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Public utilities industry developments - 1995/96; Audit risk alerts

American Institute of Certified Public Accountants

American Institute of Certified Public Accountants. Public Utilities Committee

AUDIT RISK ALERTS

Public Utilities Industry Developments—1995/96

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Industry and Economic Developments

The public utilities industry is an industry in a state of transition. The dynamic environment in which the industry operates holds many challenges and opportunities. The challenges relate to issues such as competition, cost containment, and deregulation. The opportunities relate to diversification and increased operational efficiencies and productivity. The electric, gas, and telecommunications industry is dealing with unprecedented competitive pressures while the water industry is coping with environmental laws, such as the Safe Drinking Water Act and the Clean Air Act, and regulations issued by the Environmental Protection Agency (EPA) and various state regulators.

Electric Utilities

In 1992, Congress passed the National Energy Policy Act, which provides for opening the wholesale power market to full competition. Since then, the Federal Energy Regulatory Commission (FERC) has strived to develop a framework that would ensure equal access to transmission and distribution systems while assuring fair pricing across all customer classes. In order to survive and succeed in the new competitive environment, many electric utilities are implementing strategic plans to cut costs and lower prices. Many of these strategic plans involve business combinations: merging, acquiring, partnering, and joint venturing with other utilities. Such combinations allow utilities to achieve economies of scale and increase overall productivity and efficiency. In addition, many electric utilities are restructuring and realigning existing operations in an effort to contain costs and enhance organizational efficiencies.

Gas Utilities

FERC Order 636 changed the structure of the gas industry to allow open access transportation, enabling end users to purchase gas on the spot market directly from producers. Order 636 requires gas pipelines to unbundle their services from the traditional provision of gas services. Such unbundling has allowed industrial users to bypass local distribution companies and purchase gas directly from producers and pipelines. As a result, gas customers—especially electric generators and other large industrial users—now have the ability to make gas supply choices that are market-driven rather than mandated by regulation. As gas utilities enter their second full year of operations under Order 636, they are adapting to the competitive environment in a number of ways:

- Investing in natural gas storage facilities. Storage allows local distribution companies to purchase natural gas at off-peak prices and pass the savings on to customers.
- Using natural gas marketing initiatives. Marketing initiatives assist gas utilities in their efforts to combine supply, transportation, and storage capabilities into efficient, cost-effective service packages.
- Expanding to different market segments and geographic regions. Market and geographic expansion allows gas utilities to diversify and gain new competitive advantages.

A relaxed regulatory environment, designed to let market forces work, has thus given gas companies an unprecedented level of operational flexibility.

Telecommunications

The advent of competition, the rapid introduction of advanced technology, and the divestiture of local companies by AT&T continue to increase both local telephone rates and the business risks faced by telephone utilities. The breakdown of regulatory barriers at both the state and federal levels has allowed competitors to enter telecommunication services markets with increasing frequency. At the same time, it has allowed telecommunication providers to enter new markets in areas of increased competition, such as cable services.

Water Utilities

Recent environmental laws enacted by Congress and the related regulations administered by the EPA and various state regulators have set stringent standards for water utilities and their operations. For example, the EPA raises national standards for water purity at least once every three years in accordance with the Safe Drinking Water Act and the Clean Air Act. In order to meet the increased standards, water utilities are often faced with increased costs related to (1) substantial capital investments, (2) highly paid technical personnel, and (3) expensive water treatment chemicals. When planning the audit of water utilities, auditors should consider such cost increases and should consider whether they are recoverable from water customers.

The Impact of Competition on Accounting Decisions

The monopoly status granted to utilities in the past brought with it governmental regulation of rates charged for the services the utilities provided. This regulation is performed through various rate-making processes, which determine selling prices and specify overall levels of revenue, the types and amounts of rates that may be charged, and the various classes of users to which the different rates apply. Rate-making also influences the application of generally accepted accounting principles (GAAP) by public utilities.

AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), requires that, in planning the audit, auditors should consider "matters relating to the entity's business and the industry in which it operates." Increased competition and other economic factors affecting the public utilities industry raise a number of issues that may increase audit risk and should be carefully considered by auditors as they plan their audits. For example, as a result of increased competition, some utilities may find that the actual useful lives of certain assets are shorter than originally anticipated or that costs deferred in accordance with Financial Accounting Standards Board (FASB) Statement No. 71, *Accounting for the Effects of Certain Types of Regulation* (FASB, *Current Text*, vol. 2, sec. Re6), may not be recoverable. These and other issues are addressed further in the "Audit Issues and Developments" section of this Audit Risk Alert.

Regulatory and Legislative Development

Rural Utilities Service Approval of AICPA Peer Review Program

In July 1995, the Rural Utilities Service (RUS)—formerly the Rural Electrification Administration—approved the AICPA peer review program as meeting its quality review requirements under Section 1773.5(c)(3)(iii) of the Code of Federal Regulations (CFR). If a CPA firm previously had a review under the AICPA quality review program, it will be deemed to be in compliance with the RUS peer review requirements.

