Revenue for power and utilities companies

New standard.
New challenges.

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Revenue viewed through a new lens

Again and again, we are asked what's changed under the new standard: what do I need to tweak in my existing accounting policies for revenue? It's just not that simple.

The new standard introduces a core principle that requires companies to evaluate their transactions in a new way. It requires more judgment and estimation than today's accounting and provides new guidance to determine the units of account in a customer contract. The transfer of control of the goods or services to the customer drives the amount and pattern of revenue recognition; this is a change from the existing risks and rewards model. As a result, there will be circumstances in which there will be a change in the amount and timing of revenue recognition. Even in circumstances where the effect of the new standard is not significant, a new analysis and controls are likely required.

Less has been said about disclosures, but the new standard requires extensive new disclosures.

There is ongoing analysis and debate about the accounting for power and utilities arrangements under the new standard. The AICPA formed a Power and Utility Entities Revenue Recognition Task Force (P&U AICPA Task Force) to address the key accounting questions. The SEC and FASB have also deliberated some of the questions raised by the industry.

This publication summarizes the most significant issues for power and utilities companies – the issues that involve significant analysis and debate within the industry.

What's inside

Scope

The new standard applies to contracts with customers unless it is in the scope of other guidance.

P&U companies engage in various activities, regulated or not, from production to trading and distribution of commodities – e.g. electricity, oil, natural gas, water.

In assessing whether these activities are in the scope of the new standard, P&U companies will first need to focus on whether the counterparty to these activities meets the definition of a customer.

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

A critical part of identifying whether the counterparty is a customer is whether the promised good or service is an output of the entity's ordinary activities. The new standard does not define ordinary activities and, as a result, judgment will be required to make this determination. The transfer of a nonfinancial asset that is not a part of the entity's ordinary activities is not in the scope of the new standard (see Sales of nonfinancial assets).

If the counterparty meets the definition of a customer, P&U companies will next need to assess whether the contract is in the scope of other guidance. The new standard is often referred to as a residual standard because it applies only when the contract with a customer is not in the scope of other guidance such as leases or derivatives and hedging.

A contract can be partially in the scope of the new standard and partially in the scope of other guidance. If the other accounting guidance specifies how to separate and/or initially measure one or more parts of a contract, then the other guidance is applied first to those requirements. Otherwise, the separation and measurement guidance in the new standard is used to separate and/or initially measure the parts of the contract in the scope of the new standard and the parts of the contract in the scope of other guidance.

Regulated operations

P&U companies that have regulated operations provide products and services to their customers in accordance with the terms and conditions determined by the regulator. All regulated sales by a utility are conducted subject to a regulator-approved tariff.

A tariff-based sale of a commodity to a customer is an output of the entity's ordinary activities. However, some tariff fees will remain in the scope of Topic 980 (regulated operations) if the fee relates to an alternative revenue program (ARP). As a result, the new standard applies to the transfer of goods or services under a tariff except for revenues associated with ARPs. This is the case even if the ARP is governed by separate provisions of the same tariff.

Alternative revenue programs

ARPs allow P&U companies with regulated activities to adjust future tariff rates (usually as a surcharge applied to future billings) in response to past activities or completed events – e.g. reducing the effects of extreme weather on monthly bills, compensating the P&U company for sales lost due to conservation programs, and providing the P&U company a return on investment in such conservation programs.

Under legacy US GAAP, Subtopic 980-605 applied to ARP revenues. However, legacy US GAAP did not require ARP revenues to be reported separately from other revenues generated through tariffs.

Under the new standard, ARP revenue will continue to be in the scope of Subtopic 980-605 because it represents contracts with regulators (not customers) and because other guidance applicable to the arrangement exists. In addition, the new standard amended Subtopic 980-605 to require ARP revenues to be presented separately from revenues recognized under the new standard. However, these amendments do not provide guidance on how to separate these revenues.

The following are two acceptable methods.

— **Method A.** Revenue from contracts with customers is based on the total tariff price at the time the utility service is rendered, including amounts representing the collection of previously recognized ARP revenues. The ARP revenue amount in a given period should include both:
  - the recognition of 'originating' ARP revenues – i.e. when the regulator-specified conditions for recognition have been met; and
  - an equal and offsetting reversal of the amount of ARP revenues recorded in revenue from contracts with customers that is being recovered through incorporation in the price of utility service.

— **Method B.** Revenue from contracts with customers excludes the portion of the tariff representing ARP revenues that was initially recorded in prior periods. The amount of ARP revenue reflects only the initial recognition of 'originating' ARP revenues – i.e. when the regulator-specified conditions for recognition have been met. When those amounts are subsequently included in the price of the utility service and billed to customers, they are recorded as a recovery of the associated regulatory asset or liability.

We believe P&U companies can make an accounting policy election and apply either method on a consistent basis.

Example – Presentation of Topic 606 and ARP revenues

In Year 2, Utility Co. bills customers $10 million from tariff-based sales. This amount includes $2 million of billings related to ARP revenues recognized in Year 1. Assume the remainder of the tariff billings in Year 2 meets the criteria to be recognized as revenue in Year 2.

In Year 2, Utility Co. also recognizes $3 million of ARP revenue that will be billed to customers in Year 3.

The following illustrates the presentation of Utility Co.'s revenues under Methods A and B:

Year 2 ($ millions)	Method A	Method B
Topic 606 revenue	$10	$8[2]
ARP revenue	$1[1]	$3
Total revenue	**$11**	**$11**

Notes:

1. ARP revenue recognized in Year 2 ($3 million) - ARP revenue recognized in Year 1 ($2 million).
2. Tariff billings in Year 2 ($10 million) - ARP revenue recognized in Year 1 ($2 million).

Derivatives

When P&U companies enter into commodity sales contracts (e.g. a forward contract to sell fixed quantities of a commodity in the future), whether the contract is in the scope (or partially in the scope) of the new standard will depend on whether those contracts meet the definition of a derivative, contain an embedded derivative, and whether the normal purchase / sell exception is met and applied.

P&U companies will need to continue to analyze their contracts under the derivatives and hedging guidance before applying the new revenue standard. The new standard does not apply to any portion of a contract covered under that other guidance. A P&U company will apply the new standard only to portions of the contract not covered by other topics.

Leases

A lease is not in the scope of the new standard. When a contract contains both lease and non-lease components, the leases standard (both Topic 840 and the new standard) provides guidance on separating the lease and non-lease components. However, the leases standard requires consideration to be allocated to the lease and non-lease components using guidance in the new standard. The new standard is then applied to the non-lease components.

The new leases standard is effective one year after the effective date of the new revenue standard, and entities should consider whether the transition to the new leases standard will affect the scope of its contracts. For example, the current leases guidance (Topic 840) characterizes maintenance as an 'executory cost' within its scope, while the new leases standard considers maintenance activities as a non-lease component. As a result, a P&U company will need to consider how to allocate consideration to the lease and non-lease components identified under Topic 842 and whether or not it changes the timing of recognizing revenue. See KPMG's Handbook Leases for further details on the effect of the new leases standard including Chapter 4 for separating components of a contract and Chapter 13 for transition issues.

Contributions in aid of construction (CIAC)

CIAC represents an amount received by a regulated utility to ensure that the appropriate party is paying for the costs of utility infrastructure, and that the price of the utility service is economical and fair for all customers. In other words, CIAC is charged to a particular customer so that other customers do not have to pay for a customer-specific investment.

For example, a regulated utility may need to build infrastructure to serve a customer in an undeveloped area and it would not be economical to provide that connection based on current rates; therefore, the utility charges that customer for the investment in order to not increase rates on other customers. In that case, the regulator calculates the amount of CIAC paid by the customer, which represents the uneconomic portion of the investment.

Under legacy US GAAP, many P&U companies viewed CIAC as a cost reimbursement that was not in the scope of revenue guidance and recorded the CIAC payment as an offset to the cost of the property, plant and equipment constructed. P&U companies will typically be able to continue this practice under the new standard when the CIAC payment is made subject to a regulator's calculation. However, if a P&U company historically accounted for CIAC as a component of revenue, it will likely apply the new standard to the payment.

