

IFRS news

Emerging issues and practical guidance*

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Utilities industry prepares for change



Three high-profile projects at the IASB – leasing, revenue recognition and financial instruments – may produce significant changes in financial reporting in the utilities industry in the medium term. Konstantin Suplatov from PwC's Treasury Group in the UK and Ralph Welter of PwC's Accounting Consulting Services in Germany look first at an IFRIC interpretation that is newly applicable for utilities in 2010, then consider the potential impacts of the three key projects mentioned above.

IFRIC 18, 'Transfers of assets from customers'

IFRIC 18, 'Transfers of assets from customers', which is particularly relevant to the utility industry, was issued in response to the diversity in practice that arose when management entered into arrangements in which customers transferred assets to the entity.

What are the key requirements?

IFRIC 18 applies to agreements with a customer for the transfer of property, plant and equipment that is used to connect the customer to a network or provide the customer with an ongoing supply of goods or services. It also applies if the customer transfers cash to the entity and that cash is used only to build an asset that is used to connect the customer to a network and/or provide ongoing access to goods or services. For example, the interpretation applies to the accounting by a utility provider when a property developer installs water mains and pipes to connect the property to the water network and transfers the mains and pipes to the utility provider. The developer has exchanged the pipes and utilities with the utility provider in order to get a connection to the network and/or receive an ongoing supply of water.

Issues to consider

The key issues to consider when applying the interpretation are:

- Was an asset received?
- How should the asset be valued?
- How should the related income be recognised?

IFRIC 18 requires an item of property, plant and equipment that has been received from a customer to be recognised as part of the recipient's own property, plant and equipment if it meets the definition of an asset in the Framework. For example, management of a water utility should consider whether it can use the pipes and mains to supply other customers;

when to sell, maintain or replace the assets; and whether it can use the assets as security for its borrowings.

The asset is recognised initially at fair value. The corresponding credit is revenue, which is recognised in accordance with IAS 18, 'Revenue'. This revenue is either recognised in the income statement immediately or at a later date, depending on when the revenue recognition criteria in IAS 18 are met. In other words, revenue is recognised when each separately identifiable service is delivered. When only one service is provided, revenue is recognised when the service is performed. This might be the case when the connection is made and there is no further obligation, or as the ongoing services are delivered when the connection is not a separate service. When more than one service is provided, revenue is allocated to each service using an appropriate method – such as relative fair value or cost plus a reasonable margin – and recognised when each service is delivered.

There are two key features that indicate that connection to a network is a separately identifiable service:

1. The service is delivered to the customer and has stand-alone value for that customer; and
2. The fair value of the service can be measured reliably.

The 'stand-alone value' means the customer transferring the asset receives value from the connection separately from any other service received subsequently. The properties to be sold by the developer in the above example are likely to be more valuable with access to the water network than without; it is therefore likely that there is a stand-alone value in the connection. The water utility recognises the fair value of the pipes and mains as revenue immediately if it has no further service obligations resulting from the transaction.

An indicator that the supply of goods or services is separately identifiable is that the customer making the transfer receives the ongoing access, or goods or services, at a lower price than would be charged without the transfer.

Assume that the developer in the above example has agreed with the water utility that it will transfer the water mains and pipes in exchange for a discount on its own site water bills for two years. The developer has received two services: the connection of its customers, and the discount on its own bills. The water utility identifies the revenue attributable to these services separately and measures it by reference to the fair value of each service. The connection revenue is recognised immediately if the fair value can be measured reliably. The remaining revenue is spread over the two-year period, as the discount is given over two years.

The transferred assets in many regulatory regimes oblige the utility to render ongoing related services, and the fair values of the assets and the ongoing related service obligation cannot be separately identified. The reason they might not be separately identifiable could be that the amount the customer has to pay is not specific to the asset transferred but is a lump-sum-type connection fee; or the fee not only relates to the assets that

directly connect the building but also to a share in the assets that connect the area. This might be the street in which the building is situated. It may be appropriate in these cases to defer the income over the period in which the utility has to provide an ongoing service.

When will the new interpretation apply?

The interpretation applies prospectively to transfers of assets from customers received on or after 1 July 2009. However, it is effective for EU entities for financial years beginning after 31 October 2009. In our view, even where an entity applies IFRIC 18 for the first time in a financial year beginning after 31 October 2009, it should still apply the interpretation's requirements to transfers received after 1 July 2009. This will require a prior-year adjustment where the impact is material.

