

**GENERALLY ACCEPTED ACCOUNTING PRINCIPLES
FOR REGULATED UTILITIES: EVOLUTION AND IMPACTS**

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EXECUTIVE SUMMARY

The accounting for regulated utilities is at a dangerous crossroads. Primarily because of changes in the regulatory environment, the accounting standards utilities must follow in their published financial reports are changing. Those accounting standards are referred to as "generally accepted accounting principles" or GAAP. Many fear that changes in GAAP will limit the options of regulators.

Though accounting for regulated utilities is intended to follow ratemaking rather than vice versa, GAAP has the ability to intrude into the ratemaking process. Though regulators have the authority to define accounting for ratemaking purposes, arguments by utilities that regulators must adopt accounting treatments for ratemaking that parallel the required treatment for financial reporting are often persuasive to regulators. GAAP has considerable institutional legitimacy, and it identifies the professional standards of accounting. If it is not adopted for ratemaking, utilities will incur some additional record-keeping costs. But, most importantly, GAAP is the accepted medium for the communication of financial information to the public.

Those who set accounting standards have recognized since 1958 that regulators have an economic impact on jurisdictional firms. The most significant impact is the ability of the regulator to create assets for a utility by allowing the utility to include current costs in future rates. That mechanism, the creation of regulatory assets, has allowed regulators to balance the financial needs of the utility with the need to prevent sharp increases in rates.

In 1982, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation," which identified the circumstances under which the recording of regulatory assets was appropriate. Even when it was promulgated, FAS No. 71 was limited to specific conditions, which included the reasonable probability that costs could be collected from customers. Subsequently, the FASB issued other Statements that provided additional guidance to utilities and regulators regarding the establishment of regulatory assets and other utility-specific issues.

Today, the Securities and Exchange Commission (SEC) and the FASB have begun to question the continued applicability of FAS No. 71. Specifically, they are concerned with the probability of eventual cost recovery for deferred costs. In 1990, the FASB issued FAS No. 106, "Employer's Accounting for Postretirement Benefits Other Than Pensions," which required all employers--regulated and unregulated--to record the costs of postretirement benefits (primarily the costs of health care for retirees) as those obligations were incurred during the service life of the employee. Prior to FAS No. 106, those costs had been recorded as they were paid out after the employee's retirement. When the FASB, through its Emerging Issues Task Force (EITF) considered the application of FAS No. 106 to regulated firms, it applied stringent rules to the creation of regulatory assets--rules that were more rigorous than those required by FAS No. 71. The result is that utility and regulator judgement regarding the probability of collection of costs through rates has been circumscribed by changes in GAAP.

Though GAAP is often referred to as a fixed set of mandates, its definition is far different. GAAP is evolutionary and includes the conventions, rules, and formal statements that define accounting practice at any point in time. The FASB has detailed a hierarchy of accounting authority for the definition of GAAP. At the top, are the formal pronouncements of the FASB; at the bottom is the prevalent practice in particular industries and accounting literature. Because GAAP at the bottom of the hierarchy is defined by prevalent practice, it can be argued that regulators help establish GAAP, although GAAP established at higher levels of the hierarchy clearly takes precedence for public reporting.

Shortly after the Great Crash of 1929, the SEC was given the authority to establish accounting standards. But the SEC almost immediately delegated its authority to private organizations. As a result, three successive organizations have been vested with the authority to establish accounting standards. The first two were committees of the American Institute of Certified Public Accountants (AICPA). The current standards setting organizations is the FASB, which is an independent private organization.

The FASB was created in an attempt to broaden participation in accounting standards setting. For its most formal statements, it employs notice-and-comment

rulemaking. Its pronouncements are pragmatic and political in that they attempt to identify workable, consensus positions.

The establishment of accounting standards by regulatory agencies--state and federal--is subordinated to regulatory considerations. The federal regulatory agencies having the greatest impact on the establishment of regulatory accounting policy--the Federal Energy Regulatory Commission and the Federal Communications Commission--and the state public service commissions apply a variety of organizational approaches to the establishment of accounting policy. All regulatory commissions face the difficult issue of establishing accounting policy for jurisdictional utilities that balances the needs of ratepayers with the requirements that utilities comply with GAAP for public reporting. Because the values which necessarily surround public utility regulation are different from the values which shape the establishment of accounting policy by the FASB and the SEC, there will always be tension. At best, temporary equilibrium solutions can be developed, such as the solution embedded in FAS No. 71, which minimize the conflict between regulators and the financial and accounting communities.

In these changing times, prior to allowing utilities to create regulatory assets, regulators should exercise care to insure that the probability of eventual recovery of deferred costs exists. Those who set accounting policy should also take care to insure that "broad brush" solutions do not eliminate tools that are still appropriate for some utility markets.

Regulators and those who establish accounting policy face two challenges. The first is to identify the utility markets within which the existing equilibrium solution (largely defined by FAS No. 71) still applies. The introduction of competition into utility markets has been far from pervasive, and traditional ratemaking still applies in specific circumstances. The second challenge is to develop new accounting tools that are workable in more competitive markets.

Meeting these challenges will require a close working relationship between state and federal regulators, the SEC, the FASB, and the AICPA. That relationship must transcend specific accounting issues and be adequately institutionalized to survive the certain turnover of staff and commissioners. The NARUC Staff Subcommittee on

Accounts has made a strong start toward establishing the necessary working relationship among the affected players.

Meeting these challenges will also require the creative application of the talents of all the parties and a mutual respect for the disparate responsibilities of the affected groups. Regulatory accounting has survived challenges before; with hard work, goodwill, and the mutual desire to serve the public, it can survive this one as well.

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FOREWORD

Recently, the accounting for regulated utilities has become the subject of widespread debate. Two issues that have brought accounting issues to the attention of commissions are state commission implementation of FAS No. 106 dealing with postretirement benefits and increasing concern by the Financial Accounting Standards Board and the Securities and Exchange Commission over the viability of the regulatory compact, i.e., costs will be recovered when prudently incurred.

This report describes the current debate over the ability of regulators to assure the reasonable probability of collection of deferred costs and provides background materials. It describes the development of generally accepted accounting principles (GAAP) and their significant impact on public utility regulation. The report lays a base for continued discussion of the present and future economic effects of regulation and the means by which those effects are to be communicated to the public in utility financial statements.

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CHAPTER 1

THE GAAP DEBATE

Accounting for regulated industries is at a dangerous crossroads. Caught between the forces of increasing competition that mean departure from rate-base, rate-of-return regulation and the increasing concerns of the financial community over the ability of regulators to assure future recovery of postponed costs, regulators are at risk of losing the accounting tools that allow them to balance the needs of the disparate members of the regulatory community. The accounting flexibility that sometimes has allowed regulators to balance the needs of ratepayers and utilities may be impaired in the debate over seemingly innocuous accounting standards.

Regulatory accounting may not always be given the respect it deserves. Regarded by many as little more than a necessary evil and the exclusive preserve of technical experts at state commissions, utilities, and accounting firms, accounting standards and regulations infrequently take center stage in regulatory proceedings. When they do, the issues are often expected to be arcane and technical and not central to public policy interests.

Admittedly, accounting, which is defined as the "process of recording, measuring, interpreting, and communicating financial data,"¹ is not likely to engender keen interest or excitement in even its most riotous moments. But those who ignore or deny the importance of accounting to the regulatory process do so at their peril. Today, more than ever, accounting issues are "big-ticket" items, changes in accounting rules seem to have the potential to limit regulatory options, and the fragile balance between regulators

¹ Joel G. Siegel and Jae K. Shim, *Dictionary of Accounting Terms* (Hauppauge, NY: Barron's Educational Series, Inc., 1987), 6. Throughout this report, we will address only financial accounting, which, according to Siegel and Shim, "relates to the preparation of financial statements for external users..." (Emphasis added.) Managerial accounting is the other side of accounting; it involves the "communication of financial information that is used by management to plan, evaluate, and control within an organization." (Emphasis added.)

and those who set accounting standards, an equilibrium that has served both well in the past, is in danger of being shattered.

At the heart of that fragile equilibrium are the accounting standards, usually referred to as Generally Accepted Accounting Principles or GAAP. GAAP, which to most members of the regulatory community appears to be wrapped in impenetrable layers of complexity, defines the rules for the presentation of financial information and the preparation of financial statements. GAAP allows for comparability between the financial statements of firms, makes changes in the financial condition of firms to be apparent, and prevents many varieties of obfuscation of financial statements. GAAP provides the medium by which regulated utilities communicate with capital markets. In Chapter 2 of this report, we will further describe GAAP and identify its multiple sources and complexity.

Some might argue that GAAP and regulation are worlds apart. Regulators have the authority to establish uniform systems of accounts for the industries they regulate. They can prescribe the format and content of reports provided to them. And they are sovereign, within the constraints of the law, in their ability to determine the costs to be included in public utility rates.

When the utilities report their financial condition to the public, they are bound, just as tightly, by the requirements of the Securities and Exchange Commission (SEC), which has the authority to set accounting standards and demand compliance with them. The SEC elected not to set its own accounting standards but to allow GAAP as established by the professional accounting community to govern reporting. Though the SEC does not itself set accounting standards, it still requires compliance with those set by its designee and is an important player in the establishment of accounting standards.

Companies, both regulated and unregulated, must prepare their external financial statements in accordance with GAAP to obtain an independent auditor's certificate, to conform to SEC requirements, to have their securities listed on a stock exchange, to issue new bonds or stock, and to meet a number of other requirements. Though GAAP does not carry the force of law, compliance with GAAP is a virtual requirement of doing business for both SEC registered firms and any other firms that need to communicate

their financial position to the public. Willful intent to deceive through the preparation of misleading financial statements may subject the utility and its independent accountants to lawsuits, with the potential for civil or criminal penalties.

Given the dual standards for regulated firms, which are the commission requirements for rate setting and GAAP requirements for external reporting, why is there a problem? Give the regulators the information they require, some might argue, give the financial markets the information they require, and never the twain shall meet.

Although that reasoning might seem persuasive, in practice GAAP and regulation are inextricably linked. Regulation impacts GAAP and GAAP, in turn, impacts regulation. As a result, the establishment and application of GAAP, that set of seemingly innocuous standards, conventions, and rules, becomes the battleground for competing interests with millions of dollars at stake. As long as regulators are concerned with the financial health of the utilities they regulate, they must be concerned with the perceptions the financial markets have of those utilities. For communication with financial markets, GAAP, for better or worse, is regarded as the only game in town.

The objective of this report is not to provide detailed analysis of any individual GAAP standard. Nor is this report intended to make accountants of those uninterested in accounting issues. In general, this report has three objectives. It (1) examines the policy implications of developments in accounting for regulated enterprises, (2) provides background materials that define GAAP and detail its development, and (3) lays a base for the search for solutions to the current dilemma in regulatory accounting, a dilemma which threatens to destroy the equilibrium between regulators and accountants that has existed since at least 1982. In specific, this report identifies the pressures placed on regulators to adopt GAAP standards and the impact of regulation on GAAP. It defines GAAP, details the difference between GAAP for regulated and unregulated enterprises, and looks at how accounting policy is set by federal and state regulatory commissions. It details the formal process for the establishment of GAAP and identifies points of access for interested parties. It evaluates trends in the regulatory environment and the practice of accounting that are likely to limit regulatory options unless a new dialogue is established between regulators and those who create and interpret GAAP.

The Impact of Regulation on GAAP

The Financial Accounting Standards Board (FASB), which is the current SEC-appointed source of formal GAAP, issues its pronouncements in an ongoing series of Statements of Financial Accounting Standards, most of which apply equally to both regulated and unregulated businesses. However, in recognition of the peculiar economic impact of the ratemaking process, since 1982 the FASB has issued four Statements reflecting the application of GAAP to regulated enterprises alone. These four Statements, which are discussed in more detail in Chapter 4, are:

1. FAS Statement No. 71,² "Accounting for the Effects of Certain Types of Regulation," issued in 1982, which confirms the economic impacts of regulation and requires the creation of regulatory assets under certain, limited circumstances.
2. FAS No. 90, "Regulated Enterprises - Accounting for Abandonments and Disallowances of Plant Costs," issued in 1986, which amends FAS No. 71 and addresses the issue of plant abandonments and disallowances, which became a serious issue at the time.
3. FAS No. 92, "Regulated Enterprises - Accounting for Phase-In Plans," issued in 1987, which further amends FAS No. 71 and sets conditions under which a portion of the costs of newly completed plants may be deferred for future recovery.
4. FAS No. 101, "Regulated Enterprises - Accounting for the Discontinuation of Application of FASB Statement 71," which outlines conditions under which the use of FAS No. 71 no longer may be appropriate.

² For the remainder of this report, Statements of Financial Accounting Standards will be referred to as FAS followed by the appropriate number of the standard. For example, Statement of Financial Accounting Standards No. 71 will be referred to as FAS No. 71. Exceptions will be made when quoting other authors, who may have used other citation methods such as SFAS No. 71, and in footnotes where the appropriate citation method will be used.

The economic circumstances of regulated firms are, of course, different than those of unregulated enterprises. Among other factors, regulated utilities may be natural monopolies, operate in imperfect markets, are subject to economies of scale, have large fixed and nonliquid investment, and produce goods for which there is relative inelasticity of demand.³ But in addition to these characteristics, which are attributable to the size of public utilities, their product, and their market position, other characteristics of public utilities are created *directly by the impact of regulation*. Two of those characteristics caused by regulation--the creation of assets by regulators and the close relationship between costs and prices--have been incorporated into GAAP.

In a unregulated firm, when a cost is incurred and payment is made, the accounting transaction records the initial expense and the subsequent outflow of cash from the firm. The assets of the firm are reduced through that transaction. For example, if a storm were to damage the firm's place of business, the owner would have to pay for repairs. Overall, the owner is worse off than before the storm. Or if an unregulated manufacturer were to abandon a partially completed plant, the abandonment loss would be reflected as a reduction in current earnings to be assumed by shareholders.

Regulated firms are different. The regulator may choose to allow the costs of storm clean-up to be included in future rates by amortizing asset costs over a future period. By doing so, the regulator has a direct economic impact on the firm. The regulator has created an asset--the future revenue stream related to the recovery of the clean-up costs. Similarly, if a regulator were to choose to allow some portion of an abandoned plant to be included in the rate base, those costs would be converted to future revenues and shareholders would not assume the full costs. Regulators capitalize expenses that, in unregulated firms, would be expensed in the current account period. Those capitalized costs are then amortized as they are included in rates. The creation of

³ For an excellent description of the economic factors impacting regulated public utilities see, Charles F. Phillips, Jr., *The Regulation of Public Utilities* (Arlington, VA: Public Utilities Reports, Inc., 1993), 49-81.

a regulatory asset that is recovered over a period of time through rates, therefore, represents a compromise between immediately expensing a cost (and an immediate loss to shareholders) and an immediate charge to ratepayers (and an immediate spike in rates). Table 1-1 illustrates the differences between these accounting transactions for unregulated and regulated firms.

TABLE 1-1. Accounting Treatment of Storm Damage--Regulated/Unregulated Firms

Type Firm	Year	Debit	Credit	Result
Unregulated Firms	Year 1	Charge full cost of damage to expense	Reduce cash to record cash outlay	Results in a one-time write-off of the whole amount: profits are reduced.
Regulated Firms (with approval of regulator)	Year 1	Creation of regulatory asset	Reduce cash to record cash outlay	Results in gradual charge to expense as the asset is expensed over time
	----- Subsequent Years	----- Recognition of partial expense	----- Partial reduction in amount of regulatory asset	Loss is offset by revenue recovered through rates: profits are not reduced.

As Statement of Financial Accounting Standards No. 71, issued by the Financial Accounting Standards Board (FASB), states:

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 costs in allowable costs for ratemaking purposes.⁴

⁴ Financial Accounting Standards Board, "Statement of Financial Accounting Standards No. 71: Accounting for the Effects of Certain Types of Regulation," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume I* (Burr Ridge, IL: Irwin, 1993), par. 58.

In addition to its ability to create assets, the regulatory process itself creates a second distinguishing economic characteristic of regulated firms. For unregulated firms, costs are just one of the factors used to determine prices. Non-regulated firms are often limited by competitors and the price preferences of consumers when they set prices. In rare cases, if no competitors exist and consumers have no substitute goods available, unregulated firms can set their prices at any level irrespective of their costs. In either case, there is no direct link between costs and prices.

For utilities in traditional, noncompetitive utility markets regulated under rate-base, rate-of-return regulation, however, there is a direct relationship between costs prudently incurred and revenues. Commission rate orders have never guaranteed that even prudently incurred costs will be recovered under rate-base, rate-of-return regulation due to such factors as unanticipated expenses and imprecise estimates of future revenues and expenses. But rate orders create a significant probability that deferred costs will be converted to revenues. In fact, the relationship between costs and revenues is firm enough that regulated utilities are sometimes thought of as subject to a cost-reimbursement contract. Indeed, the FASB says, "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."⁵

Some correctly argue that the cost-reimbursement analogy is overstated. Utility rates under traditional rate-of-return regulation are based on the utility's test-year costs. Those rates are, however, prospective and reflect the opportunity provided to the utility to earn a reasonable rate of return. The costs from the test year that drove the rates are simply used as a predictor of future costs.⁶ Indeed, prohibitions on retroactive ratemaking can make cost reimbursement illegal. Even though the FASB's cost-

⁵ Ibid., par. 3.

⁶ Richard A. Latourette and Donald Coates, "Delaware PSC Staff Deferred Expense Research Project Results" (August 1993), 1.

reimbursement analogy may be imprecise, it is undeniable that a close relationship exists for regulated utilities between costs and revenues.

That close relationship between costs and revenues and the ability to create assets are the cornerstones of the regulatory compact as viewed by regulators, utilities, and investors. That implicit contract allows regulated utilities to earn a fair rate of return on invested capital as a result of having provided service to all customers in the service territory.⁷ In the past, the regulatory compact has functioned, in part, because ratemaking mechanisms have allowed utilities to include prudently incurred costs in rates. The regulatory compact has been strengthened because the recording of regulatory assets within the financial statements of utilities allowed utilities to communicate the probability of future collection of costs to investors. Over the years, the FASB has recognized the validity of the regulatory compact and has, therefore, created mechanisms within GAAP to allow for certain actions of regulators to be publicly reported in the financial statements of regulated firms. The result is that GAAP for regulated firms is different than it is for non-regulated firms in certain circumstances.

The establishment by the FASB and its predecessors of special provisions of GAAP for regulated firms, however, has not been accomplished without considerable controversy. Later chapters of this report will address in detail the specific FASB statements that define GAAP for regulated utilities. We will also see later that as regulated utilities begin to operate in more competitive markets, the FASB and the SEC have begun to seriously question both the ability of regulators to create assets that represent probable future economic benefits and the direct link between costs and prices. At the core of these questions is the growing suspicion that the regulatory compact is no longer operable.

⁷ Irwin M. Stelzer, "The Utilities of the 1990s," *The Wall Street Journal*, 7 January, 1987, 20, as cited in Phillips, *The Regulation of Public Utilities*, 21.

The Impact of GAAP on Regulation

The impact of GAAP on regulation is as significant to regulators as the impact of regulation on GAAP. In the case of the impact of regulation on GAAP, only a few accounting standards are involved. But in the case of GAAP's impact on regulation, every general accounting standard also applies to regulated firms and has the potential for creating regulatory dilemmas.⁸ An example of the impact of a general standard on regulated utilities is the effect of FAS No. 106, which, in general, requires accrual accounting for the costs of postretirement benefits other than pensions. That standard applies to all firms, regulated and non-regulated. Though 475 comment letters were received in response to the FASB's exposure draft and sixty-two groups and individuals provided testimony in FASB public hearings,⁹ implementation by unregulated firms was accomplished with little controversy. Such is not the case for utilities under state regulatory commission jurisdiction, and considerable controversy has developed around implementation. The controversy over the application of FAS No. 106 by regulated utilities is described in more detail in Chapter 6.

GAAP has the ability to influence the ratemaking process--to push regulators toward ratemaking options that converge with GAAP requirements for financial reporting. Indeed, it is difficult to separate accounting from ratemaking. Utilities sometimes cite the need to conform to GAAP as justification for their proposed accounting. Observers of the regulatory process have stated that, in most instances in which a utility used GAAP as an argument for regulatory action, regulators were persuaded by those arguments. Those observers also maintain that GAAP-based arguments are carrying the day even more often than before. Though as we will see in

⁸ Some FASB statements are directed to other specific industries and are not, therefore, applicable to regulated enterprises.

⁹ Financial Accounting Standards Board, "Statement of Financial Accounting Standards No. 106: Employer's Accounting for Postretirement Benefits Other Than Pensions," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume I* (Burr Ridge, IL: Irwin, 1993), par. 517.

Chapter 6, adoption of GAAP for ratemaking purposes is not unanimous. There are a number of reasons that GAAP has such a compelling hold on utilities and regulators.

Though it is unfair to assume that utilities are driven only by financial self-interest, there are clearly circumstances in which the GAAP solution is the solution that represents the financial best interests of the utility. For example, when Ameritech filed a Petition for Ratemaking with the Federal Communications Commission (FCC) for modifying the FCC's rule requiring that the compound prime rate of interest be used for accruing AFUDC, Ameritech cited the inconsistency of the FCC's rule with GAAP as one of the arguments justifying its petition.¹⁰ Utilities, it is also argued, support ratemaking which conforms to GAAP because they regard commission orders based on GAAP standards as a form of insurance against commission policy changes. No commission can bind a future commission. But if the current commission adopts a GAAP-based policy, a future commission is unlikely to reverse the policy.

But there are reasons other than the self-interest of the utilities, that GAAP-based arguments are so persuasive. First of all, GAAP carries with it the considerable institutional legitimacy of the financial community. It is developed through a formal process that brings together the best counsel of the financial professions. Official FASB positions, the most authoritative source of GAAP today, "are determined only after extensive due process and deliberation."¹¹ Prior to the beginning of any public utility commission hearing in which adoption of a FASB Statement is proposed, the Statement has already been subjected to extensive review and deliberation by the FASB, a procedure that has given the Statement substantial legitimacy and the blessing of the financial and accounting communities.

¹⁰ Ken Ackerman, "Federal Communications Commissions Common Carrier Bureau Accounting and Audits Division," Paper presented at the meeting of the NARUC Staff Subcommittee on Accounts, Aspen, Colorado, September 1993, 4.

¹¹ Mark A. Carden and Craig M. Cameron, "Taxes: A New Generation for Utilities," *Public Utilities Fortnightly* (Arlington, VA: Public Utilities Reports, Inc, February 15, 1992), 17.

Second, GAAP identifies the professional standards of accounting. It derives its standards from the basic principles all accountants learn early in their education. As a result, to accountants and finance professionals, GAAP is not simply one method of accounting; GAAP is the "right" and only professionally valid answer. Though, as we will see later, GAAP is flexible and evolutionary rather than fixed and immutable. It may be as unreasonable to expect an engineer to build a bridge that fails to meet the standards of the engineering profession as it is to expect an accountant to propose or endorse a financial solution to a regulatory problem that does not conform to GAAP.

In addition, GAAP is conservative. Conservatism is, in fact, one of the Qualitative Characteristics of Accounting Information identified by the FASB in Statement of Financial Accounting Concepts No. 2. That statement defines conservatism as "a prudent reaction to uncertainty to try to ensure that uncertainties and risks in business situations are adequately considered."¹² Because GAAP is defined by the professional accounting community, it is generally conservative and reflects a conservative, prudent outlook. And when millions of dollars are at stake in regulatory proceedings, prudence and conservatism are probably warranted.

If GAAP is not adopted for ratemaking, some inefficiencies are created for utilities. Multiple sets of books may be required, though in an age of computerization, the cost of keeping separate financial data for regulatory purposes should be less onerous than in the past. For utilities that operate in more than one regulatory jurisdiction, financial record keeping requirements can further proliferate. This causes some additional cost and confusion if the various jurisdictions apply disparate ratemaking treatments, particularly if those treatments differ from GAAP.

Despite the strength of these arguments for GAAP, they pale in comparison to the pressure placed on regulators to communicate the financial condition of utilities to the financial markets through the accepted language of financial accounting--GAAP.

¹² Financial Accounting Standards Board, "Statement of Financial Accounting Concepts No. 2: Qualitative Characteristics of Accounting Information," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume II* (Burr Ridge, IL: Irwin, 1993), par. 95.

Regulated utilities, even small ones, need financial capital to maintain their operations and to finance new plant. Securities of large utilities are publicly traded; their cost of issuing equity is determined by the securities markets, and the cost of their debt is determined by their bond ratings. Even smaller utilities, which may not be traded on Wall Street, rely on the assessments of their credit worthiness by lending institutions and private investors. In either case, regulators must consider the financial viability of the utilities in their jurisdictions and, therefore, feel the burden of insuring that the financial information reported accurately reflects the financial strength of the utility. Because the cost of capital is a component of utility rates, regulators have an interest in insuring that jurisdictional utilities are perceived favorably by the financial community. For communicating with the financial community, GAAP is the communications medium.

There are those who maintain that all of the furor about accurately reflecting regulatory decisions in the utility's financial statements is overstated. Today's financial markets are dominated by large, institutional investors with technical staffs and resources that enable them to make their own financial analyses. Those large investors and investment services rely on many sources of information about utilities, only one of which is the published, GAAP-based financial reports of the utility. As a result, they are aware of regulatory decisions and local circumstances. In September of 1992, for example, when the Moody's Investors Service announced that it had downgraded its securities ratings for Oklahoma Gas and Electric Company and a subsidiary, it cited the utility's "increasingly burdensome purchased power contracts, its negative regulatory environment and the depressed oil and gas sector of its service territory economy."¹³ Although some of the problems cited may have been discussed in the utility's annual reports, it is likely that Moody's turned to sources of information in addition to the utility's published financial statements.

Few commissions are likely to test the ability of bond rating agencies and major institutional investors to gather information about the financial health of regulated

¹³ "Moody's Lowers OG&E Ratings," *The Saturday Oklahoman and Time*, September 12, 1992.

utilities from sources other than published, GAAP-based financial statements, when the financial health of jurisdictional utilities is at stake. Most state public utility commissions are likely to continue to support GAAP-based accounting for utilities. Fortunately, with the participation of regulatory experts, the FASB has created tools, primarily within FAS No. 71, which simultaneously allow utilities to conform to GAAP and allow regulators to fashion ratemaking solutions in the public interest. The "customized GAAP" for regulated utilities is not perfect and probably requires periodic adjustment. But today, the accounting tools contained in that customized GAAP for regulated enterprises are being severely questioned, and the compromise between the interests of regulators in stable rates and the interests of the financial community in minimizing uncertainty in financial statements may be in jeopardy.

The Conflict of Interests

If the interests of all parties involved in the creation and use of GAAP were identical, it would be fairly simple to articulate and apply accounting standards. Unfortunately, that is not the case.

At its core, the objective of GAAP is to minimize the "potential dangers of bias, misinterpretation, inexactness, and ambiguity" in financial statements and to "render financial statements that can be reasonably compared between enterprises and between accounting periods."¹⁴ Those objectives are straightforward and laudable and should be fairly simple to operationalize. But in a business economy as complex as ours, nothing is simple.

FASB, the primary extant arbiter of GAAP, is subjected to a myriad of pressures driven primarily by the differential objectives of the groups to whom GAAP applies. Kieso and Weygandt identified a variety of players having a stake in the outcome of FASB deliberations. These include CPAs and accounting firms, the American Institute

¹⁴ Donald E. Kieso and Jerry J. Weygandt, *Intermediate Accounting* (New York: John Wiley and Sons, 1980), 8.

of Certified Public Accountants (AICPA), the investing public, industry associations, government, professional organizations, the financial community, and the business entities themselves.¹⁵ In the case of accounting for regulated industries, other interested parties include ratepayers, consumer advocates, and the regulatory agencies. Amid the clamor of these competing claims, it is no wonder that the needs of public utility regulators may not receive first priority.

The result of these varied and disproportionately represented interests is that the development of GAAP becomes a moving battlefield upon which those affected by GAAP are arrayed. That battlefield, illustrated in Figure 1-1, moves from accounting issue to accounting issue. The result, in the best case, is an equilibrium set of solutions, a truce that balances the needs of the players. Though the FASB has shown substantial independence, the unfortunate result may be a set of solutions that meets the needs of the most dominant players while limiting the options of the minor players, who in this case may be the public utility regulators and the ratepayers they represent. As we maintain throughout this report, the issues for those public utility regulators and regulated firms are far from trivial.

The Current Front

In the early 1990s, the GAAP battlefield over the validity of the regulatory compact shifted to the implementation of FAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions," which was issued by the FASB in December 1990 and effective for fiscal years beginning after December 15, 1992. That statement required that postretirement benefits other than pensions, which consist principally of health care costs, be accrued and expensed over the service life of the employee. Prior to FAS No. 106, the prevalent practice in regulated and unregulated firms had been to record the expense only when the expenditures were made after the employee's retirement (the pay-as-you-go method). At this point, it is sufficient to note

¹⁵ Ibid., 14.

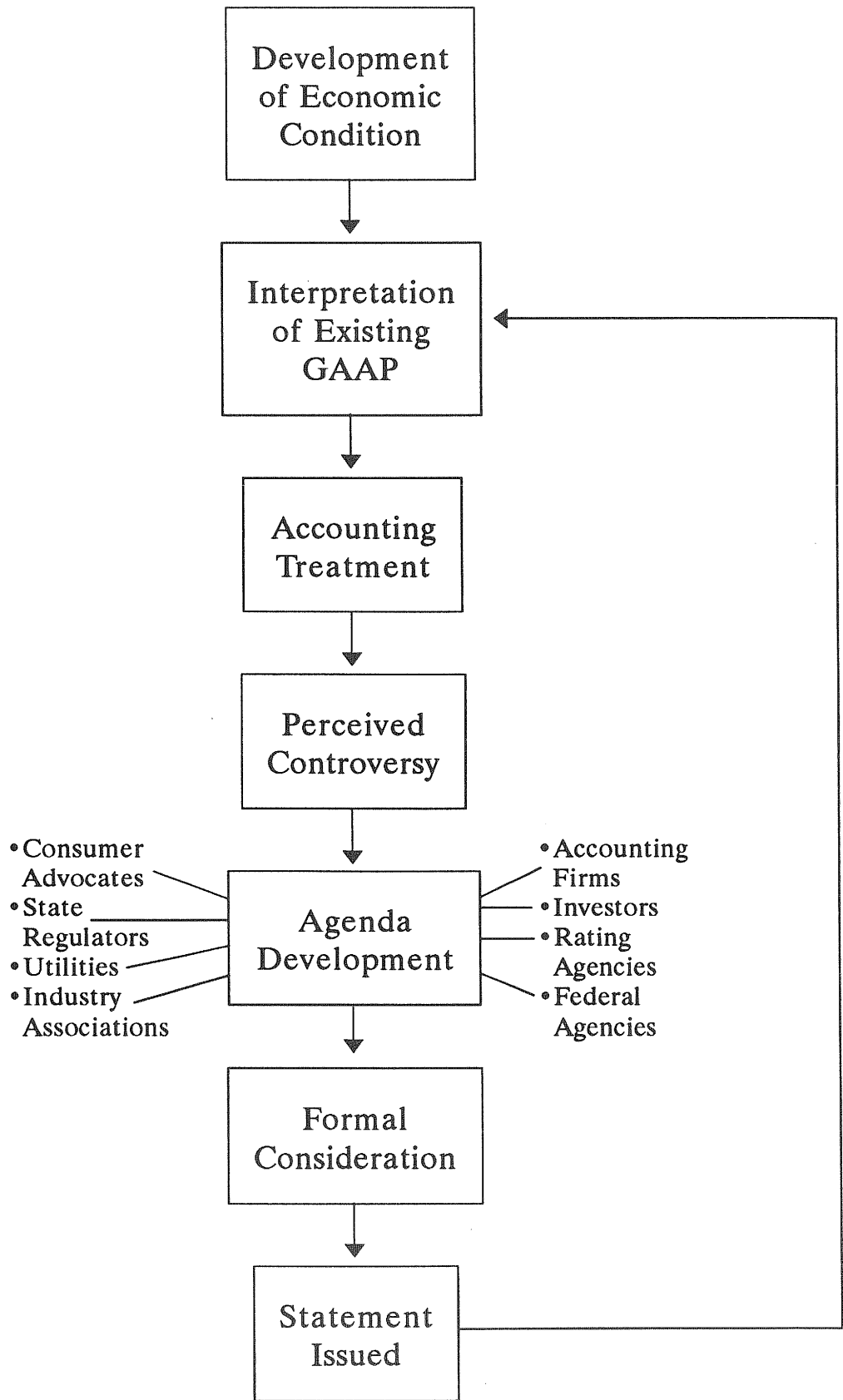


Fig. 1-1. The GAAP Battlefield.