Audit Issues and Developments

The Interrelationship of Rate Making and Accounting

As part of the rate-making process of governmental regulation, rate orders often require rate-regulated entities to observe accounting practices for rate-making purposes that are at variance with GAAP for nonregulated entities. For example, although GAAP requires the immediate recognition of research and development expenses, regulators of public utilities may require the utilities subject to their jurisdiction to defer research and development costs for rate-making purposes and amortize them over the future periods in which compensating revenues will be generated through the rate-making process.

FASB Statement No. 71 requires utilities to capitalize costs if regulation provides reasonable assurance that incurred costs will be recovered in the future through the rate-making process. For example, a regulator may permit unanticipated repair costs incurred in one fiscal period to be recovered in a future period through higher customer rates. For accounting purposes, the unanticipated repair costs should be deferred until the rates are effective and should be amortized as the revenues are collected. Similarly, if current rates are provided for costs that are expected to be incurred in the future, such as the costs of potential storm damage repairs, FASB Statement No. 71 requires that those current additional receipts be recognized as liabilities.

As they plan their audits of the financial statements of public utilities, auditors should consider inherent risk, especially risk factors relating to the regulatory structure of the industry. The recovery of regulatory assets, such as deferred energy costs, abandoned plant assets, and phase-in assets, may depend highly on the rate-making process. Assessment of audit risk should include an assessment of the risk that those costs will not be recovered. Auditors should also plan to determine whether such costs have been accounted for properly.

Continued Applicability of FASB Statement No. 71

The environment in which utilities operate is rapidly changing due to changes in the marketplace, technology, and a political climate that favors deregulation. Changes in state and federal regulation of utilities have resulted in increased use of incentive-type rate regulation, regulator-imposed conservation measures (for example, demand side management), significant regulatory disallowances and deferred rate recovery of material costs, and increased competition. In certain industries, changes in technology have created new competitors and caused the rapid obsolescence of plant and equipment. Given the movement toward deregulation and increased competitiveness of the utility operating environment, a utility's auditors must assess whether any one factor or the combined effect of these factors would lead to the conclusion that the criteria for the application of FASB Statement No. 71 are no longer met by the utility. The basic criteria for the application of FASB Statement No. 71, as discussed in paragraph 5(a) of that Statement are:

1. 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.
2. The regulated rates are designed to recover the specific enterprise's costs of providing the regulated services or products.
3. 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.

FASB Statement No. 101, *Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71* (FASB, *Current Text*, vol. 2, sec. Re6), provides several examples of reasons that may cause an enterprise, or "a separable portion" thereof, to no longer meet the criteria for applying FASB Statement No. 71. Reasons cited include deregulation, a change from cost-based rate making to another form of regulation, increasing competition that limits the ability to recover costs, and regulatory actions that limit rate relief to a level insufficient to recover costs. These factors should be considered in determining when an enterprise ceases to meet the criteria for application of FASB Statement No. 71.

In the face of retail wheeling and other competitive forces, electric utility companies have been offering wholesale customers and large industrial customers large discounts to retain their business. FASB Statement No. 101 states that a "separable portion" of the business may be the operations within a regulatory jurisdiction or a smaller portion, such as a customer class within a jurisdiction. Auditors of utilities that are discounting rates to certain classes of customers should consider the effect of such discounting on the appropriateness of the continued application of FASB Statement No. 71 for those classes of customers, even when the remainder of the utility's operations continue to meet the Statement No. 71 criteria. If discontinuance of Statement No. 71 is appropriate for a class of customers, applying Statement No. 101 may require allocation of systemwide assets and liabilities.

Because regulated enterprises may be experiencing one or more of the circumstances cited, it is important that such enterprises assess annually, and auditors consider carefully, the propriety of the continuing applicability of FASB Statement No. 71. As utilities adopt alternative regulatory plans, auditors should consider the cause-and-effect relationship between a company's own costs and revenues in reaching a determination about the appropriateness of continued application of FASB Statement No. 71. Auditors can look to such factors as—

- The basis used for setting the company's initial rates under alternative regulation and whether the regulatory intent is that such rates be cost-based.
- The frequency of price adjustments and whether the regulatory intent of adjustments is to maintain rates that are cost-based.
- The company specificity of price-adjustment formulas.
- The degree of adjustment to the company's actual costs through sharing provisions.
- How closely changes in the company's actual costs track the changes in revenues produced by applying price-adjustment formulas.