However, if a CIAC payment is not made in accordance with the regulatory framework, the payment could be in the scope of the new standard – either as an up-front payment related to future goods or services, or as a payment related to a promised good or service (see Up-front fees). As part of the evaluation, P&U companies will need to use judgment to determine if the counterparty meets the definition of a customer.

Collectibility

A regulated utility's contract with customers will typically meet the new standard's collectibility threshold.

Under legacy US GAAP, collectibility being reasonably assured was one of the criteria that had to be met to recognize revenue. The new standard requires that collection is 'probable' to conclude that a contract exists. In other words, the collectibility criterion is a gating question designed to prevent entities from applying the revenue model to problematic contracts rather than a recognition criterion (see Step 1: Identify the contract).

To determine if collection is probable, P&U companies will need to evaluate the customer's ability and intent to pay the amount of consideration to which it expects to be entitled in exchange for the goods or services that will be transferred to the customer. If the probable threshold is not met, a contract does not exist under the new standard and revenue is not recognized until it becomes probable or other criteria are met (see Step 1: Identify the contract).

A regulated P&U company may be required to serve retail utility customers with credit ratings lower than what would normally be accepted in a non-regulated business. In addition, an entity may not be able to discontinue service in certain jurisdictions (e.g. discontinuing gas utility services in the winter) even if a customer is not paying. As a result, a regulated entity has unique circumstances to consider when evaluating collectibility.

Under the new standard, regulated P&U companies will typically reach a similar conclusion about collectibility as they did under legacy US GAAP. This is because P&U companies have several mechanisms to mitigate credit risk. Furthermore, because the principle behind the collectibility threshold is to ensure the contracts are 'genuine', the regulated nature of the transaction and rate-making process that takes into account uncollectible amounts should be considered when assessing collectibility.

Contract term

Determining the contract term affects the application of other aspects of the guidance, including the measurement and allocation of the transaction price.

Under the new standard, the contract term is the duration of the contract in which the parties to the contract have presently enforceable rights and obligations. Therefore, if a contract can be unilaterally terminated by either party without paying a substantive penalty to the other party, the duration of the contract is the shorter of the:

- specified contract period; or
- period up to the point at which the contract can be terminated without incurring a substantive penalty.

Similarly, if only the customer can terminate the contract without incurring a substantive penalty, the contract only exists up to the point at which the customer can terminate the contract. In that case, the customer termination rights are akin to a customer option to renew the service and should be evaluated for the presence of a material right. That analysis considers whether any up-front fees indicate that a material right may be present.

The contract term in arrangements with retail utility customers is often limited to the services requested and received to date because the customer can terminate the contract at any time. For example, a customer could move out of their residence and disconnect their service at any time without penalty. If the contract does not have a material right, the P&U company will effectively be able to recognize the amounts earned under the tariff each day as revenue. However, if the contract is non-cancellable or there is a substantive termination penalty, then the term of the contract may be longer. The company will need to evaluate the entire contract to determine the performance obligations and when revenue is recognized, which could be different from the amount it has the right to bill each day.

Other arrangements such as power purchase agreements (PPAs) will have to be assessed to determine whether the contract is cancellable or a substantive termination penalty exists if not in the scope of other guidance (e.g. leasing or derivatives).

Series guidance

Promises to transfer a specified quantity of electricity will be considered a single 'series' performance obligation under the new standard.

The new standard requires promised goods or services to be accounted for as a single performance obligation (a 'series') if they are distinct (see Step 2: Identify the performance obligations), substantially the same, transferred over time (see Timing of recognizing revenue), and have the same pattern of transfer.

This means that the individually distinct promises that meet these criteria are combined into a single performance obligation and recognized over time using a single measure of progress.

A contract to transfer commodities that meets the over-time guidance will generally be a series because each unit:

- is distinct as the customer can benefit from it on its own, the units are not integrated nor do they transform one another;
- is substantially the same as one another; and
- contains the same pattern of transfer to the customer.

In most cases, electricity contracts will meet the over-time criteria and will be a series whereas only some gas contracts (e.g. gas utility service) will be a series (see Timing of recognizing revenue – commodity sales).

Determining if a performance obligation is a series is important because it can affect the allocation of variable consideration (see Variable consideration allocation exception), accounting for contract modifications (see Contract modifications) and disclosure requirements.

Variable consideration

The new standard requires entities to estimate variable consideration subject to the constraint.

Variable consideration in P&U contracts may arise from pricing mechanisms such as index or formula-based pricing, seasonal pricing and volume discounts.

Under legacy US GAAP, when contracts contained certain types of variable consideration (e.g. volume discounts, rebates, customer credits), revenue was recognized subject to an accrual or reserve for estimated variable consideration unless that amount could not be reasonably estimated. Other forms of variable consideration were not recognized until the underlying contingency was resolved (e.g. index-based pricing).

Under the new standard, variable consideration is estimated and included in the transaction price (subject to the constraint on variable consideration). An entity makes the estimate using the method below that will better predict the outcome.

- **Expected-value method.** A probability-weighted estimate considering a range of potential outcomes. This method is typically more appropriate when there are a large number of potential outcomes or the entity has a large number of contracts with similar characteristics.
- **Most-likely-amount method.** This method uses the single most likely amount in a range of possible consideration amounts. This method is typically more appropriate if the contract has only two (or perhaps a few) possible outcomes.

However, a P&U company may not need to estimate variable consideration if it meets either:

- the 'as-invoiced' practical expedient for recognizing revenue (see As-invoiced practical expedient); or
- the variable consideration allocation exception such that the future variable amounts are allocated entirely to distinct goods or services to be provided in the future (see Variable consideration allocation exception).

Timing of recognizing revenue

Electricity supply contracts generally will be recognized over time.

Under the new standard, entities need to evaluate each performance obligation to determine if the performance obligation is satisfied over time (see Step 5: Recognize revenue). If none of the over-time criteria are met, the entity recognizes revenue at a point in time.

Commodity sales

When P&U companies enter into contracts to deliver commodities (e.g. gas, electricity) that are in the scope of the new standard (e.g. not a derivative or a lease), the relevant over-time criterion to evaluate is whether the customer simultaneously receives and consumes the benefit of the commodity as the P&U company performs.

The Joint IASB/FASB Transition Resource Group (TRG) discussed the application of this criterion to commodities and agreed that entities need to evaluate the *nature* of the promise as well as:

— inherent characteristics of the commodity;

— contract terms;

— information about the infrastructure and other delivery mechanisms; and

— other relevant facts and circumstances.

In substance, the purpose of the evaluation is to determine whether the nature of the promise is to provide a good or a service. For example, a contract to deliver natural gas to temporary storage may represent a promise to deliver a good that the customer does not immediately consume as the P&U company performs. In this instance, revenue is recognized at a point in time, likely upon delivery. In contrast, a contract to provide natural gas to the customer for on-demand consumption may represent a service that immediately benefits the customer (e.g. a gas utility service) and therefore recognized over time. P&U companies will need to weigh the above considerations based on the facts and circumstances applicable to each contract and commodity.

Contracts to transfer electricity will typically meet the over-time criteria because the customer simultaneously receives and consumes the benefit of the electricity as it is delivered.

Measures of progress

Under legacy US GAAP, P&U companies typically recognized revenue in an amount that reflected the entity's right to bill the customer.

Under the new standard, when a performance obligation is satisfied over time, P&U companies need to apply a single measure of progress to the allocated transaction price in order to recognize revenue. Once a method is selected, it is applied consistently to similar performance obligations in similar circumstances.

The new standard does not prescribe a single method that must be used, but instead describes output and input methods as appropriate measures. The objective is to choose a method that best depicts the transfer of the promised goods or services to the customer. As a result, there is no free choice of which method to apply and the appropriate method is based on the nature of the good or service promised to the customer. For electricity or gas performance obligations satisfied over time, an output measure based on units delivered compared to total units to be delivered will often be an appropriate measure of progress.

