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Energy Accounting, Financial Reporting and SEC Update

Bill Graf
Christine Davine
David Horn
Tom Kilkenny
Deloitte & Touche LLP

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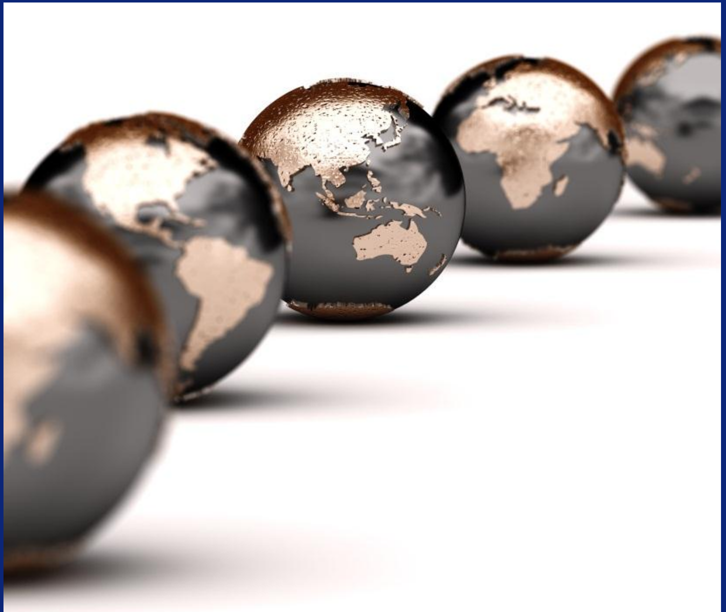


SEC Current Environment/Rulemaking

- Political environment at the SEC
  - Stronger Enforcement program
  - Financial reporting and audit task force and Accounting Quality Model
- Dodd-Frank
  - Conflict minerals
  - Proposal for CEO pay ratio disclosure
- JOBS Act (Emerging Growth Company)
  - Crowdfunding proposal
  - Report on review of disclosure for simplification and modernization (Disclosure Efficiency)
- IFRS
- Communications through social media
- Cybersecurity disclosures
- Iran-Syria Act and disclosure about business in state sponsors of terrorism