Auditors should consider whether their clients cease to meet the criteria for applying the provisions of FASB Statement No. 71 and should consequently apply the provisions of FASB Statement No. 101. FASB Statement No. 101 states that once all or a separable portion of an enterprise's operations no longer meet the criteria for application of FASB Statement No. 71, the enterprise should discontinue its application by eliminating from its balance sheet the effects of any actions of regulators that had been recognized as assets and liabilities pursuant to FASB Statement No. 71 but that would not have been recognized as assets and liabilities by enterprises in general. However, the carrying amounts of plant, equipment, and inventory measured and reported pursuant to FASB Statement No. 71 should not be adjusted unless those assets are impaired, in which case the carrying amounts of those assets should be reduced to reflect that impairment. (Impairment should be judged in the same manner as assets of enterprises in general — see "Impairment of Long-Lived Assets" in the "Accounting Issues and Developments" section of this Audit Risk Alert.) The net effect of the adjustments required by FASB Statement No. 101 should be included in income of the period of the change and classified as an extraordinary item.

Regulatory Assets

Regulatory assets are created when the rate actions of regulators provide reasonable assurance of the existence of an asset. The criteria for the establishment of such assets are contained in paragraph 9 of FASB Statement No. 71.

Because regulatory assets are recorded only if it is "probable" (as defined in FASB Statement No. 5, *Accounting for Contingencies* [FASB, *Current Text,* vol. 1, sec. C59]) that future revenue will recover those costs, a critical assessment of the sufficiency of the audit evidence available to support them is a matter that requires judgment. A currently effective rate order generally provides assurance of the existence of a regulatory asset. Generic orders of regulators may also provide evidence of the existence of a regulatory asset. Sometimes, however, because of the nature and length of the regulatory process, a rate or a generic order may not yet be available. In such cases, auditors may need to look to related jurisdictional precedent, accounting orders, or other evidence involving other utilities in order to test an assertion that recovery of regulatory assets is probable. In the absence of a rate or a generic order, discussion of the situation with the regulatory staff having jurisdiction may be advisable. Recognition of regulatory assets, in the absence of the audit evidence described above, should be approached with a high degree of professional skepticism. Factors such as a good working relationship with regulators or the recent favorable resolution of issues unrelated to the incurred costs being evaluated are not generally an adequate basis for the recognition of regulatory assets.

In addition to the provisions set forth in FASB Statement No. 71, specific criteria for the recognition and measurement of regulatory assets and related matters are included in the following pronouncements:

- FASB Statement No. 90, *Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs* (FASB, *Current Text,* vol. 2, sec. Re6)
- FASB Statement No. 92, *Regulated Enterprises—Accounting for Phase-in Plans* (FASB, *Current Text,* vol. 2, sec. Re6)
- FASB Statement No. 101, *Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71* (FASB, *Current Text,* vol. 2, sec. Re6)
- FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FASB, *Current Text,* vol. 1, sec. I08)

- FASB Emerging Issues Task Force (EITF) Issue No. 92-7, *Accounting by Rate-Regulated Utilities for the Effects of Certain Alternative Revenue Programs*
- EITF Issue No. 92-12, *Accounting for OPEB Costs by Rate-Regulated Enterprises*
- EITF Issue No. 93-4, *Accounting for Regulatory Assets*

Auditors should refer to these pronouncements, when applicable, in evaluating the propriety of a client's accounting for regulatory assets.

Auditors should consider whether the amount and recovery period of regulatory assets, as well as the amount of regulatory assets not earning a return, are adequately disclosed in the financial statements. The staff of the Securities and Exchange Commission (SEC) has indicated its preference that, for publicly held enterprises, disclosures include the amount and nature of regulatory assets and liabilities as well as the manner in which the financial statements would differ if the enterprise were not regulated, including differences in methods of depreciation. The SEC staff has also indicated that, when a regulated enterprise has a rate case or cases subject to appeal through the regulatory or judicial system, the enterprise should disclose the status of each issue on appeal and indicate how the item is recorded in the financial statements.

Certain regulatory assets (for example, costs deferred under a phase-in plan and those that relate to postretirement benefits other than pensions) have prescribed maximum recovery periods and methods. Other regulatory assets (for example, those arising from flow-through income tax accounting) may have a recovery period related to their underlying nature. Recovery periods related to other regulatory assets are left to the judgment of the utility and its regulator. Auditors should be aware that in the changing regulatory environment the recovery of regulatory assets over a long period of time may call into question whether such assets are probable of recovery.

Deferral of an incurred cost is permitted only if it is probable of recovery. If uncertainties develop after a regulatory asset has been recorded, management should reconsider whether the asset will be recovered through rates. If not, the asset should be written off. If the asset is not impaired but uncertainties exist, auditors should consider the adequacy of disclosures in the financial statements regarding the uncertainty and the need to add an explanatory paragraph in the auditor's report. See also the sections of this Audit Risk Alert entitled "Impairment of Long-Lived Assets", "Risks and Uncertainties", and "Elimination of Uncertainty Reporting."

