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Point of view
Power sector – New revenue Standard could impact profile of revenue and profit recognition

In a nutshell

- The **profile of revenue and profit recognition** will change for some entities as the new Standard is more detailed and more prescriptive than the existing guidance and introduces new complexities. In particular, power companies will need to consider:
  - the impact of new guidance where pricing mechanisms include variable amounts;
  - the accounting for breakage;
  - whether particular **costs relating to obtaining a contract** must be capitalised;
  - how to account for **contract modifications;**
  - the extent to which **distinct goods or services** are supplied, which should be accounted for separately;
  - when **upfront fees** should be recognised as revenue; and
  - the appropriate accounting for **exchanges of goods and services.**
- The new Standard requires significantly more **disclosures** relating to revenue and entities will need to ensure that **appropriate processes** are in place to gather the information.

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What's happened?

The International Accounting Standards Board (IASB) has published a new Standard, IFRS 15 Revenue from Contracts with Customers ('the new Standard'). The new Standard outlines a single comprehensive model of accounting for revenue arising from contracts with customers and supersedes current revenue recognition guidance, which is found currently across several Standards and Interpretations within IFRSs. The core principle is that an entity recognises revenue to reflect the transfer of goods or services, measured as the amount to which the entity expects to be entitled in exchange for those goods or services. However, the new Standard does not apply to transactions or elements of transactions that are instead within the scope of other standards, for example the leasing or financial instruments standards

The new Standard is effective for reporting periods beginning on or after 1 January 2017, with earlier application permitted. This is subject to EU endorsement. Entities can choose to apply the Standard retrospectively or use a modified approach in the year of application. It is the result of a convergence project with the US Financial Accounting Standards Board (FASB) that began in 2002. Almost fully converged, the most significant differences between IFRSs and US GAAP relate to interim disclosures and timing of adoption.

Implications for Power sector

Below, we highlight certain key impacts resulting from the new Standard that will be of particular interest to those in the power sector and then consider parts of the new Standard that may contribute to those impacts. Of course many more complexities exist and, as described below, Deloitte has produced further guidance which explores these in greater detail.

How might this affect you?

The timing of revenue and profit recognition may be significantly affected by the new Standard

Whereas previously IFRSs allowed significant room for judgement in devising and applying revenue recognition policies and practices, IFRS 15 is more prescriptive in many areas relevant to the retail, wholesale and distribution sector.

How might this affect you?

The timing of revenue and profit recognition may be significantly affected by the new Standard

Whereas previously IFRSs allowed significant room for judgement in devising and applying revenue recognition policies and practices, IFRS 15 is more prescriptive in many areas relevant to the power sector. Applying these new rules may result in significant changes to the profile of revenue and, in some cases, cost recognition. This is not merely a financial reporting issue. As well as **preparing the market and educating analysts** on the impact of the new Standard, entities will need to consider wider implications. Amongst others, these might include:

- changes to **key performance indicators** and other **key metrics**;
- changes to the **profile of tax cash payments**;
- availability of **profits for distribution**;
- for **compensation and bonus plans**, impact on the timing of targets being achieved and the likelihood of targets being met; and
- potential non-compliance with **loan covenants**.

Current accounting processes may require changes to cope with the new Standard

As explained below, IFRS 15 introduces new requirements to move to a more conceptual approach. The complexity of applying this approach and of producing the detailed disclosures required by the new Standard in the power sector may require modifications to existing accounting processes. Entities should ensure they allow sufficient time to develop and implement any required modifications to processes.

What are the most significant changes?

When should variable or uncertain revenues be recognised?

Entities in the power sector often negotiate contracts that include some form of variable pricing arising from uncertain or contingent events (for example, adjustments to otherwise fixed unit pricing that are based on production exceeding or falling short of contractually specified minimum or maximum volumetric bands, stepped pricing or heat-rate based pricing structures). There are new specific requirements in respect of variable consideration such that it is only included in the transaction price if it is highly probable that the amount of revenue recognised would not be subject to significant future reversals when the uncertainty is resolved. This approach to variable and contingent consideration is different from that previously reflected in IFRSs and, in certain scenarios, will require a significant degree of judgement to estimate the amount of consideration that should be taken into account. Accordingly, the profile of revenue recognition may change for some entities as a result.

How should breakage be recognised?