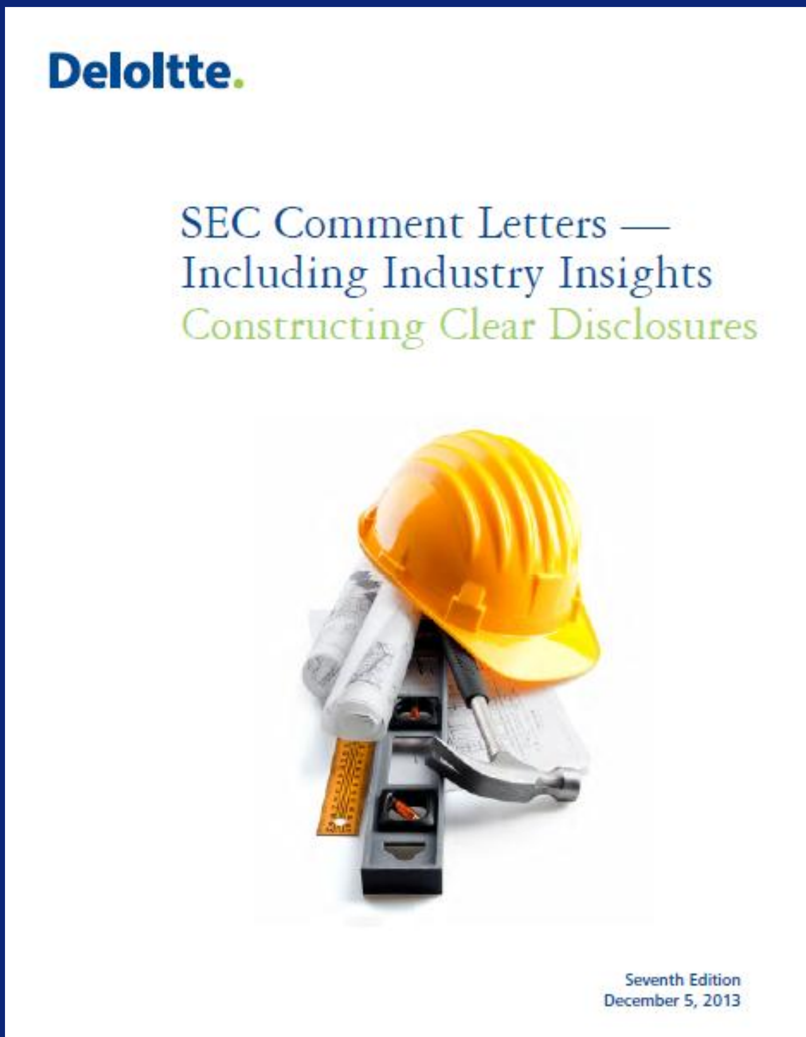
SEC Review Process

- About 9000 domestic and 1000 foreign registrants
- All issuers reviewed at least 1 out of every 3 years
- Percentage of issuers reviewed:

FY08	FY09	FY10	FY11	FY12	FY13
38%	40%	44%	48%	48%	52%

- Continuous reviews of large financial services registrants
- New office of disclosure standards
- Use of data analytics in the review of filings
- Staff is listening to analyst/earnings calls, reviewing press releases and websites and issuing comments
- Begin posting to EDGAR after 20 days (was 45 days)

SEC Comment Trends



- Insights into focus areas from the SEC comment process
- Industry Appendices
  - Consumer and Industrial Products
  - **Energy and Resources**
  - Financial Services
  - Life Sciences and Health Care
  - Technology and Telecommunications

Comments On Financial Statements

- Energy and Resources related
- Income taxes
- Intangible Assets/ Business combinations
  - Goodwill impairment disclosures
- Segments
- Revenue recognition
- Loss contingencies
- Fair value measurements
- Warrants and equity securities
- Financial instruments
- Consolidations/VIEs
- Financial statement classification
- Other-than-temporary impairments
- Pensions and OPEBs
- Dividend restrictions/restricted net assets
- Discontinued operations
- Earnings per share
- IPO considerations
  - Emerging Growth Company
  - Common issues
    - Cheap stock
- Immaterial restatements
- New accounting standards
  - Retrospective treatment
- S-X issues – Rules 3-10, 3-05, 3-09, etc.

Energy and Resources Related Comments

Power & Utilities Sector

- Footnote disclosure of dividend restrictions and schedule of parent company financial information
- Accounting for impacts of ratemaking
- Accounting for energy-related agreements

Power & Utilities and Oil & Gas Sectors

- Master limited partnerships
- Non-GAAP financial measures

Energy and Resources Related Comments

Oil & Gas Sector

- Hydraulic fracturing and other environmental risks and liabilities
- Reserve reports
- Proved undeveloped reserves
- Drilling activities, wells, acreage, and delivery commitments
- Significant changes in reserves and standardized measures

Comments Outside Financial Statements

- MD&A
  - Executive overview
    - Risks
  - Results of operations
    - Early warning disclosures
    - Foreign operations
  - Taxes
    - Foreign income taxes
    - Cash held by foreign subs
  - Liquidity
    - Debt covenant compliance
  - Critical accounting policies
  - Contractual obligations
- Risk Factors
  - Cybersecurity Risks
- Disclosures about operations in state sponsors of terrorism
- Non-GAAP Measures
  - Removing recurring expenses
  - No Non-GAAP income statements
- Financial/Operational metrics
- Executive compensation and proxy disclosures
- Material contracts
- ICFR and disclosure controls and procedures
- Backlog

Questions?

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Update on Big 3 Convergence Projects

Tom Kilkenny
Deloitte & Touche LLP

Agenda

- Financial Instruments
- Revenue Recognition
- Leasing

Financial Instruments Project Update

Financial Instruments
Project Overview

High Level Overview:

- Project impacts a broad range of instruments: Investments in debt and equity securities, loans, derivatives, trade A/R and A/P, debt liabilities and nonmarketable equity investments
- Project comprised of three major components:
  1. Classification and Measurement
  2. Impairment
  3. Hedge Accounting
- Joint project but boards have taken different approaches and are on different timelines

Financial Instruments
Classification and Measurement

Objective:

- Narrow the categories and provide meaningful investor information by category
- Categories under current US GAAP include securities held for trading, AFS or HTM and loans held for sale or held for investment

Three categories proposed:

1. Amortized Cost
2. Fair Value through OCI
3. Fair Value through Net Income

Financial Instruments
Classification and Measurement

Recent Developments:

- FASB decided in February to limit the use of the FV option
- FASB decided in March to retain separate accounting models for loans and debt securities
  - Will not move to a single business model approach
  - Investments in equity securities to be measured at FV through net income
- Decisions represent a substantial divergence from the IASB proposal

Financial Instruments
Classification and Measurement

Recent Developments *(cont.)*

- Instrument-specific credit risk on financial liabilities for which a fair value option has been elected would be recognized in OCI rather than in net income
- For derivative liabilities, any changes in fair value attributable to instrument-specific credit risk should continue to be presented in net income
- Instrument-specific credit risk should be measured as:
  – Excess of total change in fair value over the change in fair value resulting from a change in a base market risk, or
  – Using another method that more faithfully represents the portion of change in fair value attributable to instrument-specific credit risk

Financial Instruments
Classification and Measurement

Remaining Areas of Focus for FASB:

- Consider refinements to tainting guidance in ASC 320
- Extent to which reclassification between categories should be permitted or required
- Practicability exception for non-marketable equity securities

Financial Instruments
Impairment

Objective and Status of Project

- To achieve a more predictive measure of credit risk
  - Expected loss vs. incurred loss
  - Criticism of current rules in wake of credit crisis
- Boards worked jointly on two models but ultimately reached an impasse and broke apart
- December 2012 – FASB issues proposed ASU (CECL model)
- March 2013 – IASB ED exposing the “three-bucket” approach

Revenue Recognition Project Update

Revenue Project
Status Update

Project Timing:

- Exposed twice by boards
  - June 2010
  - November 2011
- Fatal Flaw circulated June 2013
- November 2013 - FASB voted to move forward with final standard
  - Three issues subject to recent deliberations
  - Final issuance in Q2 2014 appears likely
- Proposed effective date for public companies remains 2017

Revenue Project

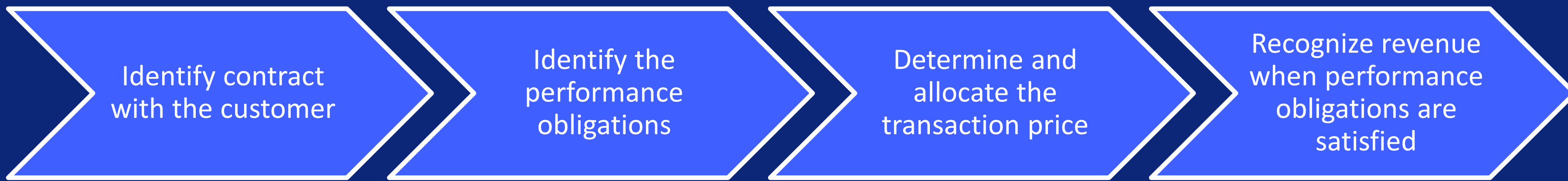
High-level Overview

Keys to proposed approach:

- Seeks to create a single comprehensive model
  - Will eliminate industry specific guidance (PPAs, Real Estate)
- Identification of performance obligations within an arrangement (similar to multiple elements)
- Determining and allocating transaction price
  - May be challenging for variable or bundled pricing
- Recognition of revenue when a customer gains control of the good or receives the service
  - Customer control = satisfaction of performance obligation

Revenue Project

Steps in Applying the Revenue Recognition Model



1. Identify the contract with the customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the separate POs
5. Recognize revenue when POs are satisfied

SOUNDS SIMPLE…RIGHT?