The addition of an explanatory paragraph to the auditor's report because of an uncertainty concerning the recoverability of a regulatory asset is not a substitute for recognition of a loss when such recognition is appropriate. Accordingly, it should first be determined whether a loss should be recognized in those situations because the asset is impaired. If it is determined that a loss is not recognized when it should be and the effect on the financial statements is material, the auditor's report should be modified for a departure from GAAP. See also the "Risks and Uncertainties" section in this Audit Risk Alert.

Stranded Costs

A recent study, *Stranded Costs Will Threaten Credit Quality of U.S. Electrics,* estimates that a substantial amount of fixed costs approved for recovery in prior regulatory climates may become "stranded," that is, not recoverable by the utility, in the future as the industry moves toward a more free market environment.[1] As regulators move away from cost-based regulation, the issue arises of whether utility customers or utility shareholders and bondholders will ultimately bear the sunk costs associated with previously constructed plants, long-term power purchase contracts, or fuel cost structures that are not economically viable at competitive, market-based rates. An auditor should be aware of and consider the impact of competition on the utility's ability to recover its costs. One factor that the auditor might consider in assessing a company's exposure to stranded costs and the possible impact of such costs on the company's financial statements is the cost structure of the utility in comparison to its competitors and in conjunction with rate-setting developments within its operating jurisdiction. The existence of such costs may suggest that an asset is impaired or that the discontinuation of regulatory accounting under FASB Statement No. 71 is appropriate, or both.

Depreciation

The estimated useful lives and the estimated removal or retirement costs of plants and other facilities may change significantly over time because of various factors, including changes in planned use due to competitive or environmental factors, governmental requirements, and physical plant changes that shorten or extend the life of the facility. The determination of estimated useful lives and removal or retirement costs involves accounting estimates. SAS No. 57, *Auditing Accounting*

[1] Moody's Investor Service, *Stranded Costs Will Threaten Credit Quality of U.S. Electrics,* August 1995.

Estimates (AICPA, *Professional Standards,* vol. 1, AU sec. 342), provides guidance to auditors on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates. In situations involving complex or highly specialized plants or facilities, auditors may need to engage a specialist to achieve the required degree of assurance regarding estimated useful lives. In these instances, auditors should consider the requirements of SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards,* vol. 1, AU sec. 336). Auditors should also consider whether estimates of useful lives of plants and other facilities are the types of significant estimates that would require disclosure under AICPA Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties.*

Regulatory agencies often require specific approval of depreciation rates used by the utilities they regulate and any changes therein. Generally, any differences between the amounts of depreciation expense that would be recognized in accordance with GAAP and those that are allowed in the rate-making process give rise to regulatory assets or liabilities. (An exception to the general rule is prescribed by FASB Statement No. 92, which prohibits the recognition of a regulatory asset for such differences if they relate to recently completed plant.) Auditors should be familiar with the applicable regulatory requirements for approval of depreciation rates and should read regulatory orders in assessing the propriety of depreciation recorded in the financial statements as well as the propriety of regulatory assets recorded in accordance with FASB Statement No. 71.

Nuclear Decommissioning

Nuclear decommissioning refers to decontaminating a nuclear power plant at the end of its useful life. In 1994, the FASB added to its agenda a project on accounting for obligations for decommissioning of nuclear power plants. Traditionally, the estimated decommissioning obligation for nuclear power plants has been treated as negative salvage value and recognized over the life of the plant as depreciation rather than reflected as a liability. The objective of the FASB's project is to determine if and when a liability for nuclear decommissioning should be recognized, how any such liability should be measured, and whether a corresponding asset is created. At the end of 1995, the FASB expects to release a proposed Statement of Financial Accounting Standards entitled *Liabilities for Closure and Removal of Long-Lived Assets* that will address this issue.

SEC Staff Accounting Bulletin (SAB) Topic 10B, *Estimated Future Costs Related to Spent Nuclear Fuel and Nuclear Electric Generating Plants,* provides guidance that should be followed by publicly held utilities on disclosures that should be made concerning the estimated future costs of storing spent nuclear fuel and decommissioning nuclear generating plants. Auditors of financial statements of utilities that own nuclear power plants should evaluate carefully the adequacy of financial statement disclosures related to decommissioning costs. In particular, they should consider whether a reliable decommissioning study has been conducted and whether estimated costs include all applicable items. Auditors should also consider the reasonableness of estimates of the useful lives of such plants. The useful lives of some plants may be substantially shorter than originally anticipated. (See the previous discussion of issues related to depreciation.) If decommissioning costs are underestimated and useful lives of plants overstated, provisions made over the lives of the plants and recovered in rates may be inadequate to cover the costs that will need to be incurred in the decommissioning process.

Because the determination of decommissioning or removal costs involves accounting estimates, auditors may find useful guidance in SAS Nos. 57 and 73.

