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Public Service Commission

August 11, 1992

Mr. Carroll Webb
Joint Administrative Procedures
Committee
120 Holland Building
Tallahassee, Florida 32399

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Re: DOCKET NO. 920296-PU - RULE 25-4.017, F.A.C.

Dear Mr. Webb:

Enclosed are the materials incorporated by reference in Rule 25-4.017, F.A.C. These materials were filed with the Department of State on August 4, 1992.

Sincerely,

Richard C. Bellak
Richard C. Bellak
Associate General Counsel

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FILED WITH THE DEPARTMENT OF STATE

I hereby certify that attached is a true and complete copy of: Statement of Financial Accounting Standards No. 71, dated December 1982; Statement of Financial Accounting Standards No. 90, dated December 1986; Statement of Financial Accounting Standards No. 92, dated August 1987; and Statement of Financial Accounting Standards No. 101, dated December 1988 which are incorporated by reference by Rule 25-4.017, Florida Administrative Code.

Under the provisions of paragraph 120.54(13)(a), F.S., the incorporated material takes effect 20 days from the date filed with the Department of State or a later date as set out below:

Effective: ______________________________________
(month) (day) (year)

Steve Tribble

Director, Division of Records & Reporting
Title

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Financial Accounting Series

Statement of Financial Accounting Standards No. 101

Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71

Financial Accounting Standards Board
of the Financial Accounting Foundation

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Summary

This Statement specifies how an enterprise that ceases to meet the criteria for application of FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, to all or part of its operations should report that event in its general-purpose external financial statements.

An enterprise's operations can cease to meet those criteria for various reasons, including deregulation, a change in the method of regulation, or a change in the competitive environment for the enterprise's regulated services or products. Regardless of the reason, an enterprise whose operations cease to meet those criteria should discontinue application of that Statement and report that discontinuation by eliminating from its statement of financial position the effects of any actions of regulators that had been recognized as assets and liabilities pursuant to Statement 71 but would not have been recognized as assets and liabilities by enterprises in general. However, the carrying amounts of plant, equipment, and inventory measured and reported pursuant to Statement 71 should not be adjusted unless those assets are impaired, in which case the carrying amounts of those assets should be reduced to reflect that impairment. The net effect of the adjustments should be included in income of the period of the change and classified as an extraordinary item.

This Statement is effective for discontinuations of application of Statement 71 occurring in fiscal years ending after December 15, 1988, but its adoption may be delayed until the issuance of annual financial statements for the fiscal year that includes December 15, 1989. Retroactive application to discontinuations reported prior to fiscal years ending after December 15, 1988 by restatement of the financial statements for the period including the date of discontinuation and periods subsequent to the date of the discontinuation is permitted but not required.

Statement of Financial Accounting Standards No. 101

Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71

December 1988

Financial Accounting Standards Board
of the Financial Accounting Foundation
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Statement of Financial Accounting Standards No. 101

Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71

December 1988

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Statement of Financial Accounting Standards No. 101

Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71

December 1988

INTRODUCTION

1. FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation,* requires that an enterprise's operations meet specific criteria for application of that Statement. Statement 71 does not address the accounting that should result when an enterprise's operations cease to meet those criteria. Since Statement 71 was issued, deregulation of certain industries and changes in the method of regulating others have caused several enterprises to discontinue application of Statement 71 for some or all of their operations.

2. The FASB has been informed that the methods used to account for those discontinuations have varied in practice. In its October 15, 1984 Issues Paper, *Application of Concepts in FASB Statement of Financial Accounting Standards No. 71 to Emerging Issues in the Public Utility Industry,* the AICPA Public Utility Subcommittee requested that the Board specify the appropriate accounting to reflect the discontinuation of application of Statement 71.

3. As a condition for its initial and continuing application, Statement 71 requires that an enterprise's operations meet the three criteria specified in paragraph 5 of Statement 71:

a. The enterprise's rates for regulated services or products provided to its customers are established by or are subject to approval by an independent, third-party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers.
b. The regulated rates are designed to recover the specific enterprise's costs of providing the regulated services or products.
c. In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the enterprise's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs. [Footnote reference omitted.]

ment 71 but would not have been recognized as assets and liabilities by enterprises in general. However, the carrying amounts of plant, equipment, and inventory measured and reported pursuant to Statement 71[1] shall not be adjusted unless those assets are impaired, in which case the carrying amounts of those assets shall be reduced to reflect that impairment. Whether those assets have been impaired shall be judged in the same manner as for enterprises in general. The net effect of the adjustments required by this Statement shall be included in income of the period in which the discontinuation occurs and shall be classified as an extraordinary item.

7. An enterprise that discontinues application of Statement 71 shall no longer recognize the effects of actions of a regulator as assets or liabilities unless the right to receive payment or the obligation to pay exists as a result of past events or transactions and regardless of future transactions.

Disclosures

8. For the period in which an enterprise reflects the discontinuation of application of Statement 71 to all or a separable portion of its operations, the enterprise shall disclose the reasons for the discontinuation and identify the portion of its operations to which the application of Statement 71 is being discontinued.

9. The disclosure requirements of APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, for extraordinary items apply to the net adjustment reported in the statement of operations as a result of applying this Statement.

---

[1]The carrying amounts of plant, equipment, and inventory for enterprises applying Statement 71 differ from those for enterprises in general only because of the allowance for funds used during construction, intercompany profit, and disallowances of costs of recently completed plants. If any other amounts that would not be includable in the carrying amounts of plant, equipment, or inventory by enterprises in general (such as postconstruction operating costs capitalized pursuant to paragraph 9 of Statement 71) are included in or netted against the carrying amounts of plant, equipment, or inventory, those amounts shall be accounted for as this Statement prescribes for the effects of actions of a regulator.

4. Failure of an enterprise's operations to continue to meet the criteria in paragraph 5 of Statement 71 can result from different causes. Examples include the following:

a. Deregulation
b. A change in the regulator's approach to setting rates from cost-based rate making to another form of regulation
c. Increasing competition that limits the enterprise's ability to sell utility services or products at rates that will recover costs
d. Regulatory actions resulting from resistance to rate increases that limit the enterprise's ability to sell utility services or products at rates that will recover costs if the enterprise is unable to obtain (or chooses not to seek) relief from prior regulatory actions through appeals to the regulator or the courts.

Regardless of the reason for an enterprise's discontinuation of application of Statement 71, this Statement specifies how that discontinuation shall be reported in the enterprise's general-purpose external financial statements.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Discontinuation of the Application of Statement 71

5. When an enterprise determines that its operations in a regulatory jurisdiction no longer meet the criteria for application of Statement 71, that enterprise shall discontinue application of that Statement to its operations in that jurisdiction. If a separable portion of the enterprise's operations within a regulatory jurisdiction ceases to meet the criteria for application of Statement 71, application of that Statement to that separable portion shall be discontinued. That situation creates a presumption that application of Statement 71 shall be discontinued for all of the enterprise's operations within that regulatory jurisdiction. That presumption can be overcome by establishing that the enterprise's other operations within that jurisdiction continue to meet the criteria for application of Statement 71.

Accounting to Reflect the Discontinuation of Application of Statement 71

6. When an enterprise discontinues application of Statement 71 to all or part of its operations, that enterprise shall eliminate from its statement of financial position prepared for general-purpose external financial reporting the effects of any actions of regulators that had been recognized as assets and liabilities pursuant to State-

Amendment to Opinion 30

10. This Statement amends Opinion 30 only to the extent that classification of the net effect of discontinuing the application of Statement 71 as an extraordinary item pursuant to paragraph 6 of this Statement shall be made without regard to the criteria in paragraph 20 of that Opinion.

Effective Date and Transition

11. This Statement shall be effective for discontinuations of application of Statement 71 occurring in fiscal years ending after December 15, 1988. If an enterprise has issued financial statements in which the provisions of this Statement have not been applied to a discontinuation occurring in the fiscal year that includes December 15, 1988, the financial statements for the interim period of the discontinuation and subsequent interim periods within that fiscal year shall be restated. For discontinuations reported in fiscal years ending prior to December 15, 1988, retroactive application by restatement of the financial statements for the period including the date of discontinuation and periods subsequent to the date of discontinuation is permitted but not required. Any financial statements restated shall disclose the nature of the restatement and its effect on income before extraordinary items, extraordinary items, net income, and related per share amounts for each period restated. Interim and annual financial statements for periods that ended prior to the date of discontinuation of application of Statement 71 shall not be restated.

12. Enterprises with discontinuations occurring in fiscal years that include December 15, 1988 or December 15, 1989 may delay adopting this Statement until the issuance of annual financial statements for the fiscal year that includes December 15, 1989. Enterprises delaying adoption of this Statement shall, when adopting this Statement, restate their interim and annual financial statements for the period including the date of discontinuation and periods subsequent to that date and shall disclose the nature of the restatement and its effect on income before extraordinary items, extraordinary items, net income, and related per share amounts for each period restated.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the affirmative vote of six members of the Financial Accounting Standards Board. Mr. Lauver dissented.

Mr. Lauver dissents from the issuance of this Statement because it does not require the effects of all specialized practices followed while an enterprise applied Statement 71 to be eliminated from the balance sheet at the time the enterprise discontinues application of that Statement. Specialized practices whose effects are not required to be eliminated upon discontinuing application of Statement 71 are capitalizing an allowance for earnings on shareholders' investment, capitalizing interest on bases different from those permitted by Statement 34, and capitalizing profits on intercompany sales. The effects of those specialized practices that are permitted to remain in the balance sheet have been reported as components of asset accounts (inventory and plant) that would have existed absent those components rather than in separate asset accounts and are said, therefore, not to represent assets resulting solely from actions of regulators. Mr. Lauver believes that the effects of all specialized practices followed while applying Statement 71 are assets (or liabilities) resulting solely from actions of regulators, are substantively the same regardless of balance sheet classification, and should be eliminated to enhance subsequent comparability with other enterprises that are not subject to Statement 71 and to enhance distinctions from enterprises that continue to be subject to Statement 71.

As indicated herein, a rationale for conclusions expressed in this Statement is that, although conceptually correct to eliminate from the balance sheet all effects of the specialized practices followed while applying Statement 71, the cost of doing so, for the practices mentioned in the preceding paragraph, would exceed the benefits derived and that elimination is prohibited by this Statement. Although Mr. Lauver believes it is appropriate for a standard setter to refrain from requiring a conceptually correct solution when costs are judged to exceed benefits, he believes it is inappropriate to preclude a conceptually correct solution in financial statements of an enterprise that concludes that the benefits it perceives will exceed the costs that it alone will bear.

Members of the Financial Accounting Standards Board:

Dennis R. Beresford, *Chairman*
Victor H. Brown
Raymond C. Lauver
James J. Leisenring
C. Arthur Northrop
A. Clarence Sampson
Robert J. Swieringa

Appendix A

EXAMPLES OF THE APPLICATION OF THIS STATEMENT TO SPECIFIC SITUATIONS

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Appendix A

EXAMPLES OF THE APPLICATION OF THIS STATEMENT TO SPECIFIC SITUATIONS

13. This appendix provides examples of the application of this Statement to some specific situations. The examples do not address all possible applications of this Statement.

Assets Recorded Based Solely on Expected Future Revenue to Be Provided by the Regulator

14. Utility A operates solely in one regulatory jurisdiction. At December 31, 19X1, Utility A concludes, based on current market conditions, that it no longer meets the criteria for the application of Statement 71. Utility A's statement of financial position at December 31, 19X1 includes the following items:

a. Deferred purchased power costs (costs of power used for operations in prior periods that were expected to be recovered from customers as a result of an automatic adjustment clause)
b. Deferred costs of abandoned plant (costs for which recovery was being provided through rates)
c. Deferred costs of repairing storm damage.

How should those items be reported at December 31, 19X1?

15. All of those items should be eliminated from the enterprise's statement of financial position when it ceases to apply Statement 71. The resulting charge to income, net of any related tax effects, should be reported as an extraordinary item in the period that includes December 31, 19X1. The enterprise should no longer defer those costs and report them as assets because they could not be reported as assets by enterprises in general. Enterprises in general would report a receivable for those items only if a right to receive payment exists as a result of past events or transactions and regardless of future transactions (such as future sales).

16. For example, a contract between a supplier and a customer for the sale of fuel oil may specify that next year's sales price will be adjusted based on the supplier's current-year cost of fuel oil. Even though it is probable that a future economic benefit (the ability to charge a higher price in the future) will result from the supplier's current-year cost of fuel oil, no asset exists at the end of the current year be-

cause the transactions (sales to the customer) that give the supplier control of the benefit are in the future. However, if the contract provides that the customer is obligated to pay additional amounts related to past purchases and regardless of future purchases, the supplier has an asset and it does not matter whether that payment is made in a single amount or when the customer will pay for next year's purchases.

Liabilities Recorded Based Solely on Actions of the Regulator

17. Utility B operates in two regulatory jurisdictions, State 1 and State 2. Forty percent of Utility B's operations are located in State 1 and 60 percent in State 2; system-wide assets, liabilities, and certain gains and losses are allocated 40 percent to State 1 and 60 percent to State 2. At December 31, 19X2, Utility B concludes, based on current and expected future market conditions in State 1, that it no longer meets the criteria for application of Statement 71 to its operations in State 1. No similar conditions exist in State 2, and actions of State 1's regulators are not expected to influence the decisions of regulators in State 2. Utility B's statement of financial position at December 31, 19X2 includes the following items:

Deferred gain on restructuring debt, being amortized for rate-making purposes on an allocated basis by both states	$50,000
Revenues collected subject to refund in prior years in State 1, expected to be refunded through future rates	$75,000

How should those items be reported at December 31, 19X2?

18. The portion of the deferred gain allocable to State 1 (determined in the example to be 40 percent of $50,000, or $20,000), net of any related tax effects, should be eliminated from the enterprise's statement of financial position when it ceases to apply Statement 71 to its operations in State 1. No adjustment should be made for the deferred gain applicable to State 2. The regulatory-created accrual for revenues subject to refund in State 1, net of any related tax effects, should be eliminated. Whether any liability related thereto exists should be determined under generally accepted accounting principles for enterprises in general. For example, amounts that were collected in the current or prior periods for which refunds will be made *regardless of future sales* should continue to be reported as liabilities after application of Statement 71 is discontinued. The credit to income resulting from the above adjustments, net of any related tax effects, should be reported as an extraordinary item in the period that includes December 31, 19X2.

Regulatory-Created Assets Resulting from the Recording of Deferred Income Taxes Not Recognized for Rate Making

19. Utility C operates solely in one regulatory jurisdiction. At June 30, 19X3, Utility C concludes, based on new legislation, that it no longer meets the criteria for application of Statement 71. Utility C had adopted FASB Statement No. 96, *Accounting for Income Taxes*, in 19X2 and because of applying Statement 71 had recorded a regulatory-created asset of $650,000 for deferred taxes resulting from temporary differences that had not been recognized in the rate-making process but that were expected to be recovered in the future. What reporting is required for that regulatory-created asset?

20. Utility C should eliminate that regulatory-created asset from its statement of financial position when the enterprise ceases to apply Statement 71. The charge to income, net of any related tax effects, should be reported as an extraordinary item in the period that includes June 30, 19X3.

Appendix B

BASIS FOR CONCLUSIONS

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Appendix B

BASIS FOR CONCLUSIONS

Introduction

21. This appendix summarizes considerations that were deemed significant by members of the Board in reaching the conclusions in this Statement. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

22. An FASB Exposure Draft, *Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71*, was issued for public comment on July 8, 1988. The Board received 81 letters of comment in response to the Exposure Draft. The Board concluded that it could reach an informed decision on the basis of existing information without a public hearing.

Overall Conclusions on the Discontinuation of Application of Statement 71

23. For an enterprise with operations that meet the criteria for application of Statement 71, actions of a regulator may result in the recognition of assets and liabilities because the regulator may specify the amount and timing of recognition of allowable costs for rate-making purposes.

24. The conclusion that the criteria of Statement 71 are no longer met as a result of changes in circumstances is a significant event in terms of financial reporting for an enterprise. An objective of financial reporting is to achieve comparability of accounting information. Paragraph 119 of FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, states that this objective "is not to be attained by making unlike things look alike any more than by making like things look different." In this instance, achieving that objective requires reporting the effect of that significant event so that an enterprise that discontinues application of Statement 71 is distinguished from an enterprise that does not.

25. When an enterprise determines that it ceases to meet the criteria for application of Statement 71, assets and liabilities recognized solely because of judgments about the effects of actions of the regulator cease to meet the criteria for recognition. The Board concluded that the change in circumstances that led to the discontinuation of application of Statement 71 should be reported in financial statements. The approach set forth in the Exposure Draft required adjusting the

ment, and inventory should be adjusted to the amounts that would have been recorded had Statement 71 never been applied but that the cost of determining and removing the allowance for funds used during construction and intercompany profit and of computing the interest that would have been capitalized in accordance with Statement 34 would exceed the benefits derived.

29. The Board considered permitting but not requiring enterprises that discontinue application of Statement 71 to adjust their carrying amounts of plant, equipment, and inventory to the amounts that would have been recorded had Statement 71 never been applied. Some Board members did not believe that adjustments to the carrying amounts of those assets were appropriate absent impairment. Other Board members believed the advantages of prescribing a consistent method of discontinuing application of Statement 71 were sufficient to outweigh their concern about prohibiting an enterprise from using what those Board members believe to be the conceptually correct approach. For those reasons, this Statement does not permit enterprises that discontinue application of Statement 71 to adjust the carrying amounts of plant, equipment, and inventory to the amounts that would have been recorded had Statement 71 never been applied.

30. In determining the appropriate financial reporting for an enterprise that discontinues application of Statement 71, the Board considered whether the accounting for a change in circumstances should be based on the guidance contained in APB Opinion No. 20, *Accounting Changes*. The Board recognizes that the change from one accounting model to another is an unusual accounting event that is different from a discretionary change in accounting because the former is dictated by changed circumstances. That change is somewhat analogous to a "change in estimate effected by a change in accounting principle," described in paragraphs 11 and 32 of Opinion 20, that is required to be accounted for as a change in estimate. The Board concluded that, because the change in circumstances eliminates the justification for recognizing assets and liabilities whose recognition was based solely on judgments made about the effect of the rate-making process, that change should be reported as a separate component of net income of the period of the change.

31. The discontinuation of application of Statement 71 may, in some circumstances, not meet the criteria for extraordinary items in paragraph 20 of Opinion 30. The Board concluded that extraordinary-item treatment represents a practical and reasonable way to classify the adjustments resulting from the discontinuation of Statement 71 in a statement of operations. This Statement amends Opinion 30 to

financial statements of the enterprise so that they are comparable, at the date of the change and in future periods, with the financial statements of other enterprises that had never applied Statement 71.

26. Most respondents disagreed with the Exposure Draft's requirement to adjust the amounts recorded as plant, equipment, and inventory to the amounts that would have been recorded had the enterprise never applied Statement 71. The reasons given by those respondents for not adjusting the amounts recorded as plant, equipment, and inventory when discontinuing the application of Statement 71 included (a) viewing the allowance for funds used during construction as an acceptable substitute for interest that would have been capitalized under FASB Statement No. 34, *Capitalization of Interest Cost*, (b) the general notion, as expressed in paragraph 88 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, that "once an asset or liability is recognized, it continues to be measured at the amount initially recognized until an event that changes the asset or liability or its amount occurs and meets the recognition criteria," (c) the precedent that the adoption of Statement 34 by enterprises in general was prospective, and (d) the assertion that the cost of obtaining the information necessary to adjust the amounts recorded as plant, equipment, and inventory exceeded the benefits derived from the adjustments.

27. Other respondents agreed with the Exposure Draft's requirement to adjust the amounts recorded as plant, equipment, and inventory to the amounts that would have been recorded had the enterprise never applied Statement 71. Those respondents viewed the differences in amounts recorded as plant, equipment, and inventory due to application of Statement 71 as no different from the separately identified effects of actions of a regulator recognized as assets and liabilities, such as deferred storm damage costs or deferred gains on reacquired debt. Those respondents agreed that those amounts should be eliminated upon the discontinuation of application of Statement 71.

28. Absent impairment, this Statement does not permit adjustment of the carrying amounts of plant, equipment, and inventory measured and recorded pursuant to Statement 71 when an enterprise discontinues application of Statement 71 to all or a portion of its operations. Some Board members agree that the allowances for funds used during construction were an acceptable substitute for the amounts of interest that would have been capitalized in accordance with Statement 34 and that once an asset is measured and recognized pursuant to generally accepted accounting principles, the cost basis of that asset, absent impairment or the occurrence of other events that change the asset or its amount, should not be adjusted. Other Board members believe that, in principle, the carrying amounts of plant, equip-

the extent that classification of the net effect of discontinuing the application of Statement 71 as an extraordinary item is made without regard to the criteria in paragraph 20 of that Opinion.

32. Some respondents asserted that an enterprise that discontinues the application of Statement 71 can justify continued recognition of assets and liabilities arising from the rate-making process because of judgments about the probability of their recovery from or payment to ratepayers. Those assertions were typically based on definitions of assets and liabilities in paragraphs 25 and 35 of FASB Concepts Statement No. 6, *Elements of Financial Statements*, which state:

> Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
>
> Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. [Footnote references omitted.]

33. Statement 71 recognizes that in certain circumstances the rate-making process provides a link between costs and revenues in one period and revenues in the future. When an enterprise meets the criteria for the application of Statement 71, the rate-making process can affect the recognition of assets and liabilities. The Board believes that continuing to recognize assets and liabilities based solely on judgments about the rate-making process is not appropriate when an enterprise ceases to meet the criteria for application of Statement 71. After an enterprise ceases to meet the criteria for application of Statement 71, it is in a position comparable to enterprises in a number of industries that are subject to regulation but do not apply Statement 71.

34. For enterprises that cease to meet the criteria for applying Statement 71 and continue to be subject to rate regulation, that regulation is similar to a contractual obligation to sell goods or services in the future at an established price or to other forms of price control. A contract that an enterprise in general believes is probable of generating higher than normal gross profits in the future does not provide a basis for the current recognition of an asset representing the anticipated "excess" gross profits related to that contract, nor does it provide a basis for deferring contract-related costs that would otherwise be charged to expense. Similarly, a contract that is probable of generating a lower than normal gross profit does not create a liability unless the contract meets the criteria of FASB Statement No. 5, *Accounting for Contingencies*, for accrual of a loss contingency.

35. This Statement does not provide detailed guidance for reaching judgments about whether application of Statement 71 should be discontinued. Similarly, Statement 71 does not provide detailed guidance for reaching judgments about whether it is appropriate to apply Statement 71. Because applicability of Statement 71 is and must remain a matter of judgment and because the objectives are clear, the Board decided that it was unnecessary to prescribe detailed guidance for reaching the judgments required by this Statement and by Statement 71.

36. Some respondents asked that this Statement define the term *costs* as it is used in the examples in paragraph 4. Some respondents argued it should be defined as "allowable costs" and other respondents argued it should be defined as "incurred costs." The term *costs* is used in paragraph 4 of this Statement consistent with its usage in paragraph 5 of Statement 71. As explained in paragraph 67 of the Basis for Conclusions to Statement 71, the term *costs* in paragraph 5 of Statement 71 is based on allowable costs.

Application of Overall Conclusions to Specific Items

37. The Board concluded that the approach required by this Statement would be easier to understand and implement with examples. Therefore, an appendix with examples is included.

38. The Exposure Draft included a reference to the use of estimates, averages, and computational shortcuts when implementing its provisions because of its requirement to adjust fixed assets to the amounts that would have been recorded had Statement 71 never been applied. This Statement requires significantly fewer adjustments to fixed assets than the approach in the Exposure Draft, and the Board concluded that the specific reference to the use of estimates, averages, and computational shortcuts was unnecessary.

39. Some respondents to the Exposure Draft disagreed with its application to "separable portions" of an enterprise's operation, and other respondents suggested that a separable portion of an enterprise should be no less than an enterprise's operations within a regulatory jurisdiction or a reportable segment as defined in FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*. Those respondents stated that discontinuing application of Statement 71 for a portion of an enterprise's operations or a portion of an enterprise's operations within a regulatory jurisdiction would not be meaningful and could be confusing to preparers and users of the financial statements. Other respondents agreed with discontinuing application of Statement 71 for separable portions of an enterprise's operations and indicated that this was consistent with the application

of Statement 71. Paragraph 6 of Statement 71 states:

> If some of an enterprise's operations are regulated and meet the criteria of paragraph 5, this Statement shall be applied to only that portion of the enterprise's operations.

40. This Statement does not modify paragraph 6 of Statement 71. Statement 71 is applied to separable portions of an enterprise's operations, and therefore the discontinuation of application of Statement 71 should be applied to separable portions of an enterprise's operations. The separable portion may be an enterprise's operations within a regulatory jurisdiction or a smaller portion (such as a customer class within a regulatory jurisdiction), either of which could require the allocation of system-wide assets and liabilities.

41. This Statement does not modify FASB Statement No. 90, *Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs*. If the substance of the actions of the regulator for a separable portion of an enterprise's operations is an explicit, but indirect, disallowance of costs of a recently completed plant, that disallowance should be accounted for as prescribed by Statement 90. The application of Statement 71, as amended, is not optional. An enterprise's operations that meet the criteria for application of Statement 71 are required to be reported consistent with Statement 71, and an enterprise whose operations cease to meet the criteria for application of Statement 71 is required to discontinue application of Statement 71 as prescribed in this Statement.