Revenue Project

Progress Since the Original Exposure Draft

Refined identification of separate performance obligations

- Acknowledgement that goods or services in consecutive delivery arrangements may not be distinct “in the context of the contract”
- Forward energy sale with daily deliveries cited as example
- Addresses time value of money concern
- Contract modification rules could still prove challenging (blend-and-extends)

Revenue Project

Progress Since the Original Exposure Draft

Onerous performance obligations guidance removed

- Concerns that rules would add significant complexity and may lead to unintended consequences
- Disagreement over appropriate level to assess (performance obligation, contract, broader)
- Existing industry-specific loss contract rules under IFRS and US GAAP will continue to apply (e.g. ASC 605-35)
- FASB to consider as a separate project in the future

Revenue Project
Fatal Flaw Issues Recently Resolved

Recent Deliberations

- Collectibility related to credit risk
  - Threshold for rev rec based on probability; diverged answer?
  - Price concession vs. bad debt expense
- Constraint for variable consideration
  - Recognize the minimum amount not subject to significant reversal
  - Based on probability and subject to reassessment
  - Operational?
- Accounting for licenses
  - Transfer of control at a point in time or over time

Revenue Project
Considerations Going Forward

Potential Industry Challenges:

- Variable and step pricing
- Contract modifications
  - Financing element in blend-and-extends?
  - Accounting for partial terminations
- Identification of separate PO’s within bundled deals
  - RECs combined with electricity?
- Project will not address EEI request to provide clarity on accounting for bundled arrangements
  - Multiple Element Arrangement vs. Hybrid
  - Area of significant diversity in practice

Revenue Project

Considerations Going Forward

Revenue Implementation:

- Given change in guidance and removal of industry-specific rules, concerns that significant diversity may result
- AICPA has formed industry task forces to address most significant implementation issues
- Pervasive areas may be addressed by FASB (similar to DIG but less prolific)
- Other guidance developed is expected to be memorialized/published by AICPA but will not be authoritative
- 16 industries (including P&U) are participating

Leasing Project Update

Leases Project

Recent Timeline and Redeliberations Status

The following summarizes key dates in regards to the timeline:

Key dates	Description
May 2013	**FASB and IASB issue revised leases exposure draft**
September 2013	**Comments on revised exposure draft due** *More than 640 comment letters received*
November 2013	**Redeliberations plan established** *Almost all key aspects of proposal to be revisited*
January 2014	**Redeliberations begin** *Alternatives presented on path forward for (1) lessor accounting, (2) lessee accounting, and (3) small-ticket leases [no formal decisions reached]*
March 2014	**Redeliberations continue** *Boards discussed path forward for (1) lessor accounting model, (2) lessee accounting model, (3) lease term, (4) small-ticket leases, and (4) short-term lease accounting*

The Boards are expected to continue their redeliberations through much of 2014 and there are no indications as to when a final standard will be issued.

Leases Project

What’s in and What’s Out

Scope

- Generally similar to current U.S. GAAP
- Excludes leases to explore for/use nonregenerative resources, leases of biological assets, and leases of intangible assets

Short-term leases

- Lease term of 12 months or less
- Elective in nature by underlying asset class
- Accounted for in a manner similar to today’s operating leases

Small-Ticket Lease Considerations

- Applying lease accounting at a portfolio level ✓
- Explicit materiality requirement exception X
- Recognition and measurement exemption for small-ticket leases ?

Leases Project

Definition of a Lease

A contract that conveys the right to use an asset for a period of time, in exchange for consideration

Identified Asset	Control
Requires an identified asset • Explicitly or implicitly specified • Substitution rights must be considered	Must have ability to direct the use and derive benefit from use • Rights to substantially all economic benefits from use over the lease term • Taking all of the output will no longer be determinative

Feedback Received…

- ✓ **Clarification of guidance on substitution rights needed**
- ✓ **More guidance needed on how to assess control when lessee was involved with design**
- ✓ **Additional guidance on *highly interrelated goods and services* needed**
- ✓ **Need to address assessment of control where two or more parties can make decisions**

Leases Project
Lessee Accounting Model

Decisions to Date

- Project brings most leases on balance sheet (like today's capital leases)
- Project introduces the right-of-use (ROU) asset approach under which a lessee records:
  - ROU asset – right to use the leased asset
  - Lease liability – obligation to make lease payments

Decisions Reached at March 2014 Joint Meeting

- FASB and IASB primarily considered two approaches:
  - Single-model approach – a lessee would account for all leases as a financed purchase of the ROU asset
  - Dual-model approach – a lessee would consider the guidance in IAS 17 when determining if a lease should be classified as Type A or Type B

FASB is leaning towards dual-model approach while IASB is leaning towards single-model approach.