Source: Authors' construct.

that implementation of FAS No. 106 for ratemaking for utilities under state jurisdiction was far from uniform, and the FASB reaction to that disparate state implementation created considerable furor. Some state commissions elected to continue the pay-as-you-go method. Others adopted FAS No. 106 fully for ratemaking. Others adopted modified versions.¹⁶

As a result of the diversity of state policies, the Emerging Issues Task Force (EITF) of the FASB began to consider the issue of the appropriate accounting for postretirement costs by rate regulated enterprises (EITF Issue 92-12). In January 1993, the EITF announced that a regulatory asset, which would reflect the probable recovery through rates of deferred postretirement costs, should be recognized only under certain circumstances. Those circumstances were significantly more restrictive than the requirements previously applied by FAS No. 71. Part of the EITF announced consensus was that a regulatory asset could not be recorded if the pay-as-you-go system was maintained for ratemaking. Furthermore, it announced that a regulatory asset could be recorded only if postretirement costs were included in rates within five years from the date of adoption of FAS No. 106.¹⁷ From a mechanism as seemingly innocuous as the imposition of time limits, a storm of contention emerged.

FAS No. 71 had not prescribed time limits for recovery of deferred costs. A ten-year limit for recovery of plant phase-in costs had been provided within FAS No. 92. With regard to those time limits within FAS No. 92, the Chief Accountant of the Federal Energy Regulatory Commission (FERC) had stated:¹⁸

¹⁶ John Kiebel et al., "FAS 106 Developments in Other Jurisdictions," (Jefferson City, MO: Missouri Public Service Commission, September 1993).

¹⁷ Emerging Issues Task Force of the FASB, "Minutes of the January 21, 1993 FASB Emerging Issues Task Force Meeting, Issue 92-12: Accounting for OPEB Costs by Rate-Regulated Enterprises," 2.

¹⁸ Russell E. Faudree, Jr. "Comments on Regulatory-FASB Interrelationships and Developments," Paper presented at the 27th Regulatory Conference at Iowa State University, Ames, Iowa, May 17-19, 1988, 5-6.

Over the years, the FERC and its predecessor agency, the Federal Power Commission, has kept its accounting regulation in lock-step with (GAAP). This has been possible because GAAP, at least until the recent past, has recognized that regulation itself creates economic effects that should be recognized in the financial statements of the regulated company. The FASB, however, when it issued its Statement No. 92, for the first time departed from the valid concept of asset recognition based upon a measure of the probability of recovery by prohibiting recognition of valid regulatory assets related to phase-in plans unless they met certain arbitrary guidelines unrelated to economics of a regulated enterprise.

The further imposition of time limits (referred to commonly as "fence posts") by the EITF for FAS No. 106 was regarded by some as a new and even more serious challenge to the authority of regulators. The NARUC Staff Subcommittee on Accounts¹⁹ and the Chief Accountant for the Federal Energy Regulatory Commission (FERC)²⁰ have gone on record as being strongly opposed. The regulated utilities, in general, are supportive of FASB's efforts to limit long-term deferral of FAS No. 106 costs and are opposed to pay-as-you-go treatment of FAS No. 106 costs.

The EITF action was symptomatic of larger concern over the recording of regulatory assets by both the FASB and the SEC, which in general have endorsed EITF consensus positions.²¹ The EITF action on FAS No. 106 can be regarded as an assault on a wider front on the treatment of costs by regulators and the financial reporting by regulated utilities. Carl Greene, Chairman of the American Gas Association Accounting

¹⁹ NARUC Staff Subcommittee on Accounts, "Comments of the NARUC Staff Subcommittee on Accounts to the Emerging Issues Task Force: Accounting for OPEB Costs by Rate Regulated Enterprises," undated document, 5.

²⁰ Russell E. Faudree, Jr., Letter to Mr. Mark Carden of the FASB, November 5, 1992, 3.

²¹ Financial Accounting Standards Board, "Statement of Financial Accounting Standards No. 111: Rescission of FASB Statement No. 32 and Technical Corrections," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume I* (Burr Ridge, IL: Irwin, 1993), footnote 4.

Advisory Council, stated that the real issue under consideration is "the survivability of SFAS 71."²²

Clearly the debate over the implementation of FAS No. 106 has spread far beyond technical, nonsubstantive accounting issues. That new and alleged intrusion by FASB and the SEC into regulatory authority, while serious enough in its specific impact, is indicative of three larger developments that threaten to usurp regulatory authority across a broad front.

First, the financial community and government agencies, reeling from the recent savings and loan debacle, are anxious to avoid a repeat performance and generally are likely to opt for more accounting rigidity and less discretion by regulators. According to Charles Stalon, "regulatory discretion in American society seems to be increasingly difficult to justify."²³

The second development is the proliferation of legal suits attempting to hold accounting firms responsible for damages related to incorrectly presented financial information. In the past few years, a liability crisis has developed for accountants and auditors. According to Shaun O'Malley, Chairman and Senior Partner at Price Waterhouse, "runaway litigation is threatening the survival of accounting firms of all sizes and indeed has the power to destroy the accounting profession as a whole."²⁴ In 1991, the costs of settling or defending lawsuits for the six biggest accounting firms was \$477 million, or nine percent of total auditing and accounting revenues, and nearly all

²² Carl W. Greene, "The Utility Perspective of EITF Issue 92-7 (Special Rate Mechanisms). Accounting and Rate-Making Aspects of Implementing SFAS 106," Paper presented at the National Association of Regulatory Utility Commissioners Staff Subcommittee on Accounts Fall Meeting, Madison, Wisconsin, September 23, 1992, 3.

²³ Charles G. Stalon, "New Wine in Old Bottles: Electric Industry Competition and Old Regulatory Structures," Paper presented to the Transportation and Public Utility Group of the American Economic Association, Anaheim California, January 6, 1993, 11.

²⁴ Shaun F. O'Malley, "Legal Liability is Having a Chilling Effect on the Auditor's Role," *Accounting Horizons*, 7 no. 3 (June 1993), 82.

observers expect costs to continue to rise.²⁵ The result, according to one knowledgeable observer, is that many accountants are currently seeking greater degrees of surety and clear, defensible guidance regarding classification of financial assets.

The third, and most important, development driving the assault on regulatory flexibility is the loss of confidence by the financial and accounting communities in the ability of the regulator to assure the probability of rate recapture of regulatory assets. At precisely the time that more surety is being demanded by the accounting community, utility markets are becoming less certain and less predictable. Competition is being introduced into utility markets that were once dominated by monopoly providers, and incentive regulation is gaining a substantial foothold. The financial and accounting communities have taken note of those trends and the reaction of regulators to those trends. They are concluding that the regulatory compact may be unenforceable and that regulatory assets created by regulators may never be converted through rates to revenue by the utility. One of the thorniest issues confronting regulators and utilities is the identification of those markets where the regulatory compact still exists and those markets where it does not.

In addition to the "systematic deferrals of the recovery of a regulated enterprise's costs by a regulator," representatives of the "Big Six" accounting firms cite five other current conditions that might be regarded as warning signs that the current equilibrium solution (primarily articulated within FAS No. 71) no longer may be applicable.²⁶ Those other five conditions are:²⁷

²⁵ Ibid., 84.

²⁶ Paul R. Bjorn (Price Waterhouse), Dennis B. Bongers (KPMG Peat Marwick), Richard W. Braun (Ernst and Young), James M. Dewey (Price Waterhouse), David J. Farling (Coopers and Lybrand), Benjamin A. McKnight (Arthur Andersen & Co.), William S. Reardon (Coopers and Lybrand), and Jan A. Umbaugh (Deloitte and Touche), "Regulated Enterprises--FAS 106," Letter to Porter E. Childers, Executive Director-Accounting and Financial Matters, United States Telephone Association, June 1, 1992, 13.

²⁷ Ibid.

- Chronic excess capacity (e.g., generating capacity and/or readily available supplies) resulting in nonearning assets.
- Rates per MCF or kWh which are currently, or forecasted in the future, to be higher than those of neighboring utilities and/or alternative competitive energy sources.
- Substantial regulatory disallowances.
- Proposed or actual rulemakings which are designed to stimulate competition and/or design rates which are based on other than "pure" cost of service concepts (e.g., rates tied to CPI factors, incremental pricing, flex pricing designed to enable utilities to meet competition and maintain load, etc.).
- Rate increase moratoriums.

FASB concern over the legitimacy of the regulatory compact is not new. Indeed, the FASB explicitly recognized in FAS No. 101 that there may come a time when regulatory assets recorded under FAS No. 71 no longer meet the requirements of that standard. Reportedly, several major utilities have determined that their operations no longer meet the requirements of FAS No. 71 and have adopted the accounting rules for unregulated enterprises.

The regulated utilities and the accountants who audit and attest to the validity of the financial statements of utilities are now less than certain that there exists a direct relationship between costs and revenues for regulated utilities. They now doubt that regulators can provide probable and reasonable assurance of recovery of the costs of regulatory assets. Ultimately, FAS No. 71 and the flexibility it allowed regulators may be modified by the FASB. Indeed, the EITF action regarding accounting for postretirement benefits are not the only indications that the FASB may restrict the future application of FAS No. 71. In addition, the EITF has taken action on two other issues--the further consideration of the accounting for postretirement benefits (EITF issue 93-4) and consideration of electric revenue adjustment mechanisms (EITF issue 92-7)--which have the potential to further limit regulatory flexibility and the application of FAS No. 71.

The question of most significance to state regulators is whether they will retain the ability to create regulatory assets in appropriate circumstances or whether regulators will lose an important tool they have employed to balance the needs of the ratepayers with the needs of investors. Complete elimination of the ability of utilities to report regulatory assets as authorized by regulatory commissions would:

1. signal the end of the "customized" GAAP for regulated utilities,
2. limit the ability of regulators to create solutions of mutual benefit to ratepayers and utilities that could be communicated to capital markets,
3. apply a "broad brush" solution across all utility markets, some of which are not significantly affected by competition.

If FAS No. 71 is constrained by the addition of fence posts, regulators would be subject to arbitrary limits, limits which are not, necessarily, tied to the economic effects of regulation. The practical ramification of a restrictive definition of GAAP is to render regulatory tools ineffective and to further diminish the validity of the regulatory compact. If regulators are denied the ability to create deferred cost-recovery programs, regulators will lose a major tool for the achievement of equities between generations and between ratepayers and utilities.

This conflict over the regulatory compact and the ability of regulators to create regulatory assets is building and is likely to shake and shape regulatory accounting for some time to come. Regulators need to protect the public in rapidly changing utility environments; utilities need to survive competitive pressures; accountants need to make certain that disclosures in their client's financial statements are reasonably accurate and complete and, to the extent possible, protect them from lawsuits; and the FASB and the SEC need to insure that the investing public is protected from the presentation of misleading financial data. These disparate and often conflicting interests cause what seems to be an intractable problem. Even if the furor over the implementation of FAS No. 106 dies down, other issues, perhaps even more significant financially and potentially

disruptive are looming--issues such as asset impairments, nuclear decommissioning costs, and recording environmental liabilities.

Solutions will, undoubtedly, be hard to come by. Before attempting to find solutions, we first need to lay out in greater detail the definition and sources of GAAP, the processes and institutions that form GAAP, the creation and operation of the accounting mechanisms that currently allow regulatory accounting and GAAP to converge, the interaction between state and federal regulators, and the role of state public utility commissions in setting accounting policy for jurisdictional firms.

CHAPTER 2

THE DEFINITION, HIERARCHY, AND BASIC PRINCIPLES OF GAAP

The common perception, particularly among nonaccountants, is that GAAP is a monolithic "thing," a clear, nearly immutable set of standards that leaves no room for the application of judgement. Accountants tend to fuel that erroneous perception by referring to GAAP authoritatively, citing GAAP as if it is a fixed set of commandments, and creating the impression that the establishment of accounting policy for an enterprise allows no choice of accounting treatment or requires no application of judgement.

In fact, GAAP is an amalgam of shifting standards, which fall far short of explicitly resolving every accounting conflict for utilities (or any other enterprises) and which are drawn from disparate sources and documents. Within GAAP there are some fixed rules, such as the requirement (cited in Chapter 1) that the costs of post retirement benefits be recorded on an accrual basis or the requirement in FAS No. 92 that phase-in plans be completed within ten years. But, no matter how fervently the legal advisors to accounting firms might wish otherwise, the application of GAAP often requires the application of judgement. According to the FASB:

As more accounting standards are issued, the scope for individual choice inevitably becomes circumscribed. But there are now and will always be many accounting decisions to be made by reporting enterprises involving a choice between alternatives for which no standard has been promulgated or a choice between ways of implementing a standard.¹

Some of those choices required of accountants address such basic and diverse issues and functions as the definition of assets, liabilities, revenues, and expenses, the measurement

¹ Financial Accounting Standards Board, "Statement of Financial Accounting Concepts No. 2: Qualitative Characteristics of Accounting Information," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume II* (Burr Ridge, IL: Irwin, 1993), par. 7.

of assets, the allocation of costs, the level of detail to provide, and the material to include in footnotes or supplemental materials to financial reports.²

Though a considerable aura of credibility is attached to GAAP, it is not established in a professional vacuum. It is, instead, pragmatic, utilitarian,³ and subject to the same societal forces that drive the establishment of all laws, rules, and standards in a democratic society.

The Definition of GAAP

Contained within the auditor's statement in the financial reports of every utility, and indeed every firm, is a statement that says something like:⁴

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of (at) December 31, 19XX, and the results of its operations and its cash flows for the year then ended, *in conformity with generally accepted accounting principles.* [Emphasis added.]

But what is GAAP? And where does it come from?

Although accounting has been around since the Third Century B.C., the attempt to establish accounting standards is a fairly recent phenomenon. In the U.S., it was not until the establishment of the Securities and Exchange Commission (SEC) in 1934 that the basis was laid for the establishment of uniform accounting standards to be applied to

² Ibid., par. 8.

³ Richard G. Schroeder, Myrtle Clark, and Levis D. McCullers, *Accounting Theory: Text and Readings* (New York: John Wiley and Sons, Inc., 1991), 21.

⁴ American Institute of Certified Public Accountants, "AU Section 411: The Meaning of *Present Fairly in Conformity with Generally Accepted Accounting Principles* in the Independent Auditor's Report," *AICPA Codification of Statements on Auditing Standards: Numbers 1 to 71* (Chicago, IL: Commerce Clearing House, Inc., 1993), AU Section 411.01, 309.

all firms under SEC jurisdiction. Though those accounting standards have been under development for sixty years, no single, authoritative definition of GAAP exists.⁵

The most official description of GAAP, and one that confirms the fact that it is complex, time-sensitive, and subject to interpretation, is provided by Accounting Principles Board (APB) Statement No. 4. APB No. 4 says in relevant part:

Generally accepted accounting principles incorporate the consensus at any time.....⁶

Present generally accepted accounting principles are the result of an evolutionary process that can be expected to continue.⁷

Generally accepted accounting principles therefore is a technical term in financial accounting. Generally accepted accounting principles encompass the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. The standard of "generally accepted accounting principles" includes not only broad guidelines of general application, but also detailed practices and procedures.⁸

Generally accepted accounting principles are conventional--that is, they become generally accepted by agreement (often tacit agreement) rather than by formal derivation from a set of postulates or basic concepts. The principles have developed on the basis of experience, reason, custom, usage, and, to a significant extent, practical necessity.⁹

⁵ Schroeder, Clark, and McCullers, *Accounting Theory*, 21.

⁶ Accounting Principles Board, "APB Statement No. 4: Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," *Financial Accounting Standards: Original Pronouncements as of June 1, 1980* (Chicago, IL: Commerce Clearing House, Inc., 1980), par. 27.

⁷ *Ibid.*, par. 32.

⁸ *Ibid.*, par. 138.

⁹ *Ibid.*, par. 139.

These definitions hardly create an immutable set of standards providing clear and incontrovertible guidance in every instance, and it is clear why accountants sometimes differ in their interpretation and application of GAAP.

In addition to those attributes listed above, a number of other characteristics of the codified portions of GAAP are apparent. First of all, GAAP is reactive, responding to problems once they have developed, rather than attempting to anticipate problems before they arise. Recognition of its own responsibility to rapidly react to emerging problems caused the FASB to establish the Emerging Issues Task Force (EITF) in 1984.¹⁰ But even the EITF is focused on current accounting dilemmas and is not forward looking, and some still criticize the FASB for being far too slow to respond to troublesome issues. The FASB has limited ability to scan the horizon, identify issues, and react to them before they create dilemmas for practicing accountants. Instead, FASB agenda items typically percolate up to the FASB from practicing accountants, through the EITF and other affiliated organizations. An exception to the reactive nature of the FASB may be its conceptual framework project, which was taken on by the FASB to set out some fundamentals of accounting as a guide to the profession and to instruct the public. That project will be discussed in greater detail later in this chapter and in Appendix C.

GAAP is incremental. Decisions often build on prior pronouncements, and pronouncements are sometimes amended or superseded. For instance, The FASB Schedule of Amended and Superseded Accounting Pronouncements consists of twenty-one pages.¹¹ Thus, rather than being cast in stone for all time, GAAP is evolutionary and subject to modification as circumstances change. For instance, FAS No. 71 was issued in December 1982 and followed two earlier accounting pronouncements addressing regulatory assets. It provided what was thought at the time to be adequate

¹⁰ Schroeder, Clark, and McCullers, *Accounting Theory*, 10.

¹¹ Financial Accounting Standards Board, "Appendix B: Schedule of Amended and Superseded Pronouncements," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume II* (Burr Ridge, IL: Irwin, 1993), B-1 through B-21.

guidance to enable utilities to reflect the economic effects of regulation in their financial statements. But even as FAS No. 71 was being implemented, changing conditions in the utility industry, particularly in the electric industry, indicated a need for further guidance for utilities. In December 1986, the FASB issued FAS No. 90, which provided guidance on accounting for plant abandonments and disallowances. In August of 1987 the FASB issued FAS No. 92, which further amended FAS No. 71 by setting conditions under which a portion of the costs of newly completed plants could be deferred. Finally, in late 1988, in recognition of the impact of competition and other changes in cost-based regulation, the FASB released FAS No. 101, which outlined conditions under which the continued use of FAS No. 71 by a utility might be inappropriate.

GAAP is pragmatic. It represents a workable solution to an identified problem rather than the optimum solution.¹² For example, FAS No. 92 requires that plant phase-in plans be completed within ten years. This represented a "workable" solution which addressed concerns that phase-in plans extending more than ten years reduced the probability of ultimate recovery. It certainly was not an "optimum" solution, in that a ten year allowance is no more defensible than nine- or eleven-year phase-in allowance. Under certain conditions, a phase-in period of fourteen or fifteen years might be more desirable and still meet the "probability" test. Alternatively, instead of focusing its efforts on developing workable solutions to existing problems, GAAP could be developed through techniques such as deduction (moving from general principles to specific solutions), induction (development of principles from specific observations of current practice), or the scientific method (development and testing of hypotheses).¹³ But given the social and political forces that impact the development of accounting standards in the U.S., the pragmatic approach is the only method likely to be effective in the long term.

GAAP is created by compromise and consensus and is, thereby, the acceptable standard. Indeed, the laborious due-process procedure introduced by the Accounting

¹² Schroeder, Clark, McCullers, *Accounting Theory*, 19.

¹³ *Ibid.*, 18-20.

Principles Board (APB) and expanded on by the FASB is one indicator of the drive to insure that accounting standards are acceptable to the business community.¹⁴

And in its drive to make GAAP an acceptable standard, the current process for establishing GAAP is, at least to a considerable extent, representative. When the FASB was formed in 1973 to replace the APB, one of the organizational objectives was to broaden the base of support for the establishment of accounting standards. Critics had argued that the APB, which consisted wholly of CPAs, did not provide adequate representation of other affected groups.¹⁵ As we will see in the next chapter, the FASB is supported by an elaborate superstructure of governing and advisory organizations and has established a process for setting accounting standards that encourages input by affected parties. Later in this report, we will discuss the criticisms of the FASB and its attempts to become more open and representative.

As a result of these characteristics, GAAP is, in several senses, political.¹⁶ First, some FASB statements are a direct response to public concerns or to national legislation. Examples are APB Opinion No. 2, which addressed accounting for the investment tax credit; FAS No. 96 and FAS No. 109, which addressed accounting for income taxes; and FAS No. 114, which addressed the accounting for impaired loans. FAS No. 114 was a direct reaction to the banking and savings and loan crises. And very recently, driven by the widespread public interest in executive compensation, the FASB began to consider the issue of accounting for stock options provided as compensation to executives. The consideration of that issue unleashed a political storm. A member of the U.S. Senate introduced legislation to require the FASB to maintain the current accounting method while another Senator introduced legislation to mandate that stock options be recorded as compensation.

¹⁴ David Solomons, *Making Accounting Policy: The Quest for Credibility in Financial Reporting* (New York: Oxford University Press, 1986), 243.

¹⁵ *Ibid.*, 29-30.

¹⁶ By stating that the process for establishing GAAP is political, we mean that it is responsive to public concern and subject to collective decision making.

Second, GAAP, as articulated by the various standard-setting bodies, can be regarded as political because it deals with collective decision making and the allocation of scarce resources. Because the parties with an interest in the outcome of FASB deliberations have different objectives, the FASB effectively allocates benefits among the contending parties. Those benefits include the ultimate financial gain associated with a favorable standard. According to the American Accounting Association:¹⁷

...every policy choice represents a trade-off among differing individual preferences, and possibly among alternative consequences, regardless of whether the policy-makers see it that way or not. In this sense, accounting policy choices can never be neutral. There is someone who is granted his preference, and someone who is not.

Resource allocation is the hallmark of political systems.¹⁸ As long as the process for setting accounting standards is institutional rather than left to the market, political conflict (as opposed to economic conflict) over resource allocation will be inevitable.

Former FASB member, David Mosso suggests that politics will be a part of the accounting standards setting process as long as accounting standards are regarded as rules of professional conduct, rather than as rules of measurement. The former, according to Mosso, require a political process for their establishment; the latter can be established by research and experimentation. He believes that accounting standards are rules of conduct rather than rules of measurement and concludes that, "The FASB was created out of the ashes of predecessors burned up in the fires of the resulting political process."¹⁹

¹⁷ Robert G. May and Gary L. Sundem, "Research for Accounting Policy: An Overview," *Accounting Review*, October 1976, 752, as cited in Solomons, *Making Accounting Policy*, 234.

¹⁸ Janice A. Beecher and Ann P. Laubach, *Compendium on Water Supply, Drought, and Conservation* (Columbus, OH: The National Regulatory Research Institute, 1989), 3.

¹⁹ David Mosso, *Viewpoints*, January 26, 1978, 1, as cited in Solomons, *Making Accounting Policy*, 243.

The fact that GAAP is political is not a failure of the standards setting process. It is instead the inevitable and appropriate result of the fact that accounting information serves society. The FASB, itself, has determined that "financial reporting is not an end in itself but is intended to provide information that is useful in making business and economic decisions..."²⁰ If usefulness is an important criterion for financial information, users must be allowed an active role in the process of establishing standards for that reporting. And as long as the process is political, there is a chance that the needs of utilities and regulators can be factored into the establishment of GAAP.

The Hierarchy of GAAP

Because of the multiple sources of GAAP, accountants and auditors were in need of guidance as to which sources were more important than others. The Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA) met that need by establishing a hierarchy of sources that identify GAAP. The FASB recognized that hierarchy and reiterated it within FAS No. 111. The current acceptable hierarchy of organizations and sources of GAAP is as follows:²¹

- a. Accounting principles promulgated by a body designated by the AICPA Council to establish such principles, pursuant to rule 203 of the AICPA Code of Professional Conduct.

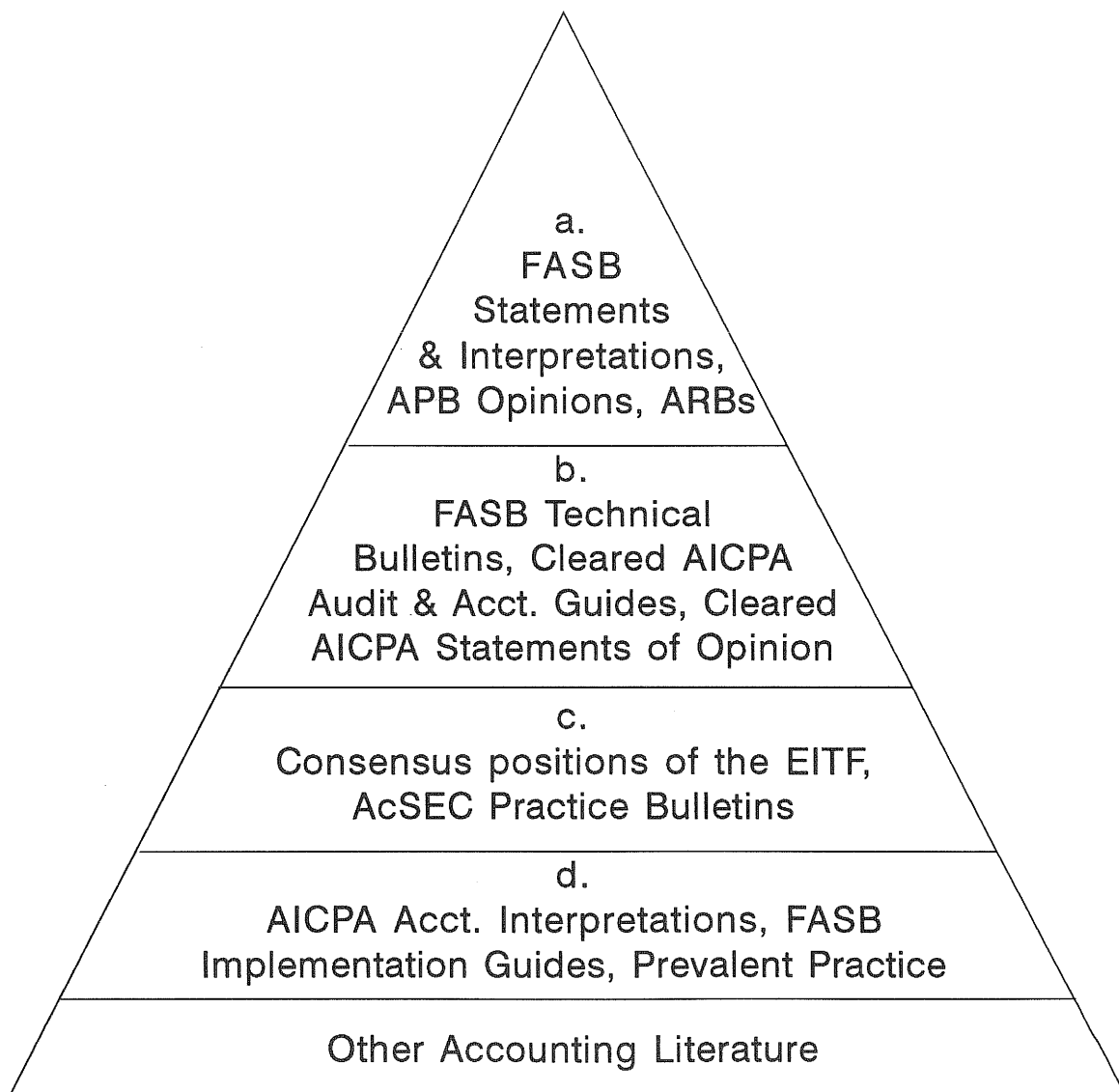
²⁰ Financial Accounting Standards Board, "Statement of Financial Accounting Concepts No. 1: Objectives of Financial Reporting by Business Enterprises," *Original Pronouncements: Accounting Standards as of June 30, 1993, Volume II* (Burr Ridge, IL: Irwin, 1993), par. 9.

²¹ AICPA, Auditing Standards Board, "AU Section 411," 310. The source cited is a compilation of AICPA Statements on Auditing Standards (SAS). The source of the specific section cited is SAS No. 69. Materials in parenthesis following each category are taken from Financial Accounting Standards Board, "Statement of Financial Accounting Standards No. 111: Rescission of FASB Statement No. 32 and Technical Corrections," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume I* (Burr Ridge, IL: Irwin, 1993), par. 25.

(FASB Statements and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins.)

- b. Pronouncements of bodies, composed of expert accountants, that deliberate accounting issues in public forums for the purpose of establishing accounting principles or describing existing accounting practices that are generally accepted, provided those pronouncements have been exposed for public comment and have been cleared by a body referred to in category (a). (FASB Technical Bulletins, cleared AICPA Industry Audit and Accounting Guides, and cleared AICPA Statements of Position.)
- c. Pronouncements of bodies, organized by a body referred to in category (a) and composed of expert accountants, that deliberate accounting issues in public forums for the purpose of interpreting or establishing accounting principles or describing existing accounting practices that are generally accepted, or pronouncements referred to in category (b) that have been cleared by a body referred to in category (a) but have not been exposed for public comment. (Consensus positions of the FASB Emerging Issues Task Force and cleared AICPA Accounting Standards Executive Committee (AcSEC) Practice Bulletins.)
- d. Practices or pronouncements that are widely recognized as being generally accepted because they represent prevalent practice in a particular industry, or the knowledgeable application to specific circumstances of pronouncements that are generally recognized. (AICPA Accounting Interpretations, FASB Implementation Guides (Q&As), and widely recognized and prevalent industry practices.)

Figure 2-1 further illustrates the GAAP hierarchy. Section "a" contains the pronouncements of the three organizations deemed by the SEC at various points in time to possess "substantial authoritative support" for the establishment of accounting standards and, thereby, granted the authority to establish GAAP. Pronouncements issued under Sections "b" and "c" still require the endorsement of a body described in Section "a" or must be developed by a body established in Section "a." According to FAS No. 111, "other accounting literature" is subordinate to these other four levels in the



Source: Authors' construct from FAS No. 111

Fig. 2-1. The Hierarchy of Accounting Pronouncements.

establishment of GAAP.²² SEC rules and interpretive releases of the SEC are regarded as having similar authority to level "a" for registered companies.²³

It can be argued that the accounting requirements of regulatory agencies establish "prevalent practice" among the jurisdictional utilities. Thus, it also can be argued that regulators establish and are a source of GAAP. Based on that argument, accounting guidelines established by regulatory agencies for jurisdictional utilities are relegated to Section "d" in the GAAP hierarchy. If regulators do not establish prevalent practice, their accounting requirements are relegated to "other accounting literature" at the base of the hierarchy. But as long as regulatory guidelines do not conflict with the guidance provided by higher levels, regulatory accounting requirements constitute GAAP and should be complied with by utilities.

When conflict does occur, higher level GAAP takes precedence over regulatory requirements for public reporting. The authority of the commissions is paramount, however, for establishing requirements for reporting to the commissions and for rate setting. Where conflicting requirements exist, the utility may have no choice but to maintain separate accounting books for each purpose, a need that should be less burdensome in this era of computerized information.

When the Section "a" organizations recognized the economic effects of regulation and explicitly recognized those effects within their pronouncements, there was no longer any question about the legitimacy of regulatory accounting. When FAS No. 71 and the other accounting standards related to regulated enterprises were established, regulatory accounting formally became a part of GAAP with endorsement from the highest level of the GAAP hierarchy.

The established hierarchy of GAAP has created a system of guidelines similar to our federal system of governance. The highest levels of GAAP authority create a

²² Ibid., "FAS No. 111."

²³ Ibid., footnote 4.

"legislative" level of mandatory accounting standards.²⁴ Those standards are mandatory only because deviation from them would require an auditor to qualify his or her opinion or explain the reasons and effects of the departures. Departures from Section "b" and "c" pronouncements only require auditors to justify and document their conclusions.²⁵

The AICPA Accounting Interpretations and FASB Implementation Guides, which create a variant of the administrative rules adopted by federal agencies pursuant to legislative authority, make up level "d." In American government, the federal government allows a vast arena for state and local governance outside the mandates of federal legislative mandates and administrative rules. This is also true in accounting where practicing accountants retain the latitude to apply their judgement in interpreting accounting policy. In fact, the FASB "strives to leave as much room as possible for individual choices and preferences while securing the degree of conformity necessary to attain its objectives."²⁶ Also at this level lie the prevalent industry practices, which are preferable but not mandatory.²⁷

The establishment of American common law is also similar in some ways to the establishment of GAAP. American common law (defined roughly as "judge-made law") is derived from the actions of judges throughout the country. There are principles that guide the formation of common law, but the law is constantly shifting as new judicial pronouncements are issued. Similarly, GAAP is evolutionary, established by multiple sources, and influenced by industry practices and consensus opinions of practitioners.

What is missing in the application of the federal analogy to accounting but present in the common law analogy is a constitution, a set of basic principles that can guide and animate the standard-setting process. In 1973, the FASB began its Concepts

²⁴ Solomons, *Making Accounting Policy*, 8.

²⁵ Patrick R. Delaney et al., *GAAP Interpretation and Application, 1993 Edition* (New York: John Wiley and Sons, Inc., 1992), 8.

²⁶ FASB, "SFAC No. 2," par. 18.

²⁷ Delaney et al., *GAAP Interpretation and Application, 1993 Edition*, 8.

Statements Project, which was designed to rectify that shortcoming. The somewhat controversial results of that process will be discussed in the following section.

The principal shortcomings of the application of the federal legislative analogy to GAAP are the lack of enforcement powers by the FASB and the essentially voluntary nature of compliance with GAAP even as it is promulgated at the highest levels of the hierarchy. (The legal mandates of SEC requirements are discussed in Chapter 5.) The AICPA, which plays a prominent role in the establishment of accounting standards, attempts to enforce compliance with GAAP. Its Rule 203 prohibits a member from:²⁸

...expressing an opinion that financial statements conform with generally accepted accounting principles if those statements contain a material departure from an accounting principle promulgated by the Financial Accounting Standards Board, unless the member can demonstrate that because of unusual circumstances the financial statements otherwise would have been misleading.