As-invoiced practical expedient

The new standard provides a practical expedient whereby an entity can recognize revenue as it has the right to invoice the customer if that amount corresponds directly with the value to the customer of the entity's performance completed to date. When an entity applies the as-invoiced practical expedient, it effectively bypasses estimating the transaction price (see Step 3: Determine the transaction price), allocating the transaction price to performance obligations (see Step 4: Allocate the transaction price), and the requirement to disclose the transaction price related to the remaining performance obligations.

The as-invoiced practical expedient typically applies when an arrangement is priced on a per quantity basis (P × Q). However, if a contract includes fixed fees in addition to per-unit invoicing (whether paid up front or over time), payments to the customer or volume rebates/discounts, then an entity may be precluded from using the as-invoiced practical expedient. This is because those provisions typically result in billings not corresponding to the value transferred to the customer.

Assessing whether the invoice amount represents the value to a customer will require additional analysis when the per-unit price changes throughout the arrangement. The TRG discussed the as-invoiced practical expedient and generally agreed that changing prices do not, on their own, preclude an entity from applying the as-invoiced practical expedient. However, the TRG agreed that the following need to be present in order to apply the as-invoiced practical expedient when there are changing rates:

— the reasons for the change in price per unit have to be substantive – e.g. for a valid business reason, such as changing costs or price index.

— the amount of the change approximates the change in value to the customer – e.g. the change in a forward pricing curve of a commodity.

For example, a contract to purchase electricity at prices that change each year based on the observable forward market price of electricity would likely qualify for the as-invoiced practical expedient because the rates per unit reflect the market value of those units.

Step vs. strip pricing

P&U companies enter into contracts to deliver fixed quantities of commodities with fixed pricing. The following are common examples.

— **Strip pricing.** The price per unit is stated at a constant rate for a fixed quantity. For example, a contract to provide 1 million MWh at a stated price of $50/MWh over the entire contract.

— **Step pricing.** The price per unit is stated but it changes over the term of the contract. For example, a contract to deliver 1 million MWh of electricity where the price per MWh is $50 in Year 1, $60 in Year 2 and $70 in Year 3.

Under legacy US GAAP, P&U companies typically recognized revenue in an amount that reflected the company's right to bill the customer. Under the new standard, the provision of these services will typically be a series accounted for as a single performance obligation satisfied over time. P&U companies will need to select a measure of progress that may or may not match the contract billings.

Under either type of contract, an output method where the entity recognizes the transaction price in proportion to the amount of electricity delivered will typically be acceptable. In a strip contract, this could result in a pattern of recognition that matches customer billings. In a step contract with increasing prices, recognizing revenue at a constant rate as each unit is delivered would result in recognizing revenue faster than the initial billings.

P&U companies should consider whether the right to consideration corresponds directly with the value to the customer for each type of contract (see As-invoiced practical expedient). A P&U company generally will be able to apply the as-invoiced practical expedient to both step and strip pricing contracts when they can support that the invoiced amount corresponds directly to value to the customer. As a result, under the new standard, P&U companies may be able to continue with its legacy practice of recognizing revenue as it can bill the customer.

Example – Electricity contract with step pricing

Power Co. enters into a four-year non-cancellable PPA with Customer to provide 25,000 MWh of electricity each year.

Year	Quantity (MWh)	Rate per MWh	Amount
1	25,000	$30	$ 750,000
2	25,000	31	775,000
3	25,000	32	800,000
4	25,000	33	825,000
Total	**100,000**		**$3,150,000**

Power Co. concludes that the electricity is a series accounted for as a single performance obligation satisfied over time. Therefore, the total transaction price of $3,150,000 needs to be recognized using a single measure of progress.

Power Co. considers whether the as-invoiced practical expedient can be applied to recognize revenue because it has the right to bill the customer. Power Co. concludes that the changes in prices are commensurate with changes in value to the customer because the increases correspond with expected market prices. As a result, Power Co. recognizes revenue as each unit is delivered in an amount that corresponds with its billings to Customer.

Note: If the unit rates charged each period were not consistent with the value to be received by the customer, then Power Co. would use an output method and recognize the transaction price in proportion to the electricity delivered to date. In that case, Power Co. would recognize $787,500 each year: (25,000 MWh / 100,000 MWh) × $3,150,000.

Allocating the transaction price

P&U companies should consider but do not need to default to the forward curve price when estimating the stand-alone selling price of commodities.

P&U companies often enter into forward sale contracts of various commodities. For those contracts in the scope of the new standard, sales of certain commodities (e.g. oil, certain natural gas contracts) will not be a single performance obligation because they do not meet the criteria to be recognized over time (see Timing of recognizing revenue – commodity sales). As a result, each unit of the commodity will be a separate performance obligation for which the P&U company will need to allocate consideration.

Under legacy US GAAP, P&U companies typically recognized revenue when they delivered the commodities in an amount that corresponded to billings. When a contract for a storable commodity included a step price increase, they still only recognized revenue in proportion to billings because the amount allocated to delivered items was limited to consideration that was not contingent on future performance.

In general, the new standard requires entities to allocate the transaction price to the performance obligations on a relative stand-alone selling price basis. The stand-alone selling price is the price for which an entity would sell a promised good or service separately to a customer (see Step 4: Allocate the transaction price).

The new standard does not prescribe a specific approach to estimating the stand-alone selling price other than that the approach should maximize the use of observable inputs. A forward curve is one example of an observable input. Other information such as cost and margin objectives, views on future prices, potential supply, demand and/or logistical issues could also provide relevant data points.

While the forward curve is an example of an observable input, an entity is not required to use the forward curve price as the stand-alone selling price of a commodity in all circumstances. However, the forward sales curve may be one of the factors an entity considers when determining the contract price, along with other factors such as counterparty creditworthiness, delivery location and other entity-specific factors.

Variable consideration allocation exception

The new standard provides an exception to the general allocation guidance for variable consideration that does not relate to the entire contract. Variable consideration could be attributable to one or more, but not all, of the performance obligations in a contract; or one or more, but not all, of the distinct goods or services promised in a series.

When both of the following criteria are met, P&U companies will be required to allocate the variable amount to one or more, but not all, performance obligations or distinct goods or services.

a. The terms of the variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service that forms part of a series (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service).
b. Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective.

When either of the criteria is not met, variable consideration is allocated on a relative stand-alone selling price basis in a manner consistent with the rest of the transaction price.

When a P&U company enters into a contract to transfer a specified quantity of commodities in exchange for market- or index-based pricing at the time the goods are transferred, the contract contains variable consideration because the ultimate amount to which the entity will be entitled is not known at contract inception. The P&U company will then need to evaluate whether it should allocate the variable amounts to a distinct unit of the commodity.

Commodity supply contracts that contain only market- or index-based pricing will generally qualify for the exception.

- Criterion (a) will generally be met because the terms of the variable payment relate specifically to the company's efforts to deliver the commodity – i.e. the variability is solely attributed to and resolved as a result at the market price upon transfer to the customer.
- Criterion (b) will generally be met because the market price depicts the amount of consideration to which the company expects to be entitled upon transfer of each distinct commodity.

This analysis is the same regardless of whether the specified amount of distinct commodities are transferred at a point in time (e.g. storable commodities) or over time as part of a series (e.g. an electricity or residential gas utility service). However, when contracts include other consideration (either fixed or variable) or have more complex payment terms, further consideration will be required to determine whether both criteria are met.

Practically, when variable consideration can be allocated directly to each commodity transferred, the P&U company will not need to estimate variable consideration beyond the amounts transferred for recognition purposes. Additionally, the P&U company will have the ability to exclude the variable amounts from the disclosure of the transaction price allocated to remaining performance obligations under one of the optional exemptions provided to that disclosure.

Example – Fixed quantities with variable pricing

Power Co. enters into a four-year non-cancellable contract with Customer to sell 10,000 MWh of electricity to Customer over four years. Customer will pay the spot rate on the day each MWh is delivered to Customer.

Power Co. concludes that the promise to deliver electricity is a series and should be accounted for as a single performance obligation satisfied over time. Power Co. also concludes that an output method whereby it recognizes revenue based on each unit delivered to the customer is an appropriate measure of progress.