Leases Project

Lessee Classification – FASB Only

- All leases, with the exception of short-term leases, will be recorded on the balance sheet
- Will still be a classification exercise
  - Type A leases
    - Generally consistent with today's capital leases and will reflect the lease as a form of finance
    - Expense will be more front-loaded
  - Type B leases
    - Generally consistent with today's operating leases
    - Expense will be recorded on a straight-line basis

Leases Project

Lessee ROU and Lease Liability Measurement

Initial measurement	**Right-of-use asset** • Present value (PV) of lease payments + lessee's initial direct costs • Initial direct costs: Incremental costs directly attributable to negotiating and arranging a lease • Recognize lease incentives as a reduction in the right-of-use asset **Lease liability** • PV of lease payments
Subsequent measurement	**Right-of-use asset** • Amortized cost: Method of amortization depends on the classification of the underlying asset from the FASB perspective (i.e., either Type A or Type B) • Impairment: Refer to existing standards (ASC 360) **Lease liability** • Amortized cost: Use the effective interest method

Leases Project

Lessor Accounting Model

Will retain existing lessor accounting with minimal changes:

- Classification criteria would be consistent with IAS 17
  - Type A lease – generally consistent with today's capital/finance leases
  - Type B lease – generally consistent with today's operating leases
- Accounting for dealer profit for Type A leases still a point of debate
  - FASB view – upfront recognition of manufacturer's profit would be precluded if control of asset is not transferred to lessee
  - IASB view – manufacturer's profit, if any, should be recognized upfront

LESSOR CLASSIFICATION CRITERIA

Would account for as a Type A lease when the lease…

✓ Transfers ownership by end of lease term;

✓ Includes a purchase option that the lessee is *reasonably certain* to exercise; or

✓ There is a transfer of substantially all of the risks and rewards of ownership of the asset

If it is not conclusive that all of the risks and rewards incidental to asset ownership are transferred, then the asset would be classified as a *Type B* lease.

Leases Project

Lease Term and Reassessment Requirements

Lease term

- Defined as…

  Noncancelable period + period(s) for which it is *reasonably certain** that the lessee will exercise renewal (or termination) options.

- When determining which options to include, lessees and lessors would consider those for which lessee has an economic incentive to renew
- *Reasonably certain* is a high threshold substantially the same as *reasonably assured* in existing U.S. GAAP

Reassessment requirements*

- Lessee would be required to reassess lease term upon the occurrence of a significant event or change in circumstances under the control of the lessee
- Lessor would <u>*not*</u> be required to reassess lease term

***Tentative decisions reached during March's joint meetings**

Leases Project
Lease Payments

Fixed lease payments

- Include lease payments that are to be made over the lease term

Variable payments – only if…

- In-substance fixed payments
- Payments based on index or rate

Residual value guarantees

- Lessees would include difference between expected and guaranteed residual value

Purchase/termination options

- Treated in a manner consistent with the accounting for renewal options

Leases Project

Discount Rate

Lessee would use the…

- Rate the lessor charges the lessee when available, which would be the rate implicit in the lease
  - ✓ Initial direct costs of the lessor be included in the calculation of the rate implicit in the lease
- Incremental borrowing rate (when the rate the lessor charges the lessee is not available):
  - ✓ The term “value” in the definition of “incremental borrowing rate” refers to the cost of the ROU asset

------------------------ NOTE ------------------------

A lessee is only required to reassess the discount rate when there is a (1) lease modification, (2) change in the lease term or (3) reassessment that the lessee will exercise its option to purchase the underlying asset.

Leases Project

Lease Modifications

	Lessee	*Lessor*
Modifications resulting in a new lease	Recognize the lease modification as a new lease, separate from the original lease	
Modifications *not* resulting in a new lease	If the modification (1) expands the scope of the original lease or (2) results in a change to the lease consideration only, the lessee would use the updated lease payments and discount rate to revise the liability and ROU asset. If the modification reduces the scope of the original lease, the lessee would adjust the lease liability a proportionate amount of the ROU asset, and recognize any difference as a gain/loss.	For a Type A lease, the lessor would use the guidance in ASC 310 to determine how to account for changes in the lease receivable. For a Type B lease, the lessor would account for the modified lease as a new lease.