Revenue recognition – proposed changes

The IASB and FASB released an exposure draft (ED) in June 2010 (the final standard is due in 2011). The ED outlines a new revenue recognition model that could significantly change the way entities recognise revenue.

The new revenue recognition model is a single, contract-based, asset and liability model. Revenue is recognised upon the satisfaction of performance obligations, which occurs when control of an asset (whether a good or service) transfers to the customer. The objective of the converged standard is to increase the consistency of revenue recognition for similar contracts, regardless of industry.

How could the new standard affect utilities?

A utility sells commodities such as gas, power or water to its customers. It enters into contracts with its customers in order to do this. These contracts are in the scope of the proposed revenue recognition standard. A contract with a customer includes rights to receive consideration (cash) and obligations to provide goods (commodities) or perform services (for example, waste removal). The entity has a net contract asset when the rights exceed the obligations; it has a net contract liability when the obligations exceed the rights. The net contract position is zero if no consideration is received at inception of the contract (that is, no entry is recorded). The underlying principle in the model is that revenue is recognised when a contract asset increases (for example, the sale of power or gas) or a contract liability decreases as a result of the satisfaction of a performance obligation (for example, if an advance payment was received by the customer for the delivery of power or gas).

An entity's net asset or net liability in a contract can change for various reasons. For example, when consideration is received from a customer, the entity's gross contract asset decreases because its right to receive payment has decreased. When an entity satisfies an obligation, such as through the delivery of goods or services, its gross contract liability decreases. These new requirements are likely to reflect a typical utility's practice, so changes might be minimal. However, management

will have to identify its different sales contracts to ensure its current accounting is in line with the new rules. Many utilities provide bundled services – for example water, gas and telecoms. Management need to assess how to account for these separate performance obligations and how to potentially allocate revenue across them. These new requirements will bring minimal change to a utility that only sells a single product.

When will the new standard apply?

Full retrospective application is likely to be required; the effective date is therefore unlikely to be before 2014.

Financial instruments – proposed changes to IAS 39/IFRS 9

Some energy contracts (power, gas, coal and emissions) are likely to fall within the scope of IAS 39/IFRS 9. Many of these are entered into for the purpose of hedging or trading activities; some of the long-term contracts could contain embedded derivatives that have to be separated out.

Accounting for energy contracts in scope of IAS 39 has not been straightforward for utilities. Management should consider carefully the impact from any changes in accounting for financial instruments.

What are the key requirements?

The ED of IFRS 9, 'Financial instruments', issued in May proposes that the accounting and presentation of financial liabilities should remain the same except when the financial liabilities are designated at fair value through the profit or loss. All energy-related derivatives would be impacted by this.

The main concern regarding valuation of derivatives with negative fair value relates to the impact of 'own credit risk' – that is, fluctuations in the value of derivatives due to changes in the company's own credit rating. This can result in gains being recognised in income when the liability has had a credit downgrade, and losses being recognised when the liability's credit risk improves. Many users find this result counter intuitive, especially when there is no expectation that the change in the liability's credit risk will be realised.

Fair valuing a financial instrument could result in the instrument changing from an asset to a liability; this means that it would reflect a different credit risk adjustment depending on the movements in the market prices, which have recently been volatile.

Entities with financial liabilities designated at fair value through profit or loss (FVTPL) follow a two-step measurement approach under the proposals.

1. All changes in fair value of the financial liability are recognised in profit or loss.
2. The change in value due to changes in the liability's credit risk is recognised in other comprehensive income (OCI), with an offsetting entry to profit or loss. There is no subsequent recycling of the amounts in OCI to profit or loss.

This two-step approach does not apply to derivatives.

Financial liabilities, including derivatives, that are required to be measured at FVTPL (as distinct from those that the entity has designated at FVTPL) will continue to have all fair value movements recognised in profit or loss, with no transfer to OCI. Derivatives (including embedded derivatives) – such as gas forwards and electricity contracts for difference – will have all fair value movements recognised in profit or loss, including credit risk.