In addition to its rules, the AICPA has established a series of Statements of Auditing Standards and a Code of Professional Ethics designed to require members to comply with FASB and professional standards. The AICPA also created the Accounting Standards Executive Committee (AcSEC) and the Auditing Standards Board (ASB). The AcSEC is the source of industry audit guides and accounting guides and is the AICPA's official voice on accounting standards. The ASB sets auditing standards for the accounting profession.

Failure to abide by the Code of Professional Ethics is a cause for removal from the AICPA. CPAs, who are not members of the AICPA, are not bound by the AICPA's requirements. All CPAs are bound by individual state boards of accountancy, which can also suspend a CPA's license, but state accountancy boards have played little part in the

²⁸ AICPA, "Rule 203," as cited in Financial Accounting Standards Board, "Statement of Financial Accounting Concepts No. 4: Objectives of Financial Reporting by Nonbusiness Organizations," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume II* (Burr Ridge, IL: Irwin, 1993), 1063, note.

development of accounting standards.²⁹ Note that even with these potential penalties, companies and their individual auditors are allowed the exercise of judgement in the interpretation of accounting standards to particular situations. Occasionally, that judgement is questioned. As recently as January, 1994, the Chief Accountant for the SEC, when speaking to a meeting of the AICPA, said:³⁰

There have been too many times where accounting arguments made by registrants lack any reasonable foundation and, without being able to cite any authoritative support for the registrant's position, the auditor has acquiesced.

Given that GAAP does not provide authoritative guidance in every circumstance, the task of interpreting GAAP is sometimes formidable. Though the hierarchy of pronouncements established by the AICPA and reiterated by the FASB in FAS No. 111 is helpful, the application of those pronouncements has been subject to conflicting interpretation.

In the end, informed judgement driven by an understanding of accounting theory forms the bedrock of GAAP. In a litigious society with very large sums of money at stake and varied interpretations of critical issues, there are those who would seek to further circumscribe the application of judgement. Because more detailed guidance may be forthcoming on the accounting for regulatory assets, the accounting for regulated enterprises may be significantly changed and regulatory flexibility may be further limited. In the jargon of our federal governance analogy, the mandates of the federal government are threatening to intrude upon powers previously reserved for state and local government.

²⁹ Schroeder, Clark, and McCullers, *Accounting Theory*, 12.

³⁰ Walter Schuetze quoted in "Schuetze Unloads on Public Accountants," *Management Accounting*, LXXXV, 9 (March 1994): 12.

The FASB's Conceptual Framework Project

When, soon after its establishment, the FASB began its conceptual framework project, it had three objectives in mind:³¹

1. A description of existing accounting practice.
2. A prescription for future practice.
3. A definition of commonly used accounting terms.

A brief review of that project and its results is appropriate for this report for three reasons. First, the project produced a conceptual framework for accounting including the objectives for financial accounting, the elements of financial statements, and definitions of key accounting terms. That framework provides an excellent background, particularly for nonaccountants, and provides a context that is useful for accountants and nonaccountants. (The specific accounting principles detailed by the project are summarized in Appendix C.) Second, the conceptual framework project provides a vivid example of the force of politics on the establishment of GAAP. Third, any change in the accounting requirements for regulated utilities, such as further modification of FAS No. 71, should take place within the context provided by the concept statements. Specifically, any change should make the financial statements of a utility more useful and more reflective of the underlying economic fundamentals of the enterprise.

In October 1970, the Accounting Principles Board (APB) issued Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises." That statement was intended to improve the understanding of accounting

³¹ Paul B. W. Miller and Rodney J. Redding, *The FASB: The People, the Process, and the Politics* (Homewood, IL: Irwin, 1986), 98.

fundamentals and lay a base for the development of accounting principles.³² When it was completed, it was descriptive of accounting practice but not prescriptive.³³ Shortly after the issuance of APB No. 4, the AICPA again initiated a project to identify the objectives of financial statements and the qualitative characteristics of accounting information.³⁴ That effort by the AICPA led to the FASB conceptual framework project.

When the FASB initiated the conceptual framework project it had lofty goals that included the establishment of prescriptive norms for accounting standard setting. Although the project intended to describe existing practice, it also intended to provide direction to accountants and those who set accounting standards.³⁵ The project intended to rectify the shortcomings of APB No. 4 and to make the establishment of accounting standards less pragmatic and more deductive.

From the start, however, the FASB encountered vigorous opposition on nearly every issue as it attempted to create a prescriptive set of standards. According to Paul Miller and Rodney Redding, that adversity came from two factors: (1) the entrenched support of the status quo by accountants and their belief that a prescriptive framework might change the status quo; and (2) vigorous opposition on nearly every issue considered, opposition that frustrated the development of any consensus.³⁶ The results were a set of documents that again failed to establish a clearly prescriptive basis for setting accounting standards and that, once again, provided an implicit endorsement of

³² Accounting Principles Board, "Statement No. 4--Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," *Financial Accounting Standards: Original Pronouncements as of June 1, 1980* (Chicago, IL: Commerce Clearing House, Inc., 1980), par. 2.

³³ Patrick R. Delaney et al., *GAAP Interpretation and Application 1993*, 20.

³⁴ *Ibid.*

³⁵ FASB, "SFAC No. 5," p. 1085.

³⁶ Miller and Redding, *The FASB: The People, the Process, and the Politics*, 104.

GAAP that is for the most part pragmatic and political rather than one solely derived from clearly articulated principles of accounting.

Whether recent FASB actions have followed the guidelines of the concepts statements and made financial statements of utilities more useful is a matter of dispute. Russell Faudree, Jr., the FERC Chief Accountant expressed his opinion on the issue when he stated:

I have serious doubts as to whether some recent Statements issued by the Board meet the objectives as set forth in the concepts statements, particularly FAS-92 which pertains to accounting for phase-in plans by regulated industries. To the extent that these new Statements do not permit recognition of the economic effects of regulation they don't, in my view, result in financial statements that adequately meet the informational needs of regulators of public utilities or the general public.³⁷

The failure of the conceptual framework project to establish clearly prescriptive norms for accounting means that the likely reconsideration of FAS No. 71 and the regulatory assurance of recovery of costs will be driven, for better or worse, more by practical, immediate concerns than by theory. It will be influenced more by the need to develop a workable consensus than by questions of absolute right or wrong. Given those realities, it is imperative that public utility regulators participate in the process at every available opportunity.

³⁷ Russell F. Faudree, Jr., "Comments on Regulatory-FASB Interrelationships and Developments," Paper presented to the Twenty-Seventh Regulatory Conference at Iowa State University, Ames, Iowa, May 17-19, 1988, 1-2.

CHAPTER 3

THE INSTITUTIONS AND THE PROCESSES THAT ESTABLISH GAAP

Although GAAP can be established informally through the development of "prevalent practice," discussions about the creation of GAAP typically focus on the institutions authorized to establish mandatory, "legislative" GAAP. Those institutions have the capability to produce dramatic change in accounting practices.

This chapter describes those institutions from two perspectives:

1. The organizational perspective, which details the organization of the FASB and describes its historical roots.
2. The systems perspective, which defines the flows of issues through the FASB and outlines the due-process systems in place.

This chapter will also examine the criticisms of the FASB and its processes. Points within the standard-setting process at which public utilities and public utility regulators can have an impact will be identified.

The Roots of the FASB

Until the U.S. Congress, prompted by the financial abuses which contributed to the Great Depression, created the Securities and Exchange Commission (SEC) there was no formal mechanism for setting accounting standards. So when it established the SEC, the Congress gave it the authority to set accounting standards for businesses subject to its jurisdiction. The SEC quickly delegated that authority to the accounting profession. In its Release No. 4, dated April 25, 1938, the SEC said:

In cases where financial statements filed with this Commission pursuant to its rules and regulation under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting

principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material.¹

It was that simple phrase, "for which there is no substantial authoritative support," that gave the accounting community the opportunity to establish its own standards. The American Institute of Accountants, the forerunner of the American Institute of Certified Public Accountants (AICPA) responded quickly to the SEC's action and vested its Committee on Accounting Procedure (CAP) with the authority to establish the standards the SEC was looking for. (For simplicity's sake, we will refer to both the AICPA and its antecedents as "the AICPA" without recognizing the timing of the name changes.) Figure 3-1 summarizes the organizational history of accounting standards setting.

From 1938 to 1959, the CAP was the U.S. source of formal GAAP. In its twenty-one year reign, the CAP issued fifty-one Accounting Research Bulletins (ARBs). ARB No. 1 through ARB No. 42 were subsequently restated in ARB No. 43. ARBs were later recognized by the FASB as GAAP unless superseded or amended by later pronouncements.

Though the CAP was able to provide guidance to the accounting profession, it lacked the formal authority that was later given to the FASB. When initially issued, CAP pronouncements were not even binding on members of the AICPA, and the CAP, which was composed exclusively of AICPA members, did not have the FASB's broad base of support.² All CAP members were part-time; none was paid. No staff members were dedicated to the CAP full-time.

¹ Securities and Exchange Commission, "Release No. 4, April 25, 1938, Administrative Policy on Financial Statements," as cited in Subcommittee on Reports, Accounting, and Management of the Committee on Government Operations of the United States Senate, *The Accounting Establishment*, Document No. 95-34 (Washington, D.C.: March 1977), 1432.

² Paul B.W. Miller and Rodney Redding, *The FASB: The People, the Process, and the Politics* (Homewood, IL: Richard D. Irwin, Inc., 1986), 47-48.

1934 - 1938

Securities & Exchange Commission
- issued no accounting standards

1938 - 1959

Committee on Accounting Procedures (CAP)
- issued 51 Accounting Research Bulletins (ARBs)

1959 - 1973

Accounting Principles Board
- issued 31 Opinions & 4 Statements

1973 - present

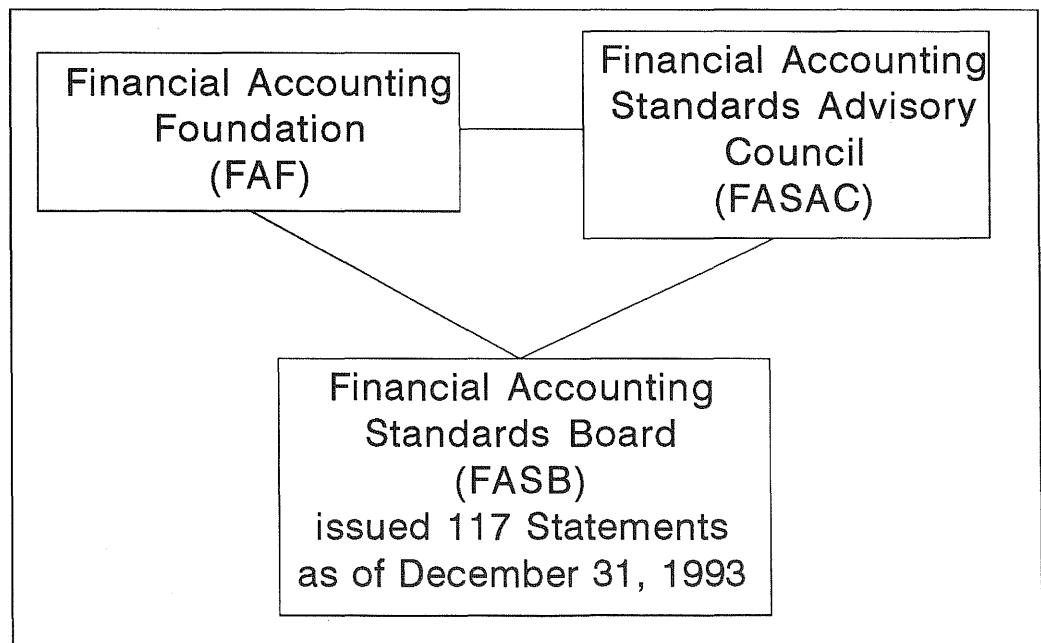


Fig. 3-1. The Institutional History of Accounting Standards .

In 1959, in order to correct some of these shortcomings and improve the effectiveness of the AICPA's standards-setting operations, the AICPA transferred the jurisdiction over accounting standards from the CAP to the Accounting Principles Board (APB), another AICPA committee. According to David Solomons, the change was largely in name only and had little substance.³ Members were still part-time and unpaid, but the APB, unlike the CAP, was given professional staff. Members of the APB were still required to be members of the AICPA, though all were not required to be in private practice.

Between 1959 and its dissolution in 1973, the APB issued thirty-one Opinions and four less formal Statements. Again, as in the case of the ARBs that had been issued by the CAP, the AICPA ultimately recognized APB Opinions as being a part of GAAP (unless superseded or amended by later pronouncements). The AICPA's Rule 203 of its Code of Professional Ethics required that departures from ARBs or APB Opinions be disclosed in footnotes to financial statements, thereby providing further credibility to the pronouncements of the CAP and APB. In addition, the AICPA staff issued its own Interpretations of APB Opinions setting out its opinion as to how APBs should be applied. But despite the minor organizational improvements that differentiated the APB from the CAP, the APB was still criticized for its inability to rapidly and effectively deal with important accounting issues. It lacked the resources and broad political support to weather the storm.

The Organization of the FASB⁴

In 1971, the AICPA established a committee, referred to as the Wheat Committee in recognition of its Chairman, Francis Wheat, to evaluate the means by which

³ David Solomons, *Making Accounting Policy: The Quest for Credibility in Financial Reporting* (New York: Oxford University Press, 1986), 27.

⁴ There are many sources of information about the FASB, which provide more detailed information than is possible within this report. One good one is the FASB itself, which has available "Facts About FASB, 1993-1994." The FASB can be reached by mail at 401 Merritt 7, P.O. Box 5116, Norwalk, Connecticut 06856-5116. Others are identified in the footnotes to this chapter.

accounting standards should be established. The Wheat Committee's report, "Establishing Financial Accounting Standards," was issued to the AICPA in 1972. The report recommended the elimination of the APB and the establishment of the FASB. The report, which was approved by the AICPA, envisioned an accounting standards-setting organization that would be more representative than its predecessors, composed of full-time members paid competitive salaries, and provided adequate staff and financial support. For the first time, the body charged with the establishment of formal GAAP was not to be a committee of the AICPA but an independent organization.

In order to achieve the twin goals of being *independent* from undue pressure by affected interests and being *dependent* on the groups that must apply the pronouncements of the FASB in order for those pronouncements to be given authority and credibility, a three-part organizational superstructure was created to simultaneously encourage participation and discourage domination.⁵

That three-part structure is composed of three distinct organizations--the Financial Accounting Foundation (FAF), the FASB itself, and the Financial Accounting Standards Advisory Council (FASAC). At the top of the organizational structure is the FAF. The FAF is a not-for-profit organization that has three responsibilities: (1) appointment of the members of the FASB and the FASAC, (2) raising the funds to support all three organizations, and (3) providing general oversight of the FASB. In addition to its provision of guidance for the private sector's accounting standards through the FASB, the FAF has also established the Governmental Accounting Standards Board (GASB).

The FAF initially considered five options for funding the FASB: voluntary funding, two varieties of support from the organizations eligible to appoint FAF trustees, a surcharge on AICPA membership, and a surcharge levied by the stock exchanges on

⁵ Miller and Redding, *The FASB: The People, the Process, and the Politics*, 30.

listed companies.⁶ The option chosen was voluntary funding. Voluntary funding combined with the sale of publications has been adequate thus far. About half of the funds raised by the FAF to support the three organizations comes from the sale of publications. A similar amount comes from donations. These proportions vary from year to year and can be effected significantly by the number of standards issued in a given year.

The appointment process for FAF trustees is complex and vitally important. (Recall that the FAF, in turn, appoints the seven members of the FASB.) The CAP and the APB were both committees of the AICPA and, therefore, allowed no representation of outsiders. When the Wheat Committee recommended the establishment of the FASB, it recommended wider representation of interests, and the FAF was constructed to allow that representation. Thirteen of the sixteen FAF trustees are effectively elected by the FAF sponsoring organizations, which are groups whose members have special knowledge of financial reporting. The current sponsoring organizations are:

- the American Accounting Association;
- the AICPA;
- the Association for Investment Management and Research;
- the Financial Executives Institute (FEI);
- the Government Finance Officers Association;
- the Institute of Management Accountants;
- the National Association of State Auditors, Comptrollers, and Treasurers; and
- the Securities Industry Association.

Four of the sponsoring-organization nominations are made by the AICPA, and two are made by the FEI. The American Accounting Association, the Association for Investment Management and Research, the Institute of Management Accountants, and the Securities Industry Association each select one trustee. Three trustees are nominated by the two

⁶ Solomons, *Making Accounting Policy*, 34.

governmental sponsoring organizations, which maintain contact with and select a member from a variety of public-interest groups. Currently, the Attorney General of the State of Illinois and the Comptroller of the Treasury of the State of Tennessee are FAF trustees. The final three members are appointed at large by the other trustees.

The remaining function of the FAF is to monitor the FASB's process. The oversight of the FASB by the FAF is general and is structured so that FAF's review function cannot directly intrude into the FASB deliberations on any specific issue.

The second leg of the three-part FASB organizational structure is the FASAC. The FASAC is also appointed by the FAF and currently has over 30 members. Its major functions are to advise the FASB on items to be included on the FASB agenda and to provide input on preliminary positions the FASB has adopted. FASAC members, like FAF members, are uncompensated.

The third and most visible organizational component is, of course, the FASB itself. There are seven full-time members of the FASB. In order to allow the members to sever their ties to former employers, they are competitively paid. FASB members are appointed by the FAF for five-year terms and are eligible for one reappointment. Formally, FASB members are chosen by the FAF based on their qualifications, which include "knowledge in financial accounting and reporting," "awareness of the financial reporting environment," and "commitment to the FASB's mission."⁷ Currently, three of the seven FASB members are from public accounting, two are from industry, one is from academia, and one is a security analyst. Five of the seven are CPAs.

FASB members are supported by a staff of about forty persons. In addition, to facilitate rapid action on developing issues and to address issues without requiring a

⁷ Financial Accounting Foundation, "Report of the Special Review Committee to the Board of Trustees," July 25, 1985, 15-18, as cited in Miller and Redding, *The FASB: The People, the Process, and the Politics*, 35-36.

formal FASB pronouncement,⁸ the FASB created the Emerging Issues Task Force (EITF) in 1984. The EITF makes recommendations to the FASB about issues to be considered and can issue its own consensus opinions, which lack the authority of FASB pronouncements but nonetheless carry significant weight. Members of the EITF are drawn primarily from public accounting firms. It is chaired by the Technical Director of the FASB.

Those who created the FASB obviously created a broader base of support for the FASB than its predecessors had enjoyed. And it is the first of the three accounting standards setting organizations to be organizationally separate from the AICPA. The extent of the separation of the FASB from the AICPA and the large accounting firms has been the subject of some debate, a debate which will be considered later in this chapter.

The FASB Process

The FASB process has the following four principal types of output:

1. **Statements of Financial Accounting Standards (FASs).** These standards, which address specific accounting issues, are the highest authority in the GAAP hierarchy. As of December 31, 1993, the FASB had issued 117 Statements of Financial Accounting Standards.
2. **Statements of Financial Accounting Concepts (SFACs).** These statements attempt to identify the fundamentals of financial accounting as a guide to the FASB itself, practicing accountants, and the public. SFACs of interest to public utility regulators and regulated utilities were discussed at some length in Chapter 2. SFACs do not establish mandatory GAAP.

⁸ Schroeder, Clark, and McCullers, *Accounting Theory*, 42.

3. **FASB Interpretations (FINs).** Interpretations expand upon previously issued Statements providing clarification or elaboration. FINs also create GAAP. As of December 31, 1993, forty FINs had been issued. FINs are required to be submitted to the FASAC for comments for a period of fifteen days, but more extensive exposure is generally provided.
4. **Technical Bulletins (TBs).** TBs are issued by the FASB staff to provide guidance on limited accounting problems or on items not directly covered by other pronouncements. TBs do not officially create GAAP. A TB cannot be issued if an accounting problem affects a significant number of firms, if the cost of administering the TB is high, or if the TB could conflict with established accounting principles. TBs must be discussed with the Board and cannot be issued if more than two members object.

For the two most formal types of pronouncements, FASs and SFACs, the FASB utilizes an extensive procedure designed to allow input from all affected parties prior to pronouncement adoption. A schematic view of that due-process procedure for major issues is provided in Figure 3-2. It is similar in many ways to the notice-and-comment rulemaking that is familiar to public utility regulators. The FASB process, which complies with the requirements of the Federal Administrative Procedures Act, includes the minimum requirements for notice-and-comment rulemaking: a notice of proposed rulemaking, a comment period, and issuance of a final rule.⁹ The FASB process is far less judicial, however, than public utility commission proceedings. It relies more heavily on informal communications and the development of consensus among members than might be allowed under public utility commission legal requirements and procedures.

Determining which issues to place on its agenda for consideration is probably the most critical step in the FASB process. A number of groups can assist the FASB to focus on an issue. The formal vehicles for bringing an issue to the FASB include the EITF, the FASAC, the FASB staff, and the SEC, with which the FASB maintains a close

⁹ Robert E. Burns, *Administrative Procedures for Proactive Regulation* (Columbus, OH: The National Regulatory Research Institute, 1988), 91.

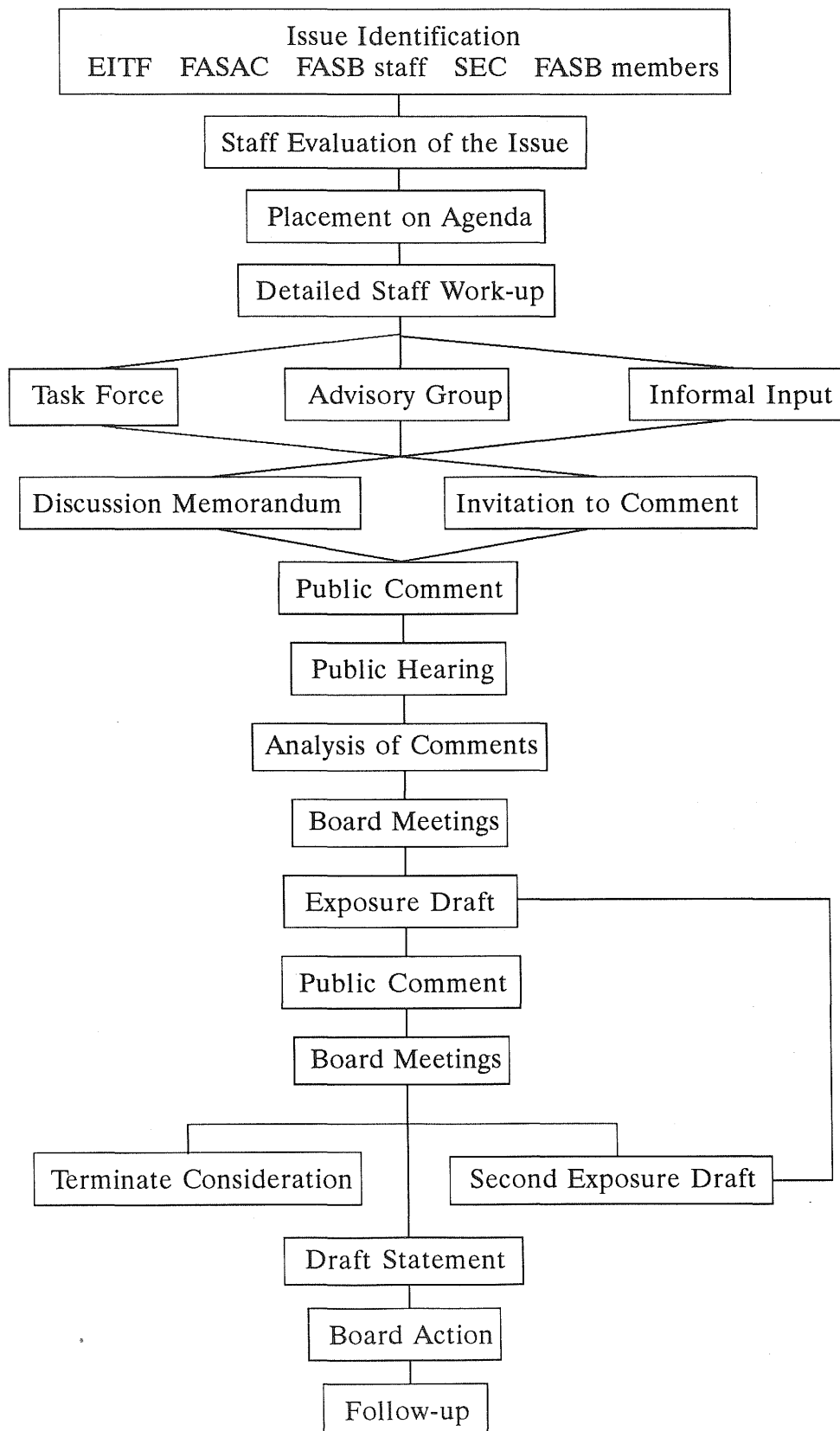


Fig. 3-2. The FASB's Due Process.

Source: Authors' construct.

relationship. FASB members themselves can also recommend issues, and the FASB maintains liaison with other groups, including committees of the AICPA and other financial organizations. Among the utility-specific standards discussed in Chapter 4 of this report, two (FAS No. 71 and FAS No. 101) were preceded by a request from the AICPA for consideration of the issues, one (FAS No. 71) was also preceded by a request from the SEC, and two were initiated by FASB member concerns (FAS No. 90 and FAS No. 92). But even if an issue is recommended to the FASB by one of the formal vehicles for issue identification, there is no guarantee that the FASB will put the issue on its agenda.

The FASB utilizes the following four criteria for determining if an issue should reach its agenda:¹⁰

1. **The pervasiveness of the problem:** the extent to which an issue is troublesome to users, preparers, auditors, or others; the extent to which there is diversity of practice; and the likely duration of the problem (i.e., is it transitory, or will it persist)
2. **Alternative solutions:** the extent to which one or more alternative solutions that will improve financial reporting in terms of relevance, reliability, and comparability are likely to be developed
3. **Technical feasibility:** the extent to which a technically sound solution can be developed, or whether the project under consideration should await completion of other projects
4. **Practical consequences:** the extent to which an improved accounting solution is likely to be acceptable generally, and the extent to which addressing a particular subject (or not addressing it) might cause others to act, e.g., the SEC or Congress.

Once an item is placed on the FASB's agenda, the FASB staff become heavily involved by performing research and more carefully defining the issue and options. The Board

¹⁰ The FASB, "Facts About FASB, 1993-1994," 2-3.

can, depending on the importance of the issue, assemble a Task Force or Advisory Group of interested parties who assist the FASB to formulate its opinion. In either case, a Discussion Memorandum or an Invitation to Comment is produced. These documents, which include a definition of the problem, a listing of the relevant issues, research findings and relevant literature, and alternative solutions, are then distributed to interested parties for comment. The Board holds public hearings after comments have been received, and any individual or group can ask to be heard. The hearing transcript, public testimony, and written comments become part of the public record.

After these initial deliberations are concluded, the Board is required to issue an Exposure Draft of the proposed solution for comment prior to the issuance of FASs. If substantial comments are received on the Exposure Draft and major revisions are warranted, the Board can issue a subsequent draft. The issuance of a second Draft requires additional time for comment and may necessitate another round of public hearings. If modifications are minor, the Board can move ahead to the final pronouncement. The Board can also terminate the project at this time if it determines that an acceptable standard cannot be developed. As distinct from FASB public hearings, at which any individual or group can ask to be heard, when the Board holds a regular meeting, the public is welcome to observe though rarely is asked to participate in the discussion.¹¹

After further discussion, the staff prepares a draft statement for approval by the Board. Five affirmative votes are now required for an FAS or SFAC, and the arguments of dissenters are published with the final pronouncement. For a time, only four affirmative votes were required to issue a FASB pronouncement. FAS No. 71 and FAS No. 90, both critical to regulatory accounting, were passed during that period with only four affirmative votes. If five votes had been required, the standards might not have been issued, at least in their current format.

¹¹ Miller and Redding, *The FASB: The People, the Process, and the Politics*, 63.

The FASB has created some ex parte requirements and limits the numbers of members who can meet internally prior to Board meetings and the number who can meet with outsiders. No public record is established for internal meetings.

The FASB possesses fairly wide latitude by public utility commission standards, and if it determines that a proposed Statement will simply modify an existing Statement or address a narrow issue, it can eliminate the establishment of a Task Force, the discussion document, and the public hearing. It must, however, still issue an Exposure Draft for public comment. (FAS No. 101, "Regulated Enterprises--Accounting for the Discontinuation of Application of FASB Statement No. 71," was issued without a public hearing.)

Following the issuance of a pronouncement, the FASB attempts to monitor its implementation and its success. Informal contacts are common and formal mechanisms are occasionally employed to solicit opinions. Issues that are unsuccessfully resolved sometimes reach the FASB agenda again.

Criticisms of the FASB

It is not surprising that an organization with the power of the FASB would be occasionally criticized. The most visible criticism of the FASB was issued in March of 1977 by the Subcommittee on Reports, Accounting, and Management of the Committee on Government Operations of the United States Senate (commonly and hereafter referred to as the Metcalf Report in honor of its Chairman, Senator Lee Metcalf of Montana).¹² That report was issued shortly after the FASB was established and came at a time of considerable financial scandal (e.g., Equity Funding) and unexpected corporate failures (e.g., Penn Central). At the time, accountants also were accused of

¹² Subcommittee on Reports, Accounting, and Management of the Committee on Government Operations of the United States Senate, "The Accounting Establishment," Document No. 95.34 (Washington, D.C.: U.S. Government Printing Office, March 1977).

other way" at overseas bribery and illegal political contributions by their clients and of following accounting rules that were far too flexible.

A central thesis of the Metcalf Report was that the FASB was unduly influenced by the accounting profession. It stated without equivocation that,¹³

...the FASB is not independent of its sponsoring groups. The manner in which the FASB is organized and operated ensures that it will be responsive to the private interests of the groups that have created it.

Indeed, though FASB has adopted a process of notice and comment rulemaking for its pronouncements, some allege that the interests of the accounting community itself and the big accounting firms are the real driving force behind FASB standards. The Metcalf Report stated that the rules and procedures developed by the FASB:¹⁴

...permit an opportunity for critical comment on FASB proposals before they are finally adopted as standards. However, they do not overcome the fact that the FASB and its staff are not fairly balanced as to the interests represented by those persons who perform the work and make the actual decisions regarding accounting standards which affect the Federal Government and the public.

The interests that were overrepresented, according to the report, were those of the accounting community.¹⁵ The report also said:

The FASB represents only the interests of its private sponsoring groups. No amount of transferring of funds and authority through intermediate organizations can alter the fact that, in the end, all of the organizations are controlled by the same self-interested parties. The inability to divorce private influence from private control impairs all efforts to achieve public

¹³ Ibid., 130.

¹⁴ Subcommittee on Reports, Accounting, and Management of the Committee on Government Operations of the United States Senate, *The Accounting Establishment*, 16.

¹⁵ Ibid., 15.

confidence in a system which vests public authority in private organizations.¹⁶

The Metcalf Report criticized the FASB's appointment process and its funding mechanism. It determined that the largest accounting firms "control" the AICPA, which at the time had exclusive authority to elect and remove the members of the FAF. FAF members had exclusive authority to appoint and remove members of the FASB.¹⁷ With regard to the funding of the FASB, the Metcalf Report stated that the funding of the FASB through the FAF was "one means of controlling its (the FASB's) activities to ensure that financial accounting standards remain compatible with the interests of the "Big Eight" and their clients."¹⁸

From these allegations, the authors of the Metcalf Report concluded that the establishment of accounting standards of vital importance to the public must be vested in a public organization. They said that the SEC's abdication of its authority gave the accounting profession the ability, "to develop and apply a body of alternative accounting standards which would be useful primarily in promoting their business objectives, rather than focusing on standards which would result in meaningful and uniform presentation of financial information to the public."¹⁹ David Solomons also said that when the SEC gave the accounting profession the opportunity to establish accounting standards, it stifled accounting innovation by any group that did not have that "substantial authoritative support" required by the SEC.²⁰

The Metcalf Report concluded that "...establishing accounting standards involves social issues that can be resolved effectively only by authorities responsible solely to the

¹⁶ Ibid., 19.

¹⁷ Ibid., 3.

¹⁸ Ibid., 153. When the Metcalf Report was issued, there were eight dominant accounting firms. Today, there are six.

¹⁹ Ibid., 132.

²⁰ Solomons, *Making Accounting Policy*, 26.

public."²¹ It also concluded that "As the branch of the Federal Government most directly representative of the public, Congress should exercise its authority to achieve proper accounting practices."²²

The question as to whether government could perform more satisfactorily than the FASB is a difficult one that has been hotly debated. The SEC, the agency to which accounting standards setting would revert on the demise of the FASB, only has jurisdiction over companies offering securities for sale across state lines or through the mail. There is no guarantee that its administrative processes would be an improvement. The federal government has not distinguished itself in those instances when it has established accounting standards. The SEC also has asserted that it does not have the money or expertise to set accounting standards.²³

Though the accounting community disputed the Metcalf Report's findings, during the same period it enacted a number of changes in the way accounting standards were set. Specifically, the FAF:²⁴

1. Opened FASB meetings to the public.
2. Changed the voting requirement for adoption of FASB pronouncements from five affirmative votes among the seven members to a simple majority. (The FAF changed the requirement back to five affirmative votes in 1991 in order to help assure that FASB pronouncements would be accepted.)
3. Eliminated the requirement that at least four of the FASB members be CPAs principally experienced in public accounting.