On June 30, 1995, the FERC issued a final rule entitled *Nuclear Plant Decommissioning Trust Fund Guidelines* that sets forth the guidelines for the formation, organization, and purpose of nuclear plant decommissioning trust funds (Funds) and for Fund investments. The rules are intended to (1) give Funds greater investment flexibility, (2) improve the returns earned on Funds contributed through wholesale electric rates, and (3) decrease the amounts collected from rate payers for decommissioning. The final rule became effective July 31, 1995.

Environmental Matters

Because of the nature of their operations, utilities are often faced with obligations driven by environmental requirements. Such obligations frequently include the disposition of materials containing polychlorinated biphenyl (PCB), the disposition of high- and low-level radioactive waste, the reduction of sulfur dioxide emissions, remediation of residuals associated with manufactured gas plant sites, and asbestos removal. Such environmental issues have the potential to result in significant costs.

Auditors of utilities that face such environmental issues should evaluate whether the accounting and disclosure requirements of FASB Statement No. 5 have been met, as well as the implications of rate regulation and FASB Statement No. 71. Additional guidance is included in the following:

- FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (FASB, *Current Text*, vol. 1, sec. C59)
- FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (FASB, *Current Text*, vol. 1, sec. B10)
- EITF Issue No. 89-13, *Accounting for the Cost of Asbestos Removal*
- EITF Issue No. 90-8, *Capitalization of Costs to Treat Environmental Contamination*
- EITF Issue No. 93-5, *Accounting for Environmental Liabilities*

Auditors of publicly held utilities should also consider the requirements of SAB No. 92, *Accounting and Disclosures Relating to Loss Contingencies*, which provides the SEC staff's interpretation of current accounting literature related to matters such as—

- The inappropriateness of offsetting probable recoveries against probable contingent liabilities
- Recognition of liabilities for costs apportioned to other potential responsible parties
- Uncertainties in the estimation of the extent of environmental liabilities
- The appropriate discount rate for environmental liabilities if discounting is appropriate
- Financial statement disclosures of environmental exit costs and other items and disclosure of certain information outside the basic financial statements

SAB No. 92 includes a separate section (Topic 10F, *Presentation of Liabilities for Environmental Costs*) that discusses the impact of environmental liabilities on the utilities industry. The SAB indicates that utilities subject to the SEC's rule (1) should not offset regulatory assets against liabilities for environmental costs and (2) should not delay recognition of probable and reasonably estimable liabilities for environmental costs until regulators have determined whether the costs are recoverable in the rate-making process.

SAB No. 92 also states that when estimating liabilities for environmental remediation, a company should consider available evidence, including the company's prior experience in remediation of contaminated sites, other companies' clean-up experience, and data released by the EPA or other organizations. The continued expansion of environmental databases has resulted in the availability of significantly more information to support a reasonable estimate of the amount of loss or range of loss. As has been noted in recent press reports, companies have been using such expanded informational resources in developing or refining their estimates of environmental liabilities. When evaluating a utility's environmental remediation liabilities, auditors may consider the evidence currently provided by the expanded environmental databases. (See also the "Accounting Issues and Developments" section of this Audit Risk Alert for information on environmental remediation liabilities.)

Derivatives

Recent years have seen a growing use of innovative financial instruments, commonly referred to as derivatives, that often are very complex and can involve a substantial risk of loss. Public utilities are increasingly entering into forward contracts, futures contracts, and options in order to hedge against losses related to the effect of changing prices and other uncertainties. As interest rates, commodity prices, and numerous other market rates and indices from which derivative financial instruments obtain their value have increased in volatility, a number of entities have incurred significant losses as a result of their use. The use of derivatives almost always increases audit risk. Although the financial statement assertions about derivatives are generally similar to assertions about other transactions, the auditors' approach to achieving related audit objectives may differ because certain derivatives are not generally recognized in the financial statements.

It is essential that auditors understand both the economics of derivatives used by the entities whose financial statements they audit and the nature and business purpose of the entities' derivatives activities. In addition, auditors should carefully evaluate their clients' accounting for any such instruments, especially those carried at other than market value. To the extent the derivatives qualify as financial instruments as defined in FASB Statements No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FASB, *Current Text,* vol. 1, sec. F25), No. 107, *Disclosures about Fair Value of Financial Instruments* (FASB, *Current Text,* vol. 1, sec. F25), and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text,* vol. 1, sec. F25), the disclosure requirements set forth in those Statements must be met. When derivatives are accounted for as hedges of on-balance-sheet assets or liabilities or of anticipated transactions, auditors should carefully review the appropriateness of the use of hedge accounting, particularly considering whether the criteria set forth in applicable accounting literature are met.

The SEC staff has indicated in public speeches and letters of comment to registrants during the past year that publicly held companies should disclose the nature and purpose of certain commodity-based derivatives activities, the nature and terms of certain commodity-based derivatives used, and the accounting methods used even when such derivatives do not meet the definition of financial instruments set forth in the FASB Statements cited above.