Power Co. observes that the transaction price is variable and considers whether it can allocate the variable amounts to each distinct MWh of electricity included in the series. Power Co. concludes that:

- criterion (a) is met because the daily spot rate relates specifically to its efforts to deliver the electricity; and
- criterion (b) is met because the market-based pricing reflects the amount to which Power Co. would expect to be entitled in exchange for transferring the electricity.

As a result, Power Co. allocates each payment to the MWh as it is delivered, and recognizes revenue equal to units delivered times the spot rate on the day of delivery.

Requirements contracts

Requirements contracts generally represent customer options for additional goods or services rather than variable consideration. P&U companies will generally recognize revenue based on the quantities delivered and amounts billed.

P&U companies enter into requirements contracts that provide customers with as much electricity or gas as they need for a stated period. The contracts have variable quantities but a stated price per quantity. Under legacy US GAAP, P&U companies typically recognized revenue as each unit was delivered in an amount that reflected the stated contract price.

P&U companies need to first analyze requirements contracts to determine if they contain a lease or a derivative. If not, the contract is in the scope of the new standard.

Under the new standard, a variable quantity sometimes represents variable consideration (e.g. a usage-based fee), but could also represent a customer option to acquire additional goods or services. Variable consideration is estimated and included in the transaction price that is allocated to the performance obligations in the contract. In contrast, optional purchases are accounted for as separate contracts when the option is exercised unless the option conveys a material right to the customer.

The TRG discussed the difference between variable consideration and optional goods or services and generally agreed on the following descriptions.

— **Options for additional goods or services.** A customer has a present contractual right (as opposed to an obligation) to purchase additional distinct goods or services. Each exercise of an option is a separate purchase decision and results in the transfer of control of additional goods or services by the entity. Before the customer exercises the option, the entity is not obligated to provide those goods or services and does not have a right to receive consideration.

— **Variable consideration.** An entity is presently obligated to transfer promised goods or services and the customer has already made its purchasing decision. The event that results in additional consideration occurs after (or as) the performance obligation is satisfied – i.e. after (or as) control of the goods or services transfers to the customer. The entity's performance obligations do not change as a result of the event or customer's actions.

A requirements contract will generally be considered optional purchases rather than variable consideration. This is because the nature of the promise is to provide the underlying commodity rather than a service of standing ready, and the customer's actions trigger an obligation for the P&U company to deliver additional distinct goods or services. As a result, P&U companies will need to evaluate whether the options convey a material right to the customer. If there is no material right, the company will recognize the revenue as each unit is delivered for the stated contract price.

Generally, P&U companies will continue with the legacy practice of recognizing revenue based on the quantities delivered and amounts billed. This is because usually the optional purchases are commensurate with stand-alone selling price.

Renewable energy credits

Renewable energy credits (RECs) are typically distinct from the sales of electricity and control transfers to the customer at a point in time.

An entity that owns renewable generation assets such as wind and solar farms are issued RECs from regulators for producing green electricity. A REC is a market-based instrument that represents the property rights to the environmental, social and other non-power attributes of renewable electricity generation. RECs are issued when one MWh of electricity is generated and delivered to the electricity grid from a renewable energy resource.

The REC is used to demonstrate compliance with renewable portfolio standards established by various jurisdictions. The entity can keep the REC or sell it to others. A buyer of the REC can use it to demonstrate compliance with the renewable portfolio standards of its jurisdiction. Many P&U companies sell electricity and the REC generated by that production on a bundled basis. However, RECs are also sold separately.

Under the new standard, RECs bundled with electricity will be separate performance obligations because the buyer can benefit from the REC on its own (i.e. without the electricity) and the REC and electricity are not inputs into a combined output. As a consequence, a P&U company will need to allocate the transaction price to the RECs and electricity (see Allocating the transaction price). While often there will be observable stand-alone sales of RECs, when market prices fluctuate it may be challenging to determine the stand-alone selling price. In that case, P&U companies will need to maximize the use of observable inputs in order to estimate the stand-alone selling price.

A REC performance obligation will be satisfied at a point in time because it does not meet any of the criteria to be recognized over time. As such, P&U companies will recognize revenue at the point in time when the customer obtains control of the REC (see Step 5: Recognize revenue).

A REC needs to be certified by the regulatory body and there is typically a lag between the time the REC is generated and when the certification process is completed and delivered to the customer. However, often the facility is pre-certified and the process involves confirming the level of output rather than focusing on the qualifications of the facility. Therefore, a P&U company will need to evaluate whether the customer obtains control of the REC when:

- the REC was created through the generation of electricity; or
- the REC is certified and delivered to the customer.

Depending on the facts and circumstances, a P&U company may conclude that control of the REC transfers and revenue should be recognized when the electricity is generated. The following factors support that control of the REC transferred before certification:

- the certification is a record-keeping function and the power generator can confirm (particularly when the facility is pre-certified), before certification, the amount of renewable electricity through using its own metering data and formulaic application of the REC ratio;
- the seller has a present right to payment for the REC before certification;
- the risks and rewards of ownership have been transferred to the customer before certification;
- the seller has no additional obligations to fulfill in order to transfer the REC to the customer – i.e. the certification process does not involve additional performance; and
- the customer can benefit and use the REC before it is received by selling or pledging its right to receive the REC once the electricity is generated, and the seller cannot direct the REC to another buyer.

However, some entities may continue to conclude, based on their facts and circumstances, that control of a REC does not transfer until the REC is certified and delivered to the customer. As a result, there may be some diversity in practice, which is consistent with legacy US GAAP.

Capacity sales

Sales of capacity generally are considered stand-ready performance obligations and will be distinct when bundled with other goods or services.

An entity that generates electricity may enter into a contract with a customer (typically a regulated utility) to sell capacity. In those transactions, the entity conveys to the customer the right to call on the generation facility to produce power when needed. Utilities are often required to purchase capacity to demonstrate to regulators that they have the ability to meet customer demand. The facilities that provide the capacity are typically 'peaker plants' that generally run only when there is a high demand and the requested power is purchased separately.

P&U companies will first need to evaluate whether the capacity sale is considered a lease or a derivative. If capacity is not considered a lease or a derivative, an entity that applies the new standard will need to determine if capacity is distinct from other promises in the contract. The following may indicate that capacity is distinct:

- the capacity and electricity are sold separately in the marketplace;
- the pricing of capacity and electricity is not dependent on the other; and/or
- the customer can benefit from the capacity on its own – e.g. if the customer is required to demonstrate access to capacity to its regulator.

Capacity sales with these characteristics will often be distinct from other items bundled in the arrangement, such as the sale of electricity, because of the regulatory environment requiring a utility customer to demonstrate available capacity. Capacity contracts generally would not be distinct when the customer is a consumer of the electricity – e.g. a capacity contract with a widget manufacturing customer.

The above characteristics also distinguish capacity sales from other arrangements such as a requirements contract or a forward contract. For example, in a requirements contract the customer only pays for the electricity it takes but a contract with distinct capacity requires the customer to pay separately for capacity and electricity at prices that do not affect each other – e.g. both capacity and electricity are priced at market. Furthermore, a requirements contract or forward contract is an arrangement to deliver electricity, while in a capacity arrangement the customer uses the capacity purchased to satisfy regulatory requirements and may never take the electricity or may purchase the electricity it needs from another supplier.

When capacity is distinct, the nature of the promise is that of standing ready to provide the underlying services because the customer secured a scarce resource as assurance that it has the ability to meet anticipated demand. Therefore, the performance obligation is satisfied over time because the customer both receives and consumes the benefit of having the capacity available each day.

While judgment is required to select an appropriate measure of progress, an output method that corresponds to the expiration of the capacity rights may be an acceptable measure of progress. This method will often result in a ratable recognition if the volume of capacity is consistent from month to month. However, if the volume of capacity fluctuates throughout the contract term, the output method may result in a pattern of recognizing revenue other than straight-line.

Up-front fees

P&U companies will need to determine if up-front fees relate to the transfer of promised goods or services or future goods or services.