42. This Statement requires that the carrying amounts of the plant, equipment, and inventory measured and recorded pursuant to Statement 71 not be adjusted unless those assets are impaired. Paragraph 7 of Statement 71 states:

> Authoritative accounting pronouncements that apply to enterprises in general also apply to regulated enterprises. However, enterprises subject to this Statement shall apply it instead of any conflicting provisions of standards in other authoritative pronouncements. [Footnote reference omitted.]

The carrying amounts of plant, equipment, and inventory for enterprises applying Statement 71 differ from those for enterprises in general only because of the allowance for funds used during construction, intercompany profit, and disallowances of costs of recently completed plants. If any other amounts that would not be includable in the carrying amounts of plant, equipment, or inventory by enterprises in general are included in or netted against the carrying amounts of plant, equip-

ment, and inventory, those amounts should be separated from the carrying amounts of plant, equipment, and inventory and accounted for as prescribed in this Statement. For example, postconstruction operating costs that were capitalized pursuant to paragraph 9 of Statement 71 represent the effects of actions of a regulator regardless of their classification in the financial statements and should be accounted for as this Statement prescribes for the effects of actions of a regulator. Another example of the effect of actions of a regulator that would require adjustment is the cumulative difference, if any, between recorded depreciation and depreciation computed using a generally accepted method of depreciation.

43. Several respondents requested that this Statement address the accounting for reapplication of Statement 71 by an enterprise that had previously discontinued application of Statement 71 for all or a portion of its operations. The Board noted that the accounting for the initial application of Statement 71 has not been raised as an issue that needs to be addressed by the Board. In addition, some Board members believe that circumstances warranting reapplication of Statement 71 will occur rarely, if at all. The Board concluded that the accounting for the initial application or reapplication of Statement 71 is beyond the scope of this Statement.

44. Several respondents suggested that this Statement should require disclosures about the discontinuation of application of Statement 71, such as disclosing the reasons for the discontinuation and the portions of the enterprise's operations that do and do not apply Statement 71. In addition, for enterprises that discontinue application of Statement 71 but continue to be subject to rate regulation, some respondents suggested that the Statement require disclosure of the rate-making concepts used by the regulator and the factors that are considered in establishing rates and, to the extent that past events will be reflected in future prices, identify and quantify those regulatory actions.

45. The Board concluded that disclosure of the reasons for discontinuing application of Statement 71 and disclosure of the portion of an enterprise's operations for which the application of Statement 71 is being discontinued would provide useful information; therefore, this Statement requires disclosure of that information. The Board concluded that it would not be appropriate to require disclosure of the effects of regulation for enterprises that discontinue application of Statement 71 but continue to be subject to regulation without addressing disclosure requirements for enterprises that have never applied Statement 71 but are subject to regulation. However, the Board encourages disclosures about the discontinuation of application of Statement 71 and the nature and effects of continuing regulation that would make the financial statements more informative and meaningful.

Effective Date and Transition

46. The Board considered whether this Statement should be applied retroactively to all enterprises that have previously discontinued application of Statement 71. The Board recognized that applying this Statement only to future discontinuations would diminish both comparability of financial statements among enterprises that have discontinued application of Statement 71 using different methods and consistency within an enterprise that reports discontinuations for portions of its operations in different periods using different methods. Although requiring restatement would increase comparability among companies discontinuing application of Statement 71 and consistency within a few enterprises that have previously discontinued the application of Statement 71 to a portion of their operations during fiscal years ending before December 15, 1988, the Board believes that those benefits do not justify the costs that would be incurred. Therefore, the Board decided that application of this Statement should be required for discontinuations occurring in annual periods ending after that date, with retroactive application to previously reported discontinuations permitted but not required. In no event should the interim or annual financial statements for periods that ended prior to the date of discontinuation of application of Statement 71 be restated.

47. Some respondents requested a delay of the effective date or a transition period to allow affected enterprises the time necessary to compute the effect of the discontinuation of application of Statement 71 pursuant to this Statement and, if necessary, time to resolve problems created by the accounting required by this Statement for loan indentures or other agreements. The Board believes that because plant, equipment, and inventory are not required to be restated for certain items as was required in the Exposure Draft, it would be rare that an enterprise would cease to meet the criteria for application of Statement 71 and would not know the accounting effect of the discontinuation. However, the Board concluded, primarily because this Statement is being issued late in the year in which it becomes effective, to allow for a delay in its required adoption.

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Financial Accounting Series

Statement of Financial Accounting Standards No. 92

Regulated Enterprises— Accounting for Phase-in Plans

an amendment of FASB Statement No. 71

Financial Accounting Standards Board
of the Financial Accounting Foundation

Statement of Financial Accounting Standards No. 92

Regulated Enterprises—Accounting for Phase-in Plans

an amendment of FASB Statement No. 71

August 1987

Financial Accounting Standards Board
of the Financial Accounting Foundation
HIGH RIDGE PARK, P.O. BOX 3821, STAMFORD, CONNECTICUT 06905-0821

Statement of Financial Accounting Standards No. 92

Regulated Enterprises—Accounting for Phase-in Plans

an amendment of FASB Statement No. 71

August 1987

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Statement of Financial Accounting Standards No. 92

Regulated Enterprises—Accounting for Phase-in Plans

an amendment of FASB Statement No. 71

August 1987

INTRODUCTION

1. FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation,* was issued in December 1982. Shortly after the Statement was issued, major events in the electric utility industry caused the Board to review the effects of the Statement on the accounting for those events. After that review, the Board decided to amend Statement 71 to provide more specific guidance on the accounting for some of those events and to change the accounting for others.

2. FASB Statement No. 90, *Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs,* addresses the accounting for some of those events. This Statement amends Statement 71 to specify the accounting for phase-in plans.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Accounting for Phase-in Plans

3. The term *phase-in plan* is used in this Statement to refer to any method of recognition of allowable costs[1] in rates that meets all of the following criteria:

a. The method was adopted by the regulator in connection with a major, newly completed plant of the regulated enterprise or of one of its suppliers or a major plant scheduled for completion in the near future (hereinafter referred to as "a plant").
b. The method defers the rates intended to recover allowable costs beyond the period in which those allowable costs would be charged to expense under gener-

[1]The term *allowable costs* is used throughout this Statement to refer to all costs for which revenue is intended to provide recovery. Those costs can be actual or estimated. In that context, allowable costs include interest costs and an allowance for earnings on shareholders' investment.

ally accepted accounting principles applicable to enterprises in general.

c. The method defers the rates intended to recover allowable costs beyond the period in which those rates would have been ordered under the rate-making methods routinely used prior to 1982 by that regulator for similar allowable costs of that regulated enterprise.

4. If a phase-in plan is ordered by a regulator in connection with a plant on which no substantial physical construction had been performed before January 1, 1988, none of the allowable costs that are deferred for future recovery by the regulator under the plan[2] for rate-making purposes shall be capitalized for general-purpose financial reporting purposes (hereinafter referred to as "financial reporting").

5. If a phase-in plan is ordered by a regulator in connection with a plant completed before January 1, 1988 or a plant on which substantial physical construction had been performed before January 1, 1988, the criteria specified below shall be applied to that plan. If the phase-in plan meets all of those criteria, all allowable costs that are deferred for future recovery by the regulator under the plan shall be capitalized for financial reporting as a separate asset (a deferred charge). If any one of those criteria is not met, none of the allowable costs that are deferred for future recovery by the regulator under the plan[3] shall be capitalized for financial reporting. The criteria to determine whether capitalization is appropriate are:

a. The allowable costs in question are deferred pursuant to a formal plan that has been agreed to by the regulator.

b. The plan specifies the timing of recovery of all allowable costs that will be deferred under the plan.

c. All allowable costs deferred under the plan are scheduled for recovery within 10 years of the date when deferrals begin.

d. The percentage increase in rates scheduled under the plan for each future year is no greater than the percentage increase in rates scheduled under the plan for each immediately preceding year. That is, the scheduled percentage increase in year two is no greater than the percentage increase granted in year one, the scheduled percentage increase in year three is no greater than the scheduled percentage increase in year two, and so forth.

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[2] "Allowable costs that are deferred for future recovery by the regulator under the plan" consist of all allowable costs deferred for rate-making purposes under the plan beyond the period in which those allowable costs would be charged to expense under generally accepted accounting principles applicable to enterprises in general.

[3] Refer to footnote 2.

Modifications of and Supplements to Phase-in Plans

6. Except as provided in paragraph 18 of this Statement, when an existing phase-in plan is modified or a new plan is ordered to replace or supplement an existing plan, the above criteria shall be applied to the combination of the original plan and the new plan. The date when deferrals begin, used in applying the criterion in paragraph 5(c), would be the date of the earliest deferral under either the new or the old plan, and the final recovery date would be the date of the last recovery of all amounts deferred under the plans.

Interrelationship of Phase-in Plans and Disallowances

7. A phase-in plan, as defined in paragraph 3, is a method of rate making intended to moderate a sudden increase in rates while providing the regulated enterprise with recovery of its investment and a return on that investment during the recovery period. A disallowance is a rate-making action that prevents the regulated enterprise from recovering either some amount of its investment or some amount of return on its investment. Statement 90 specifies the accounting for disallowances of plant costs. If a method of rate making that meets the criteria of this Statement for a phase-in plan includes an indirect disallowance of plant costs, that disallowance shall be accounted for in accordance with Statement 90.

Allowance for Earnings on Shareholders' Investment Capitalized for Rate-making Purposes

8. If specified criteria are met, paragraph 9 of Statement 71 requires capitalization of an incurred cost that would otherwise be charged to expense. An allowance for earnings on shareholders' investment[4] is not "an incurred cost that would otherwise be charged to expense." Accordingly, such an allowance shall not be capitalized pursuant to paragraph 9 of Statement 71.

9. In specified circumstances, paragraph 15 of Statement 71 requires capitalization of an allowance for earnings on shareholders' investment (a designated cost of equity funds) during construction. Paragraph 5 of this Statement requires capitalization of an allowance for earnings on shareholders' investment for qualifying phase-in plans. If an allowance for earnings on shareholders' investment is capitalized for rate-making purposes other than during construction or as part of a phase-

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[4]The phrase "an allowance for earnings on shareholders' investment," as used in this Statement, is intended to have the same meaning as the phrase "a designated cost of equity funds," used in paragraph 15 of Statement 71.

in plan, the amount capitalized for rate-making purposes shall not be capitalized for financial reporting.

Financial Statement Classification of Amounts Capitalized under Phase-in Plans

10. Cumulative amounts capitalized under phase-in plans shall be reported as a separate asset in the balance sheet. The net amount capitalized in each period or the net amount of previously capitalized allowable costs recovered during each period shall be reported as a separate item of other income or expense in the income statement. Allowable costs capitalized shall not be reported as reductions of other expenses.

Disclosure

Phase-in Plans

11. The terms of any phase-in plans in effect during the year or ordered for future years shall be disclosed. This Statement does not permit capitalization for financial reporting of allowable costs deferred for future recovery by the regulator pursuant to a phase-in plan that does not meet the criteria of paragraph 5 of this Statement or a phase-in plan related to a plant on which substantial physical construction was not completed before January 1, 1988. Nevertheless, the financial statements shall include disclosure of the net amount deferred at the balance sheet date for rate-making purposes and the net change in deferrals for rate-making purposes during the year for those plans.

Allowance for Earnings on Shareholders' Investment Capitalized for Rate-making Purposes

12. The nature and amounts of any allowance for earnings on shareholders' investment capitalized for rate-making purposes but not capitalized for financial reporting shall be disclosed.

Amendments to Existing Pronouncements

13. This Statement amends Statements 71 and 90 as follows:

a. The following sentence is added to the end of the footnote, added by paragraph

9(b) of Statement 90, at the end of the first sentence of paragraph 9 of Statement 71:

> Phase-in plans shall be accounted for in accordance with FASB Statement No. 92, *Regulated Enterprises—Accounting for Phase-in Plans.*

b. Paragraph 13 of Statement 71, as amended by Statement 90, is superseded by the following:

> Appendix B, Statement 90, and Statement 92 illustrate the accounting for the effects of regulation.

c. Paragraph 14 of Statement 71 is superseded by the following:

> The following specific standards and the standards in Statements 90 and 92 are derived from the general standards in paragraphs 9-12. The specific standards in paragraphs 15-17 and the standards in Statements 90 and 92 shall not be used as guidance for other applications of the general standards in paragraphs 9-12.

d. Paragraph 9(d) of Statement 90 is deleted.

Effective Date and Transition

14. Except as provided in paragraph 17 below, this Statement shall be effective for fiscal years beginning after December 15, 1987 and interim periods within those fiscal years. Earlier application is encouraged. At the date of initial application of this Statement, existing phase-in plans shall be evaluated under the criteria of paragraph 5 of this Statement. If those existing plans do not meet those criteria, all allowable costs deferred by the regulator under those phase-in plans[5] that have previously been capitalized shall be written off. The provisions of this Statement that address capitalization of an allowance for earnings on shareholders' investment other than during construction or as part of a phase-in plan (paragraphs 8 and 9) shall not be applied to amounts capitalized in fiscal years prior to the initial application of this Statement.

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[5]Refer to footnote 2.

15. Retroactive application of the provisions of this Statement that address accounting for phase-in plans (paragraphs 5-7, 10, and 11), in fiscal years for which financial statements have previously been issued, is permitted. If those provisions are applied retroactively, the financial statements of all prior periods presented shall be restated. In addition, the restated financial statements shall, in the year this Statement is first applied, disclose the nature of any restatement and its effect on income before extraordinary items, net income, and related per share amounts for each period presented and on retained earnings at the beginning of the earliest period presented.

16. If financial statements for prior fiscal years are not restated as permitted by paragraph 15, the effects of applying this Statement to existing phase-in plans shall be reported as the cumulative effect of a change in accounting principle, as described in APB Opinion No. 20, *Accounting Changes*, and the effect of adopting this Statement on income before extraordinary items, net income, and related per share amounts shall be disclosed.

17. Application of this Statement to an existing phase-in plan shall be delayed if both of the following conditions are met:

a. The enterprise has filed a rate application to have the plan amended to meet the criteria of paragraph 5 of this Statement or it intends to do so as soon as practicable.
b. It is reasonably possible that the regulator will change the terms of the phase-in plan so that it will meet the criteria of paragraph 5 of this Statement.

If those conditions are met, the provisions of this Statement shall be applied to that existing phase-in plan on the earlier of the date when one of those conditions ceases to be met or the date when a final rate order is received, amending or refusing to amend the phase-in plan. However, if the enterprise delays filing its application for the amendment or the regulator does not process that application in the normal period of time, application of this Statement shall not be further delayed.

18. In applying the criteria of paragraph 5 to a plan that was in existence prior to the first fiscal year beginning after December 15, 1987 and that was revised to meet the criteria of this Statement pursuant to paragraph 17 above, the 10-year criterion (paragraph 5(c)) and the requirement that the percentage increase in rates scheduled under the plan in each future year be no greater than the percentage increase scheduled under the plan for each immediately preceding year (paragraph 5(d)) shall be measured from the date of the amendment rather than from the date of the first scheduled deferrals under the original plan.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the affirmative votes of six members of the Financial Accounting Standards Board. Mr. Lauver dissented.

Mr. Lauver dissents from the issuance of this Statement because it permits including in income an imputed allowance for earnings on shareholders' investment during a phase-in period. He believes that accounting is inappropriate on conceptual grounds because the allowance should be included in income only at the time it is a component of prices charged to customers for services.

Further, he believes it is unwise policy, in the present environment, to authorize special accounting during a phase-in period. Phase-in plans are instigated because rates that would otherwise be charged are unacceptable to customers. Whatever might have been the case in a prior era, evidence now abounds, in the form of disallowances, temporary or indefinite omission of costs from rate base, competition, actual and planned deregulation, and inability to earn allowed rates of return, that the relationship between present costs and future revenues is too tenuous to warrant accounting predicated on the assumption that the marketplace will accept charges tomorrow that it finds unacceptable today.

Mr. Lauver also dissents to the issuance of this Statement because it does not require elimination from balance sheets of certain amounts capitalized as an allowance for earnings on shareholders' investment even though not in compliance with unambiguous provisions of Statement 71 that have been reiterated in this Statement and even though inconsistent with the accounting required for nonqualifying phase-in plans. He believes it is unwise policy to grant an amnesty-like approval of accounting that was determined to be inappropriate in both Statement 71 and this Statement.

Members of the Financial Accounting Standards Board:

Dennis R. Beresford, *Chairman*
Victor H. Brown
Raymond C. Lauver
David Mosso
C. Arthur Northrop
Robert J. Swieringa
Arthur R. Wyatt

Appendix A

EXAMPLES OF APPLICATION OF THIS STATEMENT TO SPECIFIC SITUATIONS

19. This appendix provides guidance for application of this Statement to some specific situations. The guidance does not address all possible applications of this Statement. All examples assume that the enterprise meets the criteria of paragraph 5 of Statement 71 for the application of Statement 71 by the enterprise.

20. Specific situations discussed in this appendix are:

	Paragraph Numbers
Accounting for a phase-in plan that includes an indirect disallowance	21–24
Applications of the definition of a phase-in plan	25–41
"Mirror CWIP"	25–29
Sale with leaseback—capital lease	30–31
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Deferral of costs before a rate order is issued	38–41
Interaction of disallowance with deferral of costs before a rate order is issued	42–43
Interaction of deferral of costs before a rate orde: is issued with a subsequent phase-in plan	44–45

Accounting for a Phase-in Plan That Includes an Indirect Disallowance

21. Utility A is an electric utility that operates solely in a single-state jurisdiction. On January 1, 19X1, Utility A's new electric generating plant becomes operational. The cost of that plant is $1 billion.

22. Utility A's regulator orders that the costs of the newly completed plant be phased in over a three-year period, as follows:

19X1—A portion o' the return (interest and an allowance for earnings on shareholders' inv stment) on unrecovered investment is deferred by excluding 25 percent of the cost of the plant from the rate base.

19X2—All of the remaining cost of the plant is to be included in the rate base with no recovery of previously deferred amounts.

19X3—All of the remaining cost of the plant is to be included in the rate base. Also, additional revenue is to be provided equal to the return on unrecovered investment excluded from rates in year 1.

The order does not provide for recovery in any year of a return on Utility A's investment in the deferred amounts. Utility A's weighted-average cost of capital in its latest rate case was 11 percent.

23. The phase-in plan is partially a disallowance of plant costs because no return on investment is provided for the deferred amounts. That disallowance should be recognized in accordance with Statement 90 when it became probable. The amount of equivalent cost disallowed should be determined as shown in Schedule 1. The recorded cost of the plant should be reduced by that amount, and a corresponding loss should be reported in 19X1.

24. The disallowance will reduce revenues only in years 1 through 3, so the depreciation charge that would otherwise be recognized for that plant in years 1 through 3 should be reduced by the amount of the effective disallowance attributable to those years (the amount in column 4 of Schedule 1). Amounts deferred under the plan (the amount for months 1-12 in column 1 of Schedule 1) should be capitalized as a separate asset, and that asset should be amortized as recovery occurs (in months 25-36), using the amounts in column 1 of Schedule 1.

Schedule 1

Utility A
Determination of Effective Disallowance
Return on Investment Disallowed for Amounts Deferred under Phase-in Plan
(in thousands)

Month	(1) Cost Deferral (Recovery)	(2) Cumulative Amount Deferred	(3) R.O.I. on Cumulative Deferral	(4) Effective Disallowance
1	$ 2,292	$ 2,292	$ 21	$ 0
2	2,291	4,583	42	21
3	2,292	6,875	63	41
4	2,292	9,167	84	61
5	2,291	11,458	105	80
6	2,292	13,750	126	99
7	2,292	16,042	147	118
8	2,291	18,333	168	137
9	2,292	20,625	189	155
10	2,292	22,917	210	173
11	2,291	25,208	231	190
12	2,292	27,500	252	207
13	0	27,500	252	224
14	0	27,500	252	222
15	0	27,500	252	220
16	0	27,500	252	218
17	0	27,500	252	216
18	0	27,500	252	214
19	0	27,500	252	212
20	0	27,500	252	210
21	0	27,500	252	208
22	0	27,500	252	206
23	0	27,500	252	204
24	0	27,500	252	202
25	(2,292)	25,208	231	201
26	(2,291)	22,917	210	182
27	(2,292)	20,625	189	164
28	(2,292)	18,333	168	146
29	(2,291)	16,042	147	129
30	(2,292)	13,750	126	112
31	(2,292)	11,458	105	95
32	(2,291)	9,167	84	78
33	(2,292)	6,875	63	62
34	(2,292)	4,583	42	46
35	(2,291)	2,292	21	31
36	(2,292)	0	0	15
Total loss to be recognized in 19X1				$5,099

Computations:

Column (1)—Cost of plant ($1 billion) × .25 × 11% ÷ 12

Column (2)—Column (2) for prior month + Column (1) for current month

Column (3)—Column (2) × 11% ÷ 12

Column (4)—Present value (at beginning of month 1) at 11% (.9167 per month) of amount in Column (3) for prior month

Applications of the Definition of a Phase-in Plan

"Mirror CWIP"

25. "Mirror CWIP" is one means of moderating the sudden, one-time increase in rates that would otherwise result from placing a newly completed utility plant in service. Under "mirror CWIP," increasing amounts of construction work in progress (CWIP) are included in the current rate base in the periods before the plant goes into service, providing the utility with a current return on a portion of its investment in construction while the construction proceeds. After the plant is placed in service, a decreasing amount of plant-in-service is excluded from the rate base each year, "mirroring" the pattern in which the construction was included in the rate base. The result of this procedure is to increase rates while the plant is under construction and to reduce the increase in rates in the initial years of the plant's service life.

26. For rate-making purposes, no allowance for funds used during construction is recognized on the portion of the construction that is included in the rate base while the asset is under construction, and an allowance for funds used during construction is recognized on the portion of the plant-in-service that is subsequently excluded from the rate base after the plant is placed in service. The same total amount is capitalized as if no construction had been included in the current rate base. Is "mirror CWIP" a phase-in plan under the definition in this Statement? What financial reporting is appropriate for a "mirror CWIP" plan?

27. The "mirror CWIP" arrangement described above is not a phase-in plan under the definition used in this Statement because it does not defer recovery of costs that would not have been deferred under the methods of rate making used prior to 1982. Rather, it effectively provides a temporary loan from customers to the utility during construction and requires repayment of that loan after the plant is placed in service.

28. If the arrangement is known to be a "mirror CWIP" arrangement at the time of the construction (for example, if that arrangement is required by law or has been specifically ordered by the regulator), an allowance for funds used during construction should be accrued on the total cumulative construction cost in each period for financial reporting. The revenue collected as a result of inclusion of construction in the current rate base should be recorded as a liability to customers, with disclosure of the approximate timing of the repayment that will be required under the "mirror CWIP" arrangement.

29. If the arrangement is not known to be a "mirror CWIP" arrangement when the construction is included in the rate base but the regulator later orders a "mirror CWIP" arrangement, the accounting described in paragraph 28 should be implemented as soon as the nature of the arrangement becomes known. That will require an adjustment for the cumulative effect of the arrangement to date. An amount should be capitalized, with a corresponding accrual of an allowance for funds used during construction, when the "mirror CWIP" arrangement becomes known. Current revenues should be reduced by an equal amount, and a corresponding liability to customers should be recognized. That amount should be the amount that would have been capitalized if the arrangement had been known to be a "mirror CWIP" arrangement when the revenue was collected during construction. That capitalized amount should be reported in the year in which the "mirror CWIP" arrangement becomes known in the same manner as if it had been capitalized during construction.

Sale with Leaseback—Capital Lease

30. Utility B sells its interest in a newly completed electric generating plant for an amount equal to its cost and leases that interest back under a lease that requires equal annual payments. The sale meets the criteria of FASB Statement No. 66, *Accounting for Sales of Real Estate,* for recognition as a sale, and the leaseback meets the criteria of FASB Statement No. 13, *Accounting for Leases,* for a capital lease. Utility B's regulator includes the lease rentals in allowable cost as they accrue. In the past, Utility B's regulator has treated other leases entered into by Utility B in the same manner, but those leases were for much less significant items of equipment—not for an interest in an electric generating plant. Is this rate-making method a phase-in plan under the definition in this Statement?

31. The rate-making method described is a phase-in plan under the definition in this Statement. Generally accepted accounting principles applicable to enterprises in general require a capital lease to be accounted for much like a purchase of the leased property. The resulting expense related to the lease consists of interest on the remaining lease obligation and depreciation based on the method used for similar owned property. In the early years of a lease, the lease rentals included in allowable cost as they accrue are significantly less than the sum of interest on the lease obligation and depreciation on the leased asset. Thus, significant deferrals will result. The method also defers recognition of expenses compared with the methods of expense recognition used by Utility B's regulator for similar assets of Utility B prior to 1982 because Utility B's interests in electric generating plants were included in allowable costs in the past based on current provisions for depreciation and for the cost of capital invested in the plants. The use of this rate-making method in the

past for leases of equipment does not change this conclusion. The definition is based on the method of rate making used prior to 1982 for similar allowable costs. Similar allowable costs would be those resulting from electric generating plants.

