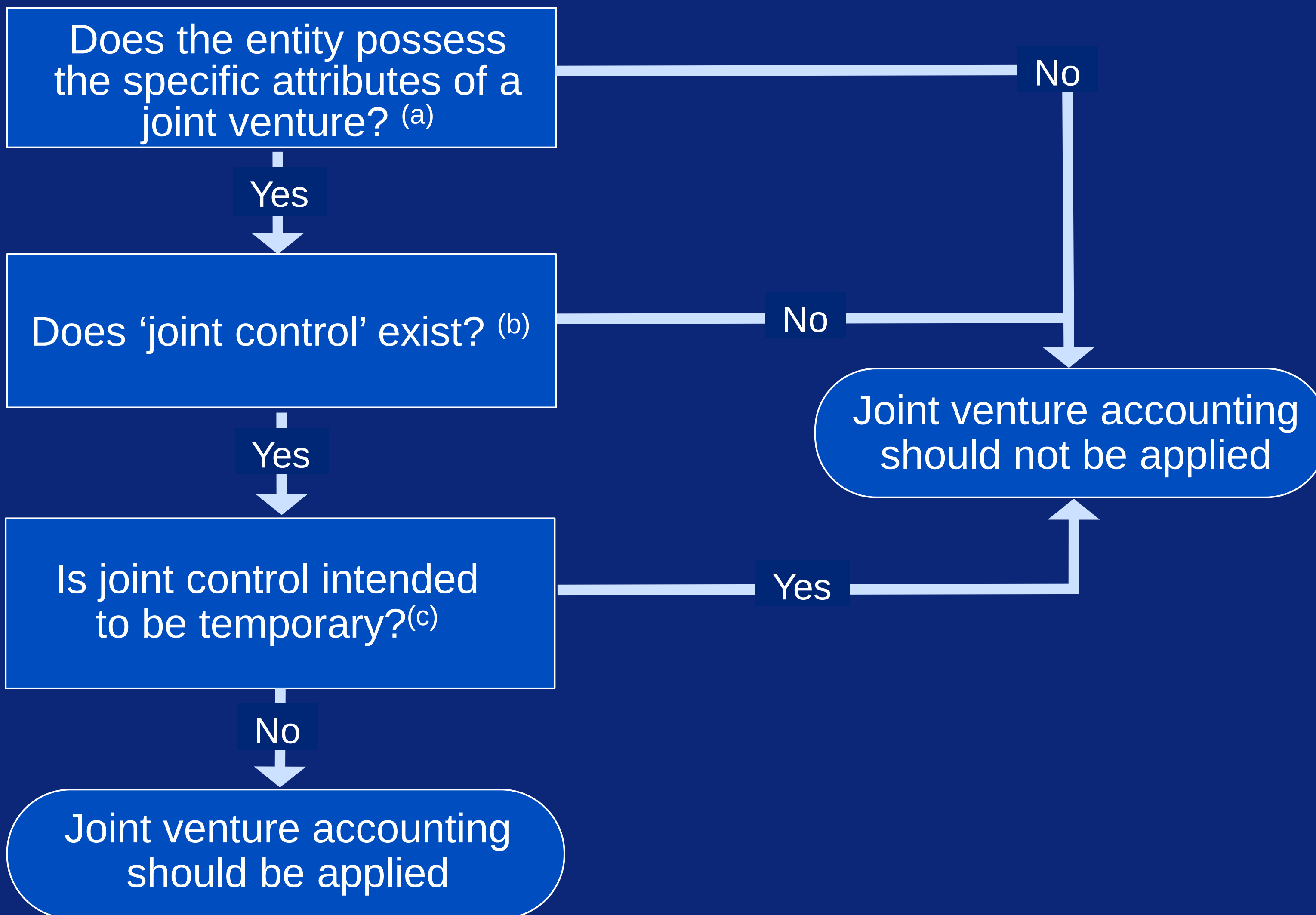
- The investor recognizes an other-than-temporary decline as an expense by writing down its investment to fair value
  - New cost basis is established
  - Cannot reverse the effects of an impairment by any means
  - Subsequent increase in the fair value of the investment are only recognized when realized

Equity Method Exposure Draft

- FASB released an exposure draft on June 5, 2015, addressing equity method investments
- Primary purpose was to simplify existing standards
  - Would eliminate the requirement to account for the basis difference between the investor cost basis and the proportionate fair value of the investee's net assets
  - Would remove the concept of retroactive adjustment when changing from a cost method to equity method of accounting upon a change in ownership or significant influence

Joint Venture Accounting

Scope of Joint Venture Accounting



Attributes of a Joint Venture

- The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors.

Joint Control

Joint control is a joint venture's most distinguishing feature. Venturers need not have equal ownership interests to have joint control, and joint control can be shared among more than two venturers. Joint control can also exist if one of the venturers has significant participating rights, provided that decisions related to the joint venture require the unanimous approval of the venturers.

Is Joint Control Temporary?

If the venturers intend to make joint control temporary (such as when a joint venture expects to conduct an initial public offering in the near future and subsequently eliminate joint control), joint venture accounting should not be applied. All facts and circumstances should be considered in the determination of whether joint control exists.

Examples of Control by One Investor

- Control of the Board of Directors
- Majority of the voting stock
- Holding of a majority of total equity
- Ability to unilaterally sell, lease, or otherwise dispose of investee's assets
- The investor has the ability to unilaterally set or significantly change the operating or capital policies of the investee, including budgets, in the ordinary course of business.
- Selecting, terminating, or setting the compensation of investee management

Unequal Ownership Interests

- Company B and Company C entered into a joint venture arrangement
- The equity interests and profit/loss allocation under the arrangement is 60:40 to B and C, respectively. While B has majority ownership, the joint venture agreement provides that all significant matters involving the activities of the joint venture (D) require unanimous approval of both B and C.