P&U companies often charge customers nonrefundable up-front fees when they first sign up a customer for services (e.g. connection fees, activation). A nonrefundable up-front fee is included in the transaction price and allocated to the performance obligations in the contract in the same manner as other consideration in the contract. However, the presence of an up-front fee often raises questions about whether any activities performed by the entity at or near contract inception transfer a good or service to the customer.

If the P&U company performs set-up activities or administrative tasks that do not transfer a good or service to the customer, no revenue (including the up-front fee) is allocated to or recognized as those services are performed. For example, performing tasks necessary to switch on the service (e.g. run a credit report, enter the customer into the system) typically would not transfer a good or service to a customer. Similarly, activities related to the entity's own assets would not transfer a good or service to the customer.

If the P&U company performs activities at the beginning of the contract that transfer a good or service to a customer, it then analyzes whether those services are distinct.

In a typical retail utility contract, the contract is cancellable by the customer at any time and therefore if the fee does not relate to a promised good or service, it relates to future contracts and generally conveys a material right to the customer. Because a day-to-day contract represents a series of renewal options, a P&U company will need to determine the number of periods for which the customer has a material right. The number of periods would be the time over which the customer benefits from not having to pay another fee upon exercising a renewal option. Consideration would be allocated to each period that there is a material right and recognized as the underlying services are transferred or the right expires.

The period over which the customer benefits from the renewal includes only those periods in which the fee influences the customer's decision to exercise its option. In that case, the P&U company needs to consider quantitative and qualitative factors to identify the periods for which the nonrefundable up-front fee provides a material right.

— **The renewal price compared with the price in the initial contract with the up-front fee.** The significance of the up-front fee and amounts paid for the initial services compared to renewals could influence a customer's decision to renew. The customer may be economically compelled to renew based on its initial investment.

— **The availability and pricing of service alternatives.** For example, if the customer could readily obtain similar services without having to pay an up-front fee, the initial payment may not be an incentive for the customer to renew because it could easily obtain services elsewhere at prices similar to the renewal price.

— **History of renewals.** If the entity has a strong history of renewals, it might indicate that the up-front fee provides an incentive for the customer to exercise its renewal option. For example, an entity might look at the average customer life or periods where the customers renew at a high rate.

P&U companies will need to apply judgment to determine the periods over which to allocate the fee and recognize the material right. That period will often be shorter than the average customer life because there may be many factors other than the up-front fee that affect the customer's period of benefit.

Contract modifications

The new standard includes a general framework for accounting for contract modifications.

Legacy US GAAP did not have contract modification guidance that would typically be applied to an arrangement in the P&U industry. The new standard provides a modification framework that applies to all transactions. P&U companies that enter into long term PPAs with fixed quantities often modify the contracts over time. As a result, P&U companies may need to reassess their accounting policies for modifications on adoption of the new standard.

Under the new standard, a contract modification is a change in the scope of a contract or price, or both. A contract modification can be accounted for on a cumulative catch-up basis or prospectively, depending on the type of modification. The following are the types of modifications.

— **Separate contract.** If the modification adds additional distinct goods or services to the arrangement at a price that is commensurate with their stand-alone selling prices, the additional goods or services are a separate contract and are accounted for prospectively. The remaining goods or services under the original contract continue to be accounted for as they were before the modification.

— **Termination of existing contract and creation of a new contract.** If the remaining goods or services are distinct from those already transferred but the pricing for the additional goods or services is not commensurate with their stand-alone selling prices, the modification are accounted for prospectively as a termination of the existing contract and the creation of a new contract.

— **Cumulative catch-up adjustment.** If the remaining goods or services are not distinct from those already transferred, the modification is accounted for on a cumulative catch-up basis.

A modification to a commodities contract will usually result in prospective accounting as either a separate contract, or a termination of an existing contract and the creation of a new contract. This is because even if the commodity is satisfied over time and combined as a series into a single performance obligation (e.g. electricity), the newly added commodities are distinct. The new standard specifically states that modification to a series is accounted for prospectively for these reasons.

Blend-and-extend agreements

P&U companies often enter into contract modifications referred to as 'blend-and-extend agreements' whereby the period of a contract is extended in exchange for a new blended price.

Example – Blend-and-extend arrangement (1)

Power Co. enters into a non-cancellable four-year contract with Customer to deliver 1 MWh of electricity per year for $60 per MWh.

At the beginning of Year 3 (two years remaining), Power Co. and Customer agree to a blend-and-extend modification to add two additional years with an additional 1 MWh each year. The modification increases the remaining term to four years.

Market prices have declined since inception of the original contract and the market price at the modification date is $50/MWh. The overall contract price is increased based on the then-current market price for the added services ($100) and blended with the pricing for the remaining term of the original contract.

As a result, the modified contract has four years remaining, priced at $55/MWh:

(($60/MWh × 2) + ($50/MWh × 2)) / 4.

Because the delivery of electricity or other commodities is typically distinct, the key question for whether the modification should be accounted for as a separate contract or as a contract termination and creation of a new contract is whether the price of the additional goods or services is commensurate with the stand-alone selling price. In particular, the issue is whether the stand-alone selling price should be compared to the stated cash selling price of the added goods or services or the overall increase in the contract value.

We believe the following approaches may be acceptable in the fact pattern in the example above.

Approach 1: Added services treated as a separate contract. This approach compares the overall contract price increase to the stand-alone selling price. This is based on a narrow read of the criterion in paragraph 606-10-25-12(b), which states that the "price of the contract increases by an amount of consideration that reflects the entity's stand-alone selling prices…" Under this approach, when the price of the entire contract increases in an amount that is consistent with market terms, the additional goods or services are treated as a separate contract. The P&U company would use the market price to account for the added goods or services and the original contract price to account for the remaining items in the original contract. As a consequence, for accounting purposes the original contract remains unchanged even though the pricing was modified.

Approach 2: Termination of existing contract and creation of a new contract. This approach compares the stated contract pricing of the additional goods or services to the stand-alone selling price. This approach is based on the basis for conclusions to the new standard, which states a modification is accounted for as a separate contract when the "pricing for those goods or services reflects their stand-alone selling price." In the example, the stated pricing of the additional services is not commensurate with the stand-alone selling price. Example 7 in the new standard illustrates a similar fact pattern where the modification is accounted for as the termination of an existing contract and creation of a new contract.

We believe Approach 1 is acceptable only when the overall price of the contract increases by the market price of the additional services. If neither the overall price of the contract nor the pricing of the additional services increase in an amount that reflects the stand-alone selling price, then only Approach 2 is appropriate.

Example – Blend-and-extend arrangement (2)

Using the same facts as the previous example, Power Co. concluded that the original contract has a single performance obligation satisfied over time that is a series of distinct services. As of the modification date, Power Co. had recognized $120 of revenue using an output-based measure of progress and there were no contract assets or liabilities.

Power Co. concludes that the added services are distinct and that the overall contract price increases by the market price, but the blended price of the added services is not commensurate with the stand-alone selling price.

Power Co. could account for the modification under either of the following approaches.

Approach 1: Added services treated as a separate contract

	Year 3	Year 4	Year 5	Year 6
Revenue remaining on original contract	$60	$60	-	-
Revenue on new contract	-	-	$50	$50
Cash received	55	55	55	55
End-of-year contract asset/(liability)	**$ 5**	**$10**	**$ 5**	**$ 0**

Approach 2: Termination of existing contract and creation of a new contract

	Year 3	Year 4	Year 5	Year 6
Revenue on new contract	$55	$55	$55	$55
Cash received	55	55	55	55
End-of-year contract asset/(liability)	**$ 0**	**$ 0**	**$ 0**	**$ 0**

Terminations

When P&U companies agree to terminate all or a portion of a contract, that change in scope is a modification under the new standard. A partial termination includes shortening the remaining term of an existing contract (e.g. a four-year contract reduced to three years). The accounting for a modification that reduces the scope of a contract depends on whether the goods or services remaining at the modification date are distinct from those already provided.

The modified contract should be accounted for:

— prospectively as a termination of an existing contract and the creation of a new contract if the remaining goods or services are distinct; or

— on a cumulative catch-up basis if the remaining goods or services are not distinct.