Sale with Leaseback—Operating Lease

32. Utility C sells its interest in a newly completed electric generating plant for an amount equal to its cost and leases that interest back under a lease that requires equal annual payments. The sale meets the criteria of Statement 66 for recognition as a sale, and the leaseback meets the criteria of Statement 13 for an operating lease. Utility C's regulator includes the lease rentals in allowable cost as they accrue. In the past, Utility C's regulator has treated other leases entered into by Utility C in the same manner, but those leases were not for an interest in an electric generating plant. Is this rate-making method a phase-in plan under the definition in this Statement?

33. The rate-making method applied to Utility C is not a phase-in plan under the definition in this Statement because it recognizes rent expense for rate-making purposes in the same way as that expense would be recognized for enterprises in general for this type of lease.

Sale with Leaseback—Profit Recognition Accelerated

34. Utility D sells its interest in a 5-year-old electric generating plant for an amount that exceeds its undepreciated cost by $500,000 and leases that interest back. The leaseback term is 20 years, and there are no renewal options. The sale meets the criteria of Statement 66 for recognition as a sale with full profit recognition, and the leaseback meets the criteria of Statement 13 for an operating lease. Utility D's regulator includes the lease rentals in allowable cost as they accrue and orders Utility D to amortize the profit, for rate-making purposes, over 10 years. The sale occurred at a time when Utility D was about to place a newly completed plant in service. Utility D has not had any similar transactions in the past. Is this rate-making method a phase-in plan under the definition in this Statement?

35. The rate-making method described is a phase-in plan under the definition in this Statement. Generally accepted accounting principles applicable to enterprises in general require a profit on a sale-leaseback transaction to be amortized over the term of the leaseback. Amortization of that profit, for rate-making purposes, over 10 years when generally accepted accounting principles applicable to enterprises in general require amortization over the 20-year leaseback term is equivalent to a deferral of allowable costs. In view of the timing of the rate order on the sale-

leaseback transaction, the presumption is that the order was issued in connection with the newly completed plant. The method cannot be compared with methods in use prior to 1982 because Utility D has had no previous transactions of this type.

Modified Depreciation Method

36. Utility E's regulator orders it to depreciate its new electric generating plant, for rate-making purposes, by using an annuity method. Under the method ordered, depreciation increases each year so that the total of depreciation and return on investment stays approximately level over the life of the plant. In the past, Utility E's regulator required the use of straight-line depreciation for electric generating plants. Is this rate-making method a phase-in plan under the definition in this Statement?

37. The rate-making method applied to Utility E is a phase-in plan under the definition in this Statement because (a) it defers depreciation expense compared with the depreciation methods that are acceptable under generally accepted accounting principles applicable to enterprises in general (annuity methods of depreciation are not acceptable under generally accepted accounting principles applicable to enterprises in general) and (b) it defers depreciation expense compared with the method of depreciation used by Utility E's regulator for Utility E's electric generating plants prior to 1982.

Deferral of Costs Before a Rate Order Is Issued

38. Utility F completes construction of a nuclear generating plant and places that plant in service. Utility F's regulator decides that it will complete its examination of the prudence of Utility F's construction cost before rates are adjusted to reflect the cost of operating the plant. During the examination and until rates are adjusted, the regulator orders Utility F to capitalize its net cost of operating the plant (operating costs, depreciation, allocable interest cost, and an allowance for earnings on shareholders' investment, all net of savings that result from operation of the new plant). Is the resulting deferral for rate-making purposes a phase-in plan? What accounting is required for financial reporting?

39. The resulting deferral is not a phase-in plan. The regulator's order to capitalize an amount pending completion of a rate hearing is designed to protect the utility

from the effects of regulatory lag[6] in the absence of a rate order—a routine procedure on the part of regulators. The definition of a phase-in plan in this Statement is not intended to encompass actions of a regulator that are designed to protect a utility from the effects of regulatory lag in the absence of a rate order, nor is it intended to encompass the regulator's subsequent treatment of any allowable costs that result from those actions.

40. Under paragraph 9 of Statement 71, Utility F should capitalize that portion of the amount capitalized for rate-making purposes that represents incurred costs that would otherwise be charged to expense, provided that it is probable that future revenue in an amount at least equal to the capitalized cost will result from inclusion of those costs in allowable costs for rate-making purposes. Otherwise, Utility F should not capitalize those costs.

41. Since the situation in this example is neither during construction nor a phase-in plan, Statement 71 does not permit capitalization of an allowance for earnings on shareholders' investment. Accordingly, Utility F should not capitalize, for financial reporting, the portion of the amount capitalized for rate-making purposes that represents an allowance for earnings on shareholders' investment. If recovery of that allowance subsequently occurs, increased earnings during the recovery period will result.

Interaction of Disallowance with Deferral of Costs Before a Rate Order Is Issued

42. Six months after the accounting order referred to in the previous example, Utility F's regulator approves part of the cost of the new plant but disallows $600,000,000—consisting of construction expenditures of $570,000,000 and amounts capitalized for rate-making purposes during this 6-month operating period prior to the rate order of $30,000,000. The recorded cost of the plant before consideration of the disallowance is $4,500,000,000. During this 6-month period, Utility F has capitalized $500,000,000 of net cost for rate-making purposes. This

[6]*Regulatory lag* is the delay between a change in a regulated enterprise's costs and a change in rates ordered by a regulator as a result of that change in costs. A shortfall in a utility's net income can occur when regulators set rates prospectively and the estimated or test-period costs on which those rates were based are less than the actual costs that are incurred during the period covered by those rates. Regulators' actions that are designed to protect a utility from the effects of regulatory lag can occur during a rate case but before a rate order is issued, as in this example, and when no rate case is under active consideration. An accounting order to a utility to capitalize the cost of repairing storm damage would be an example of the latter situation. Those actions can also be a part of a rate order. An example of that type of action would be a fuel adjustment clause that is intended to protect the utility from the effects of unanticipated changes in fuel costs.

$500,000,000 consists of an allowance for earnings on shareholders' investment of $200,000,000 and incurred costs that would otherwise be charged to expense of $300,000,000. For rate-making purposes, the balance sheet accounts, before and after the disallowance, are as follows:

	Balance before Disallowance	Disallowance	Balance after Disallowance
		(in thousands)	
Plant in Service	$4,500,000	$(570,000)	$3,930,000
Amounts Capitalized Pending Rate Order	500,000	(30,000)	470,000
Combined totals	$5,000,000	$(600,000)	$4,400,000

For financial reporting, how should the disallowance be recognized?

43. Statement 90 requires a disallowance of plant costs to be recognized as a loss. Utility F should perform the following analysis to determine the loss that should be recognized and how it will be allocated:

a. Assuming that $300,000,000 of the $500,000,000 capitalized for rate-making purposes during the 6-month period was also capitalized for financial reporting (the $200,000,000 allowance for earnings on shareholders' investment would not be capitalized), the total loss recognized by Utility F for financial reporting should be the amount that reduces the combined total of Plant in Service and Amounts Capitalized Pending Rate Order ($4,800,000,000) to the combined total that will be honored for rate-making purposes ($4,400,000,000). The recognizable loss is $400,000,000.
b. Utility F should allocate to Plant in Service the lesser of the amount of the disallowance that was allocated to Plant in Service by the regulator ($570,000,000) or the total disallowance recognized for financial reporting ($400,000,000), or $400,000,000.
c. Utility F should allocate the rest of the disallowance recognized for financial reporting, if any, to Amounts Capitalized Pending Rate Order. In this case, no amount is allocated to that asset.

The recognition of the disallowance and the effect of that recognition on the financial reporting balance sheet accounts are as follows:

	Balance before Disallowance	Recognition of Disallowance	Balance after Disallowance
		(in thousands)	
Plant in Service	$4,500,000	$(400,000)	$4,100,000
Amounts Capitalized Pending Rate Order	300,000		300,000
Combined totals	$4,800,000	$(400,000)	$4,400,000

Interaction of Deferral of Costs Before a Rate Order Is Issued with a Subsequent Phase-in Plan

44. Utility G's fact situation is identical to that of Utility F, described in the above examples, except that Utility G's regulator approves all of the costs related to the newly completed plant. Utility G's regulator adopts a formal phase-in plan intended to provide recovery of amounts deferred under the plan and amounts capitalized, for rate-making purposes, during the six-month period from the plant's in-service date to the date of the rate order. How does the phase-in plan affect the financial reporting of the costs deferred during the six-month period?

45. The phase-in plan does not affect the financial reporting of those previously deferred costs described in paragraphs 40 and 41, nor does the existence of those previously deferred costs affect the financial reporting of the phase-in plan. Accordingly, the allowance for earnings on shareholders' investment that was not capitalized previously during the period preceding issuance of the rate order may not be capitalized upon adoption of the phase-in plan.

Appendix B

BASIS FOR CONCLUSIONS

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Appendix B

BASIS FOR CONCLUSIONS

Introduction

46. This appendix summarizes considerations that were deemed significant by members of the Board in reaching the conclusions in this Statement. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

Definition of Phase-in Plans

47. This Statement specifies a phase-in plan definition different from that specified in the December 19, 1985 Exposure Draft, *Regulated Enterprises—Accounting for Phase-in Plans, Abandonments, and Disallowances of Plant Costs*. Comments received on the definition in the Exposure Draft indicated that (a) the definition might encompass some methods of rate making that had been routinely followed for years, (b) the definition could be interpreted to encompass some methods of expense recognition that are accepted for enterprises in general, and (c) the definition was considered ambiguous for phase-in plans related to a supplier's newly completed plant. The Board adopted the definition in this Statement to avoid those problems. The definition now focuses on methods of rate making that defer recognition of allowable costs that would not be deferred under generally accepted accounting principles applicable to enterprises in general and that defer recognition of allowable costs that would not have been deferred by a regulator under the methods of rate making used by that regulator for that same utility in the past.

Accounting for Phase-in Plans

Origin and Nature of Phase-in Plans

48. When a utility places a newly completed plant in service, traditional rate-making procedures establish rates to recover the allowable costs of that plant. The allowable costs include an allowance for return on the utility's remaining investment in the plant, which is greatest in the first year of the plant's service life and decreases thereafter as the plant is depreciated.

49. In recent years, a combination of circumstances caused traditional rate-making procedures to result in a phenomenon called *rate spike*. Rate spike is a major, one-time increase in rates that can result from the inclusion of the cost of new plants in rates under traditional rate-making procedures. One cause of rate spike was the high cost of nuclear power plants. The cost of those plants escalated far beyond initial expectations. Another cause was the high cost of capital. Return on investment, which is based on the cost of capital, is a major part of the cost of operating a nuclear plant. Finally, demand for many utilities' services has not grown in recent years to the extent that was expected when the decision was made to construct many of the recently completed plants. As a result, plants that were expected to be needed to meet demand have created excess capacity. The increased efficiency of the new plants has not been sufficient to offset the high construction and capitalized capital costs of those plants and the return on investment that would have been included in rates under traditional rate-making procedures.

50. Phase-in plans were developed to alleviate the problem of rate spike. Those plans are intended to moderate the initial increase in rates that would otherwise result from placing newly completed plants in service by deferring some of that rate increase to future years and providing the utility with return on investment for those deferred amounts. Instead of the traditional pattern of an increase in allowable costs followed by decreasing allowable costs for utility plants after the plants are placed in service, phase-in plans create a pattern of gradually increasing allowable costs for the initial years of the plant's service life.

Questions Raised by Phase-in Plans

51. Phase-in plans raise three questions under Statement 71. First, the very existence of a phase-in plan, whereby rate increases are postponed, calls into question whether future rates to be charged to and collected from customers will in fact be set at levels that will recover the enterprise's costs. Paragraph 5(c) of Statement 71 requires that such an assumption be reasonable as a threshold condition for application of that Statement.

52. Some phase-in plans have been discussed in public forums as ways of retaining major customers. Utility officials have stated that major industrial customers would leave their utility's service area or develop alternative sources of supply if rates were increased under normal rate-making procedures sufficiently to recover the costs of a newly completed plant. If rates cannot, immediately after a new plant is put in service, be set at levels to permit recovery of allowable costs, a question arises as to whether economic conditions or customer acceptance will permit collecting rates in the future that ultimately will recover costs.

53. The second question relates to paragraph 5(b) of Statement 71, which requires that rates be designed to recover the specific enterprise's costs of providing the regulated services or products as a condition for application of that Statement. In the past, regulators sometimes have provided rates to recover costs in periods other than the period in which the costs would be charged to expense under generally accepted accounting principles applicable to enterprises in general. The rationale for such differences has been that (a) costs like storm damage or plant abandonments were infrequently occurring and should be spread among customers of multiple years or (b) the regulator did not agree that the cost was a valid period cost of the period in which it would be recognized by nonregulated enterprises. Deferred income tax expense is an example of the latter category. Under phase-in plans, allowable costs that for years have been agreed to be costs of a period are charged to customers in a different period mainly *because otherwise rates are judged to be unacceptably high.*

54. If one accepted a premise that, in periods when rates would be unacceptably high, costs can be moved to a future period, the economic discipline inherent in a process of charging customers for the costs of the services they use would be absent. No constraint would exist on the rate-making process. In the extreme case, nothing would prevent a regulator from providing customers with free electricity and promising recovery of the costs of producing that electricity in future years when an improved local economy might be expected. Some Board members believe that the premise that rates in a given period are based on the cost of services provided to customers in that period provides a necessary constraint to accounting for the type of regulation that was addressed by Statement 71.

55. The third question raised by a phase-in plan is whether it is appropriate to capitalize an allowance for earnings on shareholders' investment after a plant begins operations. Paragraph 15 of Statement 71 requires capitalization of such an allowance as part of the acquisition cost of an asset *during construction.* Statement 71 does not permit capitalization of such an allowance under any other circumstances.

56. The Board notes that an allowance for earnings on shareholders' investment is different from other costs for which recovery is provided by regulators. An allowance for earnings on shareholders' investment is not an incurred cost but is a computed amount of earnings to which equity shareholders are deemed to be entitled if their capital is prudently employed in providing services to customers. Capitalizing such an allowance increases currently reported income. Some believe that this result is inappropriate and that income should not be recognized until revenues in the form of billable rates for services are realized. They acknowledge that a partial

exception is permitted in Statement 71 for an allowance for funds used during construction but question whether that partial exception should be extended to the case of phase-in plans. They view the current recognition of that future income, by capitalizing an allowance for earnings on shareholders' investment, as recognition of income that is not yet earned. This view, in part, led to the Board's decision, in Statement 71, to permit capitalization of an allowance for earnings on shareholders' investment only as part of the acquisition cost during construction of an asset.

Board Conclusions about Phase-in Plans

57. After considering comments received in comment letters on the Exposure Draft, the Board considered the possibility of not permitting any capitalization of allowable costs deferred pursuant to phase-in plans. For the reasons outlined above, the existence of phase-in plans calls into question the applicability of Statement 71. Observation of the actions of regulators over the past few years, since the first phase-in plan was initiated, suggests that some regulators did not view their actions or the resulting accounting to be constrained by the overriding principle that the cost of current services generally should be charged to current customers. Phase-in plans have evolved from a tightly controlled plan, which deferred recovery of some costs for a short number of years and promised recovery of those deferrals through an automatic rate adjustment mechanism within a brief time period, to open-ended plans that deferred costs indefinitely and promised recovery only when, and if, future demand grew to the point that the capacity in question was needed. The Board was concerned that such developments might undermine the credibility of financial reporting under Statement 71.

58. Despite those concerns, the Board decided against a blanket prohibition against capitalization, for financial reporting, of amounts capitalized for ratemaking purposes under phase-in plans. Rather, the Board decided that capitalization of allowable costs deferred under some types of phase-in plans should be permitted. The Board believes that if any phase-in plans are to result in capitalization of the allowable costs that are deferred pursuant to the plans, those plans should meet stringent criteria so that they will not undermine the credibility of financial reporting under Statement 71. The Board adopted the four criteria in paragraph 5 as the minimum set of criteria that it believes would satisfy that objective.

59. Many respondents to the Exposure Draft urged the Board not to impose the 10-year criterion, which they view as an arbitrary limit. The Board recognizes that the 10-year period is arbitrary, but any other period (for example, the life of the plant) would be equally arbitrary. Cost of service regulation is based on implicit presumptions that (a) operating expenses should normally be recovered in the pe-

riod in which the expenses are incurred and (2) an allowance for return on investment should normally be recovered in the period during which the investment is used to provide services to customers. Any departure from those norms requires an arbitrary decision about the appropriate time for recovery. The very existence of a phase-in plan indicates an inability to fully recover currently the allowable costs of delivering services to customers. Further, it represents a failure to realize normal expectations that return on prudent investments in operating plants would be recovered currently and that prudently incurred construction costs would begin to be recovered on a normal (usually straight-line) basis as soon as a plant was put in service. Although those departures from the norms of individual cost-of-service regulation are an adaptation to exceptional circumstances, they are such major departures that, if not tightly bounded, they could undermine the credibility of specialized accounting for regulated enterprises.

60. Some phase-in plans provided for deferral of extremely large amounts, such that phasing in those amounts and providing recovery of deferrals within 10 years was asserted to be not practicable. Board members are concerned that those costs might not be recoverable at all, and the phase-in plan might be nothing more than a means of delaying recognition of the fact that rates based on full cost of service cannot be charged to and collected from customers.

61. Board members were also concerned about changes that have occurred in the underlying environment of the electric utility industry. Cogeneration appears to be growing, some wholesale customers have changed suppliers, and the significant amounts of unused capacity presently in existence indicate that considerable competition, at least at the wholesale level, is possible. Also, some local regulators have not been inclined to support local franchise rights when the possibility of electric utility customers relocating is present. These uncertainties in the electric utility industry reinforced the Board's view that extraordinary solutions to temporary problems should themselves be temporary and that the 10-year criterion was appropriate.

62. Many respondents to the Exposure Draft urged the Board, if it concluded that the 10-year criterion was necessary, to permit partial application of that criterion. Under that approach, a utility with a phase-in plan that met all of the other criteria but extended beyond 10 years would capitalize the portion of the deferrals under the plan that would be recoverable under the plan within 10 years.

63. The Board considered and rejected partial application of and several alternatives to the 10-year criterion. Alternatives included other qualitative criteria and other quantitative criteria that specified different deferral periods and different

methods and periods for recoveries. The Board concluded that it was important to specify a time period in which *all* deferred amounts must be recovered rather than a time period in which only *some* deferred amounts must be recovered. The Board concluded that the 10-year criterion, when considered with the other criteria of paragraph 5, was the maximum acceptable time that met the objective of a set of criteria that is sufficiently stringent that the credibility of financial reporting under Statement 71 would not be compromised. Because the Board views those criteria as an interrelated set, it believes that it should not permit partial application for a phase-in plan that fails to meet one of those criteria.

64. Letters received before the Exposure Draft was issued and comments received on the Exposure Draft recommended that the regulator's selection of a specific allowable cost for deferral should not be important to accountants because any allowable cost can be selected with equal economic effect. The Board agrees that the regulator does have considerable discretion in identifying costs to be deferred under some phase-in plans because those plans merely defer a predetermined amount of allowable costs for a predetermined period of time. Since the Board decided to permit any allowable cost that is deferred for rate-making purposes under a qualifying phase-in plan to be capitalized for financial reporting, this issue became moot.

Limitation on Use of Accounting for Phase-in Plans

65. Some Board members agreed to permit the capitalization of allowable costs for plans meeting the specified criteria even though they believe that deferral of costs in those circumstances is not consistent with the premises that underlie the accounting provisions of Statement 71. Some viewed the regulators' decisions to approve phase-in plans as being driven more by market factors or competition than by the cost of the current services provided to customers. The Board concluded, however, that capitalization for financial reporting of amounts deferred pursuant to certain phase-in plans should be permitted because of the combination of circumstances experienced by electric utilities in recent years as set forth in paragraph 49. The Board views those circumstances as unusual and agreed to the accounting specified in this Statement as a means of addressing those unusual circumstances. On the other hand, the Board believes that the provisions of this Statement can be viewed as a departure from the premises of Statement 71. Accordingly, the Board decided to limit application of this Statement to phase-in plans adopted in connection with plants on which there was significant physical construction before January 1, 1988. The Board concluded that this limitation on the use of phase-in plans is appropriate because the provisions of this Statement are intended to apply in specific, known circumstances. One cannot predict the ex-

tent of future competition and deregulation in the electric utility industry or in other utility industries.

Distinction between Phase-in Plans and Disallowances

66. Some existing phase-in plans have deferred allowable costs for recovery in future periods for rate-making purposes and have not provided return on the investment in those deferred costs during the deferral period. The Board considered that type of phase-in plan and concluded that it is, in substance, partially a deferral and partially a disallowance. The environment of individual cost-of-service regulation provides an enterprise an opportunity to earn a fair return on capital invested for the benefit of the enterprise's customers. If no return is provided, the regulator has indirectly disallowed part of the cost of the related plant and the accounting should reflect that disallowance.

Allowance for Earnings on Shareholders' Investment Capitalized for Rate-making Purposes

67. An AICPA Issues Paper, *Application of Concepts in FASB Statement of Financial Accounting Standards No. 71 to Emerging Issues in the Public Utility Industry,* received by the Board in November 1984, recommended that the Board amend paragraph 9 of Statement 71 to require capitalization of any allowable cost when the criteria of that paragraph are met. Many respondents to the Exposure Draft made the same recommendation. Paragraph 9 requires capitalization only of "an incurred cost that would otherwise be charged to expense." Thus, paragraph 9 does not permit capitalization of an allowance for earnings on shareholders' investment—an allowable cost but not an incurred cost that would otherwise be charged to expense. An allowance for earnings on shareholders' investment provided by a regulator is an imputed cost. Capitalization of that cost would increase currently reported income, a result which some Board members believe is inappropriate. The Board believes that income related to an allowance for earnings on shareholders' investment generally should result from revenue realization, not from capitalization.

68. In the Exposure Draft, the Board proposed to require capitalization of the cost of equity funds (an allowance for earnings on shareholders' investment) in one other limited situation—when that allowance is deferred by the regulator in connection with a short-term cost deferral and recovery is expected either through an automatic rate adjustment clause or in the rates provided in the next rate case. Even though the situation was defined carefully, comments received about that provision of the Exposure Draft indicated that any such requirement would be in-

terpreted broadly. For example, some respondents interpreted the provision in question as contemplating a situation in which the regulator had ordered capitalization of the net cost of operating a newly completed plant during the period from the date of completion of the plant to the date of a later rate order placing the plant into rates even though recovery, if any, will be provided over the life of the newly completed plant rather than through rates provided in the next rate case.

69. After considering comments received, the Board agreed that recognition of a deferred allowance for earnings on shareholders' investment as income in other situations that were specifically mentioned in comment letters was not warranted. The Board decided that it was more appropriate to restrict capitalization, for financial reporting, of an allowance for earnings on shareholders' investment to construction and qualifying phase-in plans than to attempt to define limited other areas for which it would be permitted. That decision reflects both the Board's reluctance to permit premature recognition of income and the practical difficulties of defining situations that would warrant such capitalization. Accordingly, the Board decided not to amend Statement 71 to permit capitalization of an allowance for earnings on shareholders' investment for financial reporting in instances other than during construction or as part of a phase-in plan.

Effective Date and Transition

70. The Board considered whether this Statement should be applied only to phase-in plans ordered after the effective date or to all phase-in plans. Applying this Statement only to phase-in plans ordered after the effective date would diminish both the comparability of the resulting financial statements among enterprises and the year-to-year consistency of financial results of an enterprise that had phase-in plans ordered both before and after the effective date. Phase-in plans extend over a number of years. Applying the Statement only to phase-in plans ordered after the effective date would also permit financial-reporting recognition of phase-in plans that the Board believes could undermine the credibility of financial reporting under Statement 71. Accordingly, the Board decided that this Statement should be applied to all phase-in plans, regardless of whether they were ordered before or after the effective date.

71. In the Exposure Draft, the Board asked whether regulators would be likely to modify existing plans in order to meet the criteria of the final Statement. Comment letters received in response to the Exposure Draft indicated that such changes may well occur. Some respondents noted that their existing phase-in plans call for automatic reconsideration in the event that they do not meet the criteria of this Statement. In view of that response, this Statement provides special transition relief for

certain existing phase-in plans. The Board decided that if the regulated enterprise has requested that its regulator amend the phase-in plan in order to meet the criteria of this Statement or intends to do so as soon as practicable and it is reasonably possible that the regulator will change the terms of the plan so that it will meet the criteria of this Statement, this Statement generally would not be applied to that plan until an order is received from the regulator, either revising or refusing to revise the plan. The Board also decided that the criteria of paragraph 5 should be modified for plans that are revised to meet the criteria of this Statement. For those plans, the 10-year limitation and the prohibition against increasing percentage rate increases would be measured from the date of the revision.