²¹ Subcommittee on Reports, Accounting, and Management, *"The Accounting Establishment,"* 19.

²² *Ibid.*, 20.

²³ Solomons, *Making Accounting Policy*, 28.

²⁴ Donald E. Kieso and Jerry J. Weygandt, *Intermediate Accounting* (New York: John Wiley and Sons, Inc., 1980), 21.

4. Replaced the Board of the AICPA as the sole elector of the Foundations's Trustees with a panel of six representatives from six sponsoring organizations. (This sharing of power since has been expanded.)
5. Approved a plan to obtain broader based financing for the FASB's operations.

It should also be remembered that, at a time when the accounting community was being criticized for overly flexible standards, the FASB was beginning the process of establishing standards that, by their definition, eliminate or reduce that flexibility. Since its inception it has been free of scandal, and it has shown itself willing to modify its processes to allow public input.

Given the limitations inherent in government establishment of accounting standards, the relative success of the FASB, and the attempt by the accounting profession to establish an organization that allows public input, the best alternative seems to be, at present, to leave the setting of accounting standards to an independent, private sector organization. The evaluation of whether the FASB is adequately independent and up to the task of setting accounting standards is beyond the scope of this report and best left to an "ends" test rather than a "means" test. The FASB should, therefore, be allowed to retain the power it has as long as it continues to:

1. establish timely and responsive standards,
2. establish standards that meet the needs of users, particularly when those needs conflict with the needs of accountants and their clients,
3. avoids undue influence,
4. make decisions that are consistent with a prescriptive base rather than simply affirming current practice,
5. prove that it has the ability and the courage to consistently act in the public interest.

Recently, the FASB has shown itself willing to take on very controversial issues, such as the accounting for executive stock options and even the accounting for regulatory assets. In the end, the best, public interest evaluation of the FASB can be performed by the SEC, which has the ultimate authority under the law to designate the source of accounting standards.

Avenues of Access to the FASB

There are four general avenues of access to the FASB open to public utility regulators. They are as follows:

1. formal participation in FASB processes,
2. informal access to FASB,
3. access through the FAF and FASAC,
4. access to and through the SEC.

Formal participation in FASB processes is fairly straightforward. A subscription is available from the FASB that notifies subscribers of pending FASB actions, Discussion Memoranda, and public hearings. When the FASB considers an issue, both written and verbal presentations are solicited and used in making its decisions. Informal communications are also important to the FASB. Specific points of access may be difficult to identify, but the institutional credibility of the regulatory commissions should afford access. Informal contacts could be most effective if they were initiated prior to formal FASB action on an issue and maintained over time. One example of useful communication not specific to any single issue was the meeting in November 1992 between the EITF and representatives of the utility industry, including state regulatory commission staff and utility executives.

Informal and on-going contact with the FASB may be particularly effective given the inherent limitations of notice-and-comment rulemaking of the type used by the

FASB. As Robert Burns points out, notice-and-comment rulemaking may give notice to interested parties that an agency is about to act, but it does not guarantee participation, particularly during the key early phases of the issue's consideration. Second, notice-and-comment rulemaking does not include a formal process for a full and fair dialogue between the decision maker and affected parties, again particularly during early phases. Third, as one experience observer has noted, the comment period in notice-and-comment rulemaking may take place far too late in the process to impact the outcome.²⁵ These comments are not intended to suggest that FASB processes become more judicial or that the notice-and-comment process be abandoned; they are intended to point out the importance of maintaining on-going contact with the FASB as opposed to issue-specific involvement. Indeed, the FASB has expressed a willingness to meet at any time with representatives of interested groups.

In the process of making regulatory needs known well in advance of formal consideration of issues by the FASB, particular attention should be paid to FASB staff, who play an important role in the development of pronouncements. FASB Project Managers, for instance, play a key role in finding opportunities for consensus among Board Members.²⁶

Though the FASB provides considerable formal and informal opportunities for direct access, indirect access to the FASB could also be gained through the public members of the FAF and the members of the FASAC. Recall that the two formal, public sponsoring organizations of the FAF (the Government Financial Officers Association and the National Association of State Auditors, Comptrollers, and Treasurers) maintain liaison with a number of other public interest organizations. Those public interest organizations, such as the National Governor's Association, may be open to input from regulatory commissions. Because the FAF and FASAC do not become directly involved in FASB deliberations, access to the FAF and FASAC would not be

²⁵ Robert E. Burns, *Administrative Procedures for Proactive Regulation* (Columbus, OH: The National Regulatory Research Institute, 1988), 91-92.

²⁶ Miller and Redding, *The FASB: The People, the Process, and the Politics*, 44.

useful for input on specific pending actions and, once again, would be most effective over time.

The final point of influence on the establishment of accounting standards may be through the SEC. Though the SEC has delegated its formal control over the creation of financial accounting standards, the SEC holds the ultimate, legal authority for those standards and could, in theory at least, reassume responsibility. The FASB also attempts to maintain a working relationship with the SEC, and, in at least one instance, the SEC has overruled the FASB. In that case private interests caused the SEC to overrule the FASB, whose decision had benefitted the public interest.²⁷ It is particularly important that the National Association of Regulatory Utility Commissioners (NARUC) take advantage of all opportunities to create a working relationship with the SEC because of the SEC's expressed concern over the propriety of regulatory assets and liabilities.²⁸

In September 1992, the NARUC Staff Subcommittee on Accounts passed a resolution urging the NARUC Committee on Finance and Technology to open a dialogue with the SEC on regulatory matters in general and the treatment of regulatory assets specifically. The Staff Subcommittee also established a Task Force to monitor SEC, EITF, and FASB issues. The resolution was passed by the Committee on Finance and Technology, and a dialogue was initiated under the leadership of the Subcommittee on Accounts. Participants in those discussions have included the Chief Accountant of the SEC, representatives from the SEC, FERC staff, NARUC staff, and state regulatory commission staff. Issues discussed included regulatory assets, environmental contingencies, decoupling and conservation, and affiliate transactions.²⁹

²⁷ Solomons, *Making Accounting Policy*, 225-226.

²⁸ NARUC Staff Subcommittee on Accounts, "Need for discussion with Securities and Exchange Commission," Paper presented to the NARUC Finance and Technology Committee, Los Angeles, California, November 16, 1992.

²⁹ Denise Parrish, "Minutes of the December 13, 1993, Meeting Between SEC and NARUC Representatives," Washington, D.C., January 13, 1994, 1-3.

Given the importance of FASB and SEC actions and their potential impact on the regulation of public utilities, regulators and utilities would be well advised to vigorously participate in accounting policy making by making use of every mechanism available. In these days of rapid change for regulation, it is critical that regulators insure that those who make accounting policy understand regulatory perspectives and needs.

CHAPTER 4

ACCOUNTING STANDARDS SPECIFIC TO REGULATED UTILITIES

The Accounting Differences Between Utilities and Unregulated Businesses

In most instances, the same accounting principles that apply to unregulated enterprises also apply to regulated utilities. The ways that utility accounting differs from accounting for unregulated businesses are summarized below.

Regulatory Assets

As a result of the ratemaking process, and with the probable assurance by a regulatory commission of future cost recovery, utilities sometimes include allowable costs in a period other than the period in which those costs would be charged to expense by an unregulated enterprise. For example, a utility might amortize, with regulatory approval, a large storm loss over future periods, while an unregulated business would immediately write off such costs as current expense in the period in which they were incurred. Similarly, a utility might postpone recognition until later periods of the underrecovery of purchased gas costs under a fuel adjustment clause since those costs would eventually be recovered through rates. Unregulated businesses would charge all research and development costs against current income, while a regulator concerned with intergenerational equity might direct a utility to capitalize and amortize major research costs that would benefit future periods. Instead of recording the full cost as an expense in the period the cost was incurred, the utility would capitalize the future recoverable amount (i.e., charge the costs to an asset account rather than to an expense account at the time of expenditure). That asset would then be charged to an expense account (amortized) across the period that the costs were allowed in rates.

Intercompany Profits

Intercompany profits on sales by affiliates to regulated utilities are not eliminated in consolidated financial statements if such profits are equivalent to a reasonable return on investment. A wholly unregulated business would eliminate all intercompany profits of affiliates in consolidated statements. When regulated firms are involved, the acceptance by the regulator of the transfer price within allowable costs for ratemaking establishes a credible price and the potential of future cost recovery.

Capitalization of AFUDC

Utilities capitalize both an interest component and an equity component of funds used for construction because otherwise utilities subject to rate-base, rate-of-return regulation would not be compensated for funds invested in plant under construction, prior to the time the new plant was completed and placed in service. Unregulated businesses do not capitalize an equity component because there is no probable assurance that they will earn a return on their equity investment through prices charged to customers.

Acquisition Adjustments

Under original-cost, rate-base, rate-of-return regulation, if a utility purchases plant from another utility, it records in its plant accounts the balances carried forward from the books of the seller. Any differences between these balances and the purchase price would be recorded in an acquisition adjustment account. An unregulated business would record the entire purchase price of the acquired plant in its plant account assuming that the acquisition price represented the value of tangible assets and not goodwill. Regulatory commissions typically permit a utility to include an acquisition adjustment in rate base or to amortize it through rates only when the acquiring utility can show that an

acquisition will result in significant savings in operating expenses or that the acquisition will enable it to avoid construction of expensive additional plant facilities.

Reacquired Debt

In the process of retiring debt and, in some cases, reacquiring it, all enterprises realize gains and losses. Unregulated businesses would write off gains or losses against current income. Regulatory commissions sometimes direct utilities to set up gains and losses on reacquired debt as assets or liabilities and to amortize them over a future period in which the amortization is reflected in rates.

Plant Phase-Ins

Utilities may still carry on their books the phase-in of plants constructed before January 1, 1988. Those phase-ins were ordered by utility regulators to prevent rate shock and were allowed by FASB in FAS No. 92 to also be reflected in public financial reports.

The fact that accounting for regulated enterprises differs from accounting for unregulated enterprises does not imply that regulated enterprises do not comply with GAAP. The FASB and its predecessors have acknowledged the economic impact of rate regulation on enterprises and have issued a succession of pronouncements that deal with those impacts. The remainder of this chapter is devoted to an exploration of those pronouncements. This discussion is intended for general information and as an overview only.

Accounting Research Bulletin No. 44 (Revised)

In 1958, when it issued a revised version of ARB No. 44, "Declining-balance Depreciation," the Committee on Accounting Procedure (CAP) for the first time explicitly addressed the difference between accounting for regulated enterprises and

unregulated enterprises.¹ Declining balance depreciation had been allowed for tax purposes by the Internal Revenue Act of 1954, and in order to determine its suitability as a part of GAAP, the CAP examined its use. In ARB No. 44 (Revised), the CAP concluded that

Summary: ARB No. 44 (Revised), "Declining Balance Depreciation"

Issued: 1958

Significance: First formal recognition that reasonable probability of recovery of cost through rates can affect accounting treatment.

declining balance depreciation met accounting standards for depreciation methods (i.e., that they be systematic and rational). The CAP, therefore, concluded that declining balance depreciation could be used for general purpose financial reporting.

In Paragraph 4 of ARB No. 44 (Revised), the CAP recognized that, in some special circumstances, declining balance depreciation is appropriate for tax purposes but not financial reporting purposes. In Paragraph 8, it was more specific and recognized that some regulatory commissions recognize deferred income taxes for ratemaking and/or financial reporting but that others do not. The CAP further indicated that its preference was that deferred income taxes should be recognized by regulatory bodies for ratemaking purposes. But it also stated that, if deferred income taxes are not recognized by the regulatory authority, firms are not required to recognize the deferment of taxes if it is reasonable to expect that the higher taxes in future years will be allowed in rates.² In short, the CAP concluded that as long as there was the reasonable probability that costs would be passed on to customers in rates when those costs were incurred, utilities need not report deferred taxes in their financial statements, even though taxes had been deferred for income-tax purposes. As long as rates would provide the necessary revenue when the deferred taxes came due, no deferred taxes needed to be recorded.

¹ Robert L. Hahne and Gregory E. Aliff, *Accounting for Regulated Utilities* (New York: Matthew Bender and Co., Inc., 1991), 12.01.

² Committee on Accounting Procedure, "Accounting Research Bulletin No. 44 (Revised): Declining Balance Depreciation," *Original Pronouncements: Accounting Standards as of June 1, 1993: Volume II* (Burr Ridge, IL: Irwin, 1993), pars. 4 and 8.

Although ARB No. 44 (Revised) was unanimously approved by all twenty-one members of the CAP, two members objected to the provisions related to regulated enterprises. Both essentially argued that there should be no difference between generally accepted accounting principles for regulated and unregulated firms. One also argued, in a foreshadowing of today's debate over the continuance of the regulatory compact, that public utility rates may not be adjusted in the future to allow for the full reimbursement of utility costs incurred in a prior period.³ ARB No. 44 (Revised), including the regulatory components, has essentially been superseded by other pronouncements.

Addendum to APB Opinion No. 2

In 1962, taxes again provided the impetus for an examination of the accounting for regulated enterprises. In the Revenue Act of 1962, Congress had created the investment credit, which provided an offset to taxes in an amount equal to a specified percentage of the cost of certain depreciable assets. The issue facing the Accounting Principles Board (APB) was the period in which the credit should be reflected in the income of the firm. It could be regarded as a subsidy and a contribution to capital, a reduction in taxes in the year the credit is applied, or a reduction of taxes in a future year. In APB Opinion No. 2, "Accounting for the "Investment Credit," the APB announced its decision that the third definition carried the

Summary: Addendum to APB Opinion No. 2, "Accounting for the Investment Credit"

Issued: 1962

Significance: Provided more clarity regarding creation of regulatory assets. Said that, regardless of the source of doubt of future recovery, it is appropriate to defer expenses only when it is probable that costs will be recovered in future revenue.

³ Ibid., 61.

most weight and concluded that the credit should be reflected in income over the life of the asset.⁴

Paragraph 17 of APB Opinion No. 2 recognized, in much the same manner as had Paragraph 8 of ARB No. 44 (Revised), that regulators might require different treatment of the investment credit. In an Addendum to APB Opinion No. 2, the APB laid out in greater detail the circumstances under which it felt that different treatment was justified.⁵

The Addendum addressed the general impact of the regulatory process on accounting and asserted the dominance of the APB in prescribing the methods to be used for financial reporting, particularly in those cases where government or regulatory requirements run counter to generally accepted accounting principles. Most importantly, however, the Addendum stated that it was appropriate to defer expenses to later periods (i.e., to create regulatory assets) only when it is clear that the costs will be recoverable in future revenue. If doubt exists about future recovery, deferring expenses is not, according to the guidance of the Addendum, appropriate, regardless of the reason for the doubt.⁶

According to Robert Hahne and Gregory Aliff, the Addendum to APB Opinion No. 2 provided a long-standing basis for regulatory accounting, but by the mid-1970s, it had become apparent that the Addendum did not provide adequately detailed guidance. It did not identify which types of enterprises could apply the Addendum and which types of regulation were adequate to meet the requirements of probable future recovery of costs. The Addendum, according to Hahne and Aliff, was also increasingly used to justify almost any accounting treatment required by regulators.⁷

⁴ Accounting Principles Board, "APB Opinion No. 2: Accounting for the "Investment Credit"," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume II* (Burr Ridge, IL: Irwin, 1993), pars. 1-13.

⁵ *Ibid.*, par. 17.

⁶ *Ibid.*, Addendum.

⁷ Hahne and Aliff, *Accounting for Public Utilities*, 12.01.

On the other hand, regulators asserted that it was the utilities that were primarily responsible for abuses of the Addendum and that the independent accountants employed by the utilities regularly acquiesced to the utilities' interpretations of the "probability of future recovery" required by the Addendum.

FAS No. 71

In 1977, at the urging of the SEC and the AICPA and in response to the shortcomings of the Addendum to APB Opinion No. 2, the FASB began a project to re-evaluate the accounting standards related to regulated enterprises. In 1982 the FASB issued FAS No. 71, "Accounting for the Effects of Certain Types of Regulation." That pronouncement, which generally reiterated the theory established by the Addendum, had two major benefits. It was more specific and it established which types of regulation allowed a departure from GAAP as required for unregulated enterprises.⁸

Summary: FAS No. 71, "Accounting for the Effects of Certain Types of Regulation"

Issued: 1982

Significance: Limited creation of regulatory assets to rate regulated enterprises, to recovery of specific costs, and to those situations where rates, which include deferred costs, can be expected to be charged to and paid by customers.

Though parts of FAS No. 71 were later modified, it remains as the bulwark of regulatory accounting and the principal mechanism whereby the accounting for regulated enterprises can be accomplished in accordance with GAAP. Indeed, the majority of the differences between the accounting for regulated and unregulated enterprises cited at the beginning of this chapter are rooted in FAS No. 71. It is the first accounting pronouncement wholly devoted to the economic effects of regulation, and during its consideration, it attracted considerable attention from those it affected. In addition to input from the FASB Task Force, which included representatives of the utilities and

⁸ Ibid., 12-4.

regulatory authorities, the FASB received 197 letters in response to the Discussion Memorandum and another 172 in response to the Exposure Draft.⁹

In its early paragraphs, FAS No. 71 set out to limit its application to rate regulated enterprises and further specified that those rates must be cost based. It used the analogy of a cost-reimbursement contract to explain the required linkage between costs and revenue.¹⁰ (As was pointed out in Chapter 1, the appropriateness of the analogy between rate regulation and cost reimbursement contracts is hotly debated.) Specifically, FAS No. 71 was applied only to the external financial statements of enterprises that meet all of the following criteria:¹¹

- a. The enterprise's rates for regulated services or products provided to its customers are established by or are subject to approval by an independent, third-party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers.
- b. The regulated rates are designed to recover the specific enterprises'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.

FAS No. 71 further stipulates that if a portion of a firm's operations are subject to these conditions and other portions are not, the Statement should be applied only to that

⁹ Financial Accounting Standards Board, "FAS No. 71, Accounting for the Effects of Certain Types of Regulation," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume I* (Burr Ridge, IL: Irwin, 1993), pars. 122-124.

¹⁰ *Ibid.*, par. 3.

¹¹ *Ibid.*, par. 5.

portion that meets the conditions.¹² It also stipulates that rates must reflect the recovery of specific costs incurred in the past rather than merely an estimate of costs to be incurred in the future.¹³ For example, FAS No. 71 would apply if the costs of research and development incurred in a prior period were spread across several years by the regulator rather than being charged to expense in the year incurred. FAS No. 71 would not apply if rates were set to allow for expected, future research and development costs.

In dealing with specific regulatory accounting issues, FAS No. 71 addressed the allowance for funds used during construction, and it authorizes enterprises to report the amount capitalized for ratemaking external financial statements as well.¹⁴ It suspends the application of ARB No. 51 and APB Opinion No. 18, which required the profits on the sale of assets between affiliates to be eliminated in consolidated financial statements for regulated enterprises, if the sales price was reasonable and it was probable that rates would allow the sales price to be recouped.¹⁵

FAS No. 71 requires that regulated enterprises disclose in financial statements refunds to customers if the associated revenue was recognized in a different period and the refunds had a material effect on income. It requires disclosure of any significant costs amortized over a period that had been included in rates but not in the rate base (which has the effect of not allowing a return on investment over the period).¹⁶ In a section that has since been superseded by FAS Nos. 96 and 109, it also required utilities under certain restrictions to disclose the cumulative net amount of taxes payable for which deferred taxes have not been recognized.¹⁷

¹² Ibid., par. 6.

¹³ Ibid., par. 9.

¹⁴ Ibid., par. 15.

¹⁵ Ibid., pars. 16-17.

¹⁶ Ibid., pars. 19-20.

¹⁷ Ibid., par. 18.

In general, FAS No. 71, which is mandatory for enterprises which meet its requirements, recognizes that regulators have the ability, in certain, limited circumstances, to create assets by allowing costs, which in an unregulated enterprise would be charged to expense, to be capitalized and included in rates for later recovery. Similarly, it recognizes that regulators can reduce or eliminate the value of assets, impose a liability on an enterprise (e.g., by requiring refunds), or eliminate a liability, though regulators can only eliminate a liability that was created earlier by the regulatory process.¹⁸ FAS No. 71, however, does not give carte blanche authority to utilities to load their books with assets or defer costs at their own convenience or that of the regulator.

Paragraph 9 of FAS No. 71 states that costs, which would otherwise be charged directly to expense, shall be capitalized only if:¹⁹

- a. It is probable that future revenue in an amount at least equal to the capitalized costs 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 costs.

If emerging competition or changes in customer demand make the probability of future recapture of costs less than probable, the terms of FAS No. 71 no longer apply.²⁰ Though regulators may establish rates meant to capture costs incurred in prior periods as required by FAS No. 71, the intentions and actions of the regulator do not, in

¹⁸ Ibid., pars. 9-12.

¹⁹ Ibid.

²⁰ Ibid., 10.

themselves, control the applicability of FAS No. 71; applicability is also dependent on markets and the likelihood that customers will pay those rates.²¹ If markets change and alternatives become available to consumers, FAS No. 71 may no longer be applicable on the affected revenue stream. Since incentive rates can be cost-based, establishment of incentive rates does not, necessarily, preclude the application of FAS No. 71.

When the FASB began its consideration of the effects of regulation on enterprises, it began with two threshold questions. The first question posed in the Discussion Memorandum essentially asked, Should the accounting requirements of regulators automatically qualify as GAAP? The respondents to the Discussion Memorandum provided an emphatic "no" to that question. Based on the input received, the FASB concluded that regulation, per se, does not allow regulated firms to depart from GAAP as it is applied to unregulated enterprises.²²

Second, having concluded that rate regulation does not, by itself, justify disparate accounting treatment, the FASB essentially asked, Does regulation create economic circumstances that are substantially different from the economic conditions of unregulated firms? To that question, the answer was "yes." Citing the close relationship between costs and revenues in regulated enterprises, the FASB concluded that regulation can create economic conditions within an enterprise that may justify a customized GAAP for regulated utilities. Specifically, the regulatory treatment of some costs (i.e., allowing them to be capitalized instead of charging them directly to expense) causes an economic impact that justifies special accounting treatment, and the most significant economic impact of regulation is the ability of the regulator to create assets.²³

Those regulatory assets can take a variety of forms. In addition to the general concept of regulatory assets (and liabilities), FAS No. 71 specifically addressed intangible assets (such as purchased goodwill), leases, refunds, early extinguishment of debt,

²¹ Ibid., par. 66.

²² Ibid., pars. 51-55.

²³ Ibid., pars. 56-58.

allowance for funds used during construction, and compensated absences of employees. (FAS No. 87 later recognized that FAS No. 71 would also allow recognition of a regulatory asset for the difference between pension costs allowed for ratemaking and net periodic pension cost established under FAS No. 87.²⁴)

Even with the extensive limitations it contained, FAS No. 71 was not approved without considerable controversy. It passed by one vote (four to three). In a dissent that presaged the current debate over the legitimacy of regulatory assets, one FASB member asserted that adequate assurance of the future recoverability of costs could not be made in the utility environment of the time. He further asserted that because regulators could not provide assurance that customers will exist, that services will be provided, or that customers will pay the price set, regulatory assets should not be reported within general purpose financial statements.²⁵

Given today's utility markets it is easy to see why the application of FAS No. 71 is subject to considerable controversy. Even in the utility environment of the 1980s, it was not long after the adoption of FAS No. 71 that further guidance was required.

FAS No. 90

Prior to the 1980s, plant abandonments usually occurred in the early stages of construction, so they seldom represented a significant percentage of company assets. Losses were immediately written off by charges to current operations. If the regulator permitted recovery of the loss through rates, the abandoned plant was recorded as a deferred charge and amortized by charges to future operations. In the 1980s as a result of reduced demand forecasts, environmental concerns, rapidly escalating construction costs, and difficulties in obtaining financing, abandonment of plants under construction

²⁴ Financial Accounting Standards Board, "Statement of Financial Accounting Standards No. 87: Employers' Accounting for Pensions," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume I* (Burr Ridge, IL: Irwin, 1993), par. 210.

²⁵ FASB, "FAS No. 71," 710-711.

(particularly nuclear plants) became common. Some utilities abandoned plants that were in the later stages of construction. More than thirty major electric utilities suffered abandonment losses during this period, and in a few cases, the investments of utilities in these abandoned plants exceeded total shareholder's equity.

By the mid-1980s, it had become apparent to the FASB that developments required the economic effects of regulation to be revisited. In addition to reacting to plant abandonments, regulators, in the face of massive cost overruns, had begun to disallow some of the costs of newly constructed electric generating facilities. Some state courts also ruled that the costs of abandoned facilities could not be passed on to ratepayers.²⁶ Further, if a plant represented current overcapacity, many state commissions chose to phase-in new plant coming into service over a period of several years. The net result was that major changes were occurring in the financial condition of electric utilities, changes that required accounting recognition.

As a result of these developments, FASB members directed staff to investigate the accounting issues involved, and staff subsequently met with representatives of the regulated utilities, the AICPA, and NARUC. Following those meetings, the FASB conducted its due-process procedures and issued FAS No. 90, "Regulated Enterprises--

Summary: FAS No. 90, "Regulated Enterprises--Accounting for Abandonments and Disallowances of Plant Costs"

Issued: 1986

Significance: Requires abandoned plant to be removed from construction work-in-process or plant-in-service and to be restated as a new asset. Any portion of disallowance not allowed in rate base by regulators is to be recognized as a loss.

²⁶ Financial Accounting Standards Board, "Statement of Financial Accounting Standards No. 90: Regulated Enterprises--Accounting for Abandonments and Disallowances of Plant Costs," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume I* (Burr Ridge, IL: Irwin, 1993), par. 78.

Accounting for Abandonments and Disallowances of Plant Costs."²⁷ During the course of its deliberations, the FASB determined that additional investigation was necessary to resolve the issue of accounting for plant phase-ins and postponed consideration of phase-ins.

In FAS No. 90, the FASB concluded that when a plant is abandoned, its character changes. It is no longer a physical asset capable of generating revenue; it is essentially a monetary asset resembling a long-term receivable.²⁸ As a result, when it becomes evident that a plant, either under construction or already contained within the rate base, will be abandoned, the cost of that plant must be removed from construction work-in-process or plant-in-service, respectively.

In general, if the utility determines that the regulatory commission is likely to allow a full return on investment for the abandoned plant, just as if it continued to be included in the rate base, a new asset will be recognized at the same value as the abandoned plant. If only a portion of the cost of the asset is allowed in the rate base, the allowed portion is to be treated as a new asset (valued at the present value of the expected future revenues) and the disallowed portion (the difference between the present value of the new asset and the cost of the plant) is to be recognized as a loss.²⁹

FAS No. 90 requires that the value of the new asset created by abandonment of a plant be adjusted as circumstances change and the amount of estimated future recovery is adjusted.³⁰ It also requires that a carrying charge be added to the value of the asset for any elapsed time between the date of its recognition and the date recovery begins.³¹

²⁷ Financial Accounting Standards Board, "FAS No. 90: Regulated Enterprises--Accounting for Abandonments and Disallowances of Plant Costs," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume I* (Burr Ridge, IL: Irwin, 1993), 961-978.

²⁸ *Ibid.*, par. 47.

²⁹ *Ibid.*, par. 3.

³⁰ *Ibid.*, par. 4.

³¹ *Ibid.*, par. 5.

For disallowances of recently completed plants, FAS No. 90 requires that any disallowances be estimated, reported as a loss, and deducted from the cost of the plant. This procedure can have substantial impact on the earnings for the period, the interest coverage ratio, and other financial performance measures. This treatment is necessary even if the disallowance is indirect (i.e., if a return on investment of some portion of the plant is disallowed).³²

FAS No. 90 also clarified and amended FAS No. 71. It clarified Paragraph 15 of FAS No. 71 to allow AFUDC to be capitalized only if the inclusion of those capitalized costs in allowable costs for ratemaking is probable.³³ It amended FAS No. 71 to define "probable" as "likely" and to add several footnotes cross referencing FAS No. 71 and FAS No. 90.³⁴ Additional detail and clarification of FAS No. 90 was provided in FASB Technical Bulletin 87-2, issued in December 1987.

Part of the FAS No. 90 debate involved the role of the courts in public utility regulation. Some of the respondents to the FASB Exposure Draft objected to the requirement that an abandonment be recognized when a rate order is issued on the grounds that regulation effectively occurs in the courts. The FASB expressed its belief that the rate order is usually the event which confirms an abandonment, but it also added that an abandonment should only be recognized if a loss is probable and if it can be reasonably estimated.³⁵ It, thereby, left open the door to utilities to wait until all court appeals of a commission ordered abandonment loss have been exhausted before concluding that a loss was probable and could be reasonably estimated.

FAS No. 90 does not, by intent, address cost disallowances other than plant disallowances and abandonments. Nor does it address the flip side of the high costs of plant construction--phase-in plans. That issue was deferred to FAS No. 92.

³² Ibid., par. 7

³³ Ibid., par. 8.

³⁴ Ibid., par. 9.

³⁵ Ibid., par. 52.

State commissions have reacted to abandonments and cost overruns using a variety of mechanisms. In the case of abandonments, a common practice of regulatory commissions is to allow amortization of the investment in the abandoned plant, but with no return on the unamortized balance. Thus, a return of the funds invested is allowed, but no return on the funds invested is allowed. The amortization periods vary from commission to commission, with ten year or fifteen year periods being most common. The FERC practice was to allow recovery of 50 percent of the cost of the abandoned plant over its estimated life with a return allowed on the unamortized balance.

Several states have constitutions or statutes that prohibit regulatory commissions from authorizing a return on any plant that is not used or useful in providing utility service. This requirement has sometimes been interpreted by courts to mean that a utility cannot recover any investment in abandoned plant, even though both the original decision to build the plant and the subsequent decision to abandon it were prudent and were made with the approval of the state commission having jurisdiction.

Disallowance of a part of the cost a newly completed plant occurs when a regulatory commission concludes that management failed to adequately control plant construction costs or otherwise made imprudent decisions that adversely affect the completed cost of a new plant. There is no question that some utilities used sloppy construction practices and failed to properly document expenditures. As a result, when final costs of completed plants were three, four, or five times the amount of original estimates, regulatory commissions felt pressured to "do something" to protect ratepayers from imprudent construction costs. The result was the widespread implementation of prudence reviews of construction costs.

Sometimes, to avoid the hassle of prudence hearings, a utility may agree to a construction cap on a project before it is completed, thereby agreeing to absorb all costs in excess of a designated amount. Similarly, a commission could use the same concept as an incentive to encourage utilities to bring in projects below cost estimates.

In some instances in which utilities constructed generating capacity substantially in excess of all projected needs for the foreseeable future, regulatory commissions found it appropriate to disallow a portion of the plant costs and/or depreciation and maintenance costs.

FAS No. 92

In 1984, the financial press began to report on emerging rate problems related to new electric generating plants placed in service. Questions were raised as to whether or not the costs of those plants could be passed on to customers without a substantial loss of customer base.³⁶ At the same time regulators became concerned about likely "rate spikes" when those plants were put into service. Those dramatic, potential increases in rates were caused by the high cost of the new nuclear plants, the relatively high cost of capital at the time, and the overestimation of utility demand growth.³⁷ As a result, regulators developed phase-in plans, which were intended to postpone the introduction of the new plant into the rate base until later and to allow the utility a return on investment on the portion of the plant in service but not yet in the rate base.³⁸

As a result of these developments, the FASB began an investigation and, in August 1987, issued FAS No. 92,

"Regulated Enterprises--Accounting for Phase-in Plans."

As it considered phase-in plans, the FASB had three fundamental concerns. First, it asked whether phase-in plans violate the requirements of FAS No. 71, which requires the reasonable expectation that deferred costs will be included in future rates and paid by customers. If

Summary: FAS No. 92, "Regulated Enterprises--Accounting for Phase-in Plans"

Issued: 1987

Significance: Allowed accounting recognition of phase-in plans, but limits them to a restricted time period and requires that deferred costs must be scheduled for recovery within ten years.

³⁶ Financial Accounting Standards Board, "FAS No. 92, Regulated Enterprises--Accounting for Phase-in Plans," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume I* (Burr Ridge, IL: Irwin, 1993), par. 75.

³⁷ *Ibid.*, par. 49.

³⁸ *Ibid.*, 50.

economic conditions currently do not allow for rates to reflect the full cost of service, what is the probability that conditions at a later time will?³⁹

Second, though regulators sometimes shift costs from the period in which they were incurred to some later period, that cost shifting has a logical basis (such as the need to match the recipient of the service with the payment for the service). In the case of phase-in plans, costs were deferred simply because rates might become unacceptably high. The FASB worried that the discipline inherent in charging customers for the cost of service would be lost and excesses would result.⁴⁰

Third, the FASB asked whether an allowance for earnings on shareholder investment (on the portion of the plant in service not yet in the rate base) was different from other costs designated by regulators for recovery. Of particular concern was the fact that such an allowance would represent an increase in income though the income has not been earned yet.⁴¹

The FASB concluded that phase-in plans should be recognized in general purpose financial reports but concluded that their use should be significantly restricted so as to not compromise the integrity of utility financial reports. The FASB's limits on phase-in plans were so extensive that they created a departure for the first time from the premise that regulatory assets could be created based on the probability of recovery; instead, FASB created a standard that prohibits the creation of regulatory assets for phase-in plans regardless of the probability of cost recovery unless those plans meet other conditions.⁴²

First, FASB applied a restrictive definition of phase-in plans. In addition to limiting phase-in plans to physical plants about to be completed or recently completed,

³⁹ Ibid., pars. 51-52.