Many utilities entities apply complex forms of hedge accounting. IAS 39 paragraph 82 requires the full fair value of the hedged contract to be included in the hedge relationship. It is likely that credit risk adjustment for both liabilities and assets will lead to additional ineffectiveness; it may even cause some of the hedges to fail. This is because the movement in fair values of derivatives designated as hedging instruments will not be completely matched by the movements in credit risk in the hedged contracts.

What other changes in IFRS 9 may have an impact?

The other main areas of accounting for financial instruments that are most relevant for the utilities sector are:

- Application of 'own use' exemption – that is, evaluation of whether or not non-financial contracts that utilities entities enter into with their customers and suppliers fall within the scope of IAS 39/ IFRS 9; and
- Application of hedge accounting for non-financial items.

Many utilities entities find applying 'own use' standards onerous. This has been exacerbated recently by decreasing demand for energy. Some long-term physical supply contracts might fall within the scope of IAS 39 if the settlement arrangements are triggered when volumes delivered under the contracts fall below the minimum off-take volume. The IASB is not considering imminent changes to the scoping paragraphs (paragraphs 5-7) of IAS 39; application of the 'own use' exemption is likely to remain unchanged.

Much of the criticism of the current rules for hedging non-financial items relates to their prohibiting the hedging of individual risks, on the assumption that these are difficult to identify. Many of the energy supply contracts have detailed formulae that would allow management to identify some of the elements that they are willing to hedge (for example, many coal supply contracts include a reference to the quoted market price for coal, adjusted for quality and transportation charges). It is unclear if this issue will be addressed by the coming changes.

When will the new standard apply?

The final standard is expected to apply for financial periods beginning on or after 1 January 2013. Significant recent volatility in commodities prices and credit spreads could mean that this change in measurement has a significant impact on utilities companies' income statements. Management should prepare early.

Leasing

The accounting for leases was largely unchanged since IAS 17, 'Leases', was issued in 1982. An ED proposing sweeping changes is due imminently. It is expected to address the criticism that the 'all-or-nothing' approach in the distinction between finance and operating leases results in different accounting treatments for similar arrangements. Many important cash-out obligations are also not treated as liabilities.

The standard setters have tentatively determined that the grandfathering of existing leases will not be allowed because many leases are for long terms. Grandfathering existing leases would create, in the view of standard setters, an unacceptably long period of non-comparability.

Utilities and other entities that own pipelines or networks are likely to be significantly affected if this proposal goes ahead, as many tolling agreements will be affected.

There are currently two steps to determining whether a tolling agreement is a lease:

1. Is the agreement a lease?
2. If so, what kind of lease is it?

Step 1 is determined using IFRIC 4, 'Determining whether an arrangement contains a lease'. An arrangement is a lease under IFRIC 4 if both of the following criteria are met:

- Fulfilment of the arrangement is dependent on the use of a specified asset or assets; and
- The arrangement conveys a right to use the asset (see below).

The right to control the use of the underlying asset is conveyed if any one of the following conditions is met:

- The purchaser has the ability or right to operate the asset or direct others to operate the asset in a manner it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.
- The purchaser has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

- Facts and circumstances indicate that it is unlikely that one or more parties other than the purchaser will take more than an insignificant amount of the output or other utility that will be produced or generated by the asset during the term of the arrangement; and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

Step 2 is determined by IAS 17: only a finance lease results in recognition on the balance sheet of both the leased asset and net present value of the lease obligation.

Under the expected proposals, step 2 will become redundant, as any arrangement that meets definition of a lease in IFRIC 4 will be recognised on the balance sheet of the lessee.

The ED will propose a 'right of use' approach. This approach requires lessees to recognise an asset for its right to use the leased asset for the lease term, and a corresponding liability for the committed cash outflows. Current operating lease accounting would be eliminated. The 'right' is measured at the present value of lease payments, discounted at the lessee's incremental borrowing rate.

The 'most likely lease term' will drive measurement of the right and the obligation. This would require preparers to make regular assessments as to whether they will take up renewal options. Such assessments could be heavily affected by the developments in the energy sector, such as demand for energy, a broadening in energy sources, including green sources for power and liquefied natural gas.

The impact on lessee financial reporting, asset financing, IT systems and controls could be substantial. Management should review existing arrangements as well as consider the expected new requirements when entering into new contracts.

When will the new standard apply?

The effective date of the final standard resulting from the DP is likely to be 2014, but the expected retrospective application means management should bear the requirements in mind now.