72. The Board also considered whether the provision in this Statement, that an allowance for earnings on shareholders' investment should not be capitalized for financial reporting other than during construction or as part of a phase-in plan, should be applied only to amounts accrued for rate-making purposes after the effective date or also to amounts previously capitalized for financial reporting. The Board concluded that although capitalization in circumstances other than construction and phase-in plans can result in questionable income recognition, retroactive restatement would be burdensome and would not be warranted in view of the relatively limited amounts or time periods involved in past practices. Also, the practice is not one that would be likely to undermine the credibility of financial reporting under Statement 71. Accordingly, the Board decided that this Statement should be applied to allowances for earnings on shareholders' investment deferred for rate-making purposes after initial application of the Statement. Retroactive application is not permitted for that item.

Appendix C

BACKGROUND INFORMATION

73. Statement 71 was issued in December 1982, effective for financial statements for fiscal years beginning after December 15, 1983. In early 1984, several different circumstances caused the Board to question whether the application of Statement 71 in practice was what the Board had intended.

74. Subsequent to issuing Statement 71, the Board became aware of several phase-in plans that involved capitalization of an allowance for earnings on shareholders' investment in an operating plant. The Board considered issuing an Interpretation or permitting issuance of a Technical Bulletin to point out that capitalization of such an allowance was not permitted by Statement 71. However, after discussing the nature of phase-in plans and the reasons for their adoption with an affected company and its auditor, the Board decided to explore the use of phase-in plans in more depth before addressing the accounting for those plans.

75. During 1984, rate problems related to new nuclear electric generating plants of several utilities were widely discussed in the financial press. Comments credited to executives of those utilities indicated considerable question whether the utilities could bill rates based on the cost of those plants to their customers without losing a major part of their customer base. Some articles indicated that phase-in plans were likely for certain of those utilities, but they raised significant questions about the assurance of recovery of costs that would be deferred.

76. As a result of Board member concerns, the Board asked the staff to investigate whether guidance about the application of Statement 71 was needed in practice. The staff met several times with committees of the Edison Electric Institute (EEI), the National Association of Regulatory Utility Commissioners, and the Public Utilities Subcommittee of the American Institute of Certified Public Accountants (the AICPA Subcommittee). The Board also met with representatives of those groups and the Federal Energy Regulatory Commission.

77. In November 1984, the Board received an AICPA Issues Paper on emerging issues in the public utility industry. That paper listed 17 specific issues related to current problems in the electric utility industry identified by the AICPA Subcommittee. The Board also received a comment letter from the EEI on the issues raised in the AICPA Issues Paper.

78. The Board issued an Exposure Draft on accounting for phase-in plans, abandonments, and disallowances in December 1985. More than 1,400 organizations and individuals responded to that Exposure Draft.

79. In June 1986, the Board held a public hearing on the proposals in the Exposure Draft. Sixty-six individuals and firms presented their views at the four-day public hearing.

80. After considering comments received in comment letters and at the public hearing, the Board concluded that additional consideration was necessary to resolve the accounting issues related to phase-in plans. In December 1986, the Board issued Statement 90 to address accounting for plant abandonments and disallowances of plant costs. Subsequently, the Board continued its deliberations on accounting for phase-in plans.

81. In March 1987, the Board met in an open meeting with representatives of the EEI and four public accounting firms that audit large numbers of electric utilities. Subsequent to that meeting, the Board decided to issue this Statement to address accounting for phase-in plans and capitalization of an allowance for earnings on shareholders' investment other than during construction or as part of a phase-in plan.

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an amendment of FASB Statement No. 71

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Summary

This Statement amends FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, for two types of events that recently have occurred in the electric utility industry—abandonments of plants and disallowances of costs of recently completed plants.

This Statement amends Statement 71 to require the future revenue that is expected to result from the regulator's inclusion of the cost of an abandoned plant in allowable costs for rate-making purposes to be reported at its present value when the abandonment becomes probable. If the carrying amount of the abandoned plant exceeds that present value, a loss would be recognized. Statement 71 previously required that asset to be reported at the lesser of the cost of the abandoned plant or the probable gross revenue.

This Statement also amends Statement 71 to require any disallowed costs of a recently completed plant to be recognized as a loss. Statement 71 previously required asset impairments to be recognized but did not specify what constitutes an impairment or provide specific guidance about how impairments should be measured.

Finally, this Statement amends Statement 71 to specify that an allowance for funds used during construction should be capitalized only if its subsequent inclusion in allowable costs for rate-making purposes is probable.

This Statement is effective for fiscal years beginning after December 15, 1987 unless (a) application of the Statement would cause a violation or probable future violation of a restrictive clause in an existing loan indenture or other agreement and (b) the enterprise is actively seeking to obtain modification of that restrictive clause. In that case, this Statement is effective for fiscal years beginning after December 15, 1988.

This Statement applies to the recorded costs of previously abandoned assets, the recorded costs of assets for which future abandonment is probable or becomes probable in the future, previously disallowed plant costs, and disallowances of plant costs that are probable or become probable in the future. Restatement of financial statements for prior fiscal years is encouraged but not required.

Statement of Financial Accounting Standards No. 90

Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs

an amendment of FASB Statement No. 71

December 1986

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Statement of Financial Accounting Standards No. 90

Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs

an amendment of FASB Statement No. 71

December 1986

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Statement of Financial Accounting Standards No. 90

Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs

an amendment of FASB Statement No. 71

December 1986

INTRODUCTION

1. FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, was issued in December 1982. Shortly after that Statement was issued, major events in the electric utility industry caused the Board to review the effects of the Statement on the accounting for those events. After considering the application of the Statement, the Board decided to amend Statement 71 to provide more specific guidance for some of those events and to change the accounting for others.

2. This Statement amends Statement 71 to specify accounting for plant abandonments and disallowances of costs of recently completed plants. It also provides guidance for the capitalization of an allowance for funds used during construction (AFUDC).

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Accounting for Abandonments

3. When it becomes probable[1] that an operating asset or an asset under construction will be abandoned, the cost of that asset shall be removed from construction work-in-process or plant-in-service. The enterprise shall determine whether recovery of any allowed cost is likely to be provided with (a) full return on investment during the period from the time when abandonment becomes probable to the time when recovery is completed or (b) partial or no return on investment during that period. That determination should focus on the facts and circumstances related to the specific abandonment and should also consider the past practice and current policies of the

[1]The term *probable* is used in this Statement consistent with its use in FASB Statement No. 5, *Accounting for Contingencies*, to mean that a transaction or event is likely to occur.

applicable regulatory jurisdiction on abandonment situations. Based on that determination, the enterprise shall account for the cost of the abandoned plant as follows:

a. *Full return on investment is likely to be provided.* Any disallowance of all or part of the cost of the abandoned plant that is both *probable* and *reasonably estimable,* as those terms are used in FASB Statement No. 5, *Accounting for Contingencies,* and the related FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss,* shall be recognized as a loss, and the carrying basis of the recorded asset shall be correspondingly reduced. The remainder of the cost of the abandoned plant shall be reported as a separate new asset.
b. *Partial or no return on investment is likely to be provided.* Any disallowance of all or part of the cost of the abandoned plant that is both *probable* and *reasonably estimable,* as those terms are used in Statement 5 and Interpretation 14, shall be recognized as a loss. The present value of the future revenues expected to be provided to recover the allowable cost of that abandoned plant and return on investment, if any, shall be reported as a separate new asset. Any excess of the remainder of the cost of the abandoned plant over that present value also shall be recognized as a loss. The discount rate used to compute the present value shall be the enterprise's incremental borrowing rate, that is, the rate that the enterprise would have to pay to borrow an equivalent amount for a period equal to the expected recovery period. In determining the present value of expected future revenues, the enterprise shall consider such matters as (1) the probable time period before such recovery is expected to begin and (2) the probable time period over which recovery is expected to be provided. If the estimate of either period is a range, the guidance of Interpretation 14 shall be applied to determine the loss to be recognized. Accordingly, the most likely period within that range shall be used to compute the present value. If no period within that range is a better estimate than any other, the present value shall be based on the minimum time period within that range.

4. The recorded amount of the new asset shall be adjusted from time to time as necessary if new information indicates that the estimates used to record the separate new asset have changed. Those estimates include (a) the determination of whether full return on investment will be provided and, if not, the probable time period before recovery is expected to begin and the probable time period over which recovery is expected to be provided and (b) the amount of any probable and reasonably estimable disallowance of recorded costs of the abandoned plant. The amount of the adjustment shall be recognized in income as a loss or gain. Paragraphs 21, 22, and 24 of Appendix A illustrate how this paragraph applies to changes in the estimated time period before recovery begins and the time period over which recovery is expected to

be provided. The recorded carrying amount of the new asset shall not be adjusted for changes in the enterprise's incremental borrowing rate.

5. During the period between the date on which the new asset is recognized and the date on which recovery begins, the carrying amount shall be increased by accruing a carrying charge. The rate used to accrue that carrying charge shall be as follows:

a. If full return on investment is likely to be provided, a rate equal to the allowed overall cost of capital in the jurisdiction in which recovery is expected to be provided shall be used.
b. If partial or no return on investment is likely to be provided, the rate that was used to compute the present value shall be used. Paragraphs 20 and 23 and Schedules 1 and 2 of Appendix A illustrate that procedure.

6. During the recovery period, the new asset shall be amortized as follows:

a. If full return on investment is likely to be provided, the asset shall be amortized in the same manner as that used for rate-making purposes.
b. If partial or no return on investment is likely to be provided, the asset shall be amortized in a manner that will produce a constant return on the unamortized investment in the new asset equal to the rate at which the expected revenues were discounted. Paragraph 25 and Schedule 3 of Appendix A illustrate that procedure.

Disallowances of Costs of Recently Completed Plants

7. When it becomes probable that part of the cost of a recently completed plant will be disallowed for rate-making purposes and a reasonable estimate of the amount of the disallowance can be made,[2] the estimated amount of the probable disallowance shall be deducted from the reported cost of the plant and recognized as a loss. If part of the cost is explicitly, but indirectly, disallowed (for example, by an explicit disallowance of return on investment on a portion of the plant), an equivalent amount of cost shall be deducted from the reported cost of the plant and recognized as a loss.

Allowance for Funds Used during Construction

8. Paragraph 15 of Statement 71 requires an allowance for funds used during construction, including a designated cost of equity funds, to be capitalized in specified circumstances as part of the acquisition cost of the related asset. That cost shall be

[2] Interpretation 14 provides guidance for making a reasonable estimate of the amount of a loss.

capitalized under those circumstances only if its subsequent inclusion in allowable costs for rate-making purposes is probable.

Amendments to Statement 71

9. Statement 71 is amended as follows:

a. Footnote 6 to paragraph 9 is superseded by the following:

> [6]The term *probable* is used in this Statement consistent with its use in FASB Statement No. 5, *Accounting for Contingencies.* Statement 5 defines *probable* as an area within a range of the likelihood that a future event or events will occur. That range is from probable to remote, as follows:
>
> *Probable.* The future event or events are likely to occur.
> *Reasonably possible.* The chance of the future event or events occurring is more than remote but less than likely.
> *Remote.* The chance of the future event or events occurring is slight.

b. The following footnote is added at the end of the first sentence of paragraph 9:

> *Costs of abandoned plants shall be accounted for in accordance with paragraphs 3-6 of FASB Statement No. 90, *Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs.*

c. The following footnote is added to the end of paragraph 10:

> †Disallowances of costs of recently completed plants, whether direct or indirect, shall be accounted for in accordance with paragraph 7 of Statement 90.

d. Paragraph 13 is superseded by the following:

> Appendix B and Statement 90 illustrate the application of the general standards of accounting for the effects of regulation.

e. The following sentence is added preceding the last sentence of paragraph 15:

> Those amounts shall be capitalized only if their subsequent inclusion in allowable costs for rate-making purposes is probable.

f. The following footnote is added to the end of the third sentence of paragraph 34:

‡An exception to this general rule is provided for costs of abandoned plants. Paragraphs 16-25 of Statement 90 illustrate accounting for future revenues expected to result from the cost of an abandoned plant with a partial return or no return on investment during the recovery period.

Effective Date and Transition

10. Except as provided in paragraph 13, the provisions of this Statement shall be effective for fiscal years beginning after December 15, 1987 and interim periods within those fiscal years. Earlier application is encouraged. Retroactive application of this Statement in fiscal years for which financial statements have previously been issued is encouraged, in which case the financial statements of all prior periods presented shall be restated. In addition, the financial statements shall, in the year this Statement is first applied, disclose the nature of any restatement and its effect on income before extraordinary items, net income, and related per share amounts for each period presented and on retained earnings at the beginning of the earliest period presented.

11. If financial statements for prior fiscal years are not restated, the effects of applying this Statement to existing situations shall be reported as the cumulative effect of a change in accounting principle, as described in APB Opinion No. 20, *Accounting Changes*, and the nature of the change and the effect of adopting this Statement on income before extraordinary items, net income, and the related per share amounts shall be disclosed.

12. Initial application of this Statement will require the following adjustments to previously recorded assets with corresponding adjustments to reported net income of prior years or to the cumulative effect of an accounting change in the year of the change:

a. Amounts that were recorded in prior years for recoverable costs of abandoned plants shall be adjusted as indicated in paragraph 3. If partial or no return on investment is likely to be provided, the discount rate used to compute the present value shall be the regulated enterprise's incremental borrowing rate at the date on which the abandonment became probable.
b. Disallowed plant costs of the types described in paragraph 7 shall be deducted from the reported cost of the related asset.

13. If application of this Statement would cause a violation or probable future violation of a restrictive clause in an existing loan indenture or other agreement and the enterprise is actively seeking to obtain modification of that restrictive clause, that enterprise may delay application of this Statement for one additional year. In that case, the enterprise shall disclose, in its financial statements for the first fiscal year beginning after December 15, 1987 and interim periods within that fiscal year, (a) the effects that application of this Statement would have had on assets, retained earnings at the end of that fiscal year or interim period, income before extraordinary items, net income, and related per share amounts, (b) the nature of the violation or probable future violation that would result from application of the Statement, and (c) the steps that the company is taking to eliminate the restrictions. That enterprise shall apply this Statement, as indicated in paragraphs 10-12 above, for fiscal years beginning after December 15, 1988 and interim periods within those fiscal years.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the affirmative votes of four members of the Financial Accounting Standards Board. Messrs. Brown, Kirk, and Northrop dissented.

Messrs. Brown and Northrop dissent to this Statement's provisions concerning accounting for abandonments and disallowances of plant costs. They see no reason to modify the applicability of generally accepted accounting principles to regulated enterprises beyond those departures specifically called for by Statement 71.

Messrs. Brown and Northrop disagree with the requirement to record recoverable costs of abandoned plants at their present value and subsequently to accrue the discount resulting from this present value computation. They would record the costs associated with abandoned plants at the lower of cost or gross recoverable amount (the undiscounted amount of such costs that will be allowed in future rates). They would amortize these costs over the period during which they will be allowed for rate-making purposes. In their view, this cost recovery approach, now specified by Statement 71, should not be changed because it (1) conforms with accounting for enterprises in general and (2) is consistent with the Board's conclusion not to require recoverable costs of other regulator-created assets, such as storm damage costs, to be recorded at their present value. Further, they believe that recording recoverable costs at their present value results in inappropriate understatement of current period net

income and overstatements of net income in subsequent periods.

Messrs. Brown, Kirk and Northrop object to the requirement to recognize disallowances of costs of newly completed operating plants as losses in all cases. In their view, a regulator's disallowance of part of the cost of a fixed asset is an event warranting disclosure but not accounting recognition, except to the extent that the asset has been impaired. They believe that, barring impairment, reflecting a disallowance as a loss inappropriately recognizes reduced future revenues as reductions in current period net income. This results in overstatement of net income in subsequent periods.

Members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Victor H. Brown
Raymond C. Lauver
David Mosso
C. Arthur Northrop
Robert J. Swieringa
Arthur R. Wyatt

Appendix A

EXAMPLES OF APPLICATION OF THIS STATEMENT TO SPECIFIC SITUATIONS

14. This appendix provides guidance for application of this Statement to some specific situations. The guidance does not address all possible applications of this Statement. All the examples assume that the enterprise meets the criteria in paragraph 5 of Statement 71 for the application of Statement 71 by the enterprise. Cases similar to those illustrated in this appendix may involve income tax effects that could accrue to the utility in question. Some of those tax effects may be recognized currently under the applicable authoritative literature (presently APB Opinion No. 11, *Accounting for Income Taxes*); others may not be recognized currently. Under Opinion 11, the tax effects of timing differences are measured by the differential between income taxes computed with and without inclusion of the transaction creating the difference between taxable income and pretax accounting income. For simplicity, the examples base the income tax effects on a 34 percent tax rate and assume that those effects may be recognized.

15. Specific situations discussed in this appendix are:

	Paragraph Numbers
Accounting for an abandonment	16–25
Accounting for a disallowance of plant cost	26–27
Accounting for a disallowance of plant cost resulting from a "cost cap"	28–31
Accounting for an explicit, but indirect, disallowance	32–34

Accounting for an Abandonment

16. Assume that Utility A operates solely in a single-state jurisdiction that, in the past, has permitted recovery of amounts prudently invested in abandoned plants over an extended period of time without a return on unrecovered investment during the recovery period. Utility A decides to abandon a plant that has been under construction for some time. Although the possibility of abandoning the plant has been under consideration, abandonment was not considered probable before the actual decision was made. The recorded cost of the plant is $728 million; and the company estimates that it will incur additional contract cancellation penalties of approximately $22.5 million, which will be paid in approximately 6 months. Utility A's incre-

mental borrowing rate at the date of the decision to abandon the plant is 14 percent, compounded monthly.

17. In view of the accumulated cost of the abandoned plant, Utility A believes that it is probable that recovery of cost without return on investment during the recovery period will be granted over a period that will not be less than 5 years nor more than 10 years, but it has no basis for estimating the exact time period that will be selected by the regulator. In view of the rate-making process in Utility B's jurisdiction, it will take approximately 18 months to obtain a rate order covering the abandoned plant.

18. For income tax purposes, the abandoned plant has a basis of $500 million, including the contract cancellation penalties of $22.5 million. Utility A will deduct the cost of the abandoned plant as a loss on its income tax return in the year of the abandonment and will receive a tax benefit of 34 percent. All of the benefit of that loss will be recognized in the current year, partially through a reduction of current taxable income and carryback to prior years, the balance through offset of existing deferred taxes that will reverse during the carryforward period. Existing deferred taxes on timing differences relating to the abandoned plant total $35 million. For regulatory purposes, the tax benefit of the abandonment will be reflected as recovery of part of the cost of the abandoned plant.

19. When the abandonment becomes probable (in this case, at the date of the decision to abandon), Utility A would remove the plant from construction work-in-process. Any disallowance of the recorded cost that is probable and can be reasonably estimated would be recorded as a loss. This example assumes that no disallowance of recorded cost is anticipated. Utility A would record a separate new asset, representing the future revenues expected to result from the regulator's treatment of the cost of the abandoned plant, at the present value of those expected future revenues. The computation of the amount to be recovered would be as follows:

Recorded cost of abandoned plant		$ 728,000,000
Cancellation charges payable		22,500,000
Total		750,500,000
Less reduction of cost in an amount equal to the amounts designated by the regulator for current recovery:		
Current tax benefit of abandonment	$ 170,000,000	
Deferred taxes reversed	35,000,000	205,000,000
Net amount to be recovered in future rates		$ 545,500,000

The probable future revenues would be estimated at $9,091,667 per month for 5 years (based on an assumed straight-line recovery over the 5-year minimum period within the range), and those cash flows would be estimated to begin in 19 months. The computation of the amount to be recorded for the new asset and of the loss resulting from the abandonment would be as follows:

Present value of $9,091,667 per month at 14% for 60 months, starting at the end of the 19th month (amount to be recorded as new asset)		$ 317,107,016
Cost of abandoned plant:		
Net amount to be recovered in future rates for regulatory purposes (per table above)	$ 545,500,000	
Discount to reduce cancellation charges to present value ($22,500,000 discounted at 14% for 6 months)	(1,512,637)	543,987,363
Loss to be recognized at time of abandonment		226,980,347
Deferred tax benefit at 34%		77,139,318*
Net loss to be recognized at time of decision to abandon the plant		$ 149,741,029

*This amount consists of the following:

Deferred tax benefit of discount to reduce the expected recovery of abandonment to present value	$ 77,653,615
Deferred tax on discount to reduce cancellation charges to present value	(514,297)
Total	$ 77,139,318

The deferred tax benefit of the recovery would reverse in relation to the earnings on the unamortized asset. The deferred tax on the imputed interest on the cancellation charges would reverse as interest expense is accrued.

20. Pending receipt of a rate order, Utility A would accrue carrying charges on the recorded asset at a 14 percent annual rate. Schedule 1 shows that computation.

21. Assume that at the end of the 12th month Utility A determines that it is now probable, based on discussions with the regulator, that recovery of cost without

Schedule 1

Utility A

Accrual of Carrying Charges on Asset Resulting from Abandoned Plant

Month	Recorded Amount Beginning of Month	Carrying Charges Accrued*	Recorded Amount End of Month
1	$ 317,107,016	$ 3,699,582	$ 320,806,598
2	320,806,598	3,742,743	324,549,341
3	324,549,341	3,786,409	328,335,750
4	328,335,750	3,830,584	332,166,334
5	332,166,334	3,875,274	336,041,608
6	336,041,608	3,920,486	339,962,094
7	339,962,094	3,966,224	343,928,318
8	343,928,318	4,012,497	347,940,815
9	347,940,815	4,059,310	352,000,125
10	352,000,125	4,106,668	356,106,793
11	356,106,793	4,154,579	360,261,372
12	360,261,372	4,203,049	364,464,421

*As carrying charges are accrued, deferred income tax benefits would be reversed and income tax expense recognized in accordance with Opinion 11.

return on investment will be granted over a period that will not be less than 7 years nor more than 15 years, but it still has no basis for estimating the exact time period that will be selected by the regulator. Utility A also estimates that it will take approximately another 12 months (that is, 24 months after the date of the decision to abandon rather than the 18 months previously assumed) to obtain a rate order.

22. When new evidence makes it possible to refine a previous estimate, Utility A would adjust the recorded amount of the asset to reflect its revised estimate. The probable future revenues now would be estimated at $6,494,048 per month for 7 years (based on an assumed straight-line recovery over the 7-year minimum period within the range), and those cash flows would be estimated to begin 25 months after the date of the decision to abandon. The computation of the adjustment to the carrying amount of the asset that results from the new estimate would be as follows:

Present value of $6,494,048 per month at 14% for 84 months, starting at the end of the 25th month, which is 13 months in the future (adjusted carrying amount of asset)	$ 301,506,272
Carrying amount of asset at end of 12th month (Schedule 1)	364,464,421
Pretax loss to be recognized at end of 12th month	62,958,149
Deferred tax benefit of loss at 34%	21,405,771
Net loss to be recognized at end of 12th month	$ 41,552,378

The discount rate would not be adjusted to reflect Utility A's current incremental borrowing rate. That new rate reflects current conditions rather than the conditions that prevailed at the time of the decision to abandon.

23. Pending receipt of a rate order, Utility A would continue to accrue carrying charges on the adjusted recorded asset at a 14 percent annual rate. Schedule 2 shows that revised computation.

24. Assume that the rate order is received at the end of the 24th month and specifies a recovery period of 8 years; the resulting revenues will start approximately 1 month after the rate order is received. The probable future revenues now would be estimated at $5,682,292 per month for 8 years (based on the regulator's decision to allow straight-line recovery over an 8-year period), and those cash flows would be estimated to begin 25 months after the abandonment occurred (1 month after the rate order is received). Utility A would reflect that change by recognizing an additional loss, as follows:

Schedule 2

Utility A

Accrual of Carrying Charges on Asset Resulting from Abandoned Plant Revised to Reflect a Change in Estimate

Month	Recorded Amount Beginning of Month	Carrying Charges Accrued*	Recorded Amount End of Month
13	$ 301,506,272	$ 3,517,573	$ 305,023,845
14	305,023,845	3,558,612	308,582,457
15	308,582,457	3,600,128	312,182,585
16	312,182,585	3,642,131	315,824,716
17	315,824,716	3,684,621	319,509,337
18	319,509,337	3,727,609	323,236,946
19	323,236,946	3,771,098	327,008,044
20	327,008,044	3,815,094	330,823,138
21	330,823,138	3,859,603	334,682,741
22	334,682,741	3,904,632	338,587,373
23	338,587,373	3,950,186	342,537,559
24	342,537,559	3,996,271	346,533,830

*As carrying charges are accrued, deferred income tax benefits would be reversed and income tax expense recognized in accordance with Opinion 11.

Present value of $5,682,292 per month at 14% for 96 months (adjusted carrying amount of asset)	$ 327,104,260
Carrying amount of asset at end of 24th month (Schedule 2)	346,533,830
Pretax loss to be recognized at time of rate order	19,429,570
Deferred tax benefit of loss at 34%	6,606,054
Net loss to be recognized at time of rate order	$ 12,823,516

The discount rate would not be adjusted to reflect Utility A's current incremental borrowing rate. That new rate reflects current conditions rather than the conditions that prevailed at the time of the abandonment.

25. As recovery occurs, the recorded asset would be amortized so as to reflect earnings on the unamortized asset at the 14 percent rate used to determine the present value of the asset. Schedule 3 shows the details of that computation.