⁴⁰ Ibid., pars. 53-54.

⁴¹ Ibid., pars. 55-56.

⁴² James K. Guest, "Accounting and Financial Reporting Under the Federal Power Act and the Natural Gas Act," (Unpublished remarks: November, 1993), 7.

FAS No. 92 limited the application in the future of phase-in plans by requiring that construction be completed before January 1, 1988 or, at a minimum, that substantial construction be completed prior to that date.⁴³ As a result, FAS No. 92 was restricted to the specific time period and economic conditions prevalent at the time of its promulgation.

If a phase-in plan met the time conditions specified, all costs deferred by the regulator could be capitalized as a new asset (recall that the creation of a new asset was also required by FAS No. 90 for disallowances and abandonments of plants) only if the following four conditions were also met:⁴⁴

1. There must be a formal plan agreed to by the regulator.
2. The plan must specify the timing of the recovery of the deferred costs.
3. The deferred costs must be scheduled for recovery within ten years.
4. The percentage increase in rates for each year must be no greater than the percentage increase for the previous year. (The purpose of this requirement was to prevent "back end" loading, i.e., the avoidance of significant rate increases until the latter years of the phase-in period.)

By permitting an allowance for earnings on shareholder investment related to phase-in plans (which effectively created an imputed income), the FASB expanded the allowances created by FAS No. 71 beyond the construction period. The FASB, however, closed the door to further extension of that allowance in order to prohibit premature recognition of income.⁴⁵ It conclusively limited capitalization of investor earnings for financial reporting to phase-in plans that met the criteria described above and the

⁴³ Financial Accounting Standards Board, "FAS No. 92," pars. 3-5.

⁴⁴ *Ibid.*, par. 5 (paraphrased).

⁴⁵ *Ibid.*, par. 69.

allowance for funds used during construction.⁴⁶ FAS No. 92 also addressed modifications of phase-in plans, the distinction between phase-in plans and disallowances, and disclosure of deferred amounts in financial reports.⁴⁷

The ten-year criterion for cost recovery provoked considerable discussion. The FASB admitted that the ten-year period was arbitrary, but concluded that the departures from traditional cost-of-service regulation allowed by FAS No. 92 were so significant that they must be subject to controls. The specific departures from rate-base, rate-of-return regulation addressed by the FASB included departures from the assumption that expenses would be recovered in the period in which they were incurred and departures from the assumption that a return on investment would normally be recovered in the period during which the investment was in service.⁴⁸ The ten-year criterion was also applied because FAS No. 92 was regarded as a solution to a time-limited problem and because FASB members were concerned with long-term developments in the electric utility industry.⁴⁹

In fact, the utility industry continued to change with such rapidity that a little over a year later the FASB again issued a pronouncement dealing with the accounting for regulated enterprises. This time the FASB specified the circumstances in which utility accounting under FAS No. 71 could be discontinued.

FAS No. 101

After FAS No. 71 was issued and utilities adopted it for financial reporting, changes, such as deregulation or emerging competition, made application of FAS No. 71 no longer appropriate. The FASB, informed that the methods used to account for

⁴⁶ Ibid., par. 9.

⁴⁷ Ibid., pars. 6, 7, 11.

⁴⁸ Ibid., par. 59.

⁴⁹ Ibid., par. 61.

discontinuation of FAS No. 71 varied, and prompted by an AICPA request to re-evaluate the issue, began consideration of the methods by which the discontinuation of the use of FAS No. 71 by utilities should be reported in financial statements.⁵⁰ In December 1988, the FASB concluded its deliberations and issued FAS No. 101, "Regulated Enterprises--Accounting for the Discontinuation of Application of FASB Statement No. 71."

Summary: FAS No. 101, "Regulated Enterprises--Accounting for the Discontinuation of Application of FASB Statement No. 71"

Issued: 1988

Significance: Identifies circumstances such as deregulation or emerging competition which made FAS No. 71 no longer applicable. Requires the change in financial position caused by discontinuation to be recorded as an item of net income.

FAS No. 101 concluded that various developments can cause an enterprise to no longer be eligible to include the economic impacts of regulation in its general purpose financial statements. Four examples it listed were:⁵¹

1. Deregulation,
2. A change from cost-based ratemaking to other forms,
3. Emerging competition that limits the utility's ability to sell its services at rates that recover costs,
4. Regulatory resistance to rate increases that limit the utility's ability to recover costs if the utility is not able or not willing to obtain relief through appeal to the courts.

⁵⁰ Financial Accounting Standards Board, "FAS No. 101, Regulated Enterprises--Accounting for the Discontinuation of Application of FASB Statement No. 71," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume I* (Burr Ridge, IL: Irwin, 1993), par. 2.

⁵¹ *Ibid.*, par. 4 (paraphrased).

FAS No. 101 established two basic rules for reporting the discontinuation of application of FAS No. 71. First, it posited that if a utility no longer met the requirements for application of FAS No. 71, all assets and liabilities created under FAS No. 71 should be eliminated from its financial statements.⁵² It required that the change in the financial statements caused by discontinuation of FAS No. 71 be reported as a separate item of net income in the period of the change.⁵³ Elimination of an asset requires a charge against income; elimination of a liability requires that the utility increase its reported income.

Second, the FASB in FAS No. 101 concluded that it would not be necessary for utilities discontinuing the use of FAS No. 71 to reduce the value of plant, equipment, and inventory, even though those values might have been affected by FAS No. 71.⁵⁴ An example is the value of utility plant, to which has been added a return on investment through AFUDC during the construction period. The following arguments supported the FASB's determination that the value of plant, equipment, and inventory would not need to be adjusted when FAS No. 71 was discontinued:⁵⁵

1. AFUDC is an acceptable substitute for interest that would have been capitalized by unregulated entities.
2. Assets or liabilities are recorded at their initial value.
3. The adoption by enterprises in general of the FASB standard for capitalization of interest was prospective.
4. The cost of obtaining the necessary information and making the change in plant, inventory, and equipment values exceeds the benefits of making the change. (The fact that the benefits of information must exceed its cost is one of the

⁵² Ibid., par. 6.

⁵³ Ibid., par. 30.

⁵⁴ Ibid., par. 6.

⁵⁵ Ibid., par. 26 (paraphrased).

characteristics of accounting information identified in SFAC No. 2.)

The FASB used the analogy of a contractual obligation to sell goods in the future at an established price to describe regulated firms for which FAS No. 71 is not appropriate. Even if a firm expects to generate profits on those future sales, that expectation does not justify recognition of an asset representing those future earnings.⁵⁶ In order for assets or liabilities to be recorded, regulated utilities must not only have set rates that allow for cost recapture, they must have reasonable expectation that those services will be purchased at that price. If either part of that transaction is in doubt, FAS No. 71 does not apply and the methods described in FAS No. 101 apply for discontinuation.

In FAS No. 101, the FASB also addressed the issue of the separability of a utility's operations. Some respondents to the Exposure Draft of FAS No. 101 expressed the opinion that if FAS No. 71 did not apply to one portion of a utility's operations, it should not be applied to any operations within the same regulatory jurisdiction or reportable business segment. In the end, the FASB sided with those who believed that utilities have the ability to create finer distinctions. It concluded that FAS No. 71 could be applied to smaller portions of the utility's business, or even to some customer classes but not others.⁵⁷

FAS No. 109

Accountants calculate corporate income tax liability using prevalent accounting rules, but actual Federal income taxes payable are determined using IRS rules. For regulated firms the difference between the tax expense recorded for financial reporting purposes and the taxes paid to the government is recorded as deferred accumulated

⁵⁶ Ibid., par. 34.

⁵⁷ Ibid., pars. 39-40.

income taxes. Utilities calculate the income tax expense reported in their books of account based on straight line depreciation; actual income taxes payable are based on accelerated depreciation. Differences between IRS and accounting techniques for valuing inventory and environmental expenditures are the other major sources of the difference between tax expense and taxes paid.

Summary: FAS No. 109, "Accounting for Income Taxes"

Issued: 1992

Significance: Applied deferred tax reporting requirements to regulated firms as well as unregulated firms. Prohibits net-of-tax reporting for regulated firms and requires the creation of a deferred tax liability for taxes that are to be passed on to customers in future years.

When the FASB issued FAS No. 71, it did not specifically address accounting for deferred income taxes for regulated utilities. Since accounting for income taxes for enterprises in general was on the Board's agenda at the time, it decided to wait until it issued a general statement on accounting for income taxes before it issued a statement on accounting for income taxes for regulated enterprises.⁵⁸

In February 1992, the FASB issued FAS No. 109, "Accounting for Income Taxes," which applied to all enterprises, including those subject to rate regulation and FAS No. 71. That statement amended FAS No. 96 (also titled "Accounting for Income Taxes") by clarifying the criteria for recognition of deferred tax assets and liabilities and reducing undue complexity.⁵⁹ In short, FAS No. 109 requires that a deferred tax asset or liability be recognized for the temporary difference between the amount of pretax income and taxable income for a year or the difference between the tax basis of assets and their reported amounts in financial statements.⁶⁰

⁵⁸ Financial Accounting Standards Board, "FAS No. 109, Accounting for Income Taxes," *Original Pronouncements: Accounting Standards as of June 30, 1993, Volume I* (Burr Ridge, IL: Irwin, 1993), par. 125.

⁵⁹ *Ibid.*, par. 2.

⁶⁰ *Ibid.*, pars. 8 and 10.

Some utilities had been reporting the value of construction in progress on a net-of-tax or after-tax basis, or both; FAS No. 109 prohibits utilities from using net-of-tax reporting.⁶¹ It also requires a deferred tax liability to be recorded for tax benefits that are ultimately to be passed on to customers and for the equity component of AFUDC.⁶² In addition to recording a deferred tax asset or liability for temporary tax differences, regulated enterprises subject to FAS No. 71 must record a regulatory asset or liability if it is probable that the future decrease or increase in taxes will be passed on to customers through rates.⁶³

Summary and Conclusions

The accounting pronouncements summarized in this chapter are not the only pronouncements that apply to regulated utilities. They are, however, the principal pronouncements specifically addressing the economic effects of regulation.

Even a cursory examination leads one to the conclusion that the FASB intended for these utility accounting pronouncements to apply in very limited circumstances; they were not intended to serve as a license to allow the reporting within general purpose financial statements of any regulatory treatment a utility or regulatory commission desires. Utilities and regulatory commissions have made widespread use of the regulatory accounting prescribed by these standards. That use was, and still is, appropriate as long as the basic requirements--particularly the three criteria for the application of FAS No. 71--are met. In these days of rapidly changing utility environments and the increasing (albeit uneven) infusion of competition into utility markets, considerable care and discretion must be taken by utilities, regulators, and auditing firms to insure that the terms of these pronouncements are not abused.

⁶¹ Ibid., par. 57.

⁶² Ibid.

⁶³ Ibid., par. 29.

The ultimate criteria for the creation of deferred charges is no longer, however, the actions of regulators. Three of the four reasons cited by FAS No. 101 in 1988 for the discontinuation of the application of FAS No. 71 were related to regulatory actions. Today, the criteria that determine the probability of recovery of costs must be derived from the market conditions utilities operate within, and are likely to operate within in the foreseeable future, rather than on the actions of regulators. In some markets, even if regulators in good faith allow the creation of regulatory assets and include deferred charges in rates, by-pass of the utility's system by consumers will frustrate the recovery of costs. In other markets, the probability of cost recovery still exists. In still other markets, competition and customer choice may not exist today but may develop over time.

The creation of regulatory assets requires the probability of future cost recovery. In today's varied utility markets, the evaluation of the probability of cost recovery requires an analysis of market conditions to determine the likelihood that customers will continue to purchase services from the utility and the likelihood that the utility will be able to continue to apply cost-based, rather than market-based, pricing.

CHAPTER 5

THE IMPACT OF FEDERAL INSTITUTIONS ON REGULATORY ACCOUNTING

Though the FASB is the primary source of GAAP for regulated utilities, several federal agencies also impact the accounting for regulated utilities. When federal accounting directives do not conflict with other sources in the hierarchy of GAAP, those directives also create GAAP for regulated utilities through the establishment of "prevalent practice." This chapter will examine each of those federal agencies and its responsibilities, identify its impact on accounting for regulated utilities, and determine how conflicts between those agencies and the state commissions are resolved. Because of the extensive federal involvement in the establishment of standardized systems of accounts, this chapter also examines the role of standardized charts of accounts for regulated utilities. An assessment of the role of state public utility commissions in setting accounting policy is reserved for Chapter 6.

The Securities and Exchange Commission

Largely as a result of the Great Crash of 1929, Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934, which were designed primarily to provide potential investors with adequate and accurate financial information with which to make sound investment decisions. The SEC, which was established by the Securities Exchange Act of 1934, was the federal agency vested with the responsibility for establishing accounting standards required for implementation of securities reform.¹ As was noted in Chapter 3 of this report, the SEC, in its Release No. 4 (dated 1938), delegated its responsibility for establishing accounting standards to the professional accounting community through its "substantial authoritative support" test. Between 1938

¹ Responsibilities initially assigned to the Federal Trade Commission under the Securities Act of 1933 were transferred to the SEC upon its establishment a year later.

and 1973, the AICPA Committee on Accounting Procedure and the AICPA Accounting Principles Board were deemed to possess that substantial authoritative support, and soon after the establishment of the FASB in 1973, the SEC, in its Accounting Series Release (ASR) No. 150, stated conclusively that the FASB was the organization with the capability to meet the substantial authoritative support test. Specifically, ASR No. 150 said:²

...principles, standards and practices promulgated by the FASB in its Statements and Interpretations will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such support.

In September 1980, the SEC in ASR 280 further affirmed its endorsement of the FASB but indicated that, in rare instance, SEC opinions may differ from the FASB.³ As was noted in Chapter 2, SEC rules and interpretative releases are regarded by the FASB as having level "a" status (equal to FASB Statements) on the GAAP hierarchy for registered firms.

On those rare occasions noted in ASR 280, the SEC has asserted its power and overruled the FASB or its predecessors. In December 1962, the Accounting Principles Board (APB) issued Opinion No. 2, which addressed the investment tax credit. That Opinion stated that the gain related to the investment tax credit should be recognized over the same time period as the asset was used (the deferral approach). Recall that APB No. 2 was also one of the earliest formal recognitions of the economic impact of regulation.

A month later, in January 1963, the SEC promulgated ASR 96 which stated the SEC position that either the deferral approach or immediate recognition of the gain,

² Securities and Exchange Commission, "Accounting Series Release No. 150," Washington, D.C., December 20, 1973.

³ Securities and Exchange Commission, "Accounting Series Release No. 280," September 1980, as cited in David Solomons, *Making Accounting Policy: The Quest for Credibility in Financial Reporting* (New York: Oxford University Press, 1986), 39.

better known as the "flow through" approach, was acceptable. As a result of the SEC action, which directly contradicted APB No. 2, in March 1964 the APB issued Opinion No. 4, which adopted the SEC position allowing either method but maintaining that deferral was preferred.⁴

Later, the SEC overruled the FASB with regard to oil and gas exploration costs. In December 1977, the FASB, in response to the proliferation of accounting treatments related to oil and gas exploration, issued FAS No. 19, "Financial Accounting and Reporting by Oil and Gas Producing Companies." In FAS No. 19, the FASB ruled that certain costs of oil and gas exploration related to unsuccessful results must be charged to expense in the current period ("successful efforts costing") rather than identified with assets such as wells and facilities and carried forward for later amortization as the assets are used ("full costing"). The FASB in its argument against full costing posited that an asset must have some future value, which a "dry hole" does not have.⁵

The SEC, perhaps bowing to political pressure, disagreed with FAS No. 19 and in August 1978 released ASR No. 253, which allowed either method of costing. Again the organization designated by the SEC as the authoritative source of accounting standards, in this case the FASB, was forced to acquiesce to the SEC. In February 1979, the FASB reversed its prior position and issued FAS No. 25, "Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies."⁶

As David Solomons points out, in the case of the investment tax credit, the SEC overruled the APB in order to carry out the intentions of the Congress, which had expected the investment tax credit to immediately be reflected in the income statements

⁴ Solomons, *Making Accounting Policy*, 223.

⁵ Financial Accounting Standards Board, "Statement of Financial Accounting Standards No. 19: Financial Accounting and Reporting by Oil and Gas Producing Companies," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume I* (Burr Ridge, IL: Irwin, 1993), par. 111.

⁶ Solomons, *Making Accounting Policy*, 224-226.

of affected companies.⁷ In the case of the accounting for oil and gas exploration costs, the FASB had acted only to be overruled by the SEC, which had been influenced by Congress, which, in turn, had been influenced by private interests.⁸ In both cases, the accounting standards setting organization had attempted to limit the range of accounting options and had been overruled by the SEC.

In addition to these rare instances in which the SEC has asserted its otherwise delegated power, the SEC has three other points of influence on accounting--its enforcement powers, its accounting guidelines, which include SEC Rules and Regulations, Staff Accounting Bulletins and Accounting Series Releases, and its special powers under the Public Utilities Holding Company Act (PUHCA).

The FASB, for all its power, has no direct ability to enforce its decisions. Instead, it must rely on the SEC and the AICPA for enforcement. That requires auditors under Rules 203 and 204 of the Rules of Conduct of the AICPA's Code of Professional Ethics to certify that financial statements have been prepared in accordance with GAAP. David Solomons notes that in England, where there is no SEC to apply sanctions for violation of accounting standards and reinforce auditor requirements, the authority of the accounting standards body is often flouted.⁹

The SEC has broad enforcement and disciplinary powers, though its jurisdiction is limited to companies having securities listed on a national exchange, issuers engaged in interstate commerce or affecting interstate commerce, or issuers whose stock is traded by mail if other criteria, such as the number of shareholders and the value of total assets, are met.¹⁰ For firms subject to its jurisdiction, the SEC can:¹¹

⁷ Ibid., 222-223.

⁸ Ibid., 225-226.

⁹ Ibid., 40.

¹⁰ Ibid., 85 (note 6).

¹¹ Office of the Federal Register: National Archives and Records Administration, *The United States Government Manual* (Lanham, MD: Bernan Press, 1993), 727.

- compel obedience to the disclosure requirements of the registration and other provision of the acts,
- prevent fraud and deception in the purchase and sale of securities,
- obtain court orders enjoining acts and practices that operate as a fraud upon investors or otherwise violate the laws,
- suspend or revoke the registrations of brokers, dealers, and investment companies and investment advisers who willfully engage in such acts and practices,
- suspend or bar from association persons associated with brokers, dealers, investment companies and investment advisers who have violated any provision of the Federal securities laws, and
- prosecute persons who have engaged in fraudulent activities or other willful violations of those laws.

Other enforcement mechanisms include requesting a civil injunction from the courts to stop or prevent fraudulent activities, criminal prosecution, or administrative remedies, which include censure. With these substantial enforcement powers and the endorsement by the SEC of the FASB's accounting standards, the SEC puts the teeth in GAAP for companies under its jurisdiction.

The SEC issues three types of accounting guidelines. SEC Rules and Regulations establish the requirements for certain financial transactions and their accounting treatment. Regulation S-X, the rule most familiar to accountants, provides instructions for the format and content of financial reports provided to the SEC. Accounting Series Releases (ASR) provide interpretative responses to SEC requirements and questions that develop in their implementation. Staff Accounting Bulletins (SAB) were established in 1975 as an additional vehicle for wide dissemination of SEC administrative interpretations and staff practices. SABs do not bear the SEC's official approval but identify staff requirements for compliance with financial disclosure requirements.

The final means by which the SEC influences the accounting for regulated utilities is through the exercise of the special powers delegated to it under the PUHCA. Under

the terms of that act, which was enacted in 1935 in response to abuses by the utility holding companies, the SEC was given specific authority to regulate the accounting, reporting, and financing of those holding companies.¹² There are currently nine registered electric utility holding companies, which account for about 25 percent of the United States' electricity generation.¹³ As of 1991, there were 110 exempt electric utility holding companies, which account for over 50 percent of the electricity generated in the United States.¹⁴ There are also three gas utility holding companies. Exempt holding companies, which meet one or more of the exemptions within the act and which typically do not have extensive multi-state operations, are regulated by the SEC to a less extensive degree.

For registered utility holding companies, the SEC was given the power to:¹⁵

- approve of utility acquisitions and vertical nonutility acquisitions,
- approve of service, sales, and construction contracts and other activities between holding companies and affiliates,
- restrict acquisitions to utility-related businesses,
- approve of corporate and financial structures, and
- approve of securities sales.

¹² Robert L. Hahne and Gregory E. Aliff, *Accounting for Public Utilities* (New York: Matthew Bender and Company, Inc., 1993), 15.01.

¹³ Kenneth W. Costello, Edward H. Jennings, and Timothy W. Viezer, *Implications of a New PUHCA for the Electric Industry and Regulators* (Columbus, OH: The National Regulatory Research Institute, 1992), 13.

¹⁴ Ibid.

¹⁵ Costello, Jennings, and Viezer, *Implications of a New PUHCA for the Electric Industry and Regulators*, 12.

For exempt utility holding companies, the SEC was given the power to approve of acquisitions of 5 percent or more of another utility's securities and monitor activities by reviewing annual SEC filings and industry publications.¹⁶

In its *Ohio Power* decision (*Ohio Power v. FERC*, 954 F.2d 779 (D.C. Cir. 1992) cert. denied in *FERC v. Ohio Power Co.*, 113 S. Ct. 483 (1992)), the U.S. Supreme Court augmented the SEC's powers under PUHCA by giving the SEC sole jurisdiction over interaffiliate transactions of holding companies.¹⁷ That exclusive, affiliate jurisdiction allows the SEC to exercise price-setting powers much like those of regulatory commissions. Congress, feeling that the SEC has not adequately protected consumers in allowing utility diversification, is considering a limitation of the SEC's authority under PUHCA by rolling back the *Ohio Power* decision.¹⁸ A bill, transferring jurisdiction for non-power transactions back to the FERC and the state commissions, is pending in the Senate Energy Committee and may be voted on in the spring of 1994.

The exercise of these substantial powers over the accounting and finance of registered firms requires a large and well-staffed organization. The SEC itself is composed of five commissioners appointed by the President. Member terms are five years, and no more than three members can be from the same political party. Though the work of the SEC is primarily legal in nature,¹⁹ the SEC employs a wide range of professional staff in addition to attorneys. The primary organizations within the SEC that deal with financial and accounting issues are the Division of Corporation Finance and the Office of the Chief Accountant.

In addition to its involvement in other accounting issues, the Office of the Chief Accountant administers the SEC's statutes and rules dealing with the independence of

¹⁶ Ibid.

¹⁷ Kennedy P. Maize, "Senate Weighs FERC Regulation of Holding Company Transactions," *The Electricity Journal* 6, no. 6 (July 1993): 9.

¹⁸ Ibid., 8-9.

¹⁹ Securities and Exchange Commission, *The Work of the SEC* (Washington, D.C.: Office of Public Affairs, Policy Evaluation and Research, 1992), 36.

accountants from the firms they audit. It helps the SEC accomplish its objective of improving auditing and accounting standards and maintaining high standards of conduct by independent accountants.²⁰ For reasons including lack of character, lack of qualifications, unprofessional conduct, or willful violation of securities laws, the SEC can deny accountants the privilege of practicing before the Commission.²¹

In general and despite the very limited instances in which the SEC has overruled the APB or the FASB, the SEC has honored its delegation of authority to set accounting standards. As a result, according to Delaney et al., "the history of the SEC is one of cooperative assistance in the formulation of accounting standards."²² Today, in the face of rapidly emerging competition in utility markets, the SEC has positioned itself to more directly influence utility accounting and, by extension, ratemaking.

The SEC has begun to question the validity of the regulatory compact, and, according to Carl W. Greene, the Chairman of the American Gas Association Accounting Advisory Council, the SEC has put the utility industry on notice that it will look especially hard at regulatory and other assets deemed to be "soft."²³ The SEC has also expressed concern about the recording of revenue related to revenue adjustment mechanisms prior to billing customers and has indicated that recovery of deferrals must be certain rather than probable.²⁴ The SEC has also stated that pay-as-you-go

²⁰ Ibid., 36.

²¹ Ibid., 37.

²² Patrick R. Delaney et al., *GAAP Interpretation and Application: 1993 Edition* (New York: John Wiley and Sons, Inc., 1992), 12.

²³ American Gas Association, "A.G.A., FASB Review Accounting Issues," *Financial Quarterly Review* 43, no. 1 (Winter 1993): 15.

²⁴ NARUC Staff Subcommittee on Accounts, "Need for Discussions with Securities and Exchange Commission," Paper presented at the NARUC Committee on Finance and Technology, Los Angeles, California, November 16, 1992.

treatment of FAS No. 106 costs is not acceptable.²⁵ Those opinions are also likely to influence the FASB as it grapples with the accounting for regulated industries.

The Federal Utility Regulatory Commissions

Unlike the SEC, which has no direct rate-setting responsibility and is not concerned about quality of service, the FERC and the FCC, the two most prominent federal utility regulatory commissions, have duties similar to state regulatory commissions. (The Interstate Commerce Commission, which is not considered in this report, regulates interstate railroad service subject to the constraints of the Staggers Rail Act of 1980, which deregulated railroad rates where competition exists,²⁶ and to a very limited extent regulates interstate trucking.) Like state regulatory commissions, the FERC and the FCC set rates and monitor service quality and prescribe the manner of accounting for jurisdictional utilities.²⁷

The federal regulatory commissions derive their power from the commerce clause of the U.S. Constitution and the Interstate Commerce Act of 1887, which has been referred to as the "first great public utility law."²⁸ The commerce clause of the Constitution, Article I, Section 8, has been broadly interpreted to allow federal jurisdiction over commerce and "all processes through which trade is carried on."²⁹ The commerce clause has even allowed federal jurisdiction to intrude into intrastate commerce if circumstances cause intrastate commerce to impede interstate commerce.³⁰

²⁵ Ibid.

²⁶ Hahn and Aliff, *Accounting for Public Utilities*, 2.07[3].

²⁷ Ibid., 2.06[4].

²⁸ Ibid., 2.07[2].

²⁹ Charles F. Phillips, Jr., *The Regulation of Public Utilities: Theory and Practice* (Arlington, VA: Public Utilities Reports, Inc., 1993), 84-85.

³⁰ Ibid., 86.

By invoking powers derived from the Interstate Commerce Act of 1887, the Congress established all of the federal regulatory agencies discussed in this chapter.³¹

Initially, the federal regulatory agencies asserted jurisdiction in those limited instances in which state jurisdiction was lacking due to the interstate nature of the services being provided by utilities. But as more utility operations began to cross state lines, federal regulatory commissions assumed more importance. Over time, the federal agencies began to assume jurisdiction over all issues not specifically reserved to the states.³² Today, federal-state jurisdictional disputes continue. Indeed, according to Douglas N. Jones, "There is no single persuasive line of reasoning that leads to a neat picket-fence delineation between what "should" be federal and what "should" be state regulatory domain."³³ Those areas of jurisdictional dispute include a number of accounting issues that are mentioned later in this chapter.

The Federal Energy Regulatory Commission

The roots of the current FERC can be traced back to the Federal Power Commission (FPC), which was established by the Federal Water Power Act of 1920. From its inception until 1930, the FPC was controlled by three separate Cabinet-level departments (Interior, Agriculture, and War) and was restricted in its jurisdiction to hydroelectric projects.³⁴

In 1930, the FPC was completely reorganized and began to accumulate more substantial powers. In 1935, the Federal Power Act gave the FPC jurisdiction over

³¹ Hahne and Aliff, *Accounting for Public Utilities*, 2.07[3].

³² *Ibid.*, 2.07[1].

³³ Douglas N. Jones, "The Rational Division of Regulatory Authority Between the States and the Federal Agencies," *Public Utility Regulation in an Environment of Change*, Patrick C. Mann and Harry M. Trebing, eds. (East Lansing, MI: MSU Public Utilities Papers, 1987), 40.

³⁴ Hahne and Aliff, *Accounting for Public Utilities*, 2.07[4].

interstate electric rates, service, securities, and accounting. In 1938, the Natural Gas Act gave the FPC jurisdiction over gas transport and wholesale sale for resale in interstate commerce. The combination of the two acts, with some minor exceptions, gave the FPC identical jurisdiction over interstate gas and electric operations.³⁵

Both the Federal Power Act and the Natural Gas Act gave the FPC the authority to establish uniform accounting for firms under its jurisdiction. According to the Senate report which accompanied the Federal Power Act:³⁶

Section 301 of the Power Act...takes a long step in the direction of uniform accounting which is so essential in the industry. The authority of the Commission over the accounts of companies under its jurisdiction extends to the entire business of such companies...

That same section (mirrored by Section 8 of the Natural Gas Act) establishes the authority of the FPC to "prescribe the manner in which accounts and records are to be maintained by jurisdictional utilities."³⁷ The Federal Power Act also, in Section 318, stipulated that, if a conflict arises between FPC and SEC accounting requirements under the SEC's PUHCA responsibilities, the SEC requirements will prevail. That provision has not created a problem to date as the two agencies have not conflicted over the PUHCA.³⁸

The accounting authority granted to the FPC did not go without court testing by utilities. In 1943, the Northwestern Electric Company questioned whether the FPC had jurisdiction over both the interstate and intrastate portions of its accounting. The Supreme Court, in *Northwestern Electric Co. v. FPC*, held that the FPC did, indeed, have

³⁵ Ibid.

³⁶ U.S. Senate Report Accompanying the Federal Power Act as cited by James K. Guest, "Accounting and Financial Reporting Under the Federal Power Act and the Natural Gas Act," Unpublished Remarks, November 1993, 1.

³⁷ James K. Guest, "Accounting and Financial Reporting Under the Federal Power Act and the Natural Gas Act," Unpublished Remarks, November 1993, 1-2.

³⁸ Ibid., 2.

the authority to require a company to keep its accounts in accordance with FPC requirements and that it was able to assert its authority over general corporate and other fundamental accounts and records of the company.³⁹

In 1964, the accounting jurisdiction of the FPC was again tested in *Appalachian Power Company v. FPC*. In that case, the Appalachian Power Company contested the authority of the FPC to require jurisdictional companies to install and maintain accounts it had prescribed and to require the company to use those accounts in published financial statements. In its finding, the 4th Circuit Court held that the FPC had been charged with the protection of the public interest in general and the interests of consumers and investors specifically.⁴⁰ The Court held, therefore, that public financial reports must be consistent with reports provided to the FPC.⁴¹ Today, the financial reports issued to stockholders and the financial reports prepared for commission use are substantially similar.

Following the energy crisis of the early 1970s, it became apparent that the nation needed a national energy plan and coordination of energy policy making. As a result, the federal government in 1977 created the Department of Energy, which consolidated the responsibilities of the FPC, the Federal Energy Administration, the Energy Research and Development Administration, and the energy responsibilities of several other agencies. The Federal Energy Regulatory Commission was created as an agency of this cabinet-level department and assumed most of the FPC's jurisdiction.⁴²

The FERC is composed of five commissioners appointed by the President, subject to confirmation by the Senate. Its duties include:⁴³

³⁹ Ibid.

⁴⁰ Ibid., 2-3.

⁴¹ Hahne and Aliff, *Accounting for Public Utilities*, 11.03[1].

⁴² Ibid., 2.07[5].

⁴³ Congressional Quarterly, *Federal Regulatory Directory* (Washington, D.C.: Congressional Quarterly, 1990), 198.

- regulation of the transmission of natural gas in interstate commerce,
- regulation of producer sales of certain categories of natural gas,
- regulation of the construction, operation, and abandonment of interstate pipelines,
- review of curtailment plans proposed by natural gas companies,
- oversight of construction and operation of facilities needed by pipelines at the points of entry for import or export,
- regulation of rates and practices of interstate pipelines,
- regulation of the transmission and sale (wholesale) of electricity in interstate commerce,
- authorization of conditions, rates and charges for electric utility interconnections,
- issuance of licenses for nonfederal hydroelectric projects, and
- review of appeals from DOE remedial orders and denials of adjustments.

The FERC also has jurisdiction over the issuance of securities by electric utilities if state commissions do not assume jurisdiction. The FERC has no similar jurisdiction over the securities of gas utilities.

The FERC exercises its accounting responsibilities related to these general duties, in part, through the Office of the Chief Accountant. That office administers the Uniform System of Accounts (USOA) and conducts programs such as performing on-site financial audits, providing interpretations of the accounting system rules and regulations, and granting authority for accounting treatment.⁴⁴

As was indicated earlier in this chapter, the FERC regulates interstate gas and electric operations in much the same manner as a state public service commission

⁴⁴ Ibid., 212.

regulates intrastate operations. To address jurisdictional accounting issues, the FERC issues commission orders and Accounting Releases, which can be used to express the Chief Accountant's opinions of appropriate accounting treatment of items within the USOA.⁴⁵ The following examples of recent FERC actions with regard to accounting policy illustrate the types of issues dealt with by the Chief Accountant and the Commission.