Modifications result in a new lease when they (1) grant the lessee an additional ROU asset ***and*** ***(2)*** the additional ROU is at-market

Leases Project

Lessee Accounting Model

- **May 2014:**
  - Definition of a lease
  - Separation of lease and non-lease components
  - Initial direct costs and lease incentives
- **June 2014:**
  - Residual value guarantees
  - Subleases
  - Sale and leaseback transaction
- **Other Items:**
  - Presentation & disclosure
  - Transition & effective date
  - Leveraged leases (FASB only)
  - Private company issues (FASB only)

The staff also plan to revisit “small-ticket” leases at a later date.

Questions?

Other Topical Accounting and Financial Reporting Issues

Bill Graf
Deloitte & Touche LLP

Agenda

- Rate Regulation and Accounting Considerations
- Cross-State Air Pollution Rule
- 2013 COSO Framework

Rate Regulation and Accounting Considerations

FASB Statement 71—Thoughts

- The regulated rates are designed to recover the specific enterprise's costs of providing the regulated services or products

- FASB 92 Basis for Conclusions:
  - "If one accepted the premise that….costs can be moved to a future period, the economic discipline inherent in a process of charging customers for the cost of the services they use would be absent"
  - "…Premise that rates in a given period are based on the cost of services provided to customers in that period provides a necessary constraint to accounting for the type of regulation that was addressed by Statement 71"

Accounting for Disallowances of Plant Costs

Disallowance examples

- Direct disallowance
- Cost cap (applied pre-completion)
  - Measure the undiscounted disallowance
  - Discount the disallowance
  - Continue AFUDC until plant is completed
- Explicit, but indirect disallowance
  - Estimate future cash flows disallowed and appropriate discount rate (e.g., allowed cost of capital)

Phase-In Plan Considerations

- Current efforts of companies and regulators to moderate or nullify rate increases
- Rate programs and strategies designed to minimize rate shock in early years of in-service
- These efforts are coincident with or proximate to the in-service date and rate treatment for major, newly-completed plant—see also “planned” and “accidental”

Abandonment – When and How

SFAS 90/ASC 980-360 addresses the accounting for abandonments

- **When probable** asset will be abandoned, **remove** from CWIP or **plant in service**
- Frequent application today – older plants retired early rather than adding pollution control equip
  - Fact that this applies to operating plants and assets is often overlooked

Accounting for Business Combinations of Power & Utility Companies

- Hierarchy and Application of Applicable GAAP
- Valuation of Assets and Liabilities
- Applicability of Regulatory Offset

Cross-State Air Pollution Rule

Cross-State Air Pollution Rule

- Supreme Court Decision to Uphold CSAPR
- Differing Thoughts on Impact
  - Overlap with Clean Air Interstate Rule and Mercury and Air Toxics Standards
  - Cooperation with the States
- Justice Ginsburg Quotes King James Bible:
  - *"The wind bloweth where it listeth, and thou hearest the sound thereof, but canst not tell whence it cometh, and whither it goeth"*

2013 COSO Framework

Highlights of the 2013 COSO Framework

In 2013 COSO released an updated edition of its *Internal Control – Integrated Framework,* intended to address changes in business and operating environments since the original framework's release in 1992

- Globalization of markets and operations, complexities in laws and regulations, and the use and reliance on evolving technologies were key factors driving COSO to update the framework

The fundamental aspects of the 1992 *Internal Control – Integrated Framework* have been retained:

- Core definition of internal control
- Three categories of objectives and five components of internal control
- Important role of judgment in designing, implementing, and conducting internal control, and in assessing its effectiveness

Key changes include:

- More formal structure for the design and evaluation of the effectiveness of internal control
  - Establishes **principles** for each component of internal control
  - Provides **points of focus** regarding each **principle**
- Adds and refreshes guidance within each of the components of internal control