Accounting for a Disallowance of Plant Cost

26. Assume that Utility B operates in two state jurisdictions. After an extensive "prudence investigation," the regulator in one of those state jurisdictions disallows $865 million of the $3.6 billion total cost of Utility B's recently completed nuclear generating plant. That state jurisdiction represents approximately 50 percent of Utility B's operations, and approximately 50 percent of the output of the recently completed plant is expected to be used in that state. The tax basis of the plant is $2.4 billion. The regulator indicates that the tax benefit from a ratable portion of depreciation will be given to the shareholders as a result of the disallowance. After consultation with counsel, Utility B decides that it should not appeal the regulator's disallowance. The regulator in Utility B's other state jurisdiction has not participated in the "prudence investigation," and there is no indication that a similar disallowance is likely in that jurisdiction.

27. Utility B should recognize the effective disallowance as a loss. Because only 50 percent of the plant's cost will be recoverable from customers in the state, the effective disallowance is 50 percent of the amount disallowed, or $432.5 million. The disallowance should be recognized when the disallowance is probable and the amount of the disallowance can be reasonably estimated, and those conditions are met in this case. The tax benefit of the loss will be realized as future depreciation is taken for income tax purposes. Since the tax benefit of the plant is based on $2.4 billion and the cost of the plant prior to the disallowance is $3.6 billion, only two-thirds of the loss is available for tax benefit. A deferred tax benefit, based on two-thirds of the loss, can be recognized when the loss is recognized providing that benefit meets the criteria of Opinion 11 for recognition.

Schedule 3

Utility A

Computation of Amortization of Asset Resulting from Abandoned Plant

Month	(1) Unamortized Balance Beg. of Month	(2) Return* at 14.00%	(3) Revenues	(4) Amortization of Cost	(5) Unamortized Balance End of Month
				(Col 3–Col 2)	(Col 1–Col 4)
25	$ 327,104,260	$ 3,816,217	$ 5,682,292	$ 1,866,075	$ 325,238,185
26	325,238,185	3,794,445	5,682,292	1,887,847	323,350,338
27	323,350,338	3,772,421	5,682,292	1,909,871	321,440,467
28	321,440,467	3,750,139	5,682,292	1,932,153	319,508,314
29	319,508,314	3,727,597	5,682,292	1,954,695	317,553,619
30	317,553,619	3,704,792	5,682,292	1,977,500	315,576,119
31	315,576,119	3,681,721	5,682,292	2,000,571	313,575,548
32	313,575,548	3,658,382	5,682,292	2,023,910	311,551,638
33	311,551,638	3,634,769	5,682,292	2,047,523	309,504,115
34	309,504,115	3,610,881	5,682,292	2,071,411	307,432,704
35	307,432,704	3,586,715	5,682,292	2,095,577	305,337,127
.	.	.	.	.	.
.	.	.	.	.	.
.	.	.	.	.	.
.	.	.	.	.	.
110	58,342,320	680,661	5,682,292	5,001,631	53,340,689
111	53,340,689	622,308	5,682,292	5,059,984	48,280,705
112	48,280,705	563,275	5,682,292	5,119,017	43,161,688
113	43,161,688	503,553	5,682,292	5,178,739	37,982,949
114	37,982,949	443,134	5,682,292	5,239,158	32,743,791
115	32,743,791	382,011	5,682,292	5,300,281	27,443,510
116	27,443,510	320,174	5,682,292	5,362,118	22,081,392
117	22,081,392	257,617	5,682,292	5,424,675	16,656,717
118	16,656,717	194,328	5,682,292	5,487,964	11,168,753
119	11,168,753	130,302	5,682,292	5,551,990	5,616,763
120	5,616,763	65,529	5,682,292	5,616,763	0

*As earnings on the unamortized asset are recognized, deferred income tax benefits would be reversed and income tax expense recognized in accordance with Opinion 11.

Accounting for a Disallowance of Plant Cost Resulting from a "Cost Cap"

28. Assume that Utility C, which operates solely in one state jurisdiction, is constructing a new electric generating plant. Completion is expected to take approximately one year. The cost of the plant, which was originally expected to be $1.25 billion, is now estimated to be as follows:

Costs capitalized to date	$ 2,700,000,000
AFUDC on above for 1 year at 11.25%	303,750,000
Remaining labor, materials, etc., to complete, expected to be spent ratably over the year	469,822,500
AFUDC on above for ½ year at 11.25%	26,427,500
Total estimated cost at completion	$ 3,500,000,000

Various parties have charged that certain cost increases were a result of imprudent management of the construction.

29. To avoid the cost and time delay that would be involved in a full-scale "prudence investigation" of the construction of the plant, Utility C and its regulator agree that the total cost of the plant that will be allowable in determining depreciation and that will be allowed in Utility C's rate base will be $3.4 billion. If the eventual cost of the plant exceeds that "cap," a ratable portion of the tax benefit of depreciation will accrue to the benefit of the shareholders. For tax purposes, the plant is expected to have a net depreciable basis of $2.0 billion.

30. The loss that results from the disallowance inherent in the "cost cap" would be computed as follows:

Total estimated cost at completion	$ 3,500,000,000
Maximum allowable cost	3,400,000,000
Difference	$ 100,000,000
Loss to be recognized (present value of difference at 11.25% AFUDC rate, based on 1 year to complete)	$ 89,887,600
Deferred tax benefit of loss (2.0/3.5 × $100,000,000 × 34%)	19,428,600
Net loss to be recognized when "cost cap" is agreed to	$ 70,459,000

After the loss is recognized, AFUDC would continue to be recorded based on the remaining recorded costs. Subsequently, if additional increases in the cost of the

plant become probable and those costs are not allowable under the agreed "cost cap," those increases would also be recognized as losses from disallowances when they become probable.

31. If the regulator ordered a "cost cap" that Utility C did *not* agree to, Utility C would have to assess whether the criteria of Statement 5 for loss recognition are met. If those criteria are met, the accounting would be as indicated above. Otherwise, no loss would be recognized until that loss was probable and could be reasonably estimated. Because of the possible disallowance inherent in the "cost cap," it may no longer be probable that some amount of AFUDC will be included in allowable costs in the future, and that amount may be reasonably estimable. In that case, that amount of AFUDC would not be capitalized.

Accounting for an Explicit, but Indirect, Disallowance

32. Assume that Utility D operates solely in a single-state jurisdiction. On January 1, 19X1, Utility D's new electric generating plant becomes operational. The cost of that plant is $1 billion.

33. Utility D's regulator concludes that part of the cost of the recently completed plant was imprudently incurred. However, rather than disallow the specific costs that were imprudent, the regulator instead excludes 10 percent ($100 million) of the plant from the rate base, thereby providing no return on investment on that portion of the plant. The regulator does not intend any part of the tax benefit of depreciation to accrue to the benefit of Utility D's shareholders. The regulator indicates that the exclusion of 10 percent of the plant's cost from the rate base is intended to be permanent. The utility concludes that it will not appeal the disallowance after considering the likely outcome of an appeal.

34. Utility D should record the indirect disallowance as a loss and should estimate the amount of that loss using the best available information. If the regulator specifies the amount of cost that was imprudent, that amount may be the best estimate of the loss. Otherwise, Utility D would have to estimate the future cash flows that have been disallowed as a result of the order and determine the effective disallowance by computing the present value of those disallowed future cash flows. Since both the disallowed future cash flows and the appropriate discount rate to compute the present value would be estimates, those estimates should be calculated on a consistent basis. Accordingly, if the future cash flows are estimated based on the current weighted-average overall cost of Utility D's capital, that weighted-average overall cost of capital should also be used as the discount rate. The loss has no tax benefit to Utility D.

Appendix B

BASIS FOR CONCLUSIONS

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Appendix B

BASIS FOR CONCLUSIONS

Introduction

35. This appendix summarizes considerations that were deemed significant by members of the Board in reaching the conclusions in this Statement. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

General Considerations

36. Many letters received as the Board was developing the conclusions in this Statement objected to the Board's conclusions about accounting for abandonments and disallowances of costs of recently completed plants on the basis that those decisions departed from the historical cost model of accounting for enterprises generally. The Board provided its view of the current accounting model in paragraphs 66-70 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*. Paragraph 66 acknowledges that the current model is not a pure "historical cost" model, as follows:

> Items currently reported in financial statements are measured by different attributes, depending on the nature of the item and the relevance and reliability of the attribute measured. The Board expects the use of different attributes to continue.

37. The Board also noted that much of the accounting specified by Statement 71 is itself a departure from the accounting framework applied by nonregulated enterprises generally. That Statement recognizes that rate actions of a regulator can have economic effects and requires certain items that would be charged to expense by nonregulated enterprises to be capitalized by regulated enterprises solely because the regulator's rate actions can provide reasonable assurance of future revenue.

38. The accounting set forth in Statement 71 requires certain regulated enterprises to recognize probable increases in future revenues due to a regulator's actions as assets by capitalizing incurred costs that would otherwise be charged to expense. The Board believes those regulated enterprises should also recognize probable decreases in future revenues due to a regulator's actions as reductions of assets. General purpose financial statements that recognize asset enhancements but not asset decre-

ments would lack representational faithfulness—a critical qualitative characteristic if financial statements are to be reliable. After reviewing the frequency and magnitude of recent plant abandonments and disallowances of plant costs in the electric utility industry, the Board concluded that it should require the resulting probable decreases in future revenues to be recognized as reductions in assets if financial statements are to be representationally faithful.

39. The Board also believes that the accounting for plant abandonments required by this Statement is consistent with the accounting followed by companies in general for monetary assets under APB Opinion No. 21, *Interest on Receivables and Payables.* Whatever asset remains after a utility plant is abandoned is essentially monetary in nature.

40. Many respondents to the Exposure Draft, *Regulated Enterprises—Accounting for Phase-in Plans, Abandonments, and Disallowances of Plant Costs,* urged the Board not to adopt some of the provisions in this Statement because they would reduce some companies' retained earnings to the extent that payment of dividends, future financing on favorable terms, or both would be precluded. When a company incurs a loss, significant consequences may occur, and the Board is aware that some of the effects of the issues addressed in this Statement are major. The Board believes that those consequences result from the event that is being accounted for, not from the accounting itself. The Board believes that accounting should reflect major adverse occurrences that affect an enterprise even though the consequences of those major adverse occurrences may be significant.

41. Many respondents also urged the Board not to adopt certain provisions of this Statement because the regulated rates might decrease as a result of the accounting requirements. Others indicated that the regulated rates would increase if the accounting specified by this Statement were required. The Board believes that regulators will provide whatever rates they believe are justified; general-purpose financial reporting should not be designed to encourage or to discourage specific actions of regulators, and regulators can be expected to understand accounting that reflects the effects of their actions.

Accounting for Abandonments

42. Historically, utilities have usually abandoned plants in early stages of construction, rather than after incurring major construction costs. Prior to Statement 71, most regulated enterprises accounted for the costs of abandoned plants on a cost recovery basis; that is, no loss was recorded if revenues promised by a regulator were expected to recover the recorded costs. Statement 71 did not change that practice.

43. Recently, abandonments of plants under construction have become more common, and some utilities have abandoned plants during the later stages of construction. In many cases, the cost of abandoned plants is much greater than in the past.

44. Many respondents to the Exposure Draft indicated that the essential nature of the asset does not change when a plant is abandoned. In their view, cost-based regulation treats all assets the same; a plant under construction and an abandoned plant are both accumulated costs that will be recovered through revenues. The Board does not agree with that view and has concluded that an abandonment changes the nature of the asset. A plant under construction is expected to produce utility services that have value. An abandoned plant can produce no services. Any value that results from the abandoned plant is limited to the revenues that will be furnished through the sales of services provided by other plants.

45. Other respondents to the Exposure Draft urged the Board not to require loss recognition until the loss is probable. That is the basis for loss recognition that is provided by one of the criteria of Statement 5. The Board agrees that loss recognition should not occur until the loss is probable and reasonably estimable, consistent with Statement 5. However, some of those respondents equated *probable* with *certain*. The Board notes that the term *probable* is defined in Statement 5 and is used in the same sense in this Statement. That definition is not synonymous with *certain*, a term that connotes a much higher level of assurance than *probable*.

46. Regulators in many jurisdictions have provided recovery of the cost of abandoned plants without return on investment during the recovery period. That procedure has been described as a means of sharing the loss between customers and shareholders. A cost-recovery approach for accounting for abandonments was based on the view that the regulator was disallowing future earnings, rather than disallowing a portion of the cost of the abandoned plant. In reconsidering that issue in the context of today's environment, the Board concluded that a cost-recovery approach, in effect, delays recognition of losses that are known to have been incurred. Although that approach might have little significance when applied to relatively immaterial items, the significance of the amounts involved in recent cases indicates that recognition of losses resulting from abandonments should not be delayed beyond the date when they are probable and reasonably estimable.

47. The Board also concluded that the future revenue that will result from inclusion of the cost of an abandoned plant in allowable costs for rate-making purposes is essentially a monetary asset. In the Board's view, an abandoned plant should be written off when abandonment is probable. Unless it is probable that the cost of an abandoned plant will be entirely disallowed by the regulator, a new asset that is essen-

tially a monetary asset should be recognized. That asset most closely resembles a long-term receivable that is recognized on the basis of (a) its cost, if the stated interest rate is reasonable, or (b) its present value, if the interest rate is not stated or if the stated rate is unreasonable. The Board believes that a similar measurement basis is appropriate for expected future revenue that will result from a regulator's treatment of the cost of an abandoned plant.

48. In the Exposure Draft, the Board proposed that the overall rate of return allowed in the regulated enterprise's last rate case in the jurisdiction in which recovery is expected to be received be used to measure the present value of the future revenue that will result from an abandoned plant. Respondents to the Exposure Draft pointed out that the actual disallowance is the overall rate of return in the future rate cases covering the period during which recovery will occur. That rate is not known at the time of the abandonment. The Board agreed that a surrogate rate should be used to compute the present value of the remaining future revenues, and it decided to require the enterprise to use its incremental borrowing rate at the date the abandonment becomes probable.

49. Some respondents suggested that the interest rate used should be changed whenever the allowed overall rate of return changes during the recovery period. The Board views that approach as a means of maintaining the asset in question at its fair value. Fair value often is used in accounting to measure a newly acquired asset when that fair value is more clearly evident than the value of the asset given up. However, with the exception of certain assets that are readily marketable, the present accounting model does not adjust the carrying basis of an existing asset when the fair value of that asset changes.

50. Some respondents to the Exposure Draft indicated that the rate used to value an abandonment should be a net-of-tax rate. Other respondents asked that the Board address the tax effects of the proposed accounting for abandonments. APB Opinion No. 11, *Accounting for Income Taxes*, does not permit accounting for items with tax effects on a net-of-tax basis. Rather, deferred income taxes are provided for timing differences when they occur, and those deferred taxes are reversed when the related timing differences reverse. Opinion 11 applies to taxable enterprises that apply Statement 71 except in the limited circumstances outlined in paragraph 18 of Statement 71. Accordingly, the loss recognized to reduce the asset resulting from an abandonment to its present value and the subsequent profit that results comprise a timing difference. The tax effects of that timing difference would be recognized when the timing difference originates if appropriate under the provisions of Opinion 11.

51. The Board concluded that accruing a carrying charge on, or recognizing accretion of, the present value of the expected future revenue related to an abandonment is appropriate for two reasons. First, the basis used to record that asset recognizes the effect of the regulator's disallowance of future return on investment as a loss in the period in which the loss becomes probable and the amount can be reasonably estimated. The disallowance that already has been recognized should not reduce the reported level of return on investment in later years, and accrual of a carrying charge has the effect of maintaining the level of return on investment similar to what it would have been if there had been no disallowance. Second, the nature of the resulting asset is similar to a long-term receivable, even though Board members acknowledge that it lacks some of the characteristics of a receivable. Accordingly, they concluded that (a) the subsequent reporting should be consistent with that afforded a long-term receivable and (b) accrual of a carrying charge is consistent with accounting for a long-term receivable initially recognized at its present value.

52. A number of respondents to the Exposure Draft objected to the requirement that the amount recorded for the probable future revenue that would result from an abandonment be adjusted when a rate order is received. They indicated that the real process of regulation in some jurisdictions occurs in the courts. The Board viewed the rate order as the confirming event, permitting an estimate of the loss to be refined at that time, and it believes that will usually be the case. However, the Board agrees that a loss should not be recognized unless it is probable that a loss has occurred and the amount can be reasonably estimated. If those criteria are not met at the time of an initial rate order, the loss should not be recognized at that time.

53. The Board considered adopting a requirement that all assets representing solely the probable future revenue resulting from a regulator's actions be recorded at the present value of the future cash flows and decided not to adopt such a requirement at this time. Some Board members noted that the requirement of Statement 71 to recognize those other assets on a cost-recovery basis, which was a continuation of prior practice, does not seem to have caused major problems in practice. Other Board members noted that the rate treatment anticipated during construction, prior to abandonment of the asset under construction, was full recovery of both cost and return on investment, whereas the cost of repairing storm damage, which is sometimes afforded recovery over a period of time without return on investment, represents a cash outlay usually made with the anticipation of that rate treatment. Thus, if the Board were to conclude that recording that asset at the amount of the consideration paid is not appropriate, that conclusion would be based on considerations somewhat different from those that the Board applied to abandonments.

Disallowances of Costs of Recently Completed Plants

54. Paragraph 10 of Statement 71 addresses disallowances by a regulator. That paragraph indicates that when a disallowance occurs, "the carrying amount of any related asset shall be reduced to the extent that the asset has been impaired. Whether the asset has been impaired shall be judged the same as for enterprises in general."

55. Recently, several disallowances of major amounts of cost on recently completed plants have been well publicized. The AICPA Issues Paper, "Application of Concepts in FASB Statement of Financial Accounting Standards No. 71 to Emerging Issues in the Public Utility Industry," concludes that "the measure of whether an asset has been impaired [when part of the cost of that asset is disallowed for rate-making purposes] is whether net cash inflows (revenues less applicable expenses) are sufficient to cover the cost of the asset. In measuring expenses, interest applicable to the unit should be included, but equity return would not be included."

56. The Board concluded that the view described in the AICPA Issues Paper, which appears to describe some, but not all, of existing practice, is a narrower interpretation of an "impairment," as referred to in paragraph 10 of Statement 71, than is appropriate for the events in question. The Board believes that an impairment evaluation includes the estimation of losses in value that become determinable as a result of an identifiable event, and it concluded that a regulator's disallowance of part of the cost of a recently completed plant creates an impairment that warrants recognition.

57. Some Board members also believe that the stated reason for certain recent disallowances of plant costs—that the costs were not productive or were not necessary for the completion of the plant—indicates that those costs should not be included in the carrying amount of the related plant. Nonregulated enterprises do not continue to carry identified nonproductive costs as part of the cost of their fixed assets, and regulated enterprises also should not do so.

58. Many respondents to the Exposure Draft objected to what they considered to be a unique impairment evaluation. The Board believes that the event in question, disallowance of part of the cost of an operating plant by a regulator, is itself unique. Other enterprises do not have disallowances of their plant costs resulting from actions of a regulator.

59. The Board believes that the credibility of financial reporting in general would be diminished by the failure to recognize a diminution in value and a corresponding loss that is generally agreed to have occurred. When a regulator disallows a significant

part of the cost of a recently completed plant, financial statements that do not report that disallowance as a loss reflect adversely on the representational faithfulness of those financial statements and of financial statements generally. Accordingly, the Board decided to amend Statement 71 to require loss recognition for such a disallowance.

60. Some respondents to the Exposure Draft requested that the Board address "excess capacity" disallowances. Those disallowances relate to part of the cost of service of a recently completed plant and are based on a finding that the utility's reserve capacity exceeds an amount deemed to be reasonable. If an "excess capacity" disallowance is ordered by a regulator *without* a specific finding that the enterprise should not have constructed that capacity or should have delayed the construction of that capacity, the rate order raises questions about whether the enterprise meets the criteria for application of Statement 71, in that it is not being regulated based on its own cost of service. However, because such a rate order itself is neither a direct disallowance nor an explicit, but indirect, disallowance of part of the cost of the plant, this Statement does not specify the accounting for it. If an "excess capacity" disallowance is ordered by a regulator *with* a specific finding that the enterprise should not have constructed that capacity or should have delayed the construction of that capacity, the rate order may be an explicit, but indirect, disallowance of part of the cost of the plant, and the enterprise should account for the substance of that order as set forth in paragraph 7 of this Statement.

61. In a few recent cases, a regulator has included a recently completed plant in rates based on the assumed cost of another plant rather than based on the cost of the plant that exists. In those cases, the enterprise is not being regulated based on its own cost, and the criteria of application of Statement 71 do not appear to be met. If the rate order is based on a finding that, based on factors that were known during the construction, the utility should not have constructed the plant that it did construct, the order may be an explicit, but indirect, disallowance, and it should be accounted for as set forth in paragraph 7 of this Statement. Otherwise, unless the order is being appealed, the enterprise should consider discontinuing application of Statement 71.

62. A number of respondents indicated that it would often be impossible to determine whether an indirect disallowance had been made. They noted that regulators have considerable discretion in selecting a rate that represents a fair return on equity investment, and that specific matters included in a settlement agreement might not be apparent. The Board intends that explicit, but indirect, disallowances be reported as disallowances; it does not intend to require that an enterprise determine whether the terms of a settlement agreement or rate order contained a hidden, indirect disal-

lowance. Accordingly, paragraph 7 of this Statement was modified to indicate the Board's intent.

63. The Board considered making a more sweeping amendment of Statement 71, to require loss recognition for all cost disallowances by a regulator, whether related to a recently completed plant or otherwise. For example, regulators in some jurisdictions disallow costs of acquired companies in excess of the acquired company's book value and a variety of other types of costs. After consideration, the Board decided to limit this Statement to the relatively narrow issues that caused the Board to add a project on regulated enterprises to its agenda.

Criteria for Capitalization of AFUDC

64. Paragraph 15 of Statement 71 requires an allowance for funds used during construction, including an allowance for equity funds, to be capitalized in lieu of capitalizing interest in accordance with FASB Statement No. 34, *Capitalization of Interest Cost*, if certain criteria are met. The AICPA Issues Paper cited a need for guidance on whether AFUDC should be capitalized in a number of different situations.

65. After considering the cases in which capitalization of AFUDC is controversial, the Board concluded that AFUDC should be capitalized only if subsequent inclusion of that AFUDC in plant cost for rate-making purposes is probable. That conclusion was based on paragraph 15 of Statement 71, which is derived from the general standards in paragraph 9-12 of that Statement. Under those general standards, a cost may not be capitalized unless it is probable that the cost will be included in allowable cost in the future, and the Board concluded that the same criteria should apply to capitalization of AFUDC.

66. Some respondents to the Exposure Draft indicated that AFUDC is a cost, and it warrants capitalization whenever the general criteria of Statement 34, that interest cost is being incurred and construction is in progress, are met. The Board disagreed with this view of AFUDC. Statement 71 concluded that, if specific criteria in paragraph 15 are met, the AFUDC that will be the basis for future rates should be capitalized instead of interest computed in accordance with Statement 34. As noted above, that provision of Statement 71 was derived from the general standards in paragraphs 9-12 of that Statement. Those general standards require that inclusion of an amount in allowable cost in the future be probable for that amount to be capitalized. The Board believes that the intent of Statement 71, in accepting the amount of AFUDC that will be the basis for future rates instead of the usual capitalization of interest, was not solely to accept a surrogate computation, but also to accept a computation that was a better indicator of future cash flows for enterprises that meet

both the criteria for application of Statement 71 and the criteria of paragraph 15 of the Statement for capitalization of AFUDC. The Board concluded that allowing capitalization of amounts for which future inclusion in allowable cost for rate-making purposes was not probable would make the resulting capitalized amounts poorer indicators of the future cash flows expected to result from utility plants. Accordingly, the Board concluded that if inclusion of that AFUDC in the cost that will become the basis for future rates is not probable, the enterprise should not capitalize it. The Board also concluded that, if the specific criteria in paragraph 15 of Statement 71 are met but AFUDC is not capitalized because its inclusion in the cost that will become the basis for future rates is not probable, the regulated enterprise may not alternatively capitalize interest cost in accordance with Statement 34.

67. The Board believes that the criteria for capitalization of AFUDC are particularly relevant to two situations that have occurred in practice. In the first situation, completion of a plant under construction is reasonably possible but no longer probable, and the regulator in the governing jurisdiction routinely disallows accumulated AFUDC on abandoned plants. In that situation, the criteria required to write off previously recognized AFUDC are not met since disallowance is not probable; thus, previously capitalized AFUDC should not be written off. However, because inclusion of AFUDC in the cost allowed for future rates is no longer probable, further capitalization of AFUDC is not warranted.

68. In the second situation, a prudence investigation is in process or has taken place, and a disallowance of cost (including subsequent AFUDC on those costs) is reasonably possible. The range of such disallowance is from zero to some maximum amount, and no point within the range is more likely than any other. In that situation, because a disallowance of the maximum amount in the range is reasonably possible and thus inclusion of that amount in rates is no longer probable, subsequent capitalization of AFUDC should be discontinued for an amount of costs equal to the maximum amount that is within the range.

Definition of Probable

69. The term *probable* was defined in Statement 71 differently from how it has been defined in other authoritative literature. The Board used a definition based on the definition used in FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises*, because that definition was one of the criteria of an asset in Concepts Statement 3.