In the power sector, it is not uncommon for customers to agree, under a 'take or pay' contract, to purchase a specified minimum quantity of a particular good or service (such as the supply of gas or electricity) over a specified period of time. However, the customer has to pay the full amount stated in the contract, irrespective of whether the customer takes delivery of the minimum quantity. In some cases, customers lose their right to purchase the remaining units when the time frame expires. In other cases, the contract allows customers to defer the purchase of the remaining units to a later date, although there is no compulsion to do so. In a scenario in which customers do not always exercise all of their contractual rights, the unexercised rights are often referred to as 'breakage'. Previously, IFRSs included only limited guidance on accounting for such unexercised rights, and only in the context of customer loyalty programmes. As such, a variety of practices may currently be used in accounting for breakage. IFRS 15 includes specific guidance on breakage, which is applicable to all revenue transactions with customers. If an entity expects to benefit from breakage, it should recognise the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer (i.e. by comparing the goods or services delivered to date with those expected to be delivered overall). Otherwise, the entity should recognise any breakage amount as revenue when the likelihood of the customer exercising its remaining rights becomes remote. Entities will need to consider whether their current accounting needs to be amended in order to meet the requirements of IFRS 15.

Should contract costs be capitalised?

In addition to more prescriptive guidance on revenue recognition, the new Standard introduces specific criteria for determining whether to capitalise certain costs, distinguishing between those costs associated with obtaining a contract (e.g. sales commissions) and those costs associated with fulfilling a contract. In the power sector, this becomes an issue because significant costs may be incurred that are directly attributable to obtaining contracts with customers, for example sales commissions that are only payable if a contract is obtained. At present, different entities might treat these costs differently. The new Standard will require entities to capitalise success fees, which will have an impact on operating profits. In addition, the new Standard requires capitalised contract costs to be amortised on a systematic basis that is consistent with the pattern of transfer of the goods or services. Entities will need to exercise judgement to determine the appropriate basis and time period for this amortisation.

What is the impact if a contract is modified?

In the past, IFRSs included only limited guidance on how to account for modifications to a contract. IFRS 15 includes detailed guidance on whether a contract modification should be accounted for prospectively (as an adjustment to future revenues) or retrospectively (via an adjustment when the modification occurs). It is not uncommon for the scope or price of arrangements in the power sector to be modified – for example, blend and extend modifications – and therefore these requirements may result in a change of practice for some entities.

How to identify and allocate revenue to different goods and services?

Previously, given the lack of specific guidance in IFRSs, there was greater room for judgement when identifying the goods and services within a contract and then allocating the revenue to those goods and services. Entities may have to amend their current accounting policies as a result of the more detailed guidance in IFRS 15 and, in particular, the new rules on how revenue is allocated between different items. For example, in the power sector, a single contract may include the sale of both gas and electricity. Careful analysis and judgement may be required to determine whether the sale of each type of utility should be regarded as distinct and, if so, to determine the appropriate allocation of revenue between them based on the requirements of the new Standard. It will also be necessary to consider the appropriate allocation of any discount offered to the customer for purchasing more than one kind of utility from the company.

When should 'upfront' fees be recognised?

New detailed guidance is provided on how to account for upfront fees, which may lead to a change in practice when accounting for such fees. In some cases, this guidance may also be applicable to the provision of contributed assets such as property, plant and equipment (e.g. an electricity substation or meter) which are often used to connect customers to a network and/or provide them with ongoing access to a supply of goods and/or services such as electricity and gas. Unless control of distinct goods or services is provided to the customer at the outset, an upfront fee should be regarded as an advance payment for future goods and services and so should be recognised as revenue when those future goods or services are provided. Often, upfront fees are charged in order to cover initial sign-up costs, but this is not in itself sufficient to justify upfront revenue recognition.

Are exchanges of goods and services within the scope of the new Standard?

The current revenue guidance specifically scopes out exchanges of goods or services of a similar nature or value. The new Standard takes a slightly different approach, scoping out non-monetary exchanges between entities in the same line of business to facilitate sales to customers, or to potential customers, other than the parties to the exchange. Entities in the power sector may on occasion swap goods or services with other entities to reduce delivery costs or manage capacity. Such entities will need to consider whether the different scoping requirements will change any of their current practices. For example, as the scope exclusion is no longer restricted to goods that are "similar in nature and value", an exchange of dissimilar goods may no longer result in revenue being recognised if the contracting parties are in the same line of business and the purpose of the exchange is to facilitate sales to customers.

What else might change?

In addition to the key changes discussed above, the new Standard introduces detailed guidance in many areas regarding the reporting of revenue and entities will need to ensure that they have considered all of these when assessing the extent to which their accounting policy for revenue may need to be amended.

More detailed information on the impact of IFRS 15 can be found in Deloitte's Need to know publication available from www.ukaccountingplus.com.
Further industry publications are also available here.

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