In 1991, Natural Gas Pipeline Company of America (Natural) asked the FERC Chief Accountant to grant a waiver allowing Natural to record revenues from company-produced gas in Account 417, "Revenues from Nonutility Operations," or Account 421, "Miscellaneous Nonoperating Income." Natural argued that the FERC requirement that such revenues be recorded in Account 485, "Intracompany Transfers," subjected it to double taxation, in that revenues from company-produced gas are included in net income subject to taxation and that some states separately tax income from production.⁴⁶

In a letter order issued April 12, 1991, the Chief Accountant denied Natural's request, and on subsequent rehearing, the full Commission upheld the Chief Accountant's ruling, basing its interpretation on the argument that any revenues reported in Account 485 are reported for information only and are offset by costs in Account 800.1, "Natural Gas Well Head Purchases, Intracompany Transfers." It also argued that problems with state taxing authorities should be resolved with those authorities directly. In May of 1992, the District of Columbia Circuit Court upheld the Commission's action.⁴⁷

In a second example, in 1992, the FERC Chief Accountant denied a utility request to capitalize the costs of removing asbestos insulation. Union Electric Company had submitted a letter proposing the inclusion of asbestos abatement costs in equipment

⁴⁵ Hahne and Aliff, *Accounting for Public Utilities*, 11.02.

⁴⁶ James K. Guest, "Comments on Selected Accounting and Auditing Developments at the Federal Energy Regulatory Commission," Remarks presented at the NARUC Staff Subcommittee on Accounts, Miami Beach, Florida, March 29-April 1, 1993, 9-10.

⁴⁷ *Ibid.*, 10.

accounts and proposing to capitalize those costs at the approved depreciation rates for those equipment accounts. In denying the request, the Chief Accountant stated that the proposed treatment was not consistent with the requirements of the Uniform System of Accounts. In his letter order, he also described the relationship between FASB pronouncements and FERC accounting requirements.⁴⁸ He said:⁴⁹

The Commission's accounting requirements for public utilities are set forth in its Uniform System of Accounts (USofA). The USofA and pronouncements of the FASB are broadly based on the same accounting concepts and economic principles. For that reason, the pronouncements of FASB often serve as a useful source of authoritative accounting literature in administering the USofA. However, for financial accounting and reporting to the Commission, the USofA takes precedence over the pronouncements of FASB and any consensus reached by the EITF.

As the Chief Accountant's order indicates, though financial reports prepared for the FERC and those prepared for public reporting are substantially similar, the FERC does recognize certain instances where requirements are not identical. If GAAP, as established by the FERC under level "d" of the GAAP hierarchy (establishment of prevalent practice) conflicts with GAAP as established at higher levels of the hierarchy, the higher order GAAP must be followed for public reporting--that is, FASB and SEC requirements dominate. Conflicts have been minimized, however, since the FERC generally adopts FASB statements for ratemaking purposes as long as they do not conflict with "sound regulatory principles."⁵⁰

⁴⁸ Ibid., 47-48.

⁴⁹ Ibid., 48.

⁵⁰ Janice K. Garrison, "Comments on Selected Accounting and Auditing Developments at the Federal Energy Regulatory Commission," Paper presented to the NARUC Staff Subcommittee on Accounts, San Diego, California, March 21, 1994, 65.

The Federal Communications Commission

The FCC has roots which extend even further back than the FERC or the SEC, and federal regulation of communications predated state regulation. The regulation of telegraph companies, which were interstate from their inception, began in 1866, and as early as 1887, the ICC was given the authority to require interconnections between telegraph companies. In the early days, telephone companies were, for the most part, local operations governed by municipal franchises. As their operations expanded, they were regulated by state commissions. Early in the twentieth century, however, interstate operations of telephone companies began to assume more importance, and in 1910, the Mann-Elkins Act gave the ICC broad powers over interstate and foreign services.⁵¹

The ICC, however, was unable to give adequate attention to the growing regulatory problems associated with telecommunications, and complete regulatory authority for communications was spread across several federal agencies. In an attempt to centralize the regulation of communications by radio and wire, Congress enacted the Communications Act of 1934, which established the FCC. The FCC later assumed the responsibility for the regulation of television, cable, and satellite communications in addition to radio and wire. Though the jurisdiction over intrastate operations was left to the states, the FCC was given substantial authority. To facilitate state-federal cooperation, the FCC was given the authority to establish joint boards.⁵² Over time, the FCC, like the FERC, has increased the power of the federal regulatory agency vis-a-vis the state commissions.⁵³

In one notable example, the FCC attempted to prescribe a uniform treatment of depreciation for both itself and the states. In 1980 and 1981, the FCC issued two orders regarding the depreciation of telephone plant requiring the application of equal life

⁵¹ Phillips, *The Regulation of Public Utilities*, 758.

⁵² *Ibid.*, 758-760.

⁵³ Hahne and Aliff, *Accounting for Public Utilities*, 2.07[7].

group depreciation. Those orders, according to the FCC's argument, reflected the fact that "Congress clearly intended that there be one regime--rather than multiple regimes--of depreciation for each subject carrier."⁵⁴

The public service commissions of twenty-three states appealed the FCC order, and the Supreme Court, in *Louisiana Public Service Commission et al. v. FCC* (476 U.S. 355 (1986)), held that Congress, in the Communications Act, specifically denied the FCC the power to require states to follow FCC depreciation practices for intrastate ratemaking purposes.⁵⁵ State objections to the FCC Order were probably due as much to resistance to FCC intrusion into the intrastate ratemaking process as to any basic objection to FCC depreciation practices.

Since the 1970s, there have been attempts to modify the Communications Act of 1934. The earliest proposals would have returned some portions of the telecommunications industry to its monopoly status and, thereby, ran counter to the direction of the FCC. In more recent years, if enacted, legislative proposals would have reduced FCC jurisdiction and deregulated a substantial portion of the industry.⁵⁶ Of course, the major event affecting the FCC and its jurisdiction was the breakup of AT&T in 1984. The full impact of that event on the regulatory responsibilities of the FCC is not yet known.⁵⁷

The FCC is composed of five commissioners, who are appointed by the President with the advice and consent of the Senate. Within the staff branches of the FCC, the organization of most interest to regulators and utilities is the Common Carrier Bureau. The Bureau makes recommendations to the commission, conducts adjudicatory and rulemaking hearings, determines the legality of carrier charges, processes applications for

⁵⁴ Justice William Brennan, as cited in Daniel L. Brenner, *Law and Regulation of Common Carriers in the Communications Industry* (Boulder, CO: Westview Press, 1992), 56.

⁵⁵ *Ibid.*, 58.

⁵⁶ Phillips, *The Regulation of Public Utilities*, 764.

⁵⁷ Hahne and Aliff, *Accounting for Public Utilities* 2.07[7].

carrier service, reviews performance, conducts analysis and research, carries out enforcement activities, and administers the accounting and financial reporting system.⁵⁸ Located within the Common Carrier Bureau is the Accounting and Audits Division, and within the Division are the Accounting Policy Branch and the Audits Branch. Accounting responsibilities of the FCC include the prescription of accounting rules, the composition of and content of financial reports, and depreciation rates.⁵⁹ The FCC has no jurisdiction over securities issues of telephone companies.

The FCC issues a variety of pronouncements that impact the accounting for regulated utilities under its jurisdiction. First, the FCC is authorized by the Communications Act of 1934 to make rules and regulations necessary to the execution of its functions. FCC rules and regulations are established through administrative procedures that conform to the Administrative Procedures Act, which may include issuance of a Notice of Proposed Rulemaking (NPRM). The FCC chart of accounts for telephone companies is, for example, established by regulation and included with the Code of Federal Regulations, Title 47, Part 32. Part 64 governs affiliate transactions, Part 36 governs federal-state separations, Part 65 governs rate base, and Part 69 governs tariff access elements.

An example of the FCC's process for making changes to its rules and regulations (and also as an example of the FCC's implementation of FASB pronouncements) is its implementation of FAS No. 109. When the FASB issued FAS No. 109, Accounting for Income Taxes," it required the use of the liability method of accounting for income taxes and simplified the recognition of deferred tax assets. The liability method requires enterprises to record a deferred tax liability for any taxes deferred into the future. As discussed in Chapter 4, regulated enterprises subject to FAS No. 71 were also made

⁵⁸ Congressional Quarterly, *Federal Regulatory Directory, Sixth Edition* (Washington, D.C.: Congressional Quarterly, 1993), 157.

⁵⁹ *Ibid.*, 149.

subject to FAS No. 109; paragraph 26 of that Statement contains requirements specific to regulated enterprises.⁶⁰

In August 1989, the FCC issued an NPRM to reflect changes in the accounting for income taxes required by the FASB in FAS No. 96 (also titled "Accounting for Income Taxes"). In response to FAS No. 109, in March 1993, the FCC issued a Further Notice of Proposed Rulemaking (FNPRM) to change Part 32 to incorporate the liability method of accounting for income taxes and to add accounts to reflect the changes.⁶¹ The outcome of that rulemaking process was an FCC rule formally addressing the accounting for income taxes by jurisdictional companies.

The FCC also issues Responsible Accounting Officers Letters (RAOs) to address accounting issues. As an example, in 1992, the FASB promulgated FAS No. 112, which required employers to use accrual accounting for the costs of such postemployment benefits as unemployment benefits and worker's compensation. FAS No. 106 had required accrual accounting for postretirement benefits. Shortly after the FASB statement was issued, two large telecommunications carriers notified the FCC of their plans to implement FAS No. 112. Ameritech proposed to implement FAS No. 112 by beginning to accrue the current costs and taking a one-time charge against earnings for the cumulative effect of implementing FAS No. 112. U S West proposed to defer the accumulated costs and amortize them over a three-year period. In April 1993, the Accounting and Audits Division of the FCC issued a letter to U S West denying its proposal as inconsistent with GAAP.⁶²

In June, the FCC issued Responsible Accounting Officer Letter No. 22, which provided guidance to all carriers for implementation of FAS No. 112. The RAO

⁶⁰ Financial Accounting Standards Board, "Statement of Financial Accounting Standards No. 109: Accounting for Income Taxes," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume I* (Burr Ridge, IL: Irwin, 1993), par. 29.

⁶¹ Federal Communications Commission Common Carrier Bureau, Accounting and Audits Division, "Accounting and Reporting Matters," Paper presented to the NARUC Staff Subcommittee on Accounts, Aspen, Colorado, September, 1993, 1.

⁶² *Ibid.*, 3.

required carriers to adopt FAS No. 112 for regulatory purposes on the same date it is adopted for financial reporting (but not later than January 1, 1994). Carriers were directed to file a notice of intent to adopt FAS No. 112 to be filed no less than ninety days prior to implementation. The RAO also specified to accounts within Part 32 to be charged.⁶³

Though rule changes must be accomplished by order of the commission itself, the FCC has delegated some authority. As a result, orders also are issued by the Accounting and Audits Division of the Common Carrier Bureau. For example, in March 1993, the Bureau issued an order further automating its filing requirements. That order was issued after issuance of an Order Inviting Comments (OIC), to which several parties responded with comments.⁶⁴

The Common Carrier Bureau also issues Public Notices such as the Notice issued in September 1993 providing suggestions for carriers filing study area waiver requests.⁶⁵ Like other state and federal regulatory commissions, the FCC itself issues orders. Today most of the telecommunications carriers regulated by the FCC are subject to price cap regulation instead of traditional rate-base, rate-of-return regulation, making rate orders less prevalent than they are in state commissions.

The FCC has issued an order announcing that it will adopt GAAP to the extent that regulatory considerations permit, and, for the most part, the FCC has done so. Exceptions, such as the treatment of AFUDC and compensated absences, have occurred. In those cases, FCC requirements prevail for regulatory reporting and GAAP prevails for public reporting. The FCC requires a reconciliation of any differences between SEC-required reports and FCC required reports.⁶⁶ Because of the displacement of

⁶³ Ibid., 3-4.

⁶⁴ Ibid., 5-6.

⁶⁵ Ibid., 6.

⁶⁶ Jose-Luis Rodriguez, "Presentation of CAM Audit Spreadsheets," Paper presented to the NARUC Staff Subcommittee on Accounts, San Diego, California, March 24, 1994.

traditional rate base, rate-of-return regulation by incentive regulation and the corresponding increase in competition, interstate telecommunications providers under the jurisdiction of the FCC are less able than intrastate telecommunications providers or gas and electric utilities to meet the stringent requirements of FAS No. 71.

Federal-State Conflict Resolution

In theory, there should be no conflict between federal and state jurisdiction over accounting or other regulatory matters. Generally speaking, the federal agencies regulate interstate operations and the state commissions regulate intrastate operations. The trend has been for the federal agencies to increasingly preempt state jurisdiction where the distinction might be in doubt. Despite the statutory distinctions between state and federal jurisdiction, conflicts still arise impacting the accounting for regulated utilities. The court system provides one mechanism for the resolution of disputes between federal and state regulatory authority. Fortunately, there are other mechanisms that can be used to mitigate or resolve conflict.

Two tools authorized by the Communications Act and used by the FCC for state/federal conflict resolution are joint boards and joint conferences, established under sections 410(a), (b), and (c) of Title IV of the Act. Joint boards are intended to resolve issues which are not clearly isolated to either state or federal jurisdiction. For example, a joint board was formed to consider the interstate versus intrastate separation of a regulated company's total costs. The joint boards defined by the three sections of the Act differ in some administrative respects. Section 410(a) joint boards are convened at the discretion of the FCC; section 410(c) joint boards are mandated by Congress. Both types of joint boards consist of federal and nonfederal commissioners. Both types of joint boards "resolve" problems by agreeing to a recommended order for the full FCC, which has the power to accept or reject the recommendation.⁶⁷

⁶⁷ Douglas N. Jones et al., *Regional Regulation of Public Utilities: Opportunities and Obstacles* (Columbus, OH: The National Regulatory Research Institute, 1992), 181-182.

Joint conferences differ from joint boards in that joint boards remain in existence until an issue is resolved and an order is recommended to the full FCC. Joint conferences can be dissolved without adopting a proposed order and operate under less obligation and expectation. Joint boards have been used more than joint conferences.⁶⁸

The FCC's Accounting and Audits Division also makes extensive use of informal cooperation and coordination with state public utility commissions. The heads of both the Accounting Policy Branch and the Audits Branch of the Division are active participants on the NARUC Staff Subcommittee on Accounts.

The FERC has not used the joint board process though some would argue that it has the authority.⁶⁹ In exercising its responsibility and desire for uniformity between regulatory and financial accounting, it relies on informal coordination with state public utility commissions. The office within FERC with accounting responsibility, the Office of the Chief Accountant, is an active participant on the NARUC Staff Subcommittee on Accounts.

The Establishment and Role of Standardized Accounts

In discharging their duties, regulatory commissions have consistently been drawn to the establishment of uniform systems of accounts for jurisdictional utilities. Indeed, it is difficult to imagine how effective regulation could occur without the application of standardized accounts.

Standardized accounts accomplish two general purposes: they provide uniformity and consistency in the presentation of financial data.⁷⁰ Uniformity allows all utilities to be compared. Consistency allows a single period to be compared to other periods. For regulators, standardized charts of accounts also create accurate records, distinguish

⁶⁸ Ibid., 182-183.

⁶⁹ Ibid., 143-167.

⁷⁰ Hahne and Aliff, *Accounting for Public Utilities*, 11.02[1].

between income and capital accounts and between utility and nonutility business, accurately cost property, and provide data for rate evaluation.⁷¹ All uniform systems of accounts contain a detailed list of account numbers, a definition of each account, instructions for recording amounts in the specific accounts, and instructions for using the chart of accounts.⁷² Utilities are not prohibited from establishing subaccounts and other subsidiary records necessary to the effective management of the utility.⁷³

The first standardized, U.S. accounting systems for gas and electric utilities were prescribed by Massachusetts in 1885 and 1887 respectively. New York and Wisconsin followed in 1909.⁷⁴ By 1925, forty states had developed their own systems of accounts and had applied them to their jurisdictional utilities.⁷⁵ The first national systems of accounts were developed in the 1920s by joint action of NARUC, the National Electric Light Association and the American Gas Association.⁷⁶

The Federal Power Act of 1935, which had established the FPC, also gave it the specific authority to establish systems of accounts for the electric and gas companies it regulated. Following the passage of the Federal Power Act, NARUC and the FPC worked together to develop systems of accounts, which were essentially similar. Numbering changes to the systems of accounts were put in place in the 1950s and 1960s, but with the exception of those changes, the systems of accounts have survived largely intact since their development.⁷⁷ Today, most states have adopted the FERC or the NARUC systems of accounts for electric and gas utilities. (A listing of the states and

⁷¹ Phillips, *The Regulation of Public Utilities*, 216-217.

⁷² Hahne and Aliff, *Accounting for Public Utilities*, 11.02[1].

⁷³ Ibid.

⁷⁴ Phillips, *The Regulation of Public Utilities*, 219.

⁷⁵ Hahne and Aliff, *Accounting for Public Utilities*, 11.01.

⁷⁶ Ibid.

⁷⁷ Ibid.

their prescribed uniform chart of accounts for electric, gas, and telecommunications utilities is contained in the NARUC *Annual Report on Utility and Carrier Regulation*.⁷⁸⁾

For telephone utilities, the ICC established a uniform system of accounts in 1913, and the FCC adopted it with minor changes in 1935. In 1937, NARUC adopted a similar system for intrastate telephone utilities.⁷⁹ In 1986, the FCC substantially amended the standardized system for telephone companies.⁸⁰ Most state public utility commissions have adopted the FCC uniform system of accounts.

Amendments to both the FCC's and the FERC's uniform systems of accounts require formal rulemaking procedures and issuance of a commission order.⁸¹ The NARUC Staff Subcommittee on Accounts issues Interpretations, which reflect its opinions of proper accounting treatment within its uniform systems of accounts.⁸² The NARUC systems of accounts are periodically updated by recommendations of the NARUC Staff Subcommittee on Accounts to the Committee on Finance and Technology; final approval is provided by the NARUC Executive Committee.

For water utilities, there is no comparable federal regulatory authority, but a uniform system of accounts has been established by NARUC. The system of accounts was last updated in 1984. Though most states have adopted the NARUC system, only about half have adopted the 1984 changes.⁸³ Changes are made in the same manner as changes to the other NARUC systems of accounts.

⁷⁸ National Association of Regulatory Utility Commissioners, *Annual Report on Utility and Carrier Regulation* (Washington, D.C.: National Association of Regulatory Utility Commissioners, 1993), 123.

⁷⁹ Phillips, *The Regulation of Public Utilities*, 219-220.

⁸⁰ Hahne and Aliff, *Accounting for Public Utilities*, 11.01.

⁸¹ *Ibid.*, 11.02.

⁸² *Ibid.*

⁸³ NARUC, *Annual Report on Utility and Carrier Regulation*, 490.

As is the case for nearly all accounting rules and standards, the charts of accounts for regulated utilities are fluid and must be amended periodically so that they are reflective of changes in the economic landscape. For example, recent changes in the standardized charts of accounts incorporated instructions for the use of specific accounts to reflect the impact of emissions trading, new FASB statements on the reporting of deferred income taxes, and FASB requirements for the reporting of postretirement and postemployment costs.

CHAPTER 6

THE ROLE OF STATE PUBLIC SERVICE COMMISSIONS

The final major player in establishing accounting policy and standards for regulated public utilities is the state public service commission. With fifty states and the District of Columbia having some jurisdiction over publicly held regulated utilities, it is difficult to draw generalizations about how state commissions set accounting policy. In fact, the clearest generalization that can be made is that state regulatory commissions and the processes they employ to set accounting policy are characterized by great diversity. This chapter, however, does attempt to find some common themes in the setting of accounting policy by state public service commissions by examining three elements of state commission policy setting: (1) the organization of the accounting function and organization of commission staffs in general; (2) procedural and policy options employed by state public service commissions when confronted with accounting issues, in this case the implementation of FAS No. 106; and (3) the disparity between the values inherent in public utility regulation and those inherent in the development of accounting principles, and the chances for reconciliation of the two.

The Organization of the State PSC Accounting Function

State public service commissions have been a part of the regulatory landscape since the middle of the nineteenth century. Though they vary widely in size and structure, they generally exercise the responsibility for setting rates and assuring service quality for intrastate utility services. Like the federal regulatory commissions described in the prior chapter, they have the authority to establish accounting policy for jurisdictional utilities as it regards information provided to the commission.

The dual forces of competition and gradual deregulation have created new challenges for state public service commissions that never were faced in the past. The long standing regulatory compact based on cost of service regulation has been eroded by

the inroads of competition. Incentive regulation, some of it cost based, is rapidly spreading throughout the telephone industry. The vertically integrated natural gas industry has been split among producers, transportation and distribution companies. Large gas users commonly purchase their own gas supplies at the well head, arrange with pipeline companies for transportation, and negotiate with a gas distribution company for ultimate delivery. The electric utility industry is undergoing similar fragmentation, in which electric generating facilities may ultimately be separated from distribution activities, with users being able to purchase their power from a variety of sources. These unbundling moves have dramatically changed the role of the state public service commissions and brought with them a host of new and different challenges. Even in water utility regulation, regarded as being less affected by the inroads of competition, the need for additional capital to replace aging infrastructure and meet safe drinking water requirements, and the competing pressures for privatization and municipalization, have changed the regulatory landscape.

These challenges occur at a time of widespread disenchantment with government, and a general reluctance to fund regulatory activities. They are felt acutely by state public service commissions as they establish accounting policy.

Unlike their federal regulatory counterparts, few state commissions have created a distinct organization within their organizational structure with explicit authority for accounting issues.¹ Exceptions include the Rhode Island Public Utilities Commission (PUC), which has a Chief Accountant; the New Mexico PUC, which has an Accounting Manager to whom rate analysts and utility economists report; the Tennessee Public Service Commission (PSC), which lists an Accounting Division with a staff of twenty; and the Indiana Utility Regulatory Commission with an Accounting Division with a staff of five. A number of other states, including Idaho, Missouri, and Georgia list accounting organizations within a utilities division.

¹ This conclusion and the descriptions of state commission organizations were drawn from a review of National Association of Regulatory Utility Commissioners, *Profiles of Regulatory Agencies of the United States and Canada: Yearbook 1992-1993* (Washington, D.C.: NARUC, 1993), 22-177.

A few other state commissions combine accounting and finance or accounting and economics into a division. The Florida PSC's Division of Auditing and Financial Analysis has seventy-six staff; the New York PSC's Division of Accounting and Finance contains ninety-four authorized personnel. The Wyoming PSC lists an Accounting and Economics Division with a staff of six. Despite these exceptions, however, accounting expertise appears to be spread throughout the commission organizations. Most states do not exhibit a stand-alone accounting function on their organizational chart.

Though there are no two identical commissions, many have sector-specific divisions (i.e., an Electricity Division, a Telecommunications Division, etc.). A piece of additional evidence that accounting issues at state commissions are dealt with by a variety of staff assigned to varied positions is the fact that, of the seventy-seven state commission and consumer advocate staff who attended a recent meeting of the NARUC Staff Subcommittee on Accounts, only twenty-eight had titles that included the terms "accountant" or "auditor."² Also of interest is the fact that Certified Public Accountants currently serve as Executive Director for three large, state commissions.

State commission staff also interact with commissioners and within rate cases in various ways. In some states, commission staff become a party to cases. As a result, they are subject to ex-parte considerations and sometimes are directly charged with the representation of the interests of residential ratepayers. Even in those cases where they are charged with representation of the general public interest, rather than residential ratepayers alone, their participation tends to emphasize the interests of residential ratepayers since those ratepayers are often without other representation.

In other states, commission staff are advisory to the commissioners and not directly a party to cases. In still other states, commission staff members are split; some are designated as parties on specific cases and others are designated as advisory to the commission.

² Derived from the attendance roster of the NARUC Staff Subcommittee on Accounts, Spring Meeting, Miami, Florida, March 29-April 1, 1993.

State public service commissions are organized to insure that accounting concerns are subordinated to regulatory concerns. As a result of the diversity apparent in state public utility commission organization and function and given the wide range of state issues and circumstances, it is unreasonable to expect uniformity in accounting policy. In fact, though accounting uniformity may suffer, regulatory concerns are appropriately given their due, and locally optimal solutions are able to be created for local problems.

State Implementation of FASB Pronouncements

The FASB standards specific to regulated utilities were described in Chapter 4. In some cases, even when a FASB pronouncement does not deal explicitly with regulated utilities, the pronouncement can significantly impact state public service commissions and their jurisdictional utilities. As was indicated briefly in Chapter 1, that was the case when the FASB issued FAS No. 106, "Employer's Accounting for Postretirement Benefits Other than Pensions." The diversity of state responses to FAS No. 106 provides a good case study of the way state commissions have reacted to GAAP established at high levels of the GAAP hierarchy.

The Requirements of FAS No. 106

FAS No. 106, which was issued in December 1990 and became effective for fiscal years beginning after December 15, 1992, was intended to change the way employers account for the costs of postretirement benefits other than pensions, such as health care.³ Prior to the adoption of FAS No. 106, employers had typically recorded those costs on a pay-as-you-go basis. That is, they recorded expenses when they paid the bills for retiree benefits. Given the increasing materiality of the costs of postretirement benefits, the FASB concluded that the relevance and representational faithfulness of

³ A full evaluation of FAS No. 106, a very complex pronouncement, is beyond the scope of this report.

financial reports would be improved if the obligation to provide postretirement benefits were reflected in financial statements as those liabilities were incurred. In concluding that a liability was incurred during the service life of the employee, the FASB took the view that postretirement benefits are a form of deferred compensation, whereby the employee provides services in return for current compensation and future benefits defined by the employer. Therefore, the FASB mandated termination of the pay-as-you-go method and accrual of liabilities for postretirement benefits as those benefits were earned by the employee.⁴

Of additional concern to the FASB was the accounting for the "transition obligation," the amount of the accumulated obligation for postretirement benefits for service prior to the implementation of FAS No. 106. For example, if an employee had worked for twenty years prior to the date of implementation of FAS No. 106 and was estimated to work for ten more prior to retirement, FAS No. 106 requires annual accrual of the postretirement benefits earned in each of the next ten years worked. The transition obligation is that cost accumulated over the course of the twenty years already served. In general, the FASB gave employers two options: they could immediately expense the entire transition obligation or they could spread the costs over the average remaining service period for active plan participants. If the average remaining service life is less than twenty years, the employer could still elect to use a twenty-year amortization period.⁵

For unregulated firms, the major choice involved in FAS No. 106 implementation was whether to immediately record the transition obligation as an expense in the year of implementation or phase it in over a longer period. As noted in Chapter 1, many large firms immediately recorded the expense and immediately reduced earnings. By taking this one-time charge against current earnings, unregulated companies avoided having to

⁴ Financial Accounting Standards Board, "FAS No. 106: Employer's Accounting for Postretirement Benefits Other Than Pensions," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume I* (Burr Ridge, IL: Irwin, 1993), pars. 2-5.

⁵ *Ibid.*, par. 112.

reduce reported earnings in future years to reflect the amortization of the transition obligations. Regulated utilities, on the other hand, favored spreading the transition obligation over future years, fearing that otherwise it was not likely to be recovered through rates.

For regulated utilities, several issues complicated the implementation of FAS No. 106. The most significant of the questions facing regulated utilities were:

1. Would regulators allow the transition for ratesetting purposes from pay-as-you-go to accrual of costs? Would the full costs of accrued postretirement benefits be allowed in rates?
2. Would there be a time gap between implementation of accrual of postretirement costs and their inclusion in rates?
3. If there was a time gap or if the regulator allowed less than full accrued costs in rates, could a regulatory asset be created to reflect the difference between pay-as-you-go costs and accrued costs? That is, could those expenses be deferred for later recovery?
4. How will the regulator treat transition costs? Would they also be included in rates? Over how long a period would the regulator require transition costs to be amortized?

State public utility commission reactions to these issues were more than academic for utilities; they had a substantial financial impact on the firm. For example, the Washington Water Power Company estimated that \$4 million per year was the difference between the postretirement costs required to be reported for financial accounting purposes under FAS No. 106 and the amount of costs included in rates under pay-as-you-go. Expensing postretirement costs as required by FAS No. 106 without rate recognition was estimated to translate into a four percent decline in earnings and an eleven cent per share reduction in reported earnings for common shares outstanding.⁶

⁶ Idaho Public Utilities Commission, "In the Matter of the Applications of the Washington Water Power Company for an Order Authorizing Deferral Accounting Treatment for Post-Retirement Benefits Other Than Pensions," Case Nos. WWP-E-92-5 and WWP-G-92-2, Order No. 24673, January 27, 1993, 7.

FAS No. 106 did not specifically address regulated enterprises with the exception of paragraph 364, which said that the statement included no special provisions for regulated enterprises.⁷ The EITF, driven by the disparity between state responses to FAS No. 106, considered the application of FAS No. 106 to rate regulated enterprises in 1992 and early 1993. Of particular concern to the EITF was whether the criteria for recording a regulatory asset as defined by FAS No. 71 would be met in those instances when a regulator allows anything less than full accrual of the costs of postretirement benefits. The EITF concluded that a regulatory asset should not be recorded if the regulator continues to include postretirement benefit costs in rates on a pay-as-you-go basis.⁸

Further, the EITF agreed that if the regulator elected to adopt FAS No. 106 but elected to defer the inclusion of those costs, a regulatory asset could be recorded only if:⁹

1. It is probable that future revenue will be recovered through rates in an amount equal to the deferral,
2. The regulator has issued an order or policy statement that allows the deferral and subsequent inclusion of FAS No. 106 costs,
3. FAS No. 106 costs will be included in rates within five years,
4. The combination of the deferral and recovery periods will not exceed twenty years, and
5. The increase in rates does not escalate from year to year.

⁷ Ibid., par. 364.

⁸ Emerging Issues Task Force of the Financial Accounting Standards Board, "Minutes of the January 21, 1993 FASB Emerging Issues Task Force Meeting, Issue 92-12: Accounting for OPEB Costs by Rate-Regulated Enterprises," 2.

⁹ Ibid. (paraphrased).

Those rigorous terms, specifically the imposition of time limits for rate inclusion, could be interpreted as signifying a fundamental lack of confidence on the part of the EITF in the ability or willingness of regulators to assure probable future recovery of costs. As was noted in Chapter 1, the EITF guidance regarding FAS No. 106 went substantially beyond the constraints already imposed on regulated utilities by FAS No. 71. FAS No. 71 had simply required probable recovery of deferred costs. On the issue of postretirement costs, the EITF took the position that, irrespective of regulatory conditions or commitments, the probability of cost recovery could not be assured if the other conditions listed above were not also met.

The State Response

Not surprisingly, some state commissions and consumer advocates expressed concern over the new standards, and concern with the philosophical basis for the FASB and EITF pronouncements was augmented by the fact that significant costs were involved. In theory, it should make no difference over the long-run whether postretirement costs are paid on an accrual basis or a cash basis as long as the appropriate present value discount factors are applied. In reality, as FAS No. 106 is implemented, short-term costs will be higher because they will include the accrued costs of future payments to employees and the transition obligation. As an example, Southwest Gas Company, in evidence submitted to the Arizona Corporation Commission, estimated that the combined costs of the transition obligation and accrual of current costs will exceed pay-as-you-go costs for thirteen years and be less expensive after that.¹⁰

Procedurally, states addressed FAS No. 106 through generic hearings, specific rate cases, or a combination. California, for example, conducted a two-phase, generic hearing

¹⁰ John Kiebel et al., "FAS 106 Developments in Other Jurisdictions," (Missouri Public Service Commission, September 1993), 1. Unless otherwise cited, descriptions of state implementation of FAS No. 106 listed throughout this section are drawn from that survey.

on FAS No. 106. In phase one, the California PUC authorized jurisdictional utilities to "prefund" FAS No. 106 costs by including contributions to tax deductible funding programs in rates. Phase two adopted FAS No. 106 with some limitations for all jurisdictional utilities subject to traditional cost of service regulation and all jurisdictional telephone companies subject to incentive regulation.

The Georgia Public Service Commission initially addressed FAS No. 106 costs in a specific utility case and later adopted it for ratemaking purposes in a generic proceeding. The Colorado Public Utilities Commission, on the other hand, addressed FAS No. 106 through utility-specific actions. As of September 1993, the date of a survey conducted by the staff of the Missouri Public Service Commission of state commission implementation of FAS No. 106, a few states had not yet ruled on FAS No. 106.

Even more variety was expressed in the substantive application of FAS No. 106 to jurisdictional utilities. State commissions, which in general adopt GAAP for ratemaking unless it conflicts with regulatory principles,¹¹ reacted to FAS No. 106 in a variety of ways.

Some state public service commissions adopted FAS No. 106 in its entirety. The Arkansas Public Service Commission, the Illinois Commerce Commission, and the Pennsylvania Public Utility Commission were among the states that adopted FAS No. 106 for ratemaking.

Though most states adopted FAS No. 106 in some manner, a few states continued pay-as-you-go treatment of postretirement costs for ratemaking purposes. The Arizona Corporation Commission, the Louisiana Public Service Commission, the South Dakota Public Utilities Commission, and the Missouri Public Service Commission were among the states that maintained pay-as-you-go accounting.

¹¹ For example, see New York Public Service Commission, "In the Matter of the Development of a Statement of Policy Concerning the Accounting and Ratemaking Treatment for Pensions and Postretirement Benefits Other than Pensions," Statement of Policy and Order, Case 91-M-0890, September 7, 1993, 3-4.