70. The AICPA Issues Paper questioned whether that definition was intended to be significantly different from the definition used in Statement 5 and indicated that the

use of different definitions had caused some confusion in practice. The Board considered the concern expressed in the AICPA Issues Paper and decided to change the definition in Statement 71 to the definition in Statement 5.

71. Some respondents to the Exposure Draft indicated their belief that the definition included in this Statement was a more stringent one than that contained in FASB Concepts Statement No. 6, *Elements of Financial Statements,* and in Statement 71. In their view, the definition in this Statement is appropriate for loss recognition, but the definition that was originally included in Statement 71 was more appropriate for asset recognition. The Board believes that a single concept is involved, and one definition can be applied in practice more easily than two. Thus, the Board concluded that the change in definition in this Statement is appropriate.

Accounting for Phase-in Plans

72. The Exposure Draft proposed specific accounting for phase-in plans. After considering comments received, both in comment letters and during the public hearing, the Board concluded that additional consideration is necessary to resolve the accounting issues related to phase-in plans. Accordingly, the Board decided to issue this Statement on plant abandonments and disallowances of plant costs and to consider further how to address accounting for phase-in plans.

Effective Date and Transition

73. The Board considered whether this Statement should be applied only to events occurring after the effective date or to all events of the types addressed. Applying this Statement only to events occurring after the effective date would diminish both comparability of the resulting financial statements among enterprises and consistency within an enterprise that had experienced such events both before and after the effective date. The events addressed by this Statement tend to have long-lasting effects on financial statements. For example, a decision whether to recognize a disallowance of plant cost as a loss affects reported depreciation and net income for the life of the related plant. Accordingly, the Board decided that this Statement should be applied to all abandoned plants and disallowed plant costs, regardless of whether those events occurred before or will occur after the effective date.

74. The Exposure Draft was proposed to be effective for fiscal years beginning after December 15, 1986. The Board requested respondents who believed that additional delay in that proposed effective date was warranted for their specific situations to describe their existing circumstances in detail and explain why a delay would be appropriate and what it would accomplish.

75. Most of the respondents who requested a delay in application of the proposed Statement cited phase-in plans that might be modified if this Statement were to address accounting for phase-in plans. Few respondents indicated that a regulator's disallowance might be reconsidered or that a regulator's decision about recovery on an abandoned plant might be reconsidered.

76. Many respondents to the Exposure Draft indicated that this Statement should not be applied to regulatory actions that occurred before the effective date. They indicated that covenants, entered into without knowledge of the accounting requirements of this Statement, may now result in unintended restrictions on companies' actions. The Board recognizes that creditors may be willing to modify existing covenants for some enterprises that will be affected by this Statement. Although the Board decided to make this Statement effective for fiscal years beginning after December 15, 1987, it also decided to permit enterprises to delay application of this Statement until fiscal years beginning after December 15, 1988 if (a) application of this Statement would cause a violation or probable future violation of a restrictive clause in an existing loan indenture or other agreement and (b) the enterprise is actively seeking to obtain modification of that restrictive clause.

Appendix C

BACKGROUND INFORMATION

77. Statement 71 was issued in December 1982, effective for financial statements for fiscal years beginning after December 15, 1983. In early 1984, several different circumstances caused the Board to question whether the application of Statement 71 in practice was what the Board had intended.

78. During 1984, representatives of some regulatory commissions began to question the cost of certain new plants and to discuss possible major disallowances. Also, several plants in advanced stages of construction were abandoned. In a few states, courts ruled that utilities could not recover the costs of those abandoned plants from customers.

79. As a result of Board member concerns, the Board asked the staff to investigate whether guidance on the application of Statement 71 was needed in practice. The staff met several times with committees of Edison Electric Institute (EEI), the National Association of Regulatory Utility Commissioners, and the Public Utilities Subcommittee of the American Institute of Certified Public Accountants (the AICPA Subcommittee). The Board also met with representatives of those groups and staff members of the Federal Energy Regulatory Commission.

80. In November 1984, the Board received an AICPA Issues Paper on emerging issues in the public utility industry. That paper listed 17 specific issues related to current problems in the electric utility industry identified by the the AICPA Subcommittee. The Board also received a comment letter from EEI on the issues raised in the AICPA Issues Paper.

81. In April 1985, the Board's Task Force on Regulated Enterprises met and discussed a staff draft of a possible Exposure Draft that encompassed most of the conclusions included in this Statement.

82. Subsequent to the April 1985 task force meeting, the Board received 51 letters from 39 affected enterprises and other interested parties commenting on the positions proposed in the staff draft discussed at the task force meeting and on the Board's tentative conclusions reached at its public meetings subsequent to that task force meeting.

83. The Board issued an Exposure Draft in December 1985. More than 1,400 organizations and individuals responded to that Exposure Draft, many with multiple letters.

84. In June 1986, the Board held a public hearing on the proposals in the Exposure Draft. Sixty-six individuals and firms presented their views at the four-day public hearing.

85. After considering comments received in comment letters and at the public hearing, the Board concluded that additional consideration is necessary to resolve the accounting issues related to phase-in plans. After consideration, the Board decided to issue this Statement to address accounting for plant abandonments and disallowances of plant costs. The Board will consider accounting for phase-in plans further at a later date.

Statement of Financial Accounting Standards No. 71

Accounting for the Effects of Certain Types of Regulation

December 1982

Financial Accounting Standards Board
of the Financial Accounting Foundation
HIGH RIDGE PARK, STAMFORD, CONNECTICUT 06905

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December 1982

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Statement of Financial Accounting Standards No. 71

Accounting for the Effects of Certain Types of Regulation

December 1982

INTRODUCTION

1. Regulation of an enterprise's prices (hereinafter referred to as *rates*) is sometimes based on the enterprise's costs. Regulators use a variety of mechanisms to estimate a regulated enterprise's allowable costs,[1] and they allow the enterprise to charge rates that are intended to produce revenue approximately equal to those allowable costs. Specific costs that are allowable for rate-making purposes result in revenue approximately equal to the costs.

2. In most cases, allowable costs are used as a means of estimating costs of the period during which the rates will be in effect, and there is no intent to permit recovery of specific prior costs. The process is a way of setting prices—the results of the process are reported in general-purpose financial statements in accordance with the same accounting principles that are used by unregulated enterprises.

3. Regulators sometimes include costs in allowable costs in a period other than the period in which the costs would be charged to expense by an unregulated enterprise. That procedure can create assets (future cash inflows that will result from the rate-making process), reduce assets (reductions of future cash inflows that will result from the rate-making process), or create liabilities (future cash outflows that will result from the rate-making process) for the regulated enterprise. For general-purpose financial reporting, an incurred cost for which a regulator permits recovery in a future period is accounted for like an incurred cost that is reimbursable under a cost-reimbursement-type contract.

4. Accounting requirements that are not directly related to the economic effects of rate actions may be imposed on regulated businesses by orders of regulatory authorities and occasionally by court decisions or statutes. This does not neces-

[1] The term *allowable costs* is used throughout this Statement to refer to all costs for which revenue is intended to provide recovery. Those costs can be actual or estimated. In that context, allowable costs include interest cost and amounts provided for earnings on shareholders' investments.

sarily mean that those accounting requirements conform with generally accepted accounting principles. For example, a regulatory authority may order an enterprise to capitalize[2] and amortize a cost that would be charged to income currently by an unregulated enterprise. Unless capitalization of that cost is appropriate under this Statement, generally accepted accounting principles require the regulated enterprise to charge the cost to income currently.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Scope

5. This Statement applies to general-purpose external financial statements of an enterprise that has regulated operations that meet all of the following criteria:

a. The enterprise's rates for regulated services or products provided to its customers are established by or are subject to approval by an independent, third-party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers.[3]
b. The regulated rates are designed to recover the specific enterprise's costs of providing the regulated services or products.
c. In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the enterprise's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs.

6. If some of an enterprise's operations are regulated and meet the criteria of paragraph 5, this Statement shall be applied to only that portion of the enterprise's operations.

7. Authoritative accounting pronouncements that apply to enterprises in general also apply to regulated enterprises. However, enterprises subject to this

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[2] *Capitalize* is used in this Statement to indicate that the cost would be recorded as the cost of an asset. That procedure is often referred to as "deferring a cost," and the resulting asset is sometimes described as a "deferred cost."

[3] The appropriate structure for setting accounting standards for state and local governmental units is currently under discussion. The FASB is proposing no change with respect to the applicability or use of its pronouncements in the governmental area until that matter is resolved.

Statement shall apply it instead of any conflicting provisions of standards in other authoritative pronouncements.[4]

8. This Statement does not apply to accounting for price controls that are imposed by governmental action in times of emergency, high inflation, or other unusual conditions. Nor does it cover accounting for contracts in general. However, if the terms of a contract between an enterprise and its customer are subject to regulation and the criteria of paragraph 5 are met with respect to that contract, this Statement shall apply.

General Standards of Accounting for the Effects of Regulation

9. Rate actions of a regulator can provide reasonable assurance of the existence of an asset. An enterprise shall capitalize all or part of an incurred cost[5] that would otherwise be charged to expense if both of the following criteria are met:

a. It is probable[6] that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.
b. Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided through an automatic rate-adjustment clause, this criterion requires that the regulator's intent clearly be to permit recovery of the previously incurred cost.

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[4]For example, a regulator might authorize a regulated enterprise to incur a major research and development cost because the cost is expected to benefit future customers. The regulator might also direct that cost to be capitalized and amortized as an allowable cost over the period of expected benefit. If the criteria of paragraph 9 of this Statement were met, the enterprise would capitalize that cost even though FASB Statement No. 2, *Accounting for Research and Development Costs*, requires such costs to be charged to income currently. Statement 2 would still apply to accounting for other research and development costs of the regulated enterprise, as would the disclosure requirements of Statement 2.

[5]An *incurred cost* is "a cost arising from cash paid out or obligation to pay for an acquired asset or service, a loss from any cause that has been sustained and has been or must be paid for" (Eric L. Kohler, *A Dictionary for Accountants*, 5th ed. [Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1975], p. 253).

[6]The term *probable* is used in this Statement with its usual general meaning, rather than in a specific technical sense, and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved (*Webster's New World Dictionary of the American Language*, 2d college ed. [New York and Cleveland: World Publishing Company, 1972], p. 1132). That is the meaning referred to by FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises*.

10. Rate actions of a regulator can reduce or eliminate the value of an asset. If a regulator excludes all or part of a cost from allowable costs and it is not probable that the cost will be included as an allowable cost in a future period, the cost cannot be expected to result in future revenue through the rate-making process. Accordingly, the carrying amount of any related asset shall be reduced to the extent that the asset has been impaired. Whether the asset has been impaired shall be judged the same as for enterprises in general.

11. Rate actions of a regulator can impose a liability on a regulated enterprise. Such liabilities are usually obligations to the enterprise's customers. The following are the usual ways in which liabilities can be imposed and the resulting accounting:

a. A regulator may require refunds to customers.[7] Refunds that meet the criteria of paragraph 8 (accrual of loss contingencies) of FASB Statement No. 5, *Accounting for Contingencies*, shall be recorded as liabilities and as reductions of revenue or as expenses of the regulated enterprise.
b. A regulator can provide current rates intended to recover costs that are expected to be incurred in the future with the understanding that if those costs are not incurred future rates will be reduced by corresponding amounts. If current rates are intended to recover such costs and the regulator requires the enterprise to remain accountable for any amounts charged pursuant to such rates and not yet expended for the intended purpose,[8] the enterprise shall not recognize as revenues amounts charged pursuant to such rates. Those amounts shall be recognized as liabilities and taken to income only when the associated costs are incurred.
c. A regulator can require that a gain or other reduction of net allowable costs be given to customers over future periods. That would be accomplished, for rate-making purposes, by amortizing the gain or other reduction of net allowable costs over those future periods and reducing rates to reduce revenues in approximately the amount of the amortization. If a gain or other reduction of net allowable costs is to be amortized over future periods for rate-making purposes, the regulated enterprise shall not recognize that gain or other reduction of net allowable costs in income of the current period. Instead, it shall record it as a liability for future reductions of charges to customers that are expected to result.

[7]Refunds can be paid to the customers who paid the amounts being refunded; however, they are usually provided to current customers by reducing current charges.

[8]The usual mechanism used by regulators for this purpose is to require the regulated enterprise to record the anticipated cost as a liability in its regulatory accounting records.

12. Actions of a regulator can eliminate a liability only if the liability was imposed by actions of the regulator.

13. Appendix B illustrates the application of the general standards of accounting for the effects of regulation.

Specific Standards Derived from the General Standards

14. The following specific standards are derived from the general standards in paragraphs 9-12. The specific standards shall not be used as guidance for other applications of those general standards.

Allowance for Funds Used during Construction

15. In some cases, a regulator requires an enterprise subject to its authority to capitalize, as part of the cost of plant and equipment, the cost of financing construction as financed partially by borrowings and partially by equity. A computed interest cost and a designated cost of equity funds are capitalized, and net income for the current period is increased by a corresponding amount. After the construction is completed, the resulting capitalized cost is the basis for depreciation and unrecovered investment for rate-making purposes. In such cases, the amounts capitalized for rate-making purposes as part of the cost of acquiring the assets shall be capitalized for financial reporting purposes instead of the amount of interest that would be capitalized in accordance with FASB Statement No. 34, *Capitalization of Interest Cost*.[9] The income statement shall include an item of other income, a reduction of interest expense, or both, in a manner that indicates the basis for the amount capitalized.

Intercompany Profit[10]

16. Profit on sales to regulated affiliates shall not be eliminated in general-purpose financial statements[11] if both of the following criteria are met:

[9] Statement 34 requires capitalization of interest cost on certain qualifying assets. The amount capitalized is the portion of the interest cost incurred during the period that theoretically could have been avoided if the expenditures had not been made.

[10] The term *intercompany profit* is used in this Statement to include both profits on sales from one company to another within a consolidated or affiliated group and profits on sales from one operation of a company to another operation of the same company.

[11] ARB No. 51, *Consolidated Financial Statements*, requires that profit on sales of assets remaining in the consolidated group be eliminated in consolidated financial statements. APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, effectively extends that requirement to affiliated entities reported on the equity method.

a. The sales price is reasonable.
b. It is probable that, through the rate-making process, future revenue approximately equal to the sales price will result from the regulated affiliate's use of the products.

17. The sales price usually shall be considered reasonable if the price is accepted or not challenged by the regulator that governs the regulated affiliate. Otherwise, reasonableness shall be considered in light of the circumstances. For example, reasonableness might be judged by the return on investment earned by the manufacturing or construction operations or by a comparison of the transfer prices with prices available from other sources.

Other Specific Standards

Accounting for Income Taxes

18. Items of revenue and expense are sometimes taxable or deductible in periods other than the periods in which those items are recognized for financial reporting purposes. In some cases, a regulator does not include the income tax effect of certain transactions in allowable costs in the period in which the transactions are reported but includes income taxes related to those transactions in allowable costs in the period in which the taxes become payable. In such cases, if it is probable that income taxes payable in future years because of net reversal of timing differences will be recovered through rates based on taxes payable at that time, the enterprise shall record neither the deferred income taxes[12] that result from those timing differences nor the related asset (the probable future benefits that will result from payment of the taxes). However, the enterprise shall disclose the cumulative net amount of income tax timing differences for which deferred income taxes have not been provided. That disclosure supplements the requirements of paragraph 63 of Opinion 11 for disclosure of operating loss carryforwards, significant amounts of other unused deductions or credits, and reasons for significant variations in the customary relationships between income tax expense and pretax accounting income. Except as provided in this paragraph, regulated enterprises shall apply the requirements of Opinion 11.

[12] APB Opinion No. 11, *Accounting for Income Taxes*, requires comprehensive interperiod allocation of the income tax effect of timing differences, that is, differences between the timing of income or expense recognition in financial statements and in income tax returns.

Other Disclosure

19. For refunds that are recognized in a period other than the period in which the related revenue was recognized and that have a material effect on net income, the enterprise shall disclose the effect on net income and indicate the years in which the related revenue was recognized. Such effect may be disclosed by including it, net of related income taxes, as a line item in the income statement. However, that item shall not be presented as an extraordinary item.

20. In some cases, a regulator may permit an enterprise to include a cost that would be charged to expense by an unregulated enterprise as an allowable cost over a period of time by amortizing that cost for rate-making purposes, but the regulator does not include the unrecovered amount in the rate base. That procedure does not provide a return on investment during the recovery period. If recovery of such major costs is provided without a return on investment during the recovery period, the enterprise shall disclose the remaining amounts of such assets and the remaining recovery period applicable to them.

Amendments to Existing Pronouncements

21. Appendix A lists the amendments to existing pronouncements that result from this Statement.

Effective Date and Transition

22. This Statement shall be effective for fiscal years beginning after December 15, 1983. Earlier application is encouraged. Accounting changes adopted to conform to the provisions of this Statement shall be applied retroactively, except that:

a. Previously issued financial statements shall not be restated for changes in accounting for refunds.
b. Leases for which the inception[13] is after December 31, 1982 shall be classified in accordance with FASB Statement No. 13, *Accounting for Leases*, in financial statements commencing with initial application of this Statement. Leases for which the inception of the lease is before January 1, 1983 may be classified as they would have been classified before this Statement was issued until fiscal years beginning after December 15, 1986. Commencing no

[13]The inception of a lease is defined in FASB Statement No. 23, *Inception of the Lease*.

later than the first fiscal year beginning after December 15, 1986, those leases shall be retroactively classified in accordance with Statement 13 as amended.

23. If leases are not retroactively classified in accordance with Statement 13 in financial statements for fiscal years beginning after December 15, 1983 and before December 15, 1986 as permitted by paragraph 22(b), lessees shall disclose the amounts of additional capitalized leased assets and lease obligations that would be included in each balance sheet presented if Statement 13 had been applied retroactively.

24. In the year that this Statement is first applied, the financial statements shall disclose the nature of any restatement and its effect on income before extraordinary items, net income, and related per-share amounts[14] for each year restated. If retroactive restatement of all years presented is not practicable, the financial statements shall be restated for as many consecutive years as is practicable, and the cumulative effect of applying this Statement shall be included in determining net income of the earliest year restated (not necessarily the earliest year presented). If it is not practicable to restate any prior year, the cumulative effect shall be included in net income in the year in which this Statement is first applied. (See paragraph 20 of APB Opinion No. 20, *Accounting Changes*.) The effect on income before extraordinary items, net income, and related per-share amounts[15] of applying this Statement in a year in which the cumulative effect is included in determining that year's net income shall be disclosed for that year.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the affirmative votes of four members of the Financial Accounting Standards Board. Messrs. Block, Kirk, and Sprouse dissented.

[14]The effect on related per-share amounts need not be disclosed if the enterprise does not disclose earnings per share.

[15]See footnote 14.

Mr. Block dissents to the issuance of this Statement. He believes that the regulatory environment as it exists today does not provide the necessary assurance of realization of future revenues to justify the standards in this Statement.

In his opinion, the creation of an asset by a regulator requires, at a minimum, an exclusive franchise to deliver goods and services for which demand is insensitive to price. This means that the goods and services must be necessities and that no alternative goods and services exist as competition. Further, the creation of long-lived assets requires assurance that the regulatory environment will remain unchanged for long periods. The nature of assets created by a regulator (future amounts receivable from customers) would appear to require assurance that the customers will exist, the goods and services will be delivered to customers, and the customers will pay the decreed rates. Mr. Block does not believe that rate regulators can provide such assurances in the industries to which this Statement is likely to be applied. Because of those beliefs, Mr. Block concludes that the ratemaking process should have no bearing on principles for cost capitalization and loss recognition. Those principles should be the same for rate-regulated enterprises as they are for unregulated enterprises.

Mr. Block further believes that the assets created by regulation under this Statement are merely future accounts receivable for future sales. While he is opposed to recognizing such receivables, he notes that APB Opinion No. 21, *Interest on Receivables and Payables,* requires discounting of long-term receivables on which there is no stated interest rate or the stated rate is unreasonable. Thus, in his view, if such receivables are to be recognized, discounting at market rates of return should be required.

Mr. Kirk dissents to the issuance of this Statement because he believes the immediate increases in income resulting from the capitalization of costs imputed for equity funds used during construction (paragraph 15) and intercompany profit (paragraphs 16 and 17) are not valid reflections of the economics of rate regulation or in accordance with other generally accepted accounting principles. Unlike other allowable costs, imputed costs have not been incurred. In Mr. Kirk's opinion, even if capitalization is deemed appropriate for financial reporting purposes, income should not be recognized. The income related to allowable but imputed costs should be recognized when the rates covering the costs are charged to customers, not before.

Mr. Sprouse dissents primarily because he does not agree with the thrust of paragraph 11 related to liabilities. He agrees that a regulator can impose a liability on a regulated enterprise by requiring the enterprise to make refunds to its customers (paragraph 11(a)). In his opinion, however, "refunds" involve reductions in existing assets—either cash settlements or lump-sum deductions from the amounts due from customers. Reductions in future rates do not "refund" anything and, therefore, do not create a liability. Indeed, reductions in future

rates do not obligate a regulated enterprise to transfer assets or use them in any way that would not be required in the absence of those reductions. Of course, a sufficiently severe reduction in future rates might trigger the need to recognize impairment of assets.

In Mr. Sprouse's view, paragraph 11(b) tends to confuse the use of a formula that a regulator might properly use to set reasonably stable rates with real, often sporadic, economic events, the effects of which should be recognized in financial statements if and when they have actually occurred. In setting rates, a regulator may include a "provision for noninsurance" among the allowable costs, but that does not create a present obligation to repair unusual storm damage that has not yet occurred (paragraphs 11(b), 38, and 39). If over a period of time the amounts of uninsured losses are sufficiently less than the "provisions for noninsurance" included in allowable costs, the regulator may reduce or eliminate future allowed provisions and reduce rates accordingly. As explained in the previous paragraph, however, possible future rate reductions do not create a liability. The possibility that sometime in the future the regulator might require cash refunds to customers to reduce or eliminate the cumulative "provision for noninsurance" is too remote to be recognized as a liability.

Similarly, in a formula designed to maintain reasonably stable rates, a regulatory agency may wish to spread a gain on early extinguishment of debt over some arbitrary period, but that does not create a present obligation for the regulated enterprise to transfer assets or to use them in any way that would not be required in the absence of such a gain (paragraphs 11(c) and 35-37).

Mr. Sprouse does agree that, to the extent that there is adequate evidence that the rates set by a regulator will cause a specific cost or other amount to be recovered through future incremental revenues, the regulated enterprise has an asset or asset enhancement (a quasi-receivable) that is properly measured by that incurred cost or other amount. Accordingly, he agrees that those circumstances may call for capitalizing (a) unusual storm losses, property abandonments, plant conversions, and similar costs that have occurred (paragraph 9); (b) an imputed cost of equity funds (paragraph 15); and (c) intercompany profits included in transfer prices to affiliates (paragraphs 16 and 17).

Messrs. Kirk and Sprouse also dissent because they believe the amendment to APB Opinion 30 in paragraph 19 of this Statement that suggests that refunds be reported in income net of taxes but not as extraordinary items is unrelated to the economics of rate regulation and therefore inappropriate. They see no reason why a potentially recurring charge to income should be singled out from all other recurring or even unusual items for this special treatment.

Members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Frank E. Block
John W. March
Robert A. Morgan
David Mosso
Robert T. Sprouse
Ralph E. Walters

Appendix A

AMENDMENTS TO EXISTING PRONOUNCEMENTS

25. This Statement supersedes the Addendum, *Accounting Principles for Regulated Industries*, to APB Opinion 2.

26. Paragraph 7 provides for this Statement to be applied by enterprises that are subject to it instead of conflicting provisions of other authoritative pronouncements. The Board sees no need for references to this Statement in either existing pronouncements or future authoritative pronouncements. That conclusion requires the following amendments to existing pronouncements:

a. ARB No. 44 (Revised), *Declining-Balance Depreciation*, as amended by APB Opinion No. 6, *Status of Accounting Research Bulletins*. Delete paragraphs 8 and 9.
b. ARB 51. Delete the last sentence of paragraph 6.
c. APB Opinion No. 1, *New Depreciation Guidelines and Rules*. Delete paragraph 7.
d. APB Opinion No. 2, *Accounting for the "Investment Credit."* Delete paragraph 17.
e. APB Opinion 11. In the second sentence of paragraph 6, delete the words "(a) to regulated industries in those circumstances where the standards described in the Addendum (which remains in effect) to APB Opinion No. 2 are met and (b)."
f. APB Opinion No. 16, *Business Combinations*. Delete paragraph 6.
g. APB Opinion No. 17, *Intangible Assets*. Delete paragraph 7.
h. APB Opinion 20. Delete the last two sentences of paragraph 3.
i. APB Opinion No. 23, *Accounting for Income Taxes—Special Areas*. Delete paragraph 4.
j. APB Opinion No. 24, *Accounting for Income Taxes*. Delete paragraph 3.
k. APB Opinion No. 26, *Early Extinguishment of Debt*. Delete the last sentence of paragraph 2.
l. APB Opinion No. 29, *Accounting for Nonmonetary Transactions*. In the first sentence following subparagraph 4(d), delete the words "applies to regulated companies in accordance with the Addendum to APB Opinion No. 2, *Accounting for the Investment Credit*, 1962 and it."
m. FASB Statement No. 2, *Accounting for Research and Development Costs*. Delete paragraph 14.

n. FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt.* Delete paragraph 7.

o. FASB Statement 5. Delete paragraph 13.

p. FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises.* Delete the second sentence of paragraph 5.

q. FASB Statement 13. Delete paragraph 3.

r. FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings.* Delete paragraph 9.

s. FASB Statement No. 16, *Prior Period Adjustments.* Delete paragraph 9.

t. FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies.* Delete paragraph 9.

u. FASB Statement No. 22, *Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt.* Delete paragraph 11.

v. FASB Statement 34. Delete paragraph 5.

w. FASB Statement No. 43, *Accounting for Compensated Absences.* Delete paragraph 3.

x. FASB Statement No. 49, *Accounting for Product Financing Arrangements.* Delete paragraph 7.

y. FASB Statement No. 51, *Financial Reporting by Cable Television Companies.* Delete paragraph 2.

z. FASB Interpretation No. 18, *Accounting for Income Taxes in Interim Periods.* Delete paragraph 4.

aa. FASB Interpretation No. 22, *Applicability of Indefinite Reversal Criteria to Timing Differences.* Delete paragraph 8.

bb. FASB Interpretation No. 25, *Accounting for an Unused Investment Tax Credit.* Delete paragraph 9.