In the P&U industry, modifications will typically be accounted for prospectively because remaining services such as the provision of electricity or gas will be distinct from what has been provided.

A partial termination may result in a customer paying the P&U company a termination penalty, which may be negotiated at the time of the partial termination or contemplated in the original contract. As discussed under Contract term, a substantive termination penalty evidences that rights and obligations exist through the term to which the penalty applies. Once that term is established for accounting purposes, the entity assumes the contract will be fulfilled and the penalty is ignored for accounting purposes. If the customer subsequently exercises its termination option, the termination is accounted for as a modification because the scope of the contract for accounting purposes is decreased.

A termination penalty, regardless of whether it was stated in the contract or separately negotiated, is included in the transaction price of the modified contract and allocated to the performance obligations. As a result, the penalty received will typically be recognized over the remaining term of the contract. When the contract is completely terminated, any remaining transaction price will be recognized immediately because there is no remaining term.

Example – Partial termination with penalty

Power Co. enters into a non-cancellable three-year contract with Customer to deliver 10,000 MWh of electricity annually for $50 per MWh.

At the end of Year 1 (two years remaining), the market price drops to $45 per MWh. Power Co. and Customer agree to terminate the contract at the end of Year 2. Power Co. will continue providing Customer electricity for Year 2 at the agreed rate (i.e. $50 per MWh). As part of the modification, Power Co. and Customer negotiate a $50,000 termination payment.

This contract modification does not add any additional goods or services. Because the remaining electricity to be delivered in Year 2 is distinct from the electricity delivered before the modification, Power Co. concludes that the modification should be accounted for prospectively as the termination of the existing contract and the creation of a new contract.

The penalty of $50,000 is accounted for as part of the transaction price of the new contract for Year 2 and recognized as the remaining services are performed.

Sales of nonfinancial assets

Sales of nonfinancial assets to noncustomers will generally follow the principles of the new standard to determine when to derecognize the asset and how to measure the gain.

Under legacy US GAAP, a sale of a power plant was typically accounted for as a sale of real estate under the real estate specific revenue recognition guidance. This was the case regardless of whether the transaction was with a customer, noncustomer or met the definition of a business. See KPMG's publication Revenue: Real estate for further details on sales of real estate and comparisons of the new standard to legacy US GAAP.

The new standard supersedes the real estate specific guidance. As a result, a transfer of real estate (e.g. power plant) as well as other nonfinancial assets (e.g. equipment) will be in the scope of the new standard if those assets are an output of the P&U company's ordinary activities – i.e. the contract is with a customer. If the transfer of nonfinancial assets is not with a customer, the accounting will generally depend on whether the assets meet the definition of a business.

The transaction could be accounted for as either of the following.

— **Disposal of a business.** If the assets disposed of meet the definition of a business, the transaction is in the scope of the deconsolidation guidance in Topic 810 (consolidation).

— **Disposal of a nonfinancial asset.** Nonfinancial assets that are not a business will typically be in the scope of Subtopic 610-20 (gains and losses from the derecognition of nonfinancial assets). A sale of a nonfinancial asset to a noncustomer held in a legal entity that is not a business will also be in the scope of Subtopic 610-20 if substantially all the fair value of the assets in that entity are nonfinancial assets.

Subtopic 610-20 applies the new standard's principles to determine how to measure the gain or loss and when to derecognize the nonfinancial asset. As a result, P&U companies will apply the principles of the new standard to these arrangements, but will not present the consideration received as revenue or have the same disclosure requirements. The entity will present the gain or loss in income from operations and follow disclosure requirements applicable to the disposal of long-lived assets.

Partial sales of nonfinancial assets

Partial sales of nonfinancial assets to noncustomers can occur in a variety of ways. The following are examples.

— **Transaction 1.** A seller and a third-party investor form a venture. The seller contributes a power plant that is not a business to the newly formed venture and the third-party investor contributes cash, property or services. The seller retains a controlling financial interest in the venture post-sale and has no interest in the third party.

— **Transaction 2.** Assume the same facts as Transaction 1, except that the seller retains only a noncontrolling interest in the venture post-sale. The venture may be a joint venture.

— **Transaction 3.** A seller contributes a power plant that is not a business to a newly formed, wholly owned venture.

Sometime later, it sells a partial ownership interest in the venture to a third-party investor for cash, property or services. The consideration may come directly from the investor to the seller, or may be contributed by the investor to the venture. The seller retains a controlling financial interest in the venture post-sale and has no interest in the third party.

- **Transaction 4.** Assume the same facts as Transaction 3, except that the seller retains only a noncontrolling interest in the venture post-sale. The venture may be a joint venture.
- **Transaction 5.** A seller transfers a power plant that is not a business to an existing equity method investee in exchange for cash or noncash consideration.

Under legacy US GAAP, a partial sale of a power plant considered real estate was in the scope of the real estate specific revenue guidance. When an entity met the criteria to recognize a partial sale, it derecognized the asset in its entirety, measured the retained investment (often an equity method investment) at carryover basis, and recognized a partial gain on the sale.

After the effective date of the new standard, all of the above transactions are in the scope of Subtopic 610-20 when the transaction is not with a customer and the assets are not a business. A key difference between legacy US GAAP and the new standard relates to the measurement of the gain when the asset is derecognized. Under Subtopic 610-20, a P&U company will measure a retained investment at fair value and recognize a full gain when the asset is derecognized compared to a partial gain under legacy US GAAP.

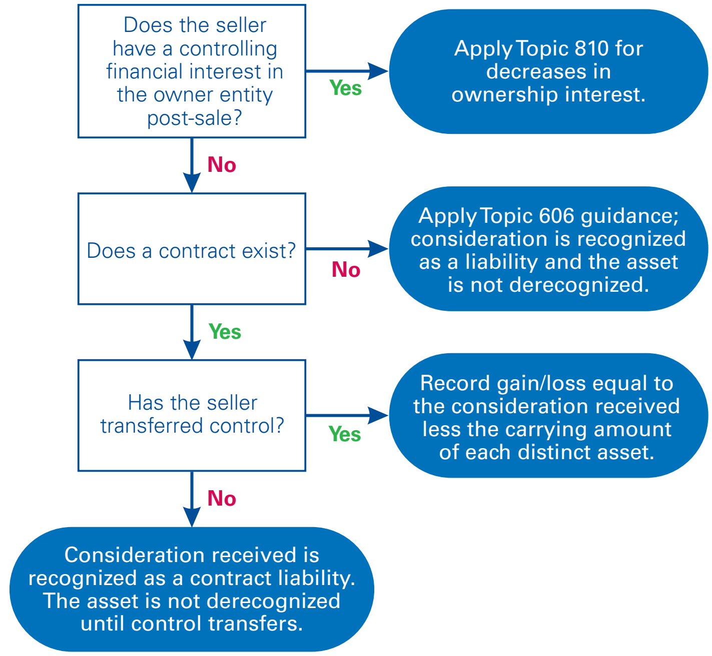
The measurement of the retained interest under Subtopic 610-20 (a nonfinancial asset) is generally consistent with the measurement of the retained interest under the consolidation guidance (a business). However, the measurement of the total gain could be different for an asset versus a business if the contract includes variable consideration.

Under Subtopic 610-20, variable consideration is estimated and included in the transaction price subject to the constraint and therefore it may be recognized upon derecognition of the asset. The consolidation guidance does not address the accounting for variable consideration and, in practice, entities typically either:

- recognize the amounts at fair value on derecognition and record subsequent adjustments through earnings each period; or
- do not recognize variable amounts until the contingency is resolved.

For an entity to derecognize a nonfinancial asset in a partial sale, it must meet the criteria for contract existence and transfer control of the asset to the counterparty. In addition to the revenue principles, Subtopic 610-20 requires an entity to first consider the consolidation guidance and whether it retains a controlling financial interest in the legal entity that holds the nonfinancial asset.

The following flowchart depicts the decision sequence for evaluating control transfer.