Many of the unique audit risk considerations presented by the use of derivatives are discussed in detail in *Audit Risk Alert—1995/96*. Also, see "Disclosures About Derivatives" in the "Accounting Issues and Developments" section of this Audit Risk Alert. The AICPA publication *Derivatives—Current Accounting and Auditing Literature* (Product No. 014888) summarizes current authoritative accounting and auditing guidance and provides background information on basic derivatives contracts, risks, and other general considerations.

Order 636 Transition Costs

FERC Order 636 requires gas pipelines to "unbundle" their services from the traditional provision of gas services. Order 636 was issued in 1992 and was subsequently revised on rehearing by Order 636-A and Order 636-B (collectively referred to herein as Order 636). Order 636 precipitated the complete transition to an open-access and competitive natural gas pipeline industry. Accordingly, pipeline companies subject to FERC jurisdiction are required by Order 636 to unbundle firm and interruptible transportation services, including gas storage services, from gas sales. In light of the increased competition in this segment of the natural gas industry as a result of Order 636, auditors should consider carefully the appropriateness of continued application of FASB Statement No. 71 by pipeline companies subject to FERC jurisdiction.

Purchased-Power Contracts

The increasing numbers of independent power producers and nonutility generators and the growing significance of purchased-power contracts as a source of system capacity have focused attention on the accounting and disclosure of purchased-power contracts.

Paragraph 7 of FASB Statement No. 47, *Disclosure of Long-Term Obligations* (FASB, *Current Text*, vol. 1, sec. C32), specifies the disclosure requirements of long-term unconditional purchase obligations that have the characteristics specified in paragraph 6 of FASB Statement No. 47. The disclosure requirements include (1) the nature and term of the obligation(s), (2) the amount of the fixed and determinable portion of the obligation(s) as of the date of the latest balance sheet presented in the aggregate and, if determinable, for each of the five succeeding fiscal years, (3) the nature of any variable components of the obligation(s), and (4) the amounts purchased under the obligation(s) for each period for which an income statement is presented. FASB Statement No. 47 allows disclosures of similar or related unconditional purchase obligations to be combined. FASB Statement No. 105 contains similar disclosure requirements for unconditional purchase obligations not subject to FASB Statement No. 47.

In addition to the disclosure requirements in FASB Statements No. 47 and No. 105, SAB Topic 10D, *Long-Term Contracts for Purchase of Electric Power*, also provides guidance concerning disclosures required for certain purchased-power contracts of publicly held entities. The disclosures suggested by the SAB include the terms and significance of such contracts to the utility, including date of contract expiration, share of plant output being purchased, estimated annual cost, annual minimum debt-service payment required, and amount of related long-term debt or lease obligations outstanding.

The SAB suggests additional disclosure if the contract provides, or is expected to provide, more than 5 percent of current or estimated future system capability. According to the *Glossary of Electric Utility Terms* published by the Edison Electric Institute, capability of a plant is defined as "the maximum load which a unit can carry under specified conditions over a given period of time without exceeding approved limits of temperature and stress." If the 5 percent test is met, the SAB gives two alternatives for disclosure. The first is separate financial statements of the vendor entity. The second is disclosure of the amount of the obligation under contract as a liability on the balance sheet, with a corresponding amount as an asset representing the right to purchase power under the contract.

The accounting for and disclosure of purchased-power contracts are also receiving increased attention. These contracts may have varying terms, but typically they are segregated into capacity and energy components. As accounting for these contracts is being considered, auditors should be aware that some of the contracts may have characteristics similar to leases. FASB Statement No. 13, *Accounting for Leases* (FASB, *Current Text*, vol. 1, sec. L10), defines a lease as an "agreement conveying the right to use the property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time." FASB Statement No. 13 further states that "a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor."

In determining whether a long-term purchased-power contract is appropriately accounted for, auditors should consider whether the purchaser has evaluated the arrangements and assessed the risks and rewards assumed and retained by the parties to the agreement. Specific factors to consider include—

- The amount and timing of the fixed, noncancelable payments due under the contract and their relationship to the fair value of the generating plant.
- The period of the contract in relation to the economic life of the plant, including the existence of any renewal options. (Particular attention should be given to whether the utility would incur a penalty—as defined in FASB Statement No. 13, as amended—if it does not exercise a renewal option.)
- The source of fuel for the plant and which party bears the risk associated with its price and availability.
- The existence of any option that allows the utility to purchase the generating plant.

If the terms of the contract convey the right to use property and equipment, the contract should be accounted for as a lease pursuant to FASB Statement No. 13.

Elimination of Uncertainty Reporting

The AICPA's Auditing Standards Board (ASB) has issued an exposure draft of a proposed SAS, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements, that would eliminate the requirement that, when certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report.