Appendix B

APPLICATION OF GENERAL STANDARDS TO SPECIFIC SITUATIONS

27. This appendix provides guidance for application of this Statement to some specific situations. The guidance does not address all possible applications of this Statement. All of the examples assume that the enterprise meets the criteria in paragraph 5 of this Statement; thus, recovery of any cost is probable if that cost is designated for future recovery by the regulator. The examples also assume that the items addressed are material. The provisions of this Statement need not be applied to immaterial items.

28. Specific situations discussed in this appendix are:

	Paragraph Numbers
Intangible assets	29—30
Accounting changes	31—32
Recovery of costs without return on investment	33—34
Early extinguishment of debt	35—37
Accounting for contingencies	38—39
Accounting for leases	40—43
Revenue collected subject to refund	44—45
Refunds to customers	46—47
Accounting for compensated absences	48—49

Intangible Assets

29. Opinion 17 requires that the cost of an intangible asset acquired after October 30, 1970 be amortized over the shorter of its estimated useful life or 40 years. That Opinion also requires that a company continually evaluate the period of amortization to determine whether later events and circumstances warrant a revised estimate of the useful life and whether the unamortized cost should be reduced significantly by a charge to income. For rate-making purposes, a regulator may permit an enterprise to amortize purchased goodwill over a specified period. In other cases, a regulator may direct an enterprise not to amortize goodwill acquired in a business combination after October 30, 1970 or to write off that goodwill.

30. If the regulator permits the goodwill to be amortized over a specific time period as an allowable cost for rate-making purposes, the regulator's action provides reasonable assurance of the existence of an asset (paragraph 9). The goodwill would then be amortized for financial reporting purposes over the period during which it will be allowed for rate-making purposes. If the regulator excludes amortization of goodwill from allowable costs for rate-making purposes, either by not permitting amortization or by directing the enterprise to write off the goodwill, the value of the goodwill may be reduced or eliminated (paragraph 10). If there is no indication that the amortization will be allowed in a subsequent period, the goodwill would be amortized for financial reporting purposes and continually evaluated to determine whether the unamortized cost should be reduced significantly by a charge to income in accordance with Opinion 17.

Accounting Changes

31. Opinion 20 defines various types of accounting changes and establishes guidelines for reporting each type. Other authoritative pronouncements specify the manner of reporting initial application of those pronouncements.

32. If a regulated enterprise changes accounting methods and the change does not affect costs that are allowable for rate-making purposes, the regulated enterprise would apply the change in the same manner as would an unregulated enterprise. Capitalization of leases with no income statement effect (paragraphs 40-43) is an example of that type of change. If a regulated enterprise changes accounting methods and the change affects allowable costs for rate-making purposes, the change generally would be implemented in the way that it is implemented for regulatory purposes. A change in the method of accounting for research and development costs, either from a policy of capitalization and amortization to one of charging those costs to expense as incurred or vice versa, is an example of that type of change.

Recovery of Costs without Return on Investment

33. In some cases, a regulator may approve rates that are intended to recover an incurred cost over an extended period without a return on the unrecovered cost during the recovery period.

34. The regulator's action provides reasonable assurance of the existence of an asset (paragraph 9). Accordingly, the regulated enterprise would capitalize the cost and amortize it over the period during which it will be allowed for rate-

making purposes. That cost would not be recorded at discounted present value. If the amounts are material, the disclosures specified in paragraph 20 of this Statement would be furnished.

Early Extinguishment of Debt

35. Opinion 26 requires recognition in income of a gain or loss on an early extinguishment of debt in the period in which the debt is extinguished. For rate-making purposes, the difference between the enterprise's net carrying amount of the extinguished debt and the reacquisition price may be amortized as an adjustment of interest expense over some future period.

36. If the debt is reacquired for an amount in excess of the enterprise's net carrying amount, the regulator's decision to increase future rates by amortizing the difference for rate-making purposes provides reasonable assurance of the existence of an asset (paragraph 9). Accordingly, the regulated enterprise would capitalize the excess cost and amortize it over the period during which it will be allowed for rate-making purposes.

37. If the debt is reacquired for an amount that is less than the enterprise's net carrying amount, the regulator's decision to reduce future rates by amortizing the difference for rate-making purposes imposes a liability on the regulated enterprise (paragraph 11(c)). Accordingly, the enterprise would record the difference as a liability and amortize it over the period during which permitted rates will be reduced.

Accounting for Contingencies

38. Statement 5 specifies criteria for recording estimated losses from loss contingencies. A regulator may direct a regulated enterprise to include an amount for a contingency in allowable costs for rate-making purposes even though the amount does not meet the criteria of Statement 5 for recording. For example, a regulator ma direct a regulated enterprise to include an amount for repairs of expected future uninsured storm damage.

39. If the regulator requires the enterprise to remain accountable for any amounts charged pursuant to such rates and not yet expended for the intended purpose, the resulting increased charges to customers create a liability (paragraph 11(b)). If a cost to repair storm damage is not subsequently incurred, the increased charges will have to be refunded to customers through future rate reductions. Accordingly, the regulated enterprise would recognize the amounts

charged pursuant to such rates as liabilities rather than as revenues. If a cost to repair storm damage is subsequently incurred, the enterprise would charge that cost to expense and reduce the liabilities at that time by recognizing income in amounts equal to the cost.

Accounting for Leases

40. Statement 13, as amended, specifies criteria for classification of leases and the method of accounting for each type of lease. For rate-making purposes, a lease may be treated as an operating lease even though the lease would be classified as a capital lease under the criteria of Statement 13. In effect, the amount of the lease payment is included in allowable costs as rental expense in the period it covers.

41. For financial reporting purposes, the classification of the lease is not affected by the regulator's actions. The regulator cannot eliminate an obligation that was not imposed by the regulator (paragraph 12). Also, by including the lease payments as allowable costs, the regulator sets rates that will provide revenue approximately equal to the combined amount of the capitalized leased asset and interest on the lease obligation over the term of the lease and, thus, provides reasonable assurance of the existence of an asset (paragraph 9). Accordingly, regulated enterprises would classify leases in accordance with Statement 13 as amended.

42. The nature of the expense elements related to a capitalized lease (amortization of the leased asset and interest on the lease obligation) is not changed by the regulator's action; however, the timing of expense recognition related to the lease would be modified to conform to the rate treatment. Thus, amortization of the leased asset would be modified so that the total of interest on the lease obligation and amortization of the leased asset would equal the rental expense that was allowed for rate-making purposes.

43. The Board notes that generally accepted accounting principles do not require interest expense or amortization of leased assets to be classified as separate items in an income statement. For example, the amounts of amortization of capitalized leased nuclear fuel and interest on the related lease obligation could be combined with other costs and displayed as "fuel cost." However, the disclosure of total interest cost incurred, required by Statement 34, would include the interest on that lease obligation; and the disclosure of the total amortization charge, required by Statement 13, would include amortization of that leased asset.

Revenue Collected Subject to Refund

44. In some cases, a regulated enterprise is permitted to bill requested rate increases before the regulator has ruled on the request.

45. When the revenue is originally recorded, the criteria in paragraph 8 of Statement 5 would determine whether a provision for estimated refunds should be accrued as a loss contingency. That provision would be adjusted subsequently if the estimate of the refund changes (paragraph 11(a)).[16]

Refunds to Customers

46. Statement 16 limits prior period adjustments (other than those that result from reporting accounting changes) to corrections of errors, adjustments that result from realization of income tax benefits of preacquisition operating loss carryforwards of purchased subsidiaries, and adjustments related to prior interim periods of the current fiscal year.

47. In accordance with Statement 16, estimated refunds that were not previously accrued would be charged to income in the first period in which they meet the criteria for accrual (paragraph 8 of Statement 5). If the amounts are material, the disclosures specified in paragraph 19 of this Statement would be furnished.

Accounting for Compensated Absences

48. Statement 43 specifies criteria for accrual of a liability for employees' compensation for future absences. For rate-making purposes, compensation for employees' absences may be included in allowable costs when the compensation is paid.

49. The liability, if any, would be accrued in accordance with Statement 43 because rate actions of the regulator cannot eliminate obligations that were not

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[16]Revenue collected subject to refund is similar to sales with warranty obligations. Paragraph 25 of Statement 5 states that "inability to make a reasonable estimate of the amount of a warranty obligation at the time of sale because of significant uncertainty about possible claims . . . precludes accrual and, if the range of possible loss is wide, may raise a question about whether a sale should be recorded. . . ." Similarly, if the range of possible refund is wide and the amount of the refund cannot be reasonably estimated, there may be a question about whether it would be misleading to recognize the provisional revenue increase as income.

imposed by the regulator (paragraph 12). By including the accrued compensation in future allowable costs on an as-paid basis, the regulator provides reasonable assurance of the existence of an asset. The asset is the probable future benefit (increased revenue) that will result from the regulatory treatment of the subsequent payment of the liability (paragraph 9). Accordingly, the enterprise also would record the asset that results from the regulator's actions.

Appendix C

BASIS FOR CONCLUSIONS

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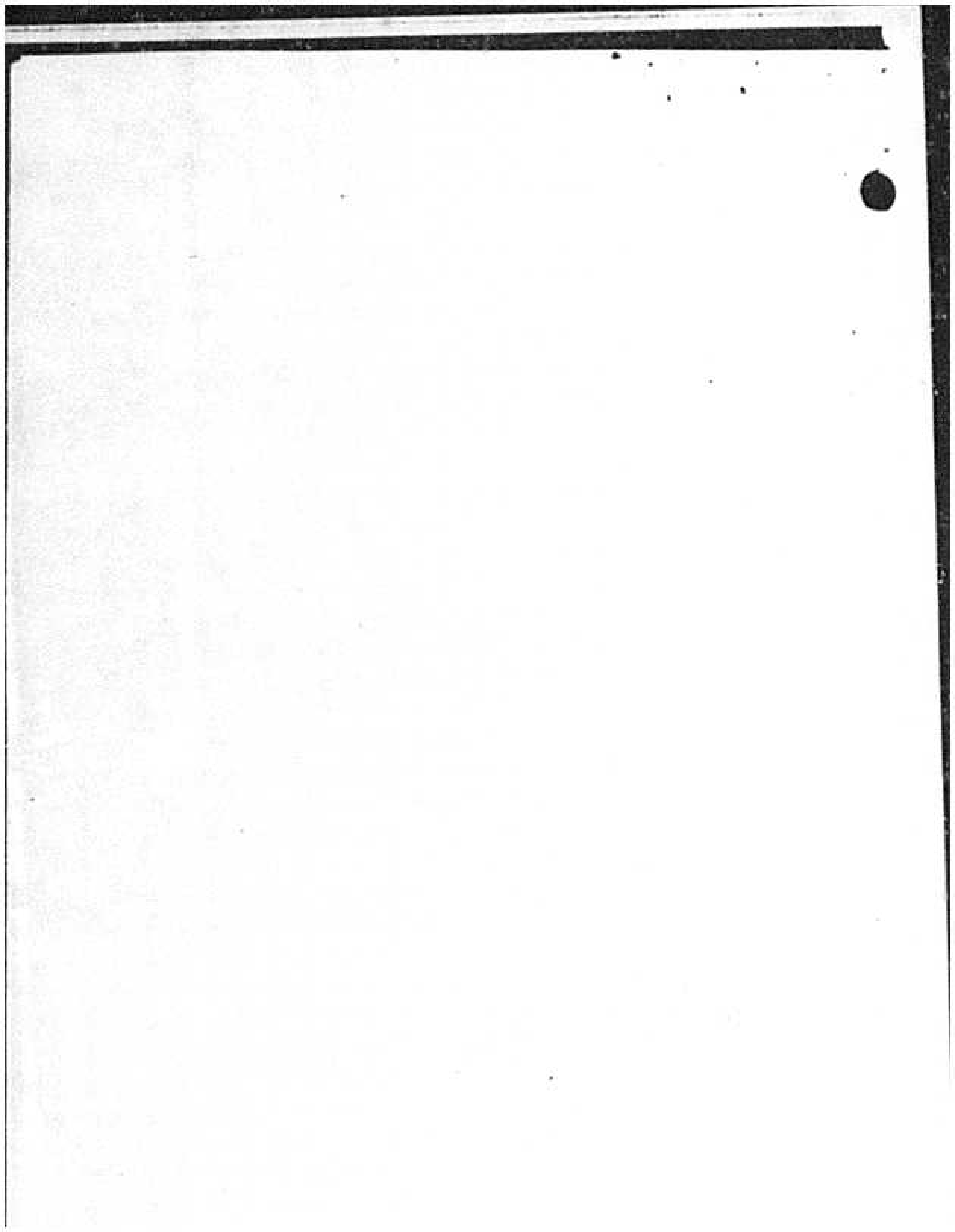

Appendix C

BASIS FOR CONCLUSIONS

Introduction

50. This appendix discusses factors deemed significant by members of the Board in reaching the conclusions in this Statement. It includes descriptions of the various alternatives considered and the Board's reasons for accepting some and rejecting others. Individual Board members gave greater weight to some factors than to others.

Relationship of Regulatory-Prescribed Accounting to Generally Accepted Accounting Principles

51. The FASB Discussion Memorandum, *Effect of Rate Regulation on Accounting for Regulated Enterprises,* presented a threshold issue: "Should accounting prescribed by regulatory authorities be considered in and of itself generally accepted for purposes of financial reporting by rate-regulated enterprises?"

52. Virtually all respondents to the Discussion Memorandum indicated that accounting prescribed by regulatory authorities should not be considered in and of itself generally accepted for purposes of financial reporting by rate-regulated enterprises. Respondents noted that the function of accounting is to report economic conditions and events. Unless an accounting order indicates the way a cost will be handled for rate-making purposes, it causes no economic effects that would justify deviation from the generally accepted accounting principles applicable to business enterprises in general. The mere issuance of an accounting order not tied to rate treatment does not change an enterprise's economic resources or obligations. In other words, the economic effect of regulatory decisions—not the mere existence of regulation—is the pervasive factor that determines the application of generally accepted accounting principles.

53. Respondents also noted that regulatory-prescribed accounting has not been considered generally accepted per se in the past.

54. The Board concluded that regulatory-prescribed accounting should not be considered generally accepted per se, but rather that the Board should specify how generally accepted accounting principles apply in the regulatory environment.

55. Some respondents to the FASB Exposure Draft, *Accounting for the Effects of Regulation of an Enterprise's Prices Based on Its Costs*, suggested that the Board clarify the relationship of this Statement to an enterprise's regulatory accounting and to regulators' actions. This Statement does not address an enterprise's regulatory accounting. Regulators may require regulated enterprises to maintain their accounts in a form that permits the regulator to obtain the information needed for regulatory purposes. This Statement neither limits a regulator's actions nor endorses them. Regulators' actions are based on many considerations. Accounting addresses the effects of those actions. This Statement merely specifies how the effects of different types of rate actions are reported in general-purpose financial statements.

Economic Effects of Regulation

56. The second threshold issue in the Discussion Memorandum was: "Does rate regulation introduce an economic dimension in some circumstances that should affect the application of generally accepted accounting principles to rate-regulated enterprises?"

57. Most respondents to the Discussion Memorandum indicated that rate regulation does introduce such an economic dimension in some circumstances. Respondents cited the cause-and-effect relationship of costs and revenues as the principal economic effect of regulation that affects accounting for regulated enterprises. They noted that cost might be one factor used by unregulated enterprises to establish prices, but it would often not be the most important factor. Usually, prices are limited by the market. An unregulated enterprise might desire to price its goods or services at a level that would recover all costs and a reasonable profit; however, the market might not permit that price. Alternatively, an unregulated enterprise might be able to increase its prices and its profit if competition does not limit its prices. In either case, cost often is not the principal determinant of prices. In contrast, for an enterprise with prices regulated on the basis of its costs, allowable costs are the principal factor that influences its prices.

58. The economic effect cited by most respondents is the ability of a regulatory action to create a future economic benefit—the essence of an asset. For example, consider a regulated enterprise that incurs costs to repair damage caused by a major storm. If the regulator approves recovery of the costs through rates over some future period or is expected to do so, the rate action of the regulator creates a new asset that offsets the reduction in the damaged asset. The enterprise has probable future economic benefits—the additional revenue that will result from

including the cost in allowable costs for rate-making purposes. The future benefits are obtained or controlled by the enterprise as a result of a past event—incurring the cost that results in the rate order. Thus, the criteria of Concepts Statement 3 for an asset are met.

59. Most respondents that opposed special accounting for the effects of regulation cited the need for comparability between regulated and unregulated enterprises. Paragraph 119 of FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, indicates that ". . . the purpose of comparison is to detect and explain similarities and differences." The Board concluded that comparability would not be enhanced by accounting as though regulation had no effect. Regulation creates different circumstances that require different accounting.

Scope

60. The Discussion Memorandum discussed regulation of various industries, and it asked whether a Board pronouncement should identify specific industries that are affected. Most respondents indicated that applicability of an FASB Statement on rate regulation should be specified by clearly describing the nature of the regulated operations to which it applies rather than by attempting to delineate specific industries. Some noted that changes in the political environment can cause changes in the nature of regulation. Accordingly, whether an industry meets the criteria for applicability might change over time. The Board agreed with those respondents and, accordingly, specified criteria that focus on the nature of regulation rather than on specific industries.

61. This Statement specifies the economic effects that result from the cause-and-effect relationship of costs and revenues in the rate-regulated environment and how those effects are to be accounted for. The nature of those effects led to the criteria for applicability of this Statement (paragraph 5).

62. The first criterion is the existence of third-party regulation. That criterion is intended to ex lude contractual arrangements in which the government, or another party that could be viewed as a "regulator," is a party to a contract and is the enterprise's principal customer. For example, the normal Medicare and Medicaid arrangements are excluded from the scope of this Statement because they are contractual-type arrangements between the provider and the governmental agency that is responsible for payment for services provided.

63. Some respondents to the Exposure Draft indicated that cooperative utilities

should be included in the scope of this Statement. They observed that some cooperative utilities' rates are subject to third-party regulation, but others' rates are set by their own governing board. The governing board is elected by the members of the cooperative, and it has the same authority as an independent, third-party regulator. In their view, the difference between cooperative utilities that are subject to third-party regulation and those that are not does not justify different accounting. The Board agreed with those respondents, and modified the first criterion to include enterprises with rates established by their own governing board providing that board is empowered by statute or by contract to establish rates that bind customers.

64. A number of governmental utility respondents to the Exposure Draft asked that governmental utilities be included within the scope of this Statement. They noted that many governmental utilities have been guided by the same accounting practices and standards as investor-owned utilities in their general-purpose financial statements, and they expressed the view that users' emphasis on comparability supports continuation of that practice. In their view, the Board's decision not to address governmental utilities in this Statement should not preclude them from applying it. The Board agreed with those respondents and modified paragraph 5(a) so as not to preclude application by governmental utilities with rates set by their own governing board.

65. The second criterion is that the regulated rates are designed to recover the specific enterprise's costs of providing the regulated services or products. If rates are based on industry costs or some other measure that is not directly related to the specific enterprise's costs, there is no cause-and-effect relationship between the enterprise's costs and its revenues. In that case, costs would not be expected to result in revenues approximately equal to the costs; thus, the basis for the accounting specified in this Statement is not present under that type of regulation. That criterion is intended to be applied to the substance of the regulation, rather than its form. If an enterprise's regulated rates are based on the costs of a group of companies and the enterprise is so large in relation to the group of companies that its costs are, in essence, the group's costs, the regulation would meet the second criterion for that enterprise.

66. The last criterion requires that it be reasonable to assume that rates set at levels that will recover the enterprise's costs can be charged to and collected from customers. Regardless of the actions of the regulator, if the market for the enterprise's regulated services or products will not support a price based on cost, the enterprise's rates are at least partially controlled by the market. In that case, the cause-and-effect relationship of costs and revenues that is the basis for the

accounting required by this Statement cannot be assumed to exist, and this Statement would not apply.

67. The Board does not intend the last criterion as a requirement that the enterprise earn a fair return on shareholders' investment under all conditions; an enterprise can earn less than a fair return for many reasons unrelated to the ability to bill and collect rates that will recover allowable costs.[17] For example, mild weather might reduce demand for energy utility services. In that case, rates that were expected to recover an enterprise's allowable costs might not do so. The resulting decreased earnings do not demonstrate an inability to charge and collect rates that would recover the enterprise's costs; rather, they demonstrate the uncertainty inherent in estimating weather conditions.

68. The last criterion also requires reasonable assurance that the regulated environment and its economic effects will continue. That requirement must be evaluated in light of the circumstances. For example, if the enterprise has an exclusive franchise to provide regulated services or products in an area and competition from other services or products is minimal, there is usually a reasonable expectation that it will continue to meet the other criteria. Exclusive franchises can be revoked, but they seldom are. If the enterprise has no exclusive franchise but has made the very large capital investment required to provide either the regulated services or products or an acceptable substitute, future competition also may be unlikely.

69. Some respondents to the Discussion Memorandum questioned whether, in light of recent events, it would ever be reasonable to assume that rates set at levels that will recover the enterprise's costs can be charged to and collected from customers. They cited recent developments—such as the use of solar devices as alternatives to certain energy utility services, increasing competition in the telecommunications industry, and deregulation of various transportation industries—as evidence that the environment of a regulated enterprise can change rapidly. The Board concluded that users of financial statements should be aware of the possibility of rapid, unanticipated changes in an industry, but accounting should not be based on such possibilities unless their occurrence is considered probable. However, changes of a long-term nature could modify the demand for an enterprise's regulated services sufficiently to affect its qualifying under the criterion of subparagraph 5(c).

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[17] As indicated in footnote 1, the term *allowable costs* is used here to include earnings permitted on shareholders' investment.

70. The first scope limitation of paragraph 8—excluding accounting for price controls imposed by governmental action in times of emergency, high inflation, or other unusual conditions—was included in the Discussion Memorandum. Price controls imposed in periods of unusual conditions are not expected to be applied consistently over an extended period. Indeed, their duration usually is limited by statute. In that environment, assurance of future benefits cannot be provided by probable future actions of the price control regulator because that regulator may not exist at a given future date.

71. Accounting for contracts in general was also excluded from the scope of the Discussion Memorandum. The economic effects of cost reimbursement contracts are in some respects similar to the economic effects of the type of regulation addressed by this Statement. However, most contracts tend to be relatively short-term, whereas regulation of enterprises covered by this Statement is expected to continue beyond the foreseeable future. The Board noted that other authoritative literature addresses contract accounting and concluded that it should exclude the general issue of contract accounting from the scope of this Statement.

72. The Discussion Memorandum described rate-making processes in several industries and asked whether each process justified the application of this Statement. As noted in paragraph 60, the Board concluded that applicability of this Statement should be specified by describing the nature of the regulated operations and the type of rate making to which it applies rather than by attempting to delineate specific industries.

73. In view of the nature of comments received, the Board concluded that the possible application of this Statement to the health care industry should be discussed. The Board does not intend to preclude application of the provisions of this Statement to the health care industry or to any other industry. Rather, application of this Statement is limited to regulated operations that meet the specified criteria for application.

74. In general, rates for services in the health care industry are not regulated based on the provider's costs. The federal Medicare and Medicaid programs usually are applied through a contractual-type arrangement (paragraph 62). Some states are applying comprehensive, prospective rate making to health care providers. In some cases, the rates set by state regulatory agencies are accepted for Medicare and Medicaid reimbursement purposes. There is some disagreement about the extent to which such rates are based on a provider's costs. If regulatory agencies in those states base rates on the provider's costs and adopt a permanent system of regulation, health care providers in those jurisdictions could

be subject to the provisions of this Statement. However, the criterion in subparagraph 5(c) also would have to be considered to determine whether the Statement applies to the enterprise.