If a P&U company continues to consolidate the legal entity, the sale of the noncontrolling interest is accounted for as an equity transaction. This is consistent with the accounting for a sale of a noncontrolling interest in a business.

If the P&U company loses control of the legal entity, it then evaluates whether it transfers control of the power plant based on the principles of the new standard. The P&U company will derecognize the asset when (or as) the former subsidiary (or buyer) obtains control of the asset as defined under the new standard. If the former subsidiary controls the asset, the P&U company will derecognize the asset and recognize a gain or loss.

Because the former subsidiary typically owns 100% of the asset, it will typically obtain control of the asset at the same time that the P&U company loses control of the former subsidiary. However, the P&U company will need to consider whether provisions of the new standard, such as the guidance on repurchase features, affect whether control is transferred.

Example – Partial sale where seller continues to consolidate the legal entity

Power Co. and Investor form a venture, XYZ LLC. Power Co:

- contributes a power plant that does not meet the definition of a business with a carrying amount of $100; and
- receives $120 in cash from Investor and a 60% interest in XYZ.

Power Co. has a controlling financial interest in XYZ post-transaction. Because Power Co. has a controlling financial interest in XYZ post-transaction, the power plant is not derecognized and Power Co. accounts for the sale of the noncontrolling interest to Investor as an equity transaction.

	Debit	Credit
Cash	120	
Noncontrolling interest[1]		40
Additional paid-in capital		80
To recognize cash received from Investor in exchange for 40% interest in XYZ.		
Note: 1. $100 carrying amount × 40% noncontrolling interest in XYZ.		

Example – Partial sale where seller transfers control

Power Co. and ABC Corp. form a venture, XYZ LLC. Power Co:

— contributes a power plant that is not a business with a carrying amount of $100 and a fair value of $300; and

— receives $180 in cash from ABC and a 40% interest in XYZ with a fair value of $120.

Power Co. does not have a controlling financial interest in XYZ, and accounts for its investment in XYZ under the equity method post-transaction. XYZ controls the real estate post-transaction.

Because post-transaction (1) Power Co. retains only a noncontrolling interest in XYZ, and (2) XYZ controls the real estate, Power Co. derecognizes the real estate and recognizes a gain for the difference between the total consideration received (which includes the fair value of the investment in XYZ) and the carrying amount of the power plant.

	Debit	Credit
Cash	180	
Investment in XYZ	120	
Power plant		100
Gain		200
To derecognize asset and recognize full gain on sale.		

Example – Partial sale where seller does not retain a controlling financial interest in the entity and does not transfer control

Power Co. and ABC Corp. form a venture, XYZ LLC. Power Co:

— contributes a power plant that is not a business with a carrying amount of $100 and a fair value of $300; and

— receives $180 in cash from ABC and a 40% interest in XYZ with a fair value of $120.

Power Co. does not have a controlling financial interest in XYZ, but it does have the right to purchase ABC's 60% interest in XYZ over the next five years for $200.

Under the new standard, when a seller has the right to repurchase an asset, control of the asset does not transfer. When the repurchase price is equal to or more than the original selling price, the contract is accounted for as a financing. As a result, Power Co. does not derecognize the power plant and recognizes a financial liability related to the cash received.

	Debit	Credit
Cash	180	
Financial liability		180
To account for the transaction as a financing.		

Applicable to all industries

Expanded disclosures

The new standard contains both qualitative and quantitative disclosure requirements for annual and interim periods. The objective of the disclosures is to provide sufficient information to enable users of the financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

Specifically, the new standard includes disclosure requirements for:

- disaggregation of revenue;
- contract balances, including changes during the period;
- performance obligations;
- significant judgments; and
- assets recognized to obtain or fulfill a contract, including changes during the period.

An entity should review these new disclosure requirements to evaluate whether data necessary to comply with the disclosure requirements are currently being captured and whether system modifications are needed to accumulate the data.

Internal controls necessary to ensure the completeness and accuracy of the new disclosures should be considered – especially if the required data was not previously collected, or was collected for purposes other than financial reporting.

Also, SEC guidance requires registrants to disclose the potential effects that recently issued accounting standards will have on their financial statements when adopted[1]. The SEC expects the level and specificity of these transition disclosures to increase as registrants progress in their implementation plans. The SEC has also stated, when the effect is not known or reasonably estimated, that a registrant should describe its progress in implementing the new standard and the significant implementation matters that it still needs to address.

Transition

An entity can elect to adopt the new standard in a variety of ways, including retrospectively with or without optional practical expedients, or from the beginning of the year of initial application with no restatement of comparative periods (cumulative effect method).

Entities that elect the cumulative effect method are required to disclose the changes between the reported results of the new standard and those that would have been reported under legacy US GAAP in the period of adoption.

For transition purposes, the new standard introduces a new term – completed contract. A completed contract is a contract for which an entity has recognized all or substantially all of the revenue under legacy US GAAP as of the date of adoption of the new standard. The concept of a completed contract is used when applying:

- certain practical expedients available during transition under the retrospective method; and
- the cumulative effect method coupled with the election to initially apply the guidance only to those contracts that are not complete.

This will require careful analysis particularly where there is trailing revenue after delivery has occurred (e.g. revenue was not fixed or determinable, collectibility was not reasonably assured, royalty arrangements). In those circumstances, the contract would not be considered complete if substantially all of the revenue had not been recognized before adoption. Applying the standard to these types of contracts at transition may result in revenue being pulled into the opening retained earnings adjustment.

Entities should consider the potential complexities involved with calculating the opening retained earnings adjustment and the recast of comparative periods (if any) when planning their implementation. It may be prudent for entities to perform transition calculations before the adoption date to ensure all potential complexities are identified.

Effective dates

Type of entity	Annual reporting periods after
Public business entities and not-for-profit entities that are conduit bond obligors	**December 15, 2017 including interim reporting periods within that reporting period.** Early adoption permitted for annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.
All other US GAAP entities, including SEC registrants that are Emerging Growth Companies	**December 15, 2018 and interim reporting periods within annual reporting periods beginning after December 15, 2019.** Early adoption permitted for annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period or interim reporting periods within the annual period subsequent to the initial application.

1. Staff Accounting Bulletin Topic 11.M.

Some basic reminders

Scope

The guidance applies to all contracts with customers unless the customer contract is specifically within the scope of other guidance – e.g. Topic 944 (insurance), Topic 460 (guarantees).

The new standard applies to contracts to deliver goods or services to a customer. A 'customer' is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

The new standard will be applied to part of a contract when only some elements are in the scope of other guidance.

Step 1: Identify the contract

Contracts can be written, oral or implied by an entity's customary business practices, but must be enforceable by law. This may require legal analysis on a jurisdictional level to determine when a contract exists and the terms of that contract's enforceability.

A contract with a customer is in the scope of the new standard when the contract is legally enforceable and all of the following criteria are met:

- the contract has commercial substance;
- rights to goods or services can be identified;
- payment terms can be identified;
- the consideration the entity expects to be entitled to is probable of collection; and
- the contract is approved and the parties are committed to their obligations.

If the criteria are not met, any consideration received from the customer is generally recognized as a deposit (liability).

Step 2: Identify the performance obligations

Performance obligations do not have to be legally enforceable; they exist if the customer has a reasonable expectation that the good or service will be provided. A promise can be implied by customary business practices, policies or statements.

Performance obligations are the unit of account under the new standard and generally represent the distinct goods or services that are promised to the customer.

Promises to the customer are separated into performance obligations, and are accounted for separately if they are both (1) capable of being distinct and (2) distinct in the context of the contract.

An exception exists if the performance obligations represent a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer over time. A series is accounted for as a single performance obligation.

Step 3: Determine the transaction price

Estimating variable consideration will represent a significant departure from legacy accounting for many entities.

When determining the transaction price, an entity uses the legally enforceable contract term. It does not take into consideration the possibility of a contract being cancelled, renewed or modified.

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer, excluding amounts collected on behalf of third parties – e.g. some sales taxes. This consideration can include fixed and variable amounts, and is determined at inception of the contract and updated each reporting period for any changes in circumstances.

