COMPANY	CASE NO.
Kansas City Power and Light Company	ER-82-66
Kansas City Power and Light Company	HR-82-67
Southwestern Bell Telephone Company	TR-82-199
Missouri Public Service Company	ER-83-40
Kansas City Power and Light Company	ER-83-49
Southwestern Bell Telephone Company	TR-83-253
Kansas City Power and Light Company	EO-84-4
Kansas City Power and Light Company	ER-85-128 & EO-85-185
KPL Gas Service Company	GR-86-76
Kansas City Power and Light Company	HO-86-139
Southwestern Bell Telephone Company	TC-89-14
Western Resources	GR-90-40 & GR-91-149
Missouri-American Water Company	WR-91-211
UtiliCorp United Inc. / Missouri Public Service	EO-91-358 & EO-91-360
Generic: Expanded Calling Scopes	TO-92-306
Generic: Energy Policy Act of 1992	EO-93-218
Western Resources, Inc./Southern Union Company	GM-94-40
St. Louis County Water Company	WR-95-145
Union Electric Company	EM-96-149
St. Louis County Water Company	WR-96-263
Missouri Gas Energy	GR-96-285
The Empire District Electric Company	ER-97-82
UtiliCorp United, Inc./Missouri Public Service	ER-97-394
Western Resources, Inc./Kansas City Power & Light Company	EM-97-515
United Water Missouri, Inc.	WA-98-187
Missouri-American Water Company	WM-2000-222
UtiliCorp United Inc. / St. Joseph Light & Power Company	EM-2000-292

MARK L. OLIGSCHLAEGER

COMPANY	CASE NO.
UtiliCorp United Inc. / The Empire District Electric Company	EM-2000-369
Green Hills Telephone Corporation	TT-2001-115
IAMO Telephone Company	TT-2001-116
Ozark Telephone Company	TT-2001-117
Peace Valley Telephone Company, Inc.	TT-2001-118
Holway Telephone Company	TT-2001-119
KLM Telephone Company	TT-2001-120
Missouri Gas Energy	GR-2001-292
The Empire District Electric Company	ER-2001-299
Oregon Farmers Mutual Telephone Company	TT-2001-328
Ozark Telephone Company	TC-2001-402
Gateway Pipeline Company, Inc.	GM-2001-585

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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

Statement of Financial Accounting Standards No. 71

Accounting for the Effects of Certain Types of Regulation

December 1982

CONTENTS

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.

Schedule 2-3

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

[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.

[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.

Schedule 2-6

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.

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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.

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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.

Schedule 2-12

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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.

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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.

WE USUALLY IDENTIFY GOODWILL AS AN ACQUISITION ADJUSTMENT

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 may 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.

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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

[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.

Append

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Appendix C

BASIS FOR CONCLUSIONS

CONTENTS

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 exclude 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).

[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

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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

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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.

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

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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.

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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.

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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.

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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.

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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.

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