General Standards of Accounting for the Effects of Regulation

75. The Board concluded that, for general-purpose financial reporting, the principal economic effect of the regulatory process is to provide assurance of the existence of an asset or evidence of the diminution or elimination of the recoverability of an asset. The regulator's rate actions affect the regulated enterprise's probable future benefits or lack thereof. Thus, an enterprise should capitalize a cost if it is probable that future revenue approximately equal to the cost will result through the rate-making process.

76. A number of respondents to the Exposure Draft asked for clarification of the types of costs addressed by paragraph 9. Those respondents expressed the view that tangible assets should be capitalized based on the criteria used by unregulated companies; paragraph 9 should be limited to other assets. Paragraph 9 was intended to address only accounting for costs that would be charged to expense by an unregulated enterprise, and the Board modified the paragraph to so indicate.

77. The regulatory process, as usually practiced, has two aspects. First, either historical or projected test period costs are used to compute the revenues necessary to provide for similar costs during the period in which the rates will be in force. Second, test period costs are adjusted to provide for recovery or to prevent recovery of costs that are considered unusual or unpredictable. If unusual or unpredictable costs are not provided for in advance, they may be recovered after their incurrence through increased rates provided for that purpose. In some cases, rate orders do not specify whether costs are (a) included as normal test period costs, used to compute rates that are intended to provide for similar future costs, or (b) incurred costs designated for specific recovery. The Board concluded that costs should be capitalized only if the future revenue is expected to be provided to permit recovery of the previously incurred cost rather than merely to provide for recovery of higher levels of similar future costs.

78. If rates are designed to be adjusted automatically for changes in operating expenses (e.g., costs of purchased fuel), the regulator's intent could be either to permit recovery of the incurred cost or merely to provide for recovery of similar future costs. Normal operating expenses such as fuel costs usually are provided for in current rates. In that case, the presumption is that the rate increase is

intended to permit recovery of similar future costs. That presumption, which would preclude capitalizing the incurred cost, can be overcome only if it is clear that the regulator's intent is to provide recovery of the incurred cost.

79. Rate actions of a regulator can also impose a liability on a regulated enterprise in the following ways:

a. A regulator can order a regulated enterprise to refund previously collected revenues.
b. A regulator can provide rates intended to recover costs that are expected to be incurred in the future. Paragraphs 38 and 39 illustrate that possibility. The resulting increased charges to customers are liabilities and not revenues for the enterprise—the enterprise undertakes to provide the services for which the increased charges were collected, and it is obligated to return those increased charges if the future cost does not occur. The obligation will be fulfilled either by refunding the increased charges through future rate reductions or by paying the future costs with no corresponding effect on future rates. The resulting increases in charges to customers are unearned revenues until they are earned by their use for the intended purpose.
c. For rate-making purposes, a regulator can recognize a gain or other reduction of overall allowable costs over a period of time. Paragraphs 35-37 illustrate that possibility. By that action, the regulator obligates the enterprise to give the gain or other reduction of overall allowable costs to customers by reducing future rates. Accordingly, the amount of the gain or cost reduction is the appropriate measure of the obligation.

80. A number of respondents to the Exposure Draft asked the Board to clarify whether paragraph 11(b), discussed in paragraph 79(b) above, was intended to apply to costs such as nuclear plant decommissioning costs. Decommissioning costs are incurred costs in the current accounting framework. Those costs and the related liabilities are imposed by regulation or statute, similar to the liability to restore the land after strip mining, discussed in paragraph 142 of Concepts Statement 3. Accordingly, paragraph 11(b) does not address those costs.

Specific Standards Derived from the General Standards

81. The specific standards derived from the general standards deal with recognition, as assets and increases in net income, of allowable costs that are not usually accepted as incurred costs in the present accounting framework. For the reasons explained below, the Board concluded that recognition is appropriate for those

allowable costs. However, the Board does not intend them to be used as guidance for other applications of the general standards in paragraphs 9-12.

Allowance for Funds Used during Construction

82. Most respondents to the Discussion Memorandum supported the present practices of public utilities in accounting for the allowance for funds used during construction. They noted that the current income statement display reflects the regulatory process used in determining the amount to be capitalized and, thus, aids the user in understanding the regulatory environment. They cited the regulator's determination of the "cost" of equity capital as a basis for accepting that amount as a cost, and they noted that unregulated enterprises do not have a similar basis. They also noted that most utilities have an obligation to construct the facilities necessary to provide regulated services. Thus, there is no option of not obtaining the required funds or using accumulated funds to retire debt instead of investing in construction, and there is no available "avoidable cost" to use as the measure of the cost of the funds used.

83. Respondents who opposed present practices of accounting for the allowance for funds used during construction indicated that the cost of equity funds should be excluded from that allowance. Those respondents cited paragraph 49 of Statement 34, which states that ". . . recognition of the cost of equity capital does not conform to the present accounting framework." However, the arguments presented by those respondents supported capitalization of interest in accordance with Statement 34. Capitalization of interest in accordance with Statement 34 would be based on actual interest rates on outstanding debt and limited to the total amount of interest cost incurred during the period. In most cases, the effect on net income would be similar to capitalizing an allowance that included a cost of equity funds.

84. Some Board members believe that the allowances for funds used during construction, computed under current utility practices, are appropriate measures of the costs of financing construction and that the regulators' actions provide reasonable assurance of the existence of assets that should be measured by the amount on which rates will be based. Other Board members believe that those amounts are acceptable substitutes for the amount of interest that would be capitalized in accordance with Statement 34 and that, absent a change in regulatory practices, the cost of a change in those accounting practices would exceed any perceived benefits. The Board concluded that the amounts capitalized for rate-making purposes also should be capitalized for financial reporting purposes.

Intercompany Profit

85. Most respondents to the Discussion Memorandum indicated that enterprises should not eliminate intercompany profits on sales to regulated affiliates if it is probable that, through the rate-making process, future revenues in amounts approximately equal to the intercompany transfer price will be provided. That revenue would result from inclusion of the intercompany profits in the amount used by the regulator as allowable cost for purposes of depreciation and return on investment. They noted that an enterprise does not recognize profits on sales to unregulated affiliates because the profits are not validated by transactions with outside parties. According to those respondents, however, an enterprise should recognize profits on sales to a regulated affiliate to the extent that the profits are included in allowable costs in the rate-making process because the profits are validated by the rate actions of the regulator. The regulator's acceptance of the transfer price provides evidence of recoverability. For rate-making purposes, the intercompany profits will be included in the depreciation used as an allowable cost, and the undepreciated amount will be included in the investment on which a return is provided as an allowable cost. Those respondents noted that ARB 51 did not require elimination of intercompany profits on sales to regulated affiliates.

86. The Board concluded that intercompany profits on sales of assets to regulated affiliates should not be eliminated in consolidated financial statements if the transfer price is reasonable and it is probable that, through the rate-making process, future revenue approximately equal to the transfer price will result from the regulated affiliate's use of those assets. In view of existing regulatory practices, the Board further concluded that the transfer price usually should be considered reasonable if the price is accepted or not challenged by the regulator that governs the regulated affiliate. Otherwise, reasonableness should be considered in light of the circumstances. For example, reasonableness might be judged by the return on investment earned by the manufacturing or construction operations or by a comparison of the transfer prices with prices available from other sources.

Other Specific Standards

Accounting for Income Taxes

87. In the past, enterprises generally have not provided for deferred income taxes if regulated rates to customers were based on taxes currently payable. Most respondents to the Discussion Memorandum supported that practice based on

the rationale of Opinion 11. Opinion 11 indicates that deferred taxes are the result of comprehensive interperiod allocation of income taxes to achieve a proper "matching" of revenues and expenses. Those respondents indicated that a provision for deferred income taxes does not achieve a proper "matching" if rates to customers are based on taxes currently payable. In that situation, the income tax expense should be recorded in the future periods in which the taxes become payable and the regulator grants a resulting rate increase. Those respondents also noted that Concepts Statement 3 concluded that deferred taxes computed under the deferred method that is prescribed by Opinion 11 do not meet the definition of a liability. They expressed the view that the Board should not require utilities to commence to apply Opinion 11 when the Board may reconsider that Opinion in the near future.

88. Other respondents indicated that deferred income taxes should be recorded in all cases. However, if rates charged to customers are based on taxes currently payable, the recorded deferred taxes should also result in an asset—the future benefit that will result from treatment of the taxes as allowable costs for regulatory purposes in the period in which those taxes become payable.

89. Some Board members believe that the general standards (paragraphs 9-12) would require a regulated enterprise to record deferred income taxes. If it is probable that income taxes payable in future years because of net reversal of timing differences will be recovered through rates based on taxes payable at that time, the enterprise also would record an asset in an amount equal to the deferred income taxes. Offsetting those deferred income taxes against the related asset normally would not be appropriate because the asset will be realized through collections from customers and the deferred income taxes will not be paid to the customers. However, the Board concluded that any possible benefits of commencing to record deferred income taxes and an offsetting asset at this time probably would not exceed the cost. Accordingly, if rates are based on income taxes currently payable and it is probable that income taxes payable in future years because of net reversal of timing differences will be recovered through rates based on income taxes payable at that time, this Statement does not permit deferred income taxes to be computed or recorded in accordance with Opinion 11. However, it does require disclosure of the cumulative amount of timing differences for which deferred income taxes have not been provided. Approximate amounts of cumulative timing differences can be estimated without the complex calculations required by Opinion 11. That information, together with the disclosures required by Opinion 11, should help users in estimating the possible future income tax and rate effects of those timing differences. The Board will reconsider its conclusions on this matter in the course of

its project on accounting for income taxes, which was added to the agenda in January 1982.

90. A number of respondents to the Exposure Draft indicated that the disclosures required by this Statement would be misunderstood by users. In their view, users might attempt to estimate unrecorded deferred taxes as a charge to current income. The Board believes that users will understand the required disclosures if affected companies explain that deferred taxes are not provided because the method of rate making assures future recovery of future taxes. The Board believes that it is important to disclose those costs which have to be recovered from future customers through future rates.

Other Specific Accounting Matters

Recovery of Cost without Return on Investment

91. The Discussion Memorandum asked whether the recoverability criterion for capitalization of costs should be based on recovery of cost (which excludes a return on equity capital) or on recovery of cost of service (which includes a return on equity capital). In some cases, a regulator may provide rates intended to recover an incurred cost over an extended period without a return on the unrecovered cost during the recovery period. That issue was intended to elicit comments on whether the capitalized costs should be carried at the present value of the amount to be recovered in those cases. Most respondents interpreted that issue as asking whether any capitalization of costs was justified if the enterprise would recover its cost but would not realize a return on the unrecovered cost during the recovery period. Thus, many of the responses did not address the valuation of the resulting asset.

92. The Board concluded that capitalized costs not related to a tangible asset provide a measure of an intangible asset. Generally accepted accounting principles do not necessarily require the carrying amount of an intangible asset to be its discounted present value, nor do they necessarily require an enterprise to consider a return on investment when evaluating possible impairment of an intangible or depreciable asset. Accordingly, the Board concluded that it should not impose such a requirement on regulated enterprises.

93. Some respondents to the Exposure Draft indicated that disclosure should be required for capitalized costs that are recovered over an extended period without a return on investment during the recovery period. Those respondents indicated that regulated enterprises should provide the same types of disclosure for a given item as unregulated enterprises do.

94. The situations in question usually result from a problem encountered by a regulated enterprise—an abandoned plant, major storm damage, or a similar event. For troubled debt restructurings, which are similar to the events in question, Statement 15 requires creditors that agree to forego interest on outstanding loans to disclose the amounts of nonearning assets included in the balance sheet. The Board agreed that regulated enterprises with capitalized costs that are recovered over an extended period without a return on investment during the recovery period should provide similar disclosure and, thus, added the requirements of paragraph 20.

Accounting for Leases

95. Statement 13, as amended, specifies criteria for classification of leases and the method of accounting for each type of lease. For rate-making purposes, a regulator may include lease payments in allowable costs as rental expense even though the lease would be classified as a capital lease under the criteria of Statement 13. The Discussion Memorandum asked for views on the economic effects of that regulatory treatment and how to account for those effects.

96. A number of respondents indicated that the classification of a lease is not affected by the regulator's actions. In their view, rate actions of the regulator cannot eliminate obligations to third parties unless the obligations were created by the regulator. Also, they observed that, over the term of a capital lease, the aggregate lease payments are equal to aggregate amortization of the leased asset and aggregate interest on the lease obligation. Thus, the regulator, by including the lease payments in allowable costs, establishes the existence of probable future benefits approximately equal to the combined amount of the capitalized leased asset and interest on the lease obligation over the term of the lease. In their view, regulated enterprises should classify leases in accordance with Statement 13 as amended. The Board agrees with that view.

97. Other respondents indicated that the regulator's action establishes that there is no asset related to the lease. They indicated that an income statement display consisting of amortization and interest would mislead users if the regulatory process based rates on rental expense. In their view, regulated enterprises should classify leases in accordance with their classification for rate-making purposes. The Board concluded that such a view focuses on the mechanics of the rate-making process rather than on the economic effects of the process. This Statement requires that regulated enterprises account for the economic effects of the rate-making process; it does not attempt to portray the mechanics of that process in financial statements.

98. The Board concluded that the nature of the expense elements for a capitalized lease (amortization and interest) are not changed by the regulator's action; however, the timing of expense recognition related to the lease should be modified to conform with the rate treatment. Thus, amortization of the leased asset would be modified so that the total interest and amortization recognized during a period would equal the rental expense included in allowable cost for rate-making purposes during that period. Although this Statement requires the expense elements of a capitalized lease to consist of amortization and interest regardless of the regulatory treatment, the Board notes that generally accepted accounting principles do not require interest expense or amortization expense to be shown as such in an income statement.

Revenue Collected Subject to Refund

99. In some jurisdictions, regulated enterprises are permitted to bill and collect requested rate increases before the regulator has ruled on the request.

100. Some respondents opposed reducing net income by the amount expected to be disallowed prior to the final rate action. In their view, if the enterprise requests the increase, the increase must be supported by the evidence. In that case, management could not take the position that some portion of the request is likely to be disallowed without providing the regulator a possible basis for disallowance. Other respondents supported application of the loss contingency provisions of Statement 5 to those rate increases. They indicated that utilities usually can predict the outcome of a rate hearing by considering recent actions of the regulator. They also indicated that it is misleading to include in net income revenue that is expected to be refunded.

101. The Board concluded that regulation does not have a unique economic effect that requires special accounting for anticipated refunds of revenue. Rather, regulation results in a contingency that should be accounted for in accordance with Statement 5, the same as other contingencies.

Refunds to Customers

102. The Discussion Memorandum asked whether the effects of rate-making transactions applicable to prior periods should be charged to income in the year in which they become estimable, as required by Statement 16 for other adjustments applicable to prior periods, or accounted for as prior period adjustments.

103. Some respondents opposed applying Statement 16 to utility refunds. Most of those respondents indicated that Statement 16 is not presently applied to significant refunds that could not be estimated in advance. They indicated that including refunds in a year other than that in which the amount refunded was included in income misstates both years, because the financial statements would not accurately reflect permitted rates of return, trends, etc. They also noted that current earnings could be reduced to a level at which existing covenants or state regulations governing investments by certain institutional investors could preclude necessary financing.

104. Respondents who favored applying Statement 16 to refunds indicated that the regulatory process does not introduce unique economic effects that warrant different accounting. In their view, the arguments supporting prior period adjustments for regulated enterprises are the same arguments that were made by unregulated enterprises before Statement 16 was issued.

105. The Board concluded that regulation does not have a unique economic effect that requires special accounting for refunds. Rather, regulation results in resolution of a previous contingency that should be accounted for the same as resolution of contingencies by unregulated enterprises. Reconsideration of Statement 16 was not within the scope of this Statement.

106. The Exposure Draft would have required disclosure of the pro forma effect of refunds on net income of each period presented, computed as though the refunds were retroactively recorded in the prior periods in which the revenue was recognized. A number of respondents objected to that requirement on the basis that the proposed disclosure indicates a need for restatement.

107. The Board believes that users are interested in two aspects of refunds. They are concerned about the impact of the refund in the year of the refund, and they also are concerned about the effect of the refund on trends of permitted earnings. Neither prior period adjustment nor current income charge provides all of the needed information. The Board concluded that users' needs could be satisfied by disclosure of (a) the effect of the refund on net income of the current year and (b) the years in which the refunded revenue was recognized.

108. In making its determination, the Board considered whether the amount disclosed should be net of related taxes. APB Opinion No. 30, *Reporting the Results of Operations*, prohibits net-of-tax disclosure of unusual or infrequently occurring items that are not extraordinary items. The Board concluded that users would not be confused by a net-of-tax disclosure of the effect of refunds.

Users understand that refunds occur from time to time in public utilities—and they are concerned with the net effect rather than the gross amounts refunded. Accordingly, the Board concluded that refunds should be disclosed net of their related tax effects. Based on comments received and its deliberations, the Board decided that a narrow amendment of Opinion 30 for utility refunds was justified. However, the Board's action is limited to utility refunds, and it is not intended to otherwise modify or question the requirements of Opinion 30.

Rate Making Based on a Fair Value Rate Base

109. Some state regulatory commissions use a "fair value rate base" for determining allowable return *on* invested capital. Normally, those commissions do not permit recovery *of* the fair value of the enterprise's assets by including depreciation of the fair value in allowable cost; rather, depreciation is based on historical cost. The Discussion Memorandum asked whether that procedure provides a basis for accounting for utility plant at its "fair value" in financial statements prepared in accordance with generally accepted accounting principles.

110. Virtually all respondents opposed the use of fair value in financial statements. Respondents indicated that fair value would present the enterprise's assets at an amount in excess of the recoverable amount of those assets. The use of depreciation based on historical cost for rate-making purposes limits recovery to that historical cost. Respondents also noted that the realized rate of return based on historical cost is not proportionately greater in jurisdictions that base rates on a fair value rate base than in other jurisdictions; thus, they question whether there is substance to that special treatment.

111. The Board concluded that if the return on investment permitted in a jurisdiction is based on fair value but recovery of cost is based on historical cost, the fair value of the assets should not be recognized in general-purpose financial statements. The Board did not need to address the accounting implications if a commission were to use fair value to determine both recovery of cost and return on capital invested because that practice currently is not used by regulators.

Acquisition Adjustments

112. A number of respondents to the Exposure Draft asked the Board to address accounting for *acquisition adjustments*. Those adjustments are the differences between the amounts paid for an acquired utility and the acquired utility's book value of its assets and liabilities. Those respondents indicated that utilities do not have goodwill because a utility cannot realize excess profits. Thus, they considered the example of goodwill in Appendix B unnecessary.

113. Opinion 16 describes how the amount paid in a business combination is allocated to the assets obtained and the liabilities assumed. Acquisition adjustments are values in excess of book value of identifiable assets obtained, valuation adjustments applicable to liabilities assumed, or goodwill or a combination of those items. Opinion 16 does not allow another possibility. The example of accounting for intangibles in Appendix B of this Statement indicates the appropriate accounting for goodwill. Additional guidance should not be needed about accounting for any portions of acquisition adjustments that represent amounts allocable to identifiable assets or liabilities such as property and equipment or intangibles amortizable over specific benefit periods.

Evidence

114. Several issues in the Discussion Memorandum identified types of evidence that might be available before a rate order is received and asked whether each would provide sufficient assurance to warrant capitalizing costs. A number of respondents indicated that judgment is needed to determine the adequacy of available evidence. In their view, all of the available evidence has to be evaluated, and the resulting decision cannot be standardized. Other respondents indicated that specific items did or did not provide adequate evidence; however, their responses appeared to differ based on the regulator involved and on their assumptions about other related circumstances.

115. The Board concluded that it should not attempt to categorize types of evidence and the reliance that should be based on each. Rather, this Statement indicates the degree of assurance required, and judgment must be exercised to evaluate whether that degree of assurance is present in various circumstances. In general, the Board concluded that costs should be capitalized only if (a) it is probable that future revenue in an amount at least equal to the cost will result from inclusion of that cost in allowable costs for rate-making purposes and (b) the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs.

Effective Date and Transition

116. This Statement prescribes the circumstances in which regulation has an economic effect that affects the application of generally accepted accounting principles, and it outlines the accounting that should result. Accounting changes that result from initial application of this Statement will involve accounting for the effects of regulation that have not been accounted for in the past and revising previous accounting that was not in accordance with the provisions of this State-

ment. Those changes are not expected to cause changes in the methods or in the results of regulation.

117. The Exposure Draft proposed that the Statement be effective for fiscal years beginning after December 15, 1982. A number of respondents suggested that the effective date be delayed to provide time for companies to determine how the Statement would affect them. The Board agreed that the proposed effective date could cause some hardship. Accordingly, this Statement is effective for fiscal years beginning after December 15, 1983.

118. Implementation of this Statement is not expected to have major effects on the accounting of most regulated enterprises. This Statement is considerably more specific than the Addendum; however, its thrust is similar. Accordingly, the Board concluded that comparability would be best achieved if this Statement were applied retroactively to the extent practicable. The Board did not extend that general approach to application of Statement 16, because Statement 16 does not permit retroactive application.

119. A number of respondents to the Exposure Draft urged the Board to permit affected companies to defer retroactive application of Statement 13. They noted that Statement 13 did not require retroactive application until the fourth year after its effective date, and they urged the Board to afford regulated enterprises the same consideration.

120. Retroactive application of Statement 13 was delayed to permit affected enterprises time to work out any resulting problems, such as indenture covenant restrictions. The Board agreed that regulated enterprises might have the same problems; thus, retroactive application of Statement 13 is not required until the first fiscal year beginning after December 15, 1986. The Board also decided that, pending retroactive application of Statement 13, regulated enterprises should furnish the same disclosure as was required of unregulated enterprises under Statement 13. Retroactive application of Statement 13 should not affect a regulated enterprise's net income or shareholders' equity. Thus, only the effect of retroactive application on the balance sheet is required by this Statement.

Appendix D

BACKGROUND INFORMATION

121. The Addendum to APB Opinion 2, issued in December 1962, outlined the general approach that has been used for accounting by regulated enterprises. On November 18, 1977, in response to requests from the Acting Chief Accountant of the Securities and Exchange Commission and from the AICPA's Accounting Standards Division, the FASB initiated a project to consider the effects of rate regulation on accounting for regulated enterprises.

122. An FASB Discussion Memorandum on rate regulation was issued on December 31, 1979. The Board received 197 letters of comment in response to the Discussion Memorandum. In May 1980, the Board conducted a public hearing on the issues in the Discussion Memorandum. Twenty-four individuals and organizations presented their views at the two-day hearing.

123. An Exposure Draft of a proposed Statement was issued on March 4, 1982. The Board received 172 letters of comment in response to that Exposure Draft.

124. An FASB task force provided counsel in preparing the Discussion Memorandum and in preparing material for Board consideration during the course of Board deliberations concerning this Statement. The task force included persons from the investment community, industry, public accounting, academe, and regulatory authorities.

Summary

This Statement provides guidance in preparing general purpose financial statements for most public utilities. Certain other companies with regulated operations that meet specified criteria are also covered.

In general, the type of regulation covered by this Statement permits rates (prices) to be set at levels intended to recover the estimated costs of providing regulated services or products, including the cost of capital (interest costs and a provision for earnings on shareholders' investments).

For a number of reasons, revenues intended to cover some costs are provided either before or after the costs are incurred. If regulation provides assurance that incurred costs will be recovered in the future, this Statement requires companies to capitalize those costs. If current recovery is provided for costs that are expected to be incurred in the future, this Statement requires companies to recognize those current receipts as liabilities.

This Statement also requires recognition, as costs of assets and increases in net income, of two types of allowable costs that include amounts not usually accepted as costs in the present accounting framework for nonregulated enterprises, as follows:

- If rates are based on allowable costs that include an allowance for the cost of funds used during construction (consisting of an equity component and a debt component), the company should capitalize and increase net income by the amount used for rate-making purposes—instead of capitalizing interest in accordance with FASB Statement No. 34, *Capitalization of Interest Cost*.

- If rates are based on allowable costs that include reasonable intercompany profits, the company should not eliminate those intercompany profits in its financial statements.

Pending completion of the Board's current project on accounting for income taxes, this Statement continues current practices of most utilities with respect to accounting for deferred income taxes. Accordingly, if the current income tax benefits (or costs) of timing differences are passed through to customers in current prices and it is probable that any resulting income taxes payable in future years will be recovered through future rates, the company should not record deferred income taxes resulting from those timing differences. However, the company should disclose the cumulative net amounts of timing differences for which deferred taxes have not been recorded.

This Statement may require that a cost be accounted for in a different manner from that required by another authoritative pronouncement. In that case, this

Statement is to be followed because it reflects the economic effects of the rate-making process—effects not considered in other authoritative pronouncements. All other provisions of that other authoritative pronouncement apply to the regulated enterprise.

This Statement clarifies the application of certain other authoritative pronouncements, which is expected to result in at least two changes in general-purpose financial statements of certain public utilities. First, expected refunds of revenue collected in prior years will be charged to income in the period in which those refunds are first recognized. Second, leases will be classified (as capital or operating leases) in accordance with FASB Statement No. 13, *Accounting for Leases*, as amended. Because Statement 13 has not been applied by some utilities in the past, this Statement provides a four-year transition period before retroactive application of lease capitalization is required. Statement 13 provided a similar transition period for unregulated enterprises.