The amendment would also expand the guidance in paragraph 37 of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards,* vol. 1, AU sec. 508), to indicate that "unusually important risks or uncertainties associated with contingencies, significant estimates, or concentrations" are matters that auditors may wish to emphasize in their reports. The amendment retains the option allowing auditors to disclaim an opinion on financial statements due to uncertainties.

The proposal does not affect the provisions of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards,* vol. 1, AU sec. 341), which requires that the auditor add an explanatory paragraph to the auditor's report when there is substantial doubt about the entity's ability to continue as a going concern.

The ASB hopes to finalize this SAS late this year and to issue an SAS that would be effective for reports issued on or after June 30, 1996. Comments on the proposed SAS were due on October 20, 1995.

Accounting Issues and Developments

Restructuring Charges

Several public utilities have recently recorded restructuring charges, and with downsizing in the electric industry and the formation of strategic alliances in the telecommunications industry, more companies may be recording such charges in the future. In considering restructuring reserves and costs, auditors should be aware of EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, for authoritative guidance on the appropriate guidance for restructurings. EITF Issue No. 94-3 provides guidance on (1) the types of costs that should be accrued and (2) the timing of recognition of restructuring charges. It also prescribes disclosures that should be included in the financial statements. For publicly held entities, SAB No. 67 (Topic 5P), *Income Statement Presentation of Restructuring Charges*, requires that restructuring charges be reported as a component of income from continuing operations.

Revenue Recognition on Long-Term Power Sales Contracts

EITF Issue No. 91-6, *Revenue Recognition of Long-Term Power Sales Contracts*, addresses revenue recognition on long-term power sales contracts that have scheduled price changes. The consensus is applicable for contracts entered into after the date of the consensus (May 21, 1992). Several issues have arisen in applying the consensus to contracts acquired in conjunction with a purchase business combination with a nonutility power generator. The first issue is whether long-term power sales contracts acquired in a purchase business combination subsequent to the date of the consensus must be accounted for by the acquiring entity in accordance with the consensus as if they were "new" contracts. The SEC staff has communicated, in various speeches and comment letters to SEC registrants, its position that contracts that are acquired in a purchase business combination subsequent to the date of the consensus should be considered to be new contracts by the acquiring entity and accounted for in accordance with the consensus.

The second issue involves contracts that in the early years include provision for fixed prices with scheduled price changes but in the later years have pricing provisions based on actual avoided costs. The consensus requires a company to recognize as revenue the lesser of (1) the amount billable under the contract or (2) an amount determined by the kilowatt hours (kwh) made available during the period multiplied by the estimated average revenue per kwh over the term of the contract. The issue is whether the consensus requires a company to determine the average revenue per kwh over the entire life of the contract, including both the years in which there are fixed payments with scheduled changes and the years based on avoided costs or whether the averaging can be applied only to the fixed portion of the contract. The SEC staff has communicated its position, in various speeches and comment letters to SEC registrants, that the estimated average revenue per kwh must be determined over the entire remaining life of the contract, since the consensus specifies "term of the contract" rather than some shorter period.

Impairment of Long-Lived Assets

In March 1995, FASB issued Statement No. 121, which establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used, and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement requires that the entity estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties.

The Statement also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results* *of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (FASB, *Current Text,* vol. 1, sec. I13). Assets that are covered by APB Opinion No. 30 will continue to be reported at the lower of the carrying amount or the net realizable value.

The Statement is effective for financial statements for fiscal years beginning after December 15, 1995. Restatement of previously issued financial statements is not permitted by the Statement. The Statement requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

Auditors of public utilities should be aware that the current industry climate of restructurings, mergers, and realignments has increased the likelihood that events or changes in circumstances that indicate that assets have been impaired may have occurred. In these instances, the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 121 may need to be applied.

The Statement also has a number of specific implications to rate-regulated enterprises:

- It amends paragraph 9 of FASB Statement No. 71 to require that, if at any time the incurred costs no longer meet the criteria of paragraph 9, they should be charged to earnings. Thus regulatory assets are now subject to a continuing probability-of-recovery test. This provision nullifies the consensus in EITF Issue No. 93-4, *Accounting for Regulatory Assets,* related to the impairment of a regulatory asset.
- It amends paragraph 10 of FASB Statement No. 71 to require that if a regulator excludes all or part of a cost from allowable costs, the carrying amount of any regulatory asset should be reduced to the extent of the excluded cost.
- It provides that if a regulator allows recovery through rates of costs previously excluded from allowable costs, a new regulatory asset should be recognized. The classification of that asset should be consistent with the classification that would have resulted had those costs been initially included in allowable costs.

In considering a public utility's implementation of FASB Statement No. 121, auditors should obtain an understanding of the policies and procedures used by management to determine whether all impaired assets have been properly identified. Management's estimates of future cash flows from asset use and impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57. SEC registrants should consider the disclosure requirements included in SAB No. 74 (Topic 11M), *Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period.*

Disclosures About Derivatives

Utilities are increasingly using derivatives to manage the price risk associated with fuel purchase and energy sales contracts. A variety of instruments including futures, forwards, options, and swap contracts have been used.