The transaction price determination also considers:

— **Variable consideration**, which is estimated at contract inception and is updated at each reporting date for any changes in circumstances. The amount of estimated variable consideration included in the transaction price is constrained to the amount for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved.

— **Noncash consideration** received from a customer is measured at fair value at contract inception.

— **Consideration payable to a customer** represents a reduction of the transaction price unless it is a payment for distinct goods or services it receives from the customer.

— **Significant financing components** may exist in a contract when payment is received significantly before or after the transfer of goods or services. This could result in an adjustment to the transaction price to impute interest income/expense.

Step 4: Allocate the transaction price

A contractually stated price or list price is not presumed to be the stand-alone selling price of that good or service.

The transaction price is allocated at contract inception to each performance obligation to depict the amount of consideration to which an entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

An entity generally allocates the transaction price to each performance obligation in proportion to its stand-alone selling price. However, when specified criteria are met, a discount or variable consideration is allocated to one or more, but not all, performance obligations.

The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. Observable stand-alone prices are used when they are available. If not available, an entity is required to estimate the price using other techniques – even if the entity never sells the performance obligation separately.

Step 5: Recognize revenue

An entity must first determine whether a performance obligation meets the criteria to recognize revenue over time.

If none of the over-time criteria are met, revenue for the performance obligation is recognized at the point in time that the customer obtains control of the goods or services.

Control is the ability to direct the use of, and obtain substantially all of the remaining benefits from the goods or services – or prevent others from doing so.

An entity recognizes revenue when it satisfies its obligation by transferring control of the good or service to the customer.

A performance obligation is satisfied ***over time*** if one of the following criteria are met:

— the customer simultaneously receives and consumes the benefits as the entity performs;

— the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or

— the entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

If control transfers ***over time***, an entity selects a method to measure progress that is consistent with the objective of depicting its performance.

If control transfers at a ***point in time***, the following are some indicators that an entity considers to determine when control has passed. The customer has:

— a present obligation to pay;

— physical possession;

— legal title;

— risks and rewards or ownership; and

— accepted the asset.

Customer options

Customer options may be accounted for as performance obligations, resulting in more revenue deferral than under legacy GAAP.

Revenue is allocated to a customer option to acquire additional goods or services, and is deferred until (1) those future goods or services are transferred or (2) the option expires when it represents a material right. A material right exists if the customer is only able to obtain the option by entering into the sale agreement and the option provides the customer with the ability to obtain the additional goods or services at a price below stand-alone selling prices.

Warranties

Warranties do not have to be separately priced to be accounted for as performance obligations.

Assurance-type warranties will generally continue to be accounted for under existing guidance – i.e. Topic 450 (contingencies). However, a warranty is accounted for as a performance obligation if it includes a service beyond assuring that the good complies with agreed-upon specifications. This could require some warranties to be separated between a service element (deferral of revenue which is then recognized as the services are provided) and an assurance element (cost accrual at the time the good is transferred).

Principal vs. agent

The new standard changes the guidance used to evaluate whether an entity is a principal or an agent.

Credit risk is no longer an indicator that an entity is a principal.

An entity identifies each specified good or service to be transferred to the customer, and determines whether it is acting as a principal or agent for each one. In a contract to transfer multiple goods or services, an entity may be a principal for some goods and services and an agent for others.

An entity is a principal if it controls the specified good or service that is promised to the customer before it is transferred to the customer.

Indicators that an entity has obtained control of a good or service before it is transferred to the customer are having primary responsibility to provide specified goods or services, assuming inventory risk, and having discretion to establish prices for the specified goods or services.

Contract modifications

A general accounting framework provides most entities with more guidance in the new standard than under legacy GAAP.

The new standard requires an entity to account for modifications either on a cumulative catch-up basis (when the additional goods or services are not distinct) or a prospective basis (when the additional goods or services are distinct).

If any additional distinct goods or services are not priced at their stand-alone selling prices, the remaining transaction price is required to be reallocated to all unsatisfied performance obligations, including those from the original contract.

Contract costs

More costs are expected to be capitalized under the new standard.

An entity cannot elect to expense or capitalize. Capitalization is required when the criteria are met.

The new standard provides guidance on the following costs related to a contract with a customer that are in the scope of the new standard:

- incremental costs to obtain a contract; and
- costs incurred in fulfilling a contract that are not in the scope of other guidance.

Incremental costs to obtain a contract with a customer (e.g. sales commissions) are required to be capitalized if an entity expects to recover those costs – unless the amortization period, which may include anticipated contracts or renewals, is less than 12 months.

Fulfillment costs that are not in the scope of other guidance – e.g. inventory, intangibles, or property, plant, and equipment – are capitalized if the fulfillment costs:

- relate directly to an existing contract or specific anticipated contract;
- generate or enhance resources that will be used to satisfy performance obligations in the future; and
- are expected to be recovered.

An entity amortizes the assets recognized for the costs to obtain and fulfill a contract on a systematic basis, consistent with the pattern of transfer of the good or service to which the asset relates.

The impact on your organization

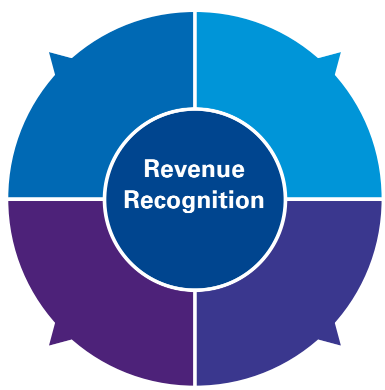
Implementation of the new standard is not just an accounting exercise.

New revenue recognition standard and corresponding accounting changes

- Impact of new revenue recognition standard and mapping to new accounting requirements
- New accounting policies – historical results and transition
- Reporting differences and disclosures
- Tax reporting/planning

Revenue recognition automation and ERP upgrades

- Automation and customization of ERP environment
- Impact on ERP systems
- General ledger, sub-ledgers and reporting packages
- Peripheral revenue systems and interfaces



Financial and operational process changes

- Revenue process allocation and management
- Budget and management reporting
- Communication with financial markets
- Covenant compliance
- Opportunity to rethink business practices
- Coordination with other strategic initiatives

Governance and change

- Governance organization and changes
- Impact on internal resources
- Project management
- Training (accounting, sales, etc.)
- Revenue change management team
- Multinational locations

As noted in the chart, the new standard could have far-reaching effects. The standard may not only change the amount and timing of revenue, but potentially requires changes in the core systems and processes used to account for revenue and certain costs. Entities may need to design and implement new internal controls or modify existing controls to address risk points resulting from new processes, judgments, estimates and disclosures. The implementation of the new standard will involve a diverse group of parties (e.g. Tax, IT, Legal, Financial Planning, Investor Relations, etc.) and entities should have a governance structure in place to identify and manage the required change. For more information about implementation challenges and considerations, see chapter 14 of KPMG's Revenue: Issues In-Depth.

KPMG Financial Reporting View

Insights for financial reporting professionals

As you evaluate the implications of new financial reporting standards on your company, KPMG Financial Reporting View is ready to inform your decision-making.

Visit kpmg.com/us/frv for news and analysis of significant decisions, proposals, and final standards and regulations.

FRV focuses on major new standards (including revenue recognition, leases and financial instruments) – and also covers existing US GAAP, IFRS, SEC matters, broad transactions and more.

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Insights for financial reporting professionals

Here are some of our resources dealing with revenue recognition under the new standard.	
Handbook	Assists you in gaining an in-depth understanding of the new five-step revenue model by answering the questions that we are encountering in practice, providing examples to explain key concepts and highlighting the changes from legacy US GAAP.
Issues In-Depth	Provides you with an in-depth analysis of the new standard under both US GAAP *and* IFRS, and highlights the key differences in application of the new standard. Additionally, chapter 14 provides implementation considerations.
Illustrative disclosures	We show how one fictitious company has navigated the complexities of the revenue disclosure requirements.
Transition options	Assists you in identifying the optimal transition method.
Industry guidance	See our other industry guidance.

Contacts

KPMG is able to assist power and utility companies navigate the accounting under the new standard.

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