Unequal Ownership Interests

- The ownership interests do not have to be split equally amongst the venturers in order for joint control to exist. The joint venture agreement provides that all significant matters involving the activities of D require unanimous approval of both venturers. As a result, neither venturer is in a position to unilaterally control D. Assuming no conditions exist that indicate substantive control of D by either B or C, joint control would exist between the venturers.

Joint Control with Management Teams

- 2 unrelated venturers, Companies R and S, form an LLC by contributing equal amounts of cash. Income is shared equally. The investors have delegated management of the LLC to a 4-member management committee (MC). Each investor appoints 2 representatives to the LLC's MC. Decisions regarding the ongoing operations of the LLC require a majority vote of the MC. The venturers can only remove a member of the MC for cause. The governing documents of the LLC state that there must always be equal representation of both venturers on the MC.

Joint Control with Management Teams

While the right to make day-to-day decisions has been assigned to a management committee, the LLC is still governed and jointly controlled by the venturers, since decisions made in the ordinary course of business require the consent of at least one representative from each of the venturers. That is, the representatives from R are required to obtain at least one vote from the representatives from S to move forward with a decision that affects ongoing operations of the LLC, and vice versa.

JV Accounting

Generally, an investor in a JV (venturer) accounts for its investment in a JV the same way as any other equity method investment under ASC 323. With the adoption of ASU 2010-02, investments in JVs are typically recorded at cost and interests in a JV retained in a de-consolidation transaction are recorded at fair value.

Fair Value Step-ups

- Company B contributes property with fair value of $50 and historical cost of $20 to the JV. Company C contributes $50 in cash to the JV, which will only be used for transactions with parties other than the venturers. Answer
  - *The JV would step-up 100 percent of the assets contributed by B to fair value ($50) as fair value is supported by an equal contribution of monetary assets ($50) by C.*

Fair Value Step-ups

- Company B sells 50 percent of certain property to C for $50. The fair value and historical cost of the assets are $100 and $40, respectively. Company C contributes the property to the JV. Company B contributes remaining portion ($50 fair value and $20 historical cost) to the JV. Answer
  - *The JV would record the contributed property at historical cost equal to $70 ($50 representing C's historical cost and $20 representing B's historical cost). No monetary assets have been contributed directly to the JV thereby precluding step-up to fair value.*

Fair Value Step-ups

- Company B contributes property with fair value of $100 and historical cost of $40 to the JV. The JV sells 50 percent of the JV to C for $50 cash. The JV distributes $50 cash to B. Answer
  - *The JV would partially step-up the contributed property to $70 ($20 historical cost for 50 percent of the property and $50 fair value for 50 percent of the property, effectively sold to C).*

Gain at JV Formation

The SEC staff's position is that contributing assets to a joint venture is not the culmination of the earnings process. The SEC staff has, however, taken a position similar to the guidance in ASC 970-323, when cash is paid to one of the joint venturers in order to balance the fair market value of assets contributed by each venturer. In such cases, the SEC staff has allowed gain recognition that is limited to the lesser of the computed gain or the amount of cash received, provided the recipient has no refund or continuing support obligation.

Undivided Interests

Undivided Interest

- ASC 970-810-20 defines as

  “An ownership arrangement in which two or more parties jointly own property, and title is held individually to the extent of each party's interest.”
- In other words, tenants in common, typically specified within an operating (or similar) agreement
  - Ownership interest is in the asset, not an LLC or holding company

Accounting for Undivided Interest

- Assessment should first consider whether or not a legal entity exists, and therefore an evaluation in accordance with ASC810 *Consolidations* is necessary

- If the asset qualifies as in substance real estate and meets other conditions, an entity may account for its undivided interest based on its pro rata share of assets, liabilities, revenue and expense

In Substance Real Estate

- Involves judgment, however certain GAAP rules exist for determining in substance real estate
- ASC 360 introduces the concept of integral equipment affixed to land
  - Integral equipment is based on the significance of the cost to remove the equipment
  - If the cost to remove inclusive of the effect (of removal) on the value of the equipment is greater than 10%, such equipment is deemed integral
- Generally, most alternative energy projects qualify as in substance real estate

Undivided Interest

- ASC 970-810-45 describes the conditions under which an entity may account for its pro rata share of the asset
  - Real property owned by undivided interests
  - Approval of two or more of the owners is not required for critical decisions
  - Investors are entitled to only their proportionate share of income and expenses
  - Investors are severally liable for their interest

Undivided Interest

- Under this method each investor records their proportionate share of assets, liabilities and the periodic revenue and expense
- Since each investor is recording their proportionate share, recognition should be subject to their accounting policies
  - Therefore there may be variability in the accounting between investors in areas such as:
  - Capitalization and depreciation
  - Impairment
  - Accounting for contractual agreements

Real Estate Joint Ventures

- Real estate ventures with undivided interests subject to joint control by the owners, shall not be presented based on the pro rata share of the assets, liabilities, revenues, and expenses

- Undivided interests subject to joint control should be presented in the same manner as investments in noncontrolled partnerships

Disclosures for Jointly Owned Electric Facilities

- SEC (SAB Topic 10.C) requires certain disclosures for jointly owned facilities
  - Extent of interests in jointly owned plant
  - Plant in-service
  - Accumulated depreciation
  - Plant under construction
  - Footnotes should state the utility's share of direct expenses in joint plant is included in the operating expenses on the income statement or the respective alternate line item

Questions?

Deloitte.