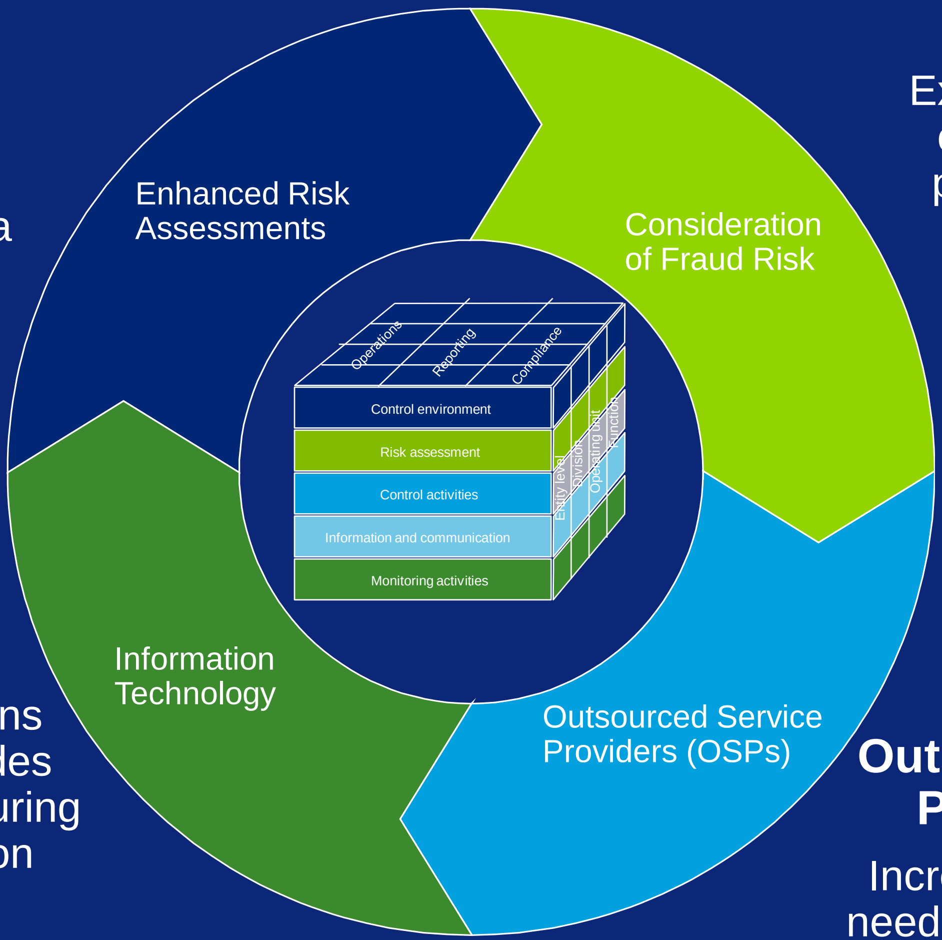
Significant Changes in the 2013 COSO Framework

Enhanced Risk Assessments

More emphasis on risk assessment concepts, including the need for a defined and approved risk assessment methodology that considers the 17 Principles

Fraud Risk Assessments

Explicit emphasis on consideration of the potential for fraud in performing risk assessments



Information Technology

Additional considerations related to IT and provides considerations for ensuring the quality of information

Outsourced Service Providers (OSPs)

Increased emphasis on need for attention to and oversight of OSPs

Transition to the 2013 COSO Framework

COSO

- 1992 Framework considered superseded after December 15, 2014

SEC

- No formal transition guidance issued by the SEC, however SEC rules require that a "suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment" be used for purposes of management's evaluation of Internal Control over Financial Reporting (ICFR)

- Staff comments include:
  - "The "SEC staff plans to monitor the transition for issuers using the 1992 framework to evaluate whether, and if, any staff or Commission actions become necessary or appropriate at some point in the future. However, at this time, I'll simply refer users of the COSO framework to the statements COSO has made about their new framework and their thoughts about transition." (SEC Chief Accountant Paul Beswick)
  - "…the longer issuers continue to use the 1992 framework, the more likely they are to receive questions from the staff about whether the issuer's use of the 1992 framework satisfies the SEC's requirement to use a suitable, recognized framework (particularly after December 31, 2014…)" (SEC Staff)

PCAOB

- PCAOB Auditing Standard No. 5 requires the auditor to use the same internal control framework used by management

Questions?