In October 1994, the FASB issued Statement No. 119 which requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statements No. 105 and No. 107.

The Statement requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. Paragraph 12 of FASB Statement No. 119 encourages, but does not require, entities to disclose quantitative information about risks associated with derivatives.

FASB Statement No. 119 was effective for financial statements issued for fiscal years ending after December 15, 1994, except for organizations with less than $150 million in total assets. For those organizations, the Statement is effective for financial statements issued for fiscal years ending after December 15, 1995.

The FASB Special Report, *Illustrations of Financial Instrument Disclosures,* contains illustrations of the application of FASB Statements No. 105, No. 107, and No. 119.

Risks and Uncertainties

In December 1994, the AICPA's Accounting Standards Executive Committee issued SOP 94-6. SOP 94-6 requires organizations to include in their financial statements disclosures about (1) the nature of their operations and (2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires organizations to include in their financial statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to change in the near term. Examples of similar estimates that may be present in financial statements of public utilities include, but are not limited to, the following:

- Specialized equipment subject to technological obsolescence
- Capitalized computer software costs
- Environmental remediation-related obligations and other environmental liabilities, such as those related to nuclear decommissioning
- Litigation-related obligations
- Contingent liabilities or obligations of other entities
- Amounts reported for long-term obligations, such as amounts reported for pensions and postemployment benefits
- Estimated net proceeds recoverable or the provisions for expected loss to be incurred, or both, on disposition of a business or assets
- Recoverability of certain regulatory assets

Examples of concentrations that may meet the criteria that require disclosure in the financial statements of public utilities in accordance with paragraph 21 of the SOP include the following:

- Concentrations in the volume of business transacted with a particular class of customer, supplier, lender, grantor, or contributor
- Concentrations in revenue from particular products or services
- Concentrations in the available sources of supply of material, labor, or services or of licenses or other rights used in the entity's operations
- Concentrations in the market or geographic area in which an entity conducts its operations

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which SOP 94-6 is first applied.

Auditors should be alert to the requirements of the new SOP and its impact on the financial statements they audit. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

AICPA Exposure Draft: Proposed Statement of Position on Environmental Remediation Liabilities

In June 1995, the AICPA issued an exposure draft of a proposed SOP, *Environmental Remediation Liabilities.* The exposure draft provides that—

- Environmental remediation liabilities should be accrued when the criteria of FASB Statement No. 5 are met, and it includes benchmarks to aid in determining when those criteria are met.
- Accruals for environmental remediation liabilities should include (1) incremental direct costs of the remediation effort, as defined, and (2) costs of compensation and benefits for employees to the extent the employees are expected to devote time directly to the remediation effort.
- Measurement of the liabilities should include (1) the entity's specific share of the liability for a specific site and (2) the entity's share of amounts related to the site that will not be paid by other potentially responsible parties or the government.
- Measurement of the liability should be based on enacted laws and existing regulations, policies, and remediation technology.
- Measurement should be based on the reporting entity's estimates of what it will cost to perform all elements of the remediation effort when they are expected to be performed and may be discounted to reflect the time value of money if the aggregate amount of the obligation and the amount and timing of cash payments for a site are fixed or reliably determinable.

The exposure draft also includes guidance on display in the financial statements of environmental remediation liabilities and on disclosures about environmental-cost-related accounting principles, environmental remediation loss contingencies, and other loss contingency disclosure considerations. A separate, nonauthoritative section of the exposure draft discusses major federal environmental pollution responsibility and cleanup laws and the need to consider various individual state and other non-U.S. government requirements. The proposed SOP also includes guidance for auditing environmental remediation liabilities, addressing audit planning, and assessing audit risk, along with the appropriate application of relevant auditing standards.

Comments on the exposure draft were due by October 31, 1995.

AICPA Accounting and Auditing Literature

Technical Practice Aids

Technical Practice Aids is an AICPA publication that includes questions received by the AICPA's Technical Information Service on various subjects and the service's responses to those questions. Section 6200 of *Technical Practice Aids* contains questions and answers specifically pertaining to regulated entities. *Technical Practice Aids* is available both as a subscription service and in a paperback edition. Order information may be obtained from the AICPA Order Department at (800) TO-AICPA, Department No. 1, and asking for product number 005055.

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This Audit Risk Alert supersedes *Public Utilities Industry Developments—1994.*

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Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1995/96* and *Compilation and Review Alert—1995/96,* which may be obtained by calling the AICPA Order Department at the number below and asking for product no. 022180 (audit) or 060669 (compilation and review).

Copies of AICPA publications referred to in this document can be obtained by calling the AICPA Order Department at (800) TO-AICPA. Copies of FASB publications referred to in this document can be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.

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