In making its decision that pay-as-you-go recording of postretirement costs should be continued, the South Dakota Public Utilities Commission listed the following arguments against utility use of FAS No. 106 for ratemaking:

1. The FASB has no direct authority over state ratemaking policies,
2. Those who pay the transition cost may not have received the benefit of past service,
3. The FASB notified businesses of a likely change in 1979; by waiting until 1993 to make a change, the transition obligation has increased significantly,
4. Future medical cost projections are too speculative,
5. Utility benefit plans are subject to change and therefore make accrual estimation impossible,
6. Health is high on the national agenda for reform,
7. Employees who work past their expected retirement compress postretirement costs into a shorter service period.

Other state commission concerns with implementation of FAS No. 106 for ratemaking purposes include the impact on rates, the ability of utilities to accurately estimate the costs of postretirement benefits, intergenerational equity, the disposition of revenues collected for accrued costs, and the length of time for the amortization of the transition benefit obligation.

Those states, which were concerned with the rate impact of FAS No. 106 implementation for ratemaking, used a variety of mechanisms to offset the increase in rates. In the case of New York, the Public Service Commission mitigated the rate impact of FAS No. 106 implementation by:

1. Establishing a rate phase-in plan of five years before the full FAS No. 106 cost level was reached,

2. Rededicating excess pension plan assets to fund future FAS No. 106 liabilities,
3. Establishing additional reporting requirements and allowing utilities incentives for reducing costs,
4. Requiring utilities to defer the difference between actual costs and rate allowances,
5. Providing for a reexamination of accounting impacts within five to seven years.

The Utah Public Service Commission allowed US West to accrue FAS No. 106 costs and to collect them in its rates. But because of overearnings, the PSC ordered an overall revenue reduction at the same time. The Idaho Public Utilities Commission issued a generic ruling that does not permit a utility to defer postretirement costs if it is already earning more than its authorized rate of return. The Washington Utilities and Transportation Commission issued a similar policy statement.

Some commissions expressed concern with the ability of utilities to accurately estimate the costs of postretirement benefits, which could result in overcollection from "monopoly" customers. In addition, it was argued that the structural mechanisms of ratemaking, which may include provisions such as an historic test year and provisions for the recapture of normalized expenses, may not allow immediate recovery of costs. If that is the case, it may not be possible to include costs booked under FAS No. 106 in rates until some time in the future.¹² Under FAS No. 71, the difference could be recorded as a regulatory asset, but the EITF required inclusion of costs within rates within five years to record a regulatory asset. Others argued that no specific guidance was necessary from the FASB or the EITF regarding implementation of FAS No. 106 by regulated utilities, in that FAS No. 71 had already provided adequate guidance.

¹² James M. Jenkins, "Presentation to the Emerging Issues Task Force of the Financial Accounting Standards Board: Issue No. 92-12: Accounting for OPEB Costs by Regulated Enterprises," November 18, 1992, 2.

Concerns were also expressed regarding intergenerational equity, specifically in regard to the transition obligation. It can be argued that if both accrued current costs and the transition obligation were allowed in rates, current ratepayers would bear both prior and current costs.¹³ Finally, some intervenors argued that FAS No. 106, paragraph 364 allowed regulated utilities to continue under the pay-as-you-go method. The EITF, of course, does not have the authority to prohibit pay-as-you-go for ratemaking purposes. The subsequent EITF decision, however, did clearly prohibit the recording of a regulatory asset if pay-as-you-go was continued for ratemaking.

Many states were concerned with the disposition of revenues collected from ratepayers for accrued postretirement costs and held until actual payout to retirees. Most mandated that collections be held in external accounts or in instruments, such as voluntary employee benefit associations (VEBAs), where earnings could be accumulated tax-free. Those states that permitted the utilities to retain the accruals internally required rate base offsets.

Finally, some states disagreed with the length of time required by the FASB for the amortization of the transition benefit obligation. Recall that the FASB had required the transition obligation to be amortized over the remaining service life of the employee or twenty years. At least two states, adopted transition periods of more than twenty years, presumably to spread the financial impact. One ordered a shorter amortization period than required by the FASB, arguing that increasing competition would make the transition obligation more likely to fall on residential ratepayers if it were spread over a longer period.

Though some states established more rigorous guidelines than those applied by the EITF, of particular interest are those instances in which state regulatory actions regarding FAS No. 106 conflicted with the EITF guidelines. For example, if a state allowed the creation of a regulatory asset combined with pay-as-you-go treatment for

¹³ Once the transition obligation is eliminated, one could also argue that accrual of postretirement benefits is more equitable on an intergenerational basis than pay-as-you-go.

ratemaking, the state policy would conflict with the EITF pronouncement. Similarly, if a state established a combined deferral and recovery period of longer than twenty years and allowed the creation of a regulatory asset, the policy also would conflict with the EITF guidelines. What is the impact when accounting and financial policies created by regulators to protect the public interest conflict with policies established by the FASB, which also serves the public (albeit a different "public")?

As stated earlier in this report, for financial reporting purposes the FASB and the SEC hold the "trump cards" in this dispute. Though the FASB and the SEC cannot mandate ratemaking treatment of costs, they do control public reporting by regulated utilities. Utilities, therefore, cannot provide the SEC financial statements affixed with the independent auditor's certification that the statement was prepared in accordance with GAAP if it clearly conflicts with GAAP. Though it can be argued that state public utility commissions create GAAP by establishing prevalent practice, GAAP as established by the EITF is a higher authority in the GAAP hierarchy.

In reality, the FASB has always (at least as far back as the release of the Addendum to APB Opinion No. 2 in 1962) restricted the ability of regulators to authorize the creation of regulatory assets by requiring the reasonable assurance of recovery. Until the establishment of the "fence posts" in the EITF pronouncement on accounting for postretirement benefits, regulators could authorize the establishment of regulatory assets if they believed that the general criteria established by FASB pronouncements were met.¹⁴ But even when only general limits existed, the ultimate authority on the appropriateness of a regulatory asset was the utility itself and its independent auditor, who was answerable to the SEC. Because of the pivotal responsibility of the utilities and independent auditors, if the EITF action to limit discretion is regarded as a lack of faith, perhaps it should be interpreted as a lack of faith in their judgement rather than a lack of faith in regulatory commissions. Whether

¹⁴ FAS No. 92 had prescribed a ten-year limit on phase-in plans. FAS No. 92 was designed to deal with a very specific, time-limited situation.

the EITF action to limit the creation of regulatory assets was necessary or appropriate is a more difficult question.

Accounting Values--Regulatory Values

When regulatory commissions and those who set accounting standards disagree, can it be assumed that one is wrong and the other right? Though it is convenient to cast blame and mutual suspicion abounds, it is an error to presume that one party or the other has acted in bad faith or made a mistake. The truth is that both regulators and the accounting establishment make decisions based on values specific to their objectives. At the core, the FASB, the SEC, and regulators all attempt to serve the public interest. But they serve different publics with different interests. As a result, the values that drive decisions differ in some important respects, and those differences go far to explain why regulators and the accounting community sometimes seem to be at odds. Fortunately, there is common ground in the interest of both to serve the public, which may provide the basis for better long-term understanding and relationships.

Public service commissions are subject to continuing pressures from a variety of sources. Utilities seek ways to increase earnings, while consumer counsels, unions, and other ratepayer advocates may take a short-term view to hold down rates for the immediate future. The FASB faces similar pressures, although from different constituencies. In some cases, public accounting firms must choose between the need to maintain professional standards and the needs of their clients.

In Chapter 1 of this report, we identified a number of groups to which the FASB must be responsive. The list included CPAs and accounting firms, the AICPA, the investing public, industry associations, government, professional organizations, the financial community, and the business enterprises themselves.¹⁵ Regulatory commissions serve a different and also diverse constituency, which includes ratepayers, jurisdictional

¹⁵ Donald Kieso and Jerry J. Weygandt, *Intermediate Accounting* (New York: John Wiley and Sons, 1980), 14.

utilities, legislators, the executive branch, the general public, consumer advocates, and other interest groups. Because no organization or process functions independently of the "clients" it serves, those clients shape the values that affect decision making. Regulatory commissions and those who set accounting standards have different clients and, therefore, different values. And different values create different acceptable outcomes.

Public utility regulatory commissions and those who set accounting standards and regulate corporate finances actually share at least six significant, common values. In addition to public service, they share an interest in efficient markets, stability, conservatism, fairness, and adequate representation of affected interests. Within these nominally shared values is, however, a wide difference of definition. Table 6-1 summarizes those differences.

TABLE 6-1. Regulatory Values--Accounting Values

NOMINAL VALUE	REGULATORY FOCUS	ACCOUNTING FOCUS
Public Service	Service to ratepayers, the public, utilities, legislature, etc.	Investors, accounting firms, financial community, etc.
Market Efficiencies	Reasonable pricing of goods and services	Timely and accurate flow of financial data
Stability	Stable service delivery systems	Stable financial markets: free entry and exit of firms
Conservatism	Protection of ratepayers in changing market	Prudent reaction to uncertainty
Fairness	No abuse of monopoly power	Auditor impartiality
Representation of Affected Interests	Judicial-style protection	Notice-and-comment rulemaking

Source: Author's Construct

When public utility regulators set utility prices, they are not acting as a proxy for competitive markets. They are, however, attempting to prevent excessive profits from being extracted from monopoly customers and to prevent unreasonable price discrimination.¹⁶ The market function of public utility regulators is to insure that the desired level of service is provided to customers at reasonable rates.¹⁷ To the extent that prices set by regulators are used by consumers to make decisions, regulators are concerned with the provision of that information to ratepayers.

When the accounting and finance communities pursue the objective of creating efficient financial markets, they have little concern with monopoly power or the prices charged to consumers. Their major concerns are that accurate and timely financial data are available, that no investor or potential investor is disadvantaged by inaccurate information or a lack of information, and that managers cannot obfuscate the performance of the firm.

Regulators have an interest in stability and insuring that services expected by consumers are available. Embedded within that interest is in the financial health of the utility. Utility financial failure is of great concern to regulators because of the impact those events could have on the stability of the utility delivery system. Financial distress is a concern because of its impact on the cost of capital and rates. Indeed, one goal of traditional public utility regulation is to "assure adequate earnings so that the public utility sector could continue to develop and expand in accordance with consumer demand."¹⁸

Though utility executives may see the accounting and finance communities as allies against the supposed limitations imposed by regulators on their ability to generate profits, in reality, the accounting and finance communities are organizationally indifferent to the financial plight of any single firm. AICPA auditing standards, in fact, require

¹⁶ Charles Phillips, *The Regulation of Public Utilities* (Arlington, VA: Public Utilities Reports, Inc., 1993), 172.

¹⁷ Ibid.

¹⁸ Ibid.

auditors to maintain an independence in mental attitude and to be fair to the firm, to creditors, and to others who may rely on the independent auditor's report.¹⁹ If an auditor employed by a firm were to take an interest in the financial well-being of that firm, the independence of that auditor would be in question.

The accounting and finance communities' interest in stability lies in the stability of financial markets, a stability that requires the entry and exit of firms as their economic circumstances merit. Accurate and timely information drives the market system, and negative information about the financial state of a firm is just as important as positive information.

The regulatory commitment to conservatism also differs from the accounting and finance commitment to conservatism. Regulators, when faced with changing markets and service delivery systems, are concerned that the interests of some consumers might be harmed by change, that changing markets may imply cross-subsidization, and that change might disrupt the previous equilibrium established between residential and commercial consumers. The commission role in this regard is, as Phillips points out, largely negative or restrictive in that commissions attempt to prevent excessive profits and unreasonable price discrimination.²⁰

As a result of these largely negative roles, regulators are sometimes seen as being hostile to change. A more accurate characterization might be that regulators are wary that the profit motive will induce utilities to seek profits from customers in the remaining monopoly markets and are careful that the interests of all consumers are protected under new market conditions.

The accounting and finance commitment to conservatism is much different. As mentioned earlier in this report, conservatism is defined by FASB Statement of Concepts No. 2 as "a prudent reaction to uncertainty to try to ensure that uncertainties and risks

¹⁹ American Institute of Certified Public Accountants, "AU Section 220, Independence," *Codification of Statements on Auditing Standards: Numbers 1 to 71* (Chicago, IL: Commerce Clearing House, Inc., 1993), 31.

²⁰ Phillips, *The Regulation of Public Utilities*, 172.

inherent in business situations are adequately considered."²¹ Conservatism, the FASB points out, does not involve or require a deliberate understatement of assets or profits.²² Thus, the accounting and finance communities' reaction to change is more ambivalent. They need not be concerned whether economic change advantages any particular sector of society; they need only be concerned that economic circumstances affected by change are accurately reflected in the financial data publicly available. The prudent, conservative reaction by the financial community to uncertainty is to present the most accurate and most thorough information available.

Public utility commissions are concerned with fairness--that all consumers are treated fairly and that they are not the victims of monopoly power. In their formal processes, they are concerned that all interests are adequately represented. For public utility commissions adequate representation assumes a legal dimension, and much attention is paid to insuring equal access to information through ex parte prohibitions, open meeting requirements, and the creation of a defensible record on which to base decisions. Public utility commissions:²³

...must satisfy the requirements of due process: investigate, give notice, hold hearings, study the record, make findings, issue orders, permit appeals. All this takes time and delays action.

The result is that public utility commissions are sometimes viewed as slow-moving and concerned with form over substance.

The accounting and finance communities are also concerned with fairness. Auditors must insure impartiality and insure that audit results are fair to managers and

²¹ Financial Accounting Standards Board, "Statement of Financial Accounting Concepts No. 2: Qualitative Characteristics of Accounting Information," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume II* (Burr Ridge, IL: Irwin, 1993), par. 95.

²² *Ibid.*, par. 93.

²³ Clair Wilcox, *Public Policies Toward Business*, 3d Edition (Homewood, IL: Richard D. Irwin, 1966), 477, as cited in Charles Phillips, *The Regulation of Public Utilities*, 175.

to statement users. Within the formal processes for establishing accounting policy, fairness is also an issue, and considerable changes have been made in those formal processes to insure better representation of varied interests. Today, the FASB employs a process that is more open to informal contact and the development of consensus than the judicial processes employed by public service commissions. The result of the disparity in operating methods is that regulators appear to be bound by process and less adaptable than the FASB.

In recent years, public utility commissions have attempted to become more proactive. To some extent, they have embraced such concepts as incentive regulation and demand-side management. Procedurally, they have experimented with alternative methods of dispute resolution--methods which rely less heavily on trial-type proceedings. But because of the public utility commission mission to protect the public against the abuses of monopoly power, commissions must adopt a cautious attitude toward change.

The fundamental values that drive public utility regulation are not likely to change even though utility markets may change. Similarly, the fundamental values of the accounting and finance communities are not likely to substantially change either. Given that divergence of values, it would be wrong to expect one to subordinate the other or to expect long-term convergence of interests.

The best that can be hoped for is to create temporary points of equilibrium, which create solutions of partial satisfaction to all affected parties. When those points of equilibrium have outlived their utility, a new equilibrium will need to be sought. Such may be the case now as the market conditions that occasioned the creation of FAS No. 71 are replaced with different conditions. Care must be taken, however, to leave FAS No. 71 in place for those noncompetitive markets that still exist, and which will continue to exist despite competitive inroads into other markets. Jurisdictional water companies provide one example.

At their core, both regulators and those who set accounting standards serve the public and, it can be argued, have served their publics well. To build productive relationships between the two does not require that one abandon its mission or acquiesce to the needs of the other. It does require "...new understandings and...a mutual

transformation of the relationship itself."²⁴ There is little to be gained from mutual suspicion and antagonism. Their joint mission of serving the public demands appreciation of individual perspectives and collaboration with the goal of finding new points of equilibrium.

²⁴ Vice President Al Gore, *Earth in the Balance: Ecology and the Human Spirit* (New York: Penguin Books USA, Inc., 1993), 35. The remarks were taken from his discussion of the solution to the arms race.

CHAPTER 7

CONCLUSIONS AND RECOMMENDATIONS

Several summary conclusions can be drawn from the complexity of the previous chapters, which described the arcane language and standards of accounting, the difference in values between regulators and those who set accounting standards, the institutional mechanisms for regulatory and accounting decision making, the state-federal balancing act, and the impact of a changing marketplace. From those summary conclusions, we can extract four action-oriented recommendations, recommendations that may help mitigate the real and potentially disruptive controversies that envelop regulatory accounting today.

Our conclusions are that:

1. GAAP is flexible and evolutionary rather than fixed and immutable. Though a hierarchy of authority exists, the application of GAAP requires interpretation and the use of judgement.
2. The formal process for setting GAAP is interactive and consensus driven though the impact of public utility regulators has not been as significant as that of the other participants in the process.
3. The accounting standards for regulated utilities have been created in response to the economic impacts of regulation, rather than the institutional processes of regulation, and in response to specific regulatory circumstances at the time of their establishment. They can be expected to change over time.
4. The federal-state interaction on regulatory accounting issues is also evolutionary. The most significant aspect of federal-state relations in recent years has been the growth of federal authority resulting from the growth of interstate utility operations.

5. The establishment of accounting policy by regulatory commissions is the product of a diverse set of organizations and processes and is subordinated to the establishment of regulatory policy.
6. The equilibrium between those who set accounting policy and those who set regulatory policy is at a point of crisis.

The definitions of GAAP are clear in their insistence on the evolutionary nature of GAAP and its need to react to changing circumstances. GAAP today will not necessarily be GAAP tomorrow. Nor is GAAP so clearly codified that it need not be subjected to intense and rigorous interpretation. There are now and will always be disputes about the interpretation of GAAP as it is applied to both regulated and unregulated firms.

The top of the hierarchy of GAAP is dominated by the FASB including the EITF, the SEC, and the AICPA. But regulators, to the extent that they establish prevalent practice, establish GAAP too. As a result, GAAP as it applies to regulated utilities is a shifting amalgam of standards simultaneously levied on regulators and influenced by regulators. The same is true for utilities. They are subject to GAAP and they create GAAP as they establish prevalent practice.

The formal processes for the establishment of GAAP at the upper reaches of the GAAP hierarchy are constructed to allow the development of consensus positions. Indeed, the history of those organizations given the authority to establish GAAP by the SEC, is a history of gradual accommodation to the necessity of widespread input and the development of consensus positions.

Critics of the FASB have argued that the formal GAAP process is dominated by the AICPA, the large auditing firms, and by their corporate clients. While there can be no question that there are dominant players in FASB proceedings, it likewise is indisputable that the FASB has made significant efforts to encourage widespread participation by all interested parties. Without question, regulators need to actively participate in those processes and to establish linkages to the process that transcend single issue consideration.

The accounting standards applicable to regulated enterprises, which were formally established by the FASB and its predecessors, were created to reflect the economic effects of regulation rather than the institutional processes of regulation. Those accounting standards, primarily embodied by FAS No. 71 and its derivative statements that allow for the creation of regulatory assets, have allowed a formal convergence between the needs of regulators and the needs of the users of financial statements. But those standards were limited from the time of their promulgation to specific situations and circumstances. While they have been effective for at least the twelve years since the promulgation of FAS No. 71, they cannot be expected to stand forever, particularly when the economic circumstances they were designed to reflect are in a constant state of change.

Today, regulatory markets are characterized more by diversity than any other factor. In some markets, competition exists. In others, traditional, rate-base, rate-of-return regulation still functions well and will continue to function for some time. As a result, the determination of the appropriateness of the creation and continuance of deferred charges must be based on the evaluation of market conditions. In the past, the focus was on the actions of the regulator. Though the actions of the regulator are not without consequence, market conditions determine whether or not the probable assurance of cost recovery exists.

State and federal regulatory commission organizations and approaches to accounting issues are characterized by substantial diversity--diversity that is a strength rather than a weakness and which facilitates an array of state "laboratories" for the solution of regulatory problems. The interaction between state and federal agencies is fluid and evolving. There is no end in sight, however, to the general encroachment of federal jurisdiction over state jurisdiction. Informal resolution of disputes and informal interaction between state and federal regulators should be continued, building on the work of the NARUC Staff Subcommittee on Accounts. In addition, federal agencies should make use of any formalized dispute resolution mechanisms available to them under the law for resolution of accounting disputes.

The establishment of accounting policy by both the state and federal regulatory agencies is subordinated to regulatory purposes--as it should be. As a result, the conflict of values between regulatory authorities and those charged with the responsibility to set accounting standards is likely to remain a permanent feature of the landscape though short-term equilibrium solutions, like the one created by FAS No. 71, may prevent open warfare.

Our final conclusion is the assertion the report began with--that regulatory accounting is at a crossroads. It was at a crossroads before the establishment of accounting standards which gave explicit recognition to regulatory assets, and today it is at a crossroads as those standards and the equilibrium they established appear to be in jeopardy. Today, with deregulation and increasing competition, the debate appears to be defined by concerns over erosion of the regulatory compact and cost-based regulation. Those concerns create a lack of confidence by the SEC and the FASB in the ability of utilities to recover in future rates the costs that have been deferred and the regulatory assets that have been established.

Fortunately, there are ways to mitigate this looming crisis of confidence and to establish a better working relationship among regulators, the SEC, and the FASB. In evaluating the information collected in the course of writing this report, we have identified four recommendations, which if implemented would help to offset the current dilemma. Those recommendations are:

1. That, prior to allowing cost deferral by utilities, public utility regulators insure that a probable assurance of cost recovery exists given current and expected market conditions.
2. That the FASB and the EITF establish accounting standards that take into account the wide diversity of utility markets.
3. That NARUC and the state commissions continue to build their liaison with the SEC and that they establish long-term, formal and informal relationships with the FASB and the AICPA--relationships that transcend single issues of accounting policy. A useful beginning and model for these

interactions is the liaison established by the Staff Subcommittee on Accounts with these organizations.

4. That the FASB, the SEC, and state and federal commissions begin an evaluation of the economic impacts of regulation in this new, partly competitive era with the twin goals of identifying those utility markets and sectors within which existing accounting tools are still applicable and creating new accounting tools reflective of the emerging economic realities in more competitive markets.

In these days of rapidly changing utility markets, public utility regulators should take particular care to insure that the probable assurance of cost recovery exists prior to allowing the creation of deferred charges. The accounting standards for regulated enterprises were always meant to apply in specific, limited circumstances. In changing utility markets, those circumstances may not uniformly exist. Similarly, those who establish accounting standards should avoid the application of "broad brush" solutions that eliminate tools that may still be effective in some utility markets.

The NARUC Staff Subcommittee on Accounts and the NARUC Committee on Finance and Technology have already established a mechanism for regular contact with the SEC (See Chapter 3). That is an important endeavor, which should be given support at the highest levels of NARUC.

Over the years, several representatives of the NARUC have testified before the FASB or the EITF. Once again, those types of interactions are important and well justify the expenditure of state budget dollars to support. But in order to create a better appreciation of regulatory needs, it may be necessary for state regulators to create enhanced long-term relationships with the FASB and the SEC. Those relationships will require support at the highest levels of NARUC and must transcend the consideration of individual accounting policies. Those relationships must also be structured to continue despite changes in staff or leadership at the FASB, the SEC, or at the regulatory commissions.

Nor should the interaction with the FASB be restricted to the FASB itself and the EITF. The FAF, the FASAC, and the FAF sponsoring organizations are important

points of access. As was described in Chapter 3, FAF trustees include representatives of government organizations; they should be amenable to discussion of the needs of state and federal regulatory commissions. FASB staff, like congressional staff, have considerable impact on decision making. The FASB regularly sends a Practice Fellow from the FASB to meetings of the NARUC Staff Subcommittee on Accounts to report on FASB matters, which is a useful beginning to a closer long-term relationship.

The NARUC relationship with the AICPA should also be strengthened for the long-term. Not only does the AICPA play a pivotal role in the development of accounting policy, but AICPA members are on the front lines of accounting controversy, being given the responsibility to certify that financial statements have been prepared in accordance with GAAP. The AICPA Public Utilities Committee currently participates in joint meetings with the Staff Subcommittee on Accounts and makes regular presentations on accounting issues. Any expansion of the involvement between NARUC and the AICPA would also be productive in building bridges of understanding between regulators and the accounting community.

As state public utility commissions confront the new challenges brought on by increasing competition, gradual deregulation, and reduced state budgets, they will also need to establish greater levels of cooperation among themselves and greater sharing of knowledge and expertise. The NARUC Staff Subcommittee on Accounts has pioneered joint ventures, such as the joint audits with the FCC of the Regional Bell Operating Companies, that might be expanded and applied to areas outside accounting.

Our second recommendation is that the NARUC, the SEC, and the FASB begin a collaborative process to evaluate the efficacy of existing accounting tools and identify accounting tools appropriate to the new economic realities attending utility markets. As we described in the previous chapter, the equilibrium points established between regulators and those who set accounting standards are time limited due to the inherent values conflict between the two. Clearly, there are portions of the utility marketplace that are still dominated by rate-base, rate-of-return regulation. For those markets, the accounting tools defined by FAS No. 71 are still appropriate.

But there are other, more competitive portions of the utility marketplace. Those portions of the marketplace simply do not meet the fairly rigorous standards that FAS No. 71 requires for the recording of a regulatory asset. In those markets, the traditional economic effects of regulation described in Chapter 1 are no longer viable.

That is not to say that regulators have no power in competitive markets or that their actions do not affect the economic position of a regulated firm, even if that firm is subject to incentive regulation. The regulatory compact may evolve in some utility markets from its traditional probable assurance of cost recovery, but regulators will continue to have an interest in and impact on the financial health of jurisdiction utilities.

In an age of varied utility markets, regulators, accountants, and utility managers will need, more than before, a variety of accounting tools, and the investing public will need accurate information with which to determine the economic condition of regulated utilities. The challenge for regulators and those who exercise the responsibility for the issuance of accurate and useful financial statements is to identify those disparate economic impacts and find appropriate ways to communicate those effects to the investing public. The focus of the FASB and the SEC thus far has been on defining what accounting tools are no longer appropriate. The next and more difficult task is to work with the entire regulatory community, through workshops, seminars, working groups, or any other creative problem-solving forums, to determine the environments within which existing tools might still work and to determine what new tools are necessary to reflect the changing economic impact of regulation in the financial statements of regulated utilities.

APPENDIX A

LIST OF ABBREVIATIONS

AcSEC	-	Accounting Standards Executive Committee
AFUDC	-	Allowance for Funds Used During Construction
AICPA	-	American Institute of Certified Public Accountants
APB	-	Accounting Principles Board
ARB	-	Accounting Research Bulletin
ASB	-	Auditing Standards Board
ASR	-	SEC Accounting Series Release
CAP	-	Committee on Accounting Procedure
CPA	-	Certified Public Accountant
EITF	-	Emerging Issues Task Force
FAF	-	Financial Accounting Foundation
FASAC	-	Financial Accounting Standards Advisory Council
FAS	-	Financial Accounting Standard
FASB	-	Financial Accounting Standards Board
FCC	-	Federal Communications Commission
FEI	-	Financial Executives Institute
FERC	-	Federal Energy Regulatory Commission
FIN	-	FASB Interpretation
FPC	-	Federal Power Commission
GAAP	-	Generally Accepted Accounting Principles
GASB	-	Government Accounting Standards Board
ICC	-	Interstate Commerce Commission
NARUC	-	National Association of Regulatory Commissioners
PSC	-	Public Service Commission
PUC	-	Public Utility Commission
PUHCA	-	Public Utility Holding Company Act

LIST OF ABBREVIATIONS--Continued

RAO	-	FCC Responsible Accounting Officer Letter
SAB	-	SEC Staff Accounting Bulletin
SEC	-	Securities and Exchange Commission
SFAC	-	Statement of Financial Accounting Concepts
TB	-	FASB Technical Bulletin
VEBA	-	Voluntary Employee Benefit Association

APPENDIX B

GLOSSARY OF REGULATORY ACCOUNTING TERMS

These definitions are written in "laypersons language" for reference when reading this report. For more complete technical definitions, reference should be made to original referenced documents or to a standard accounting dictionary. Terms marked with an asterisk (*) are those defined within the FASB's "Statement of Concepts No. 6: Elements of Financial Statements."¹ Paragraph numbers from that Statement follow each definition in parentheses.

Accounting Principles Board (APB): The organization formed by the American Institute of Certified Public Accountants in 1959 to establish GAAP. Between 1959 and 1973, the APB issued 31 Opinions and four Statements. The APB was preceded by the AICPA Committee on Accounting Procedure and was replaced as the source of GAAP when FASB was established in 1973.

Accounting Research Bulletins (ARBs): A set of 51 recommendations issued between 1939 and 1959 by the American Institute of Certified Public Accountants Committee on Accounting Procedure. ARBs are the earliest pronouncements generally regarded as a component of GAAP and were required to be applied by firms under the jurisdiction of the Securities and Exchange Commission.

Accounting Series Release (ASR): Accounting statements of the Securities and Exchange Commission. ASRs provide interpretations of SEC accounting requirements.

ASR 150: The 1973 Accounting Series Release that stated conclusively that the FASB was the organization with the capability to meet the SEC's substantial authoritative support test.

ASR 280: The 1980 ASR that further affirmed the SEC's endorsement of the FASB. In ASR 280, the SEC noted, however, that in rare instances, the SEC's opinion may differ from the FASB.

¹ Financial Accounting Standards Board, "Statement of Financial Accounting Concepts No. 6: Elements of Financial Statements," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume II* (Burr Ridge, IL: Irwin, 1993), pars. 24-89.

Accounting Standards Executive Committee (AcSEC): The American Institute of Certified Public Accountant's official voice on accounting standards. AcSEC Practice Bulletins are a source of GAAP on level "c" of the GAAP hierarchy.

Accrual Accounting: An accounting method in which expenses are recognized in financial accounts when they are incurred and revenues are recognized when they are earned. Recording of expenses and revenues under accrual accounting takes place without regard to the timing of cash receipt or disbursement.

Acquisition Adjustment: The difference between the purchase price paid by a utility to acquire plant that previously had been placed into utility service and the cost of that plant to the original owner. Acquisition adjustments are ordinarily excluded from the rate base.

Addendum to APB Opinion No. 2: A 1962 APB Opinion that provided more clarity regarding creation of regulatory assets. APB Opinion No. 2 said that, regardless of the source of doubt, it is appropriate for a rate regulated enterprise to defer expenses only when it is clear that costs will be recovered in future revenue.

Advances for Construction: Refundable payments usually received from developers to help finance utility plant construction. Advances for construction provide an important source of financing for water and sewer utilities. They are in effect interest-free loans. Since these funds are not provided by investors, Advances for Construction are commonly subtracted from the rate base.

ARB No. 44: The earliest reference to the effects of regulation within GAAP. ARB No. 44, issued in 1954 and revised in 1958, addresses declining-balance depreciation. It states that if a utility is required to currently flow through to customers the tax savings resulting from use of declining balance depreciation, accounting recognition of these tax benefits need not be made if it may reasonably be expected that increased future taxes will be allowed in rates.

Allowance for Funds Used During Construction (AFUDC): An amount added by a utility to its Construction Work in Progress Account to compensate the utility for the use of its funds (borrowed and equity) during construction of major assets and prior to their completion and inclusion in rate base. Although it is recognized as current "income," AFUDC does not provide any actual cash flow to the utility until the asset under construction is completed and included in rate base.

Allowable Costs: Costs which are determined by the regulatory authority to be a necessary part of the cost of service and, therefore, included within rates. Not all expenses included in operating income by GAAP are "allowable" when determining the revenue requirement of a utility.

Allowed Rate of Return: The rate of return, expressed as a percent, granted a utility in a rate proceeding by the appropriate regulatory commission. The rate of return is based on the embedded cost of long-term debt, plus the dividend rate of preferred stock, and an allowance for equity funds. While the embedded cost of senior debt is fairly straight-forward, the appropriate rate to be applied to the equity component is often a subject of dispute in rate proceedings.

American Institute of Certified Public Accountants (AICPA): The national organization of certified public accountants. The mission of the AICPA is to promote and maintain high professional standards of practice and to improve the quality of financial statements. Members must be CPA's.

AICPA Rule 203 of the Code of Professional Ethics: Governs the audit statement issued by the independent auditor. According to Rule 203, a member of the AICPA cannot state that the financial statements of a firm conform to GAAP if a material departure exists from FASB pronouncements, unless it can be demonstrated that reporting in accordance with GAAP would have been misleading.

Amortize: To expense a portion of an intangible asset across a number of years. For regulated firms, certain asset accounts, such as goodwill or research and development expense, can be ordered amortized and included over a period of years in the revenue requirement formula in the ratemaking process.

Assets*: Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. (Paragraph 25)

Asset Impairments: A decrease in the value of an asset.

Audit Standards: The basic principles that govern the nature and extent of the review needed in an audit to enable an accountant to express an opinion on the financial statements of an enterprise.

Auditing Standards Board (ASB): The organization established by the American Institute of Certified Public Accountants to set auditing standards for the accounting profession.

Balance Sheet: A financial statement that details the assets, liabilities and owner's equity of a firm as of a point of time. On the balance sheet assets equal the total of liabilities and owner's equity.

Certified Public Accountant (CPA): The professional designation given to an accountant in the United States who has passed the CPA examination administered by the AICPA and met the experience requirements of a given state. CPA's are licensed to render their opinions on the fair presentation of a firm's financial statements.

Code of Professional Ethics: Issued by the American Institute of Certified Public Accountants, it consists of four parts, which are the "Concepts of Professional Ethics", the "Rules of Conduct", "Interpretations of Rules of Conduct", and "Ethics Rulings". Members of the American Institute of Certified Public Accountants are bound by the Code of Professional Ethics.

Committee on Accounting Procedure (CAP): A committee established within the American Institute of Certified Public Accountants and given the authority for establishing accounting standards when the Security Exchange Committee delegated its responsibility for establishing accounting standards to the professional accounting community through its "substantial authoritative support" test. From 1938 to 1959, the CAP was the U.S. source of formal GAAP and issued 51 ARBs. ARBs continued to be recognized by the FASB as GAAP unless superseded or amended by later pronouncements.

Comparability: The presentation of financial information in a form that will permit the financial statements of a single enterprise to be compared from one period to another or that will permit the financial statements for one enterprise to be compared to financial statements of other enterprises for the same periods.

Comprehensive Income*: The change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distribution to owners. (Paragraph 70)

Conservatism: The prudent reaction to uncertainty. In accounting, conservatism does not mean the deliberate understatement of assets. Though commonly considered to be an attribute of accounting information, conservatism was not included as one of the "Qualitative Characteristics of Accounting Information" in SFAC No. 2.

Consistency: The presentation of financial data in the same manner from one period to another absent changes in policies or procedures. Consistency is incorporated as a part of comparability, which is one of the secondary objectives of accounting information according to SFAC No. 2, "Qualitative Characteristics of Accounting Information."

Construction Cap: A cost ceiling on a construction project agreed upon by the regulatory body and the utility for ratemaking purposes.

Construction Work in Progress (CWIP): Plant under construction but not yet completed and placed in service. Such plant ordinarily is excluded from rate base, but a regulator may permit a portion of the CWIP to be included in rate base if increased cash earnings are needed to maintain the utility's financial viability. A utility will not be permitted to accrue AFUDC on any CWIP included in the rate base.

Contributions in Aid of Construction: Non-refundable amounts paid to a utility to help finance construction of utility plant. Contributions in aid of construction frequently come from land developers. Because these funds, which are usually not substantial, are not provided by investors, they are usually deducted from the rate base. (Under some systems of accounts, contributions are subtracted directly from plant accounts at the time of the contribution, which achieves the same result.)

Cost of Capital: The cost to the utility of the various components of capital (debt, preferred stock, common stock). See Weighted Average Cost of Capital.

Cost of Service: The total cost of providing service to customers. Traditional rate-base, rate-of-return regulation calls for rates to be based on cost of service.

Cost Reimbursement Treatment: Reimbursing costs on a dollar for dollar basis. Rate-base, rate-of-return regulation falls short of cost reimbursement since rates are prospective and reflect the opportunity for the utility to earn a reasonable rate of return, rather than actual cost reimbursement.

Decommissioning Cost: The cost of removing a utility asset from service.

Deferred Taxes: The portion of income taxes currently collected in rates and recorded as a liability on the balance sheet, but not payable to the IRS until some future date. For utilities, deferred taxes are primarily the result of using straight-line depreciation for ratemaking (normalization) and accelerated depreciation for actual taxes. In determining the utility rate base, deferred tax liabilities are deducted in that they represent a source of funds provided by ratepayers rather than investors.

Deregulation: The process of removing a utility's activities or a portion of its activities from regulation. Deregulation occurs when changing conditions such as the advent of competition make cost-based regulation no longer feasible.

Discussion Memorandum: A document distributed by FASB to interested parties for comment for a major issue being considered by FASB. The document includes a definition of the problem, a listing of the relevant issues, research findings and relevant literature, and alternative solutions. A Discussion Memorandum is similar to an Invitation to Comment, which is also sometimes issued by the FASB. Both are followed by a formal public hearing and an Exposure Draft containing the proposed solution to the accounting problem.

Disallowed Cost: An incurred cost that is not considered necessary to providing utility service and that is not recoverable in rates. For example, a portion of plant construction costs may be disallowed because it is considered to be excessive or imprudent. Likewise, a portion of operating expenses may be disallowed when setting rates.

Disclosure: The process of making public all material information about financial matters.

Distribution to Owners*: Decreases in equity of a particular business enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners. Distributions to owners decrease ownership interest (or equity) in an enterprise. (Paragraph 67)

Early Extinguishment of Debt: Retiring debt prior to its maturity date. Early extinguishment of debt occurs most frequently when a utility can refinance outstanding debt at a lower cost.

Earnings: A term used interchangeably with net income to reflect the difference between revenues and expenses for a given period.

Earnings Per Share: Net earnings of the firm after income taxes and preferred dividend requirements divided by the number of common shares outstanding.

Earned Rate of Return: The actual return on rate base earned by a utility. The actual return may be more or less than the return "allowed" by the regulatory commission due to differences between revenues and expenses projected in a rate proceeding and those that actually occur.

Equity (or net assets)*: The residual interest in the assets of an entity that remains after deducting its liabilities. (Paragraph 49)

Embedded Cost of Debt: The average interest rate on all issues of outstanding debt, expressed as a percentage.

Emerging Issues Task Force (EITF): Created by the FASB in 1984, the EITF identifies new issues and refers them to the FASB. The EITF also can issue its own opinions. These opinions lack the authority of FASB pronouncements but receive considerable weight within the accounting community.

Expenses*: Outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations. (Paragraph 80)

Excess Capacity: Capacity that is greater than that required to meet a utility's maximum needs.

Exposure Draft: A document issued by the FASB for public comment that contains the FASB's proposed solution to an accounting issue. After receiving comments on an Exposure Draft, the FASB can move to a final pronouncement, issue a second Exposure Draft, or terminate consideration of an issue.

Fence Posts: A specific time period over which an expense can be recovered through the regulatory process. The EITF created fence posts for FAS No. 106 by prohibiting the recording of a regulatory asset to reflect the deferred costs of postretirement benefits if costs were not included in rates by regulators within five years.

Financial Accounting Foundation (FAF): A not-for-profit organization at the top of the three-part organizational superstructure charged with the establishment of formal GAAP. The FAF is responsible for the appointment of the FASB and the FASAC, raising the funds to support all three organizations (FAF, FASB, FASAC), and providing general oversight of the FASB.

Financial Accounting Standards Advisory Council (FASAC): An advisory council that is part of the FASB's three-part organizational hierarchy. The FASAC advises the FASB on items such as inclusion of items on the FASB agenda, priorities, and selection of task forces.

FAS No. 71, "Accounting for the Effects of Certain Types of Regulation": A FASB Statement issued in 1982 that defines the manner in which GAAP, as applied to utilities, differs from GAAP for unregulated enterprises. It limited creation of regulatory assets to rate regulated enterprises, to recovery of specific costs, and to those situations where rates, which include deferred costs, can be expected to be charged to and paid by customers. FAS No. 101 identifies the circumstances under which FAS No. 71 may no longer be applicable.

FAS No. 90, "Regulated Enterprises - Accounting for Abandonments and Disallowances of Plant Costs": A FASB Statement issued in 1986 that requires abandoned plant to be removed from construction work-in-process or plant-in-service and to be restated as a new asset. Any portion of disallowance not allowed in rate base by regulators is to be recognized as a loss.

FAS No. 92, "Regulated Enterprises - Accounting for Phase-In Plans": A FASB Statement issued in 1987 that allowed accounting recognition of phase-in plans, but limits them to a restricted time period and requires that deferred costs must be scheduled for recovery within ten years.

FAS No. 101, "Regulated Enterprises - Accounting for the Discontinuation of Application of FASB Statement 71": A FASB Statement issued in 1988 that identified circumstances such as deregulation or emerging competition which make application of FAS No. 71 no longer applicable.

FAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions": A FASB Statement issued in 1990 that requires employers to record the costs of postretirement benefits other than pensions over the service life of the employee rather than when they are paid out to the employee after retirement.

FAS No. 109, "Accounting for Income Taxes": A FASB Statement issued in 1992 that applied the same income tax reporting requirements to regulated firms as to unregulated firms. It prohibits net-of-tax reporting by regulated firms and requires the creation of a deferred tax liability for taxes that are to be paid in the future.

FAS No. 112, "Employers' Accounting for Postemployment Benefits": A FASB Statement issued in 1992 which requires that employers recognize the obligation to pay postemployment benefits as those liabilities are incurred rather than when they are paid.

Financial Accounting Standards Board (FASB): A private, independent board which sets accounting policy. The Board was established in 1973 and succeeded the Accounting Principles Board. The FASB is recognized by the American Association of Certified Public Accountants and the Securities and Exchange Commission as the organization officially charged with the establishment of GAAP.

FASB Interpretations (FINs): Interpretations of the FASB that expand on previously issued FASB Statements or which provide clarification or elaboration of those Statements. FINs also create GAAP. As of December 31, 1993, forty FINs had been issued. FINs are required to be submitted to the FASAC for comments for a period of 15 days, but more extensive exposure for comment is generally provided.

Flow-Through Accounting: A method of accounting for income taxes under which income tax savings resulting from the use of accelerated depreciation for tax purposes is immediately "flowed through" to utility ratepayers in the form of lower rates, instead of being recorded as a liability and spread over the life of the related properties. The IRS now prohibits the use of flow through tax accounting by utilities.

Fuel Adjustment Clause: A mechanism that passes the actual cost of fuel through to the consumer. The adjustment can be positive or negative depending on whether the actual fuel cost is higher or lower than the base amount included in present rates.

Generally Accepted Accounting Principles (GAAP): The principles, rules, procedures, and conventions of accounting practice. GAAP is defined by a hierarchy of rule-making authorities and promulgated by various types of pronouncements. GAAP is subject to change as economic circumstances change.

Gains*: Increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners. (Paragraph 82)

Goodwill: The excess of the purchase price over the fair market value of the net assets of an acquired firm. Goodwill is generally used to record the value of items such as the value of good customer relations and the name of the firm.

Income Statement: Financial statement which shows the elements (revenue and expenses) used to determine the net profit of the firm over a particular period.

Independent Auditor: The certified public accountant who, though paid by the firm being audited, provides an objective evaluation of the accuracy of financial statements. The auditor's evaluation is referred to as the Independent Accountant's Report.

Intangible Assets: Assets that do not have physical attributes and have a useful life greater than one year. Goodwill, copyrights and trademarks are examples of intangible assets. Intangible assets are amortized as expense over the life of the asset. For regulated firms, the unamortized balance is usually included in the rate base.

Investments by Owners*: Increases in equity of a particular business enterprise resulting from transfers to it from other entities of something valuable to obtain or increase ownership interests (or equity) in it. Assets are most commonly received as investments by owners, but that which is received may also include services or satisfaction or conversion of liabilities of the enterprise. (Paragraph 66)

Investment Tax Credit: A reduction in income taxes equal to up to ten percent of the cost of certain long-term assets. The investment tax credit was provided for within the Revenue Act of 1962 and repealed by the Tax Reform Act of 1986. Since utilities generally have large construction programs, the investment tax credit was very important. Investment tax credits were generally normalized for accounting purposes with the tax benefit being spread over the life of the asset generating the credit.

Liabilities*: Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. (Paragraph 35)

Losses*: Decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from expenses or distributions to owners. (Paragraph 83)

Materiality: The extent to which the exclusion of financial data would affect the understanding of the financial statements and affect the decisions made by readers. Disclosure in footnotes or financial data is required for all material items.

Normalized Accounting: An accounting procedure under which tax expense reported in a utility's income statements is calculated based on straight line depreciation, while in its income tax return the utility calculates its tax expense based on accelerated depreciation. This results in a lower tax liability than the amount shown on the income statement.

The difference between the tax expense reported in a utility's income statement and the taxes actually paid to the IRS is shown on the utility's books as a deferred income tax liability. This liability will be paid in future years when straight line depreciation exceeds tax depreciation. To comply with IRS code, a utility desiring to use accelerated depreciation in its income tax returns must "normalize" these income taxes in the manner described above. (See also Phantom Taxes and Flow Through Accounting.)

Overcapacity: When the assets of a firm are able to produce at a level higher than demand. For an electric utility, overcapacity would exist if the generating capability of the firm exceeded that required to meet the peak demand of the firm. Unacceptable levels of overcapacity can create cost disallowances and undermine the probable assurance of future cost recovery required by FAS No. 71.

Pay-as-you-go Method: Expensing cost items as payment is made rather than when the expense is incurred. FAS No. 106 required a switch from the pay-as-you-go method to the accrual of postretirement costs.

Phantom Taxes: Term used for deferred taxes which result from the normalized method of accounting.

Phase-in Plan: A plan to gradually add percentages of a newly completed plant to rate base over a period of years, thus, avoiding the "rate shock" that would result from inclusion of the entire cost of the plant in rate base at the time it is initially completed. FAS No. 92, which addresses phase-in plans, limited the phase-in period to ten years.

Plant Abandonments: An uncompleted plant on which construction work was halted prior to the time the plant was completed and placed in service. Plant abandonments were due to a variety of reasons, including excess capacity in existing facilities, excessive cost overruns that made the abandoned plant too costly to complete, environmental and safety concerns, or financing problems. Plant abandonments were addressed by FAS No. 90.

Plant Disallowances: A portion of the cost of a plant that is not included in rate base when determining rates. Disallowances can result from occurrences such as cost overruns, prudence issues, and "used" and "useful" tests. FAS No. 90 addressed plant abandonments and disallowances.

Postemployment Benefits: Benefits provided to employees after employment but before retirement. Examples could include workers' compensation, disability plans, and early retirement buyouts. Postemployment benefits were recently addressed by FASB in FASB Statement No. 112. Like FASB Statement No. 106, which addresses postretirement benefits, FASB Statement No. 112 requires the accrual of costs as the obligation to pay those costs is incurred. Financially, postemployment benefits are less significant than post retirement benefits other than pensions.

Postretirement Benefits Other Than Pensions: Benefits, primarily healthcare, which are provided to employees of any business organization after retirement. Postretirement benefits other than pensions became a major issue for utilities and regulators after the issuance of FASB Statement No. 106, which required all firms to accrue those costs across the working life of the employee rather than to expense them as payments were made to the employee after retirement.

Prevalent Practice: The commonly occurring accounting treatment within a particular industry. Prevalent practice establishes GAAP unless superseded by pronouncements at higher levels of the GAAP hierarchy. Because regulatory commissions establish prevalent practice in regulated industries, those commissions establish a form of GAAP.

Probability of Future Collection: The reasonable likelihood that deferred costs will be included in future rates and collected from ratepayers. The infusion of competition into regulatory markets has brought the probability of future collection and the application of FAS No. 71, into question.

Prudent Investment: An investment which was reasonable at the time the decision to make the investment was made.

Public Utilities Holding Company Act (PUHCA): Federal legislation enacted in 1935 that gave the SEC special authority to regulate public utility holding companies, including the accounting for those companies.

Qualified Opinion: A statement accompanying the financial statements of the firm stating that the independent auditor believes that, *except* for certain material items, the financial statements accurately reflect the financial position of the firm.

Rate Adjustment Clause: Another term for revenue adjustment mechanism. See Revenue Adjustment mechanism.

Rate Base: The assets of a utility on which the stockholders of the firm are allowed a return. Although rate base components differ slightly from one jurisdiction to another, they generally consist of plant in service less accumulated depreciation, plus plant held for future use, plus working capital, less advances for construction, contributions in aid of construction, and accumulated deferred taxes.

Rate of Return: The return allowed on total investment (debt plus preferred stock and common equity) expressed as a percent and applied to rate base.

Reasonable Return on Investment: A return equal to that which could be earned on similar investments with corresponding risks.

Recognition: The recording of economic events in the financial records of a firm.

Regulatory Assets: Assets recorded on a utility's financial statements contingent to a commitment by the regulator to allow the cost to be recouped through rates. An example would be research and development costs, which are expected to benefit future ratepayers and, thus, are amortized by order of the regulator over the period of expected future benefit instead of being expensed immediately. FAS No. 71 limits the use of regulatory assets to situations where it is probable that the specific costs will be recovered in the future. By recognizing the existence of regulatory assets, FASB recognized that the actions of regulatory commissions have a unique and tangible economic impact on regulated firms.

Regulatory Compact: The implied contract between utilities and regulatory agencies that allows utilities to earn a fair rate of return in exchange for providing quality service at a fair price to all customers in the service territory.

Regulatory Liabilities: Liabilities recorded on a utility's financial statements resulting from a requirement by the regulator that certain amounts are to be paid by the utility in the future. An example is revenue collected by the utility that has been ordered to be refunded to customers. Regulatory liabilities are the reverse of regulatory assets.

Return On Equity: The return allowed on the common equity component of a utility's capital, expressed as a percentage.

Revenue Requirement: The level of revenues necessary to cover operating expenses and taxes, plus an amount that will provide a return on rate base at the percentage authorized by the regulatory commission.

Revenues*: Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations. (Paragraph 78)

Revenue Adjustment Mechanisms: Mechanisms authorized by regulatory agencies to permit the utilities to pass through the actual costs of certain items. An example of a revenue adjustment mechanism is the fuel adjustment clause.

Securities and Exchange Commission (SEC): The federal agency established by the Securities Exchange Act of 1934 and given the responsibility for establishing accounting standards required for implementation of securities reform. The SEC delegated its responsibility for establishing accounting standards to the professional accounting community through its "substantial authoritative support" test. The FASB is the organization currently charged with responsibility for establishing accounting standards.

SEC Regulation S-X: A regulation by the Securities and Exchange Commission which specifies the form and content of required financial statements submitted to the SEC.

Staff Accounting Bulletins (SABs): SEC pronouncements that provide administrative interpretations of SEC financial reporting requirements.

Statements of Auditing Standards: AICPA pronouncements that provide standards for the performance of independent audits.

Statements of Financial Accounting Concepts (SFACs): Statements issued by FASB which attempt to identify the fundamentals of financial accounting as a guide to the FASB itself, practicing accountants, and the public. SFACs do not establish mandatory GAAP.

Statements of Financial Accounting Standards (FAS): Standards promulgated by the FASB which address specific accounting issues and are the highest authority in the GAAP hierarchy. As of December 31, 1993, the FASB had issued 117 Statements of Financial Accounting Standards.

Substantial Authoritative Support: The criterion established by the SEC by which to judge the accuracy of financial statements. In Release No. 4 in 1938, the SEC stated that financial statements prepared in accordance with principles for which there is no "substantial authoritative support" would be presumed to be misleading or inaccurate. Release No. 4, in effect, delegated to the accounting profession the responsibility and authority to establish accounting standards.

Technical Bulletins (TBs): Pronouncements issued by the FASB staff to provide guidance on limited accounting problems or on items not directly covered by other pronouncements. A TB cannot be issued if an accounting problem affects a significant number of firms, if the cost of administering the TB is high, or if the TB could conflict with established accounting principles. In the GAAP hierarchy, TBs are subordinate to FASB Statements.

Test Year: The period used when determining the rates of a utility. The test year can be historical, forecasted or a combination.

Timing Difference: A timing difference occurs any time the revenue to cover an expense is received in a different time period than when the expense actually occurs. Examples which can cause a timing difference are accelerated depreciation and fuel cost adjustments.

Unbilled Revenues: Revenues attributable to service already provided which have not been billed to the consumer.

Underrecovery: Not fully recovering an allowable expense. Underrecovery can occur due to economic circumstances or timing differences.

Uniform System of Accounts: An accounting system prescribed by a regulatory commission for mandatory use by utilities under its jurisdiction. Each type of utility service (electric, gas, telephone, and water) has a separate uniform system of accounts. Uniformity in accounting and reporting permits the financial statements of one utility to be compared with the financial statements of other similar utilities and the financial statements for one time period to be compared to other time periods.

Unqualified Opinion: A statement accompanying the financial statements of the firm stating that the independent auditor was able to complete a satisfactory examination of the relevant items of the financial statements and that the auditor believes that the financial statements accurately reflect the financial position of the firm.

Weighted Average Cost of Capital: The overall cost of capital of a firm. The estimated cost of each component is multiplied by the percent that the component represents of total capital. The sum of all the products equals the weighted average cost of capital. An example follows which shows the calculation of the pre-tax weighted average cost of capital.

	Capital Structure	Cost	Weighted Average
Debt	50%	10%	5.0%
Preferred Stock	20%	12%	2.4%
Common Stock	30%	14%	4.2%
Total	100%		11.6%

The weighted average cost of capital is often used as the overall rate of return when determining revenue requirements.

APPENDIX C

THE SPECIFIC OUTCOMES OF THE CONCEPTUAL FRAMEWORK PROJECT

A good introduction to the basic purposes of accounting has been provided by the FASB in its Conceptual Framework Project. The general outcomes of that project are described in Chapter 2. The specific results of that project are summarized here.

Between 1978 and 1985, the FASB issued the following six Statements of Financial Accounting Concepts (hereafter referred to as SFAC No. 1, etc.) under its conceptual framework project:

- SFAC No. 1: "Objectives of Financial Reporting by Business Enterprises"
- SFAC No. 2: "Qualitative Characteristics of Accounting Information"
- SFAC No. 3: "Elements of Financial Statements of Business Enterprises" (SFAC No. 3 was ultimately superseded by SFAC No. 6.)
- SFAC No. 4: "Objectives of Financial Reporting by Nonbusiness Organizations"
- SFAC No. 5: "Recognition and Measurement in Financial Statements of Business Organizations"
- SFAC No. 6: "Elements of Financial Statements" (a replacement of SFAC No. 3 and an amendment of SFAC No. 2)

Two of the four statements of interest to utilities and regulators (SFAC Nos. 1, 2, 5, and 6) provide general concepts (No. 1 and No. 2) and are generally prescriptive; two (No. 5 and No. 6) provide more detail and are more descriptive. A discussion of each follows.

SFAC No. 1 asks why financial reports are prepared; it comes to the important conclusion that they are not an end in themselves but are created to provide information

to the users of those reports.¹ Users could include internal users, such as managers; and external users, such as investors, creditors, brokers, customers, employees, and others who cannot direct managers to provide specific information and who, therefore, must rely on standardized reports.² Regulators are a special variety of user because they are technically external users but do have the authority to demand specific financial information.

In addition to emphasizing the primacy of users, SFAC No. 1 acknowledges the impact of economic, legal, political, and social factors on financial reporting.³ It also addresses the limits of accounting information by making the point that financial reports are only one source of information necessary for users.⁴ It also concludes that the information contained in financial reports is not necessarily exact but is sometimes the result of estimates or judgement.⁵ Last, SFAC No. 1 acknowledges that managers know the enterprise better than external users and gives them the responsibility of increasing the usefulness of financial statements by disclosing events and circumstances impacting the enterprise.⁶

Having concluded that usefulness is the primary objective of financial reports, the FASB in SFAC No. 2, *Qualitative Characteristics of Accounting Information*, attempted to identify the qualities that make accounting information useful. As might be expected, the FASB identified a hierarchy of qualities. Figure C.1, taken from SFAC No. 2, illustrates that hierarchy.

¹ Financial Accounting Standards Board, "Statement of Financial Accounting Concepts No. 1: Objectives of Financial Reporting by Business Enterprises," *Original Pronouncements: Accounting Standards as of June 1, 1993: Volume II* (Burr Ridge, IL: Irwin, 1993), par. 9.

² *Ibid.*, par. 28.

³ *Ibid.*, par. 9.

⁴ *Ibid.*, 22.

⁵ *Ibid.*, par. 20.

⁶ *Ibid.*, 1005-1006.

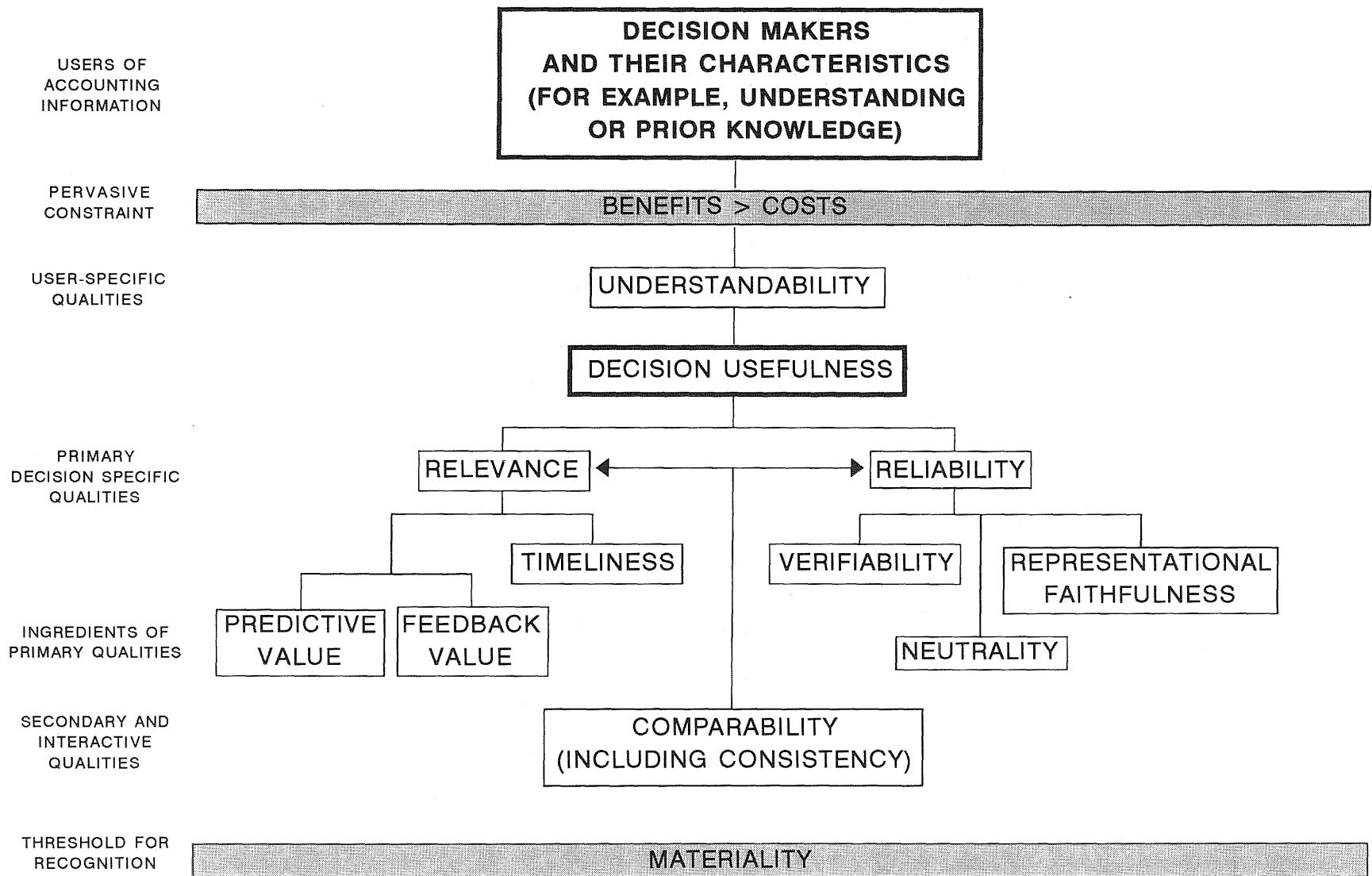


Fig. C-1. A Hierarchy of Accounting Qualities.

Source: SFAC No. 2, par. 32. Reprinted with permission of the FASB.

In the SFAC No. 2 hierarchy, relevance and reliability are the primary qualities of accounting information. Relevant information is simply information that matters to decision makers.⁷ Secondary aspects of relevance are the predictive value of the information (does it reduce uncertainty?), its feedback value (does it confirm or deny prior information), and its timeliness (is the information available while it still has the capability to influence decision making?).⁸

Relevance is equal to importance to reliability. According to SFAC No. 2, accounting information is reliable if it accurately portrays the economic conditions and events that it alleges to portray.⁹ There are three secondary aspects of reliability. They are: representational faithfulness (that is, is there a correspondence between the description of an item in the financial statement and the item it represents?); verifiability (that is, would another statement preparer similarly portray the same circumstances and events?); and neutrality (that is, is the primary consideration the creation of statements that are relevant and reliable rather than the consideration of the impact the statements may have?).¹⁰

Comparability is another secondary objective of accounting information, but rather than being applied to a single financial report, it takes two firms or two time periods to establish comparability.¹¹ Obviously, the accounting information about an enterprise becomes more valuable if it can be compared to other similar enterprises and to the same enterprise in a prior period. Though standardization and comparability are

⁷ Financial Accounting Standards Board, "Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume II* (Burr Ridge, IL: Irwin, 1993), pars. 46-47.

⁸ *Ibid.*, pars. 51-57.

⁹ *Ibid.*, par. 62.

¹⁰ *Ibid.*, pars. 63-110.

¹¹ *Ibid.*, par. 116.

useful, the FASB cautions against confusing comparability with identity, making all things appear the same when real differences may exist.¹²

All of these qualities of accounting information are subject to three constraints. First, all information is subject to cost-benefit tradeoffs. SFAC No. 2 recognizes that it is difficult to quantify the benefits of relevant and reliable accounting information but concludes that decisions about the collection of accounting information must be subjected to the same cost-benefit trade-offs.¹³ Second, SFAC No. 2 acknowledges that accounting information must be understandable but recognizes that some prior knowledge of accounting and finance is necessary. Therefore, the FASB says that accounting information should be directed toward those with some understanding of economics and business, who are willing to examine the information with some care.¹⁴ Third, accounting information is subjected to a materiality constraint. That is, the items reported must be of adequate magnitude to make a difference to decision makers.¹⁵

Conservatism is one commonly cited attribute of accounting information that is notable for its absence in the FASB hierarchy of qualities.¹⁶ SFAC No. 2 goes so far as to caution accountants against understating assets in the name of conservatism.¹⁷ According to David Solomons:¹⁸

If conservatism means the prudent assessment of uncertainty, there can be no quarrel with it. But if it goes beyond that, it is objectionable because it biases (or seeks to bias)

¹² Ibid., par. 119.

¹³ Ibid., par. 135.

¹⁴ Ibid., par. 40.

¹⁵ Ibid., par. 123.

¹⁶ David Solomons, *Making Accounting Policy: The Quest for Credibility in Financial Reporting* (New York: Oxford University Press, 1986), 99.

¹⁷ FASB, "SFAC No. 2," pars. 92-97.

¹⁸ Solomons, *Making Accounting Policy*, 101.

measurement in one direction, and bias is not consistent with reliability.

SFAC No. 5, *Recognition and Measurement in Financial Statements of Business Organizations*, is more specific than the two statements just reviewed. It identifies the financial statements that should be provided for an enterprise, describes the function of each statement, and sets out recognition criteria for items included in the financial statements.

According to SFAC No. 5, financial statements should identify the financial position of the firm at the end of the period, the earnings for the period, comprehensive income for the period, cash flows, and investments by and distributions to owners.¹⁹ The statements prescribed by SFAC No. 5 that together meet these objectives are:²⁰

Statement of Financial Position

Statement of Earnings and Comprehensive Income

Statement of Cash Flows

Statement of Investments by and Distributions to Owners

These statements generally parallel several of the financial statements provided currently by firms--the balance sheet, the income statement, and the statement of changes in owners' equity. Exceptions are the statement of cash flows, which could be interpreted differently than the current statement depending on the definition of cash employed,²¹ and the statement of comprehensive income, which differs from the income statement by

¹⁹ Financial Accounting Standards Board, "Statement of Financial Accounting Concepts No. 5, Recognition and Measurement in Financial Statements of Business Enterprises," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume II* (Burr Ridge, IL: Irwin, 1993), par. 13.

²⁰ *Ibid.*, pars. 25-57.

²¹ Paul B.W. Miller and Rodney Redding, *The FASB: The People, the Process, and the Politics* (Homewood, IL: Richard D. Irwin, 1986), 119.

the inclusion of some gains and losses, such as changes in the market value of investments, which are not included in the current income statement.²²

SFAC No. 5 also identified four recognition criteria--essentially rules for determining if items should be included in statements. Recognition is the process of identifying an item as an asset, liability, revenue or expense and recording it in accounting records.²³ The identified criteria are as follows:²⁴

1. **Definition:** Does the item meet the definition of an element of a financial statement?
2. **Measurability:** Can it be reliably measured?
3. **Relevance:** Will inclusion of the item make a difference for users?
4. **Reliability:** Does the information meet the characteristics of reliability defined by SFAC No. 2--representational faithfulness, verifiable, and neutral?

Finally, SFAC No. 6, Elements of Financial Statements, defines the 10 key elements of financial statements. It defines assets, liabilities, equity or net assets, investments by owners, distributions to owners, comprehensive income, revenues, expenses, gains, and losses.²⁵ Those definitions are included within the glossary of this report.

In total, these concept statements only partially meet the three objectives listed earlier, which were to describe existing practice, to provide a prescription for future practice, and to define common terms. Some of the reasons for the failure to more

²² FASB, "SFAC No. 5," par. 42.

²³ Ibid., par. 58.

²⁴ Ibid., par. 63.

²⁵ Financial Accounting Standards Board, "Statement of Financial Accounting Concepts No. 6: Elements of Financial Statements," *Original Pronouncements: Accounting Standards as of June 1, 1993, Volume II* (Burr Ridge, IL: Irwin, 1993), 1108-1109.

completely realize those objectives are identified in the following section. Nonetheless, the failure to provide a thoroughly prescriptive framework does not excuse the FASB from generally being guided by the concepts statements when the requirements for accounting for regulated industries are modified.