Accounting Problems of Utilities

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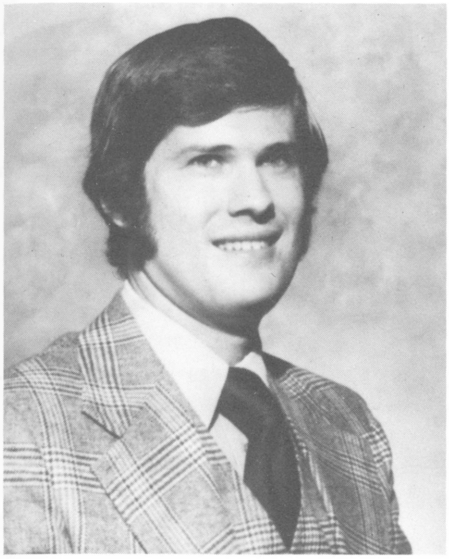

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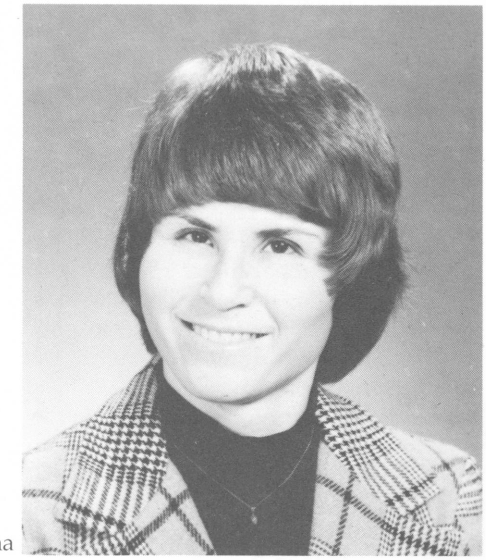

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The authors describe some of the differences in accounting practices used by regulated utility companies and the resulting non-comparability of their financial statements.

The accounting alternatives available to public utilities in the United States are sufficient to cause financial analysts to quaver when giving advice about financial statements. The analyst has to consider that regulated companies do not follow the same accounting practices as do unregulated firms. In addition, all regulated utilities do not follow the same practices since the state in which the firm operates determines the accounting methodology to be followed. Most public utility financial statements give no indication that the accounting methods followed are not those recommended by the American Institute of Certified Public Accountants. One firm, the Consolidated Natural Gas Company did give the investor some forewarning by including the following footnote to its financial statements:[1]

> "The Company's subsidiaries are subject to Federal and/or state accounting and rate regulation. In accord with the principle of matching costs and revenues, methods of allocating costs to time periods may differ from those principles generally applied by non-regulated companies as a result of allocation methods used in the rate-making process."

Even though a footnote such as the above tells the reader that there are differences in accounting procedures, it does not tell what the differences are.

Accelerated Depreciation

A problem area in accounting for several years has been with respect to accelerated depreciation and its use for tax purposes but not for financial statement purposes. The American Institute of CPAs came to the conclusion that income taxes should be allocated on the same basis as straight-line depreciation.[2] In other words, income should be normalized by use of a "Deferred Income Tax" account. APB Opinion No. 11 did much to clarify the financial statements of non-regulated firms.

Regulated firms, however, are not subject to the requirements of the AICPA and thus there is still no uniformity in the manner in which public utilities report income tax expense. In most instances consistent accounting practices with respect to accelerated depreciation and income taxes are followed within a single state. However, this is not always true. In one state a large public utility used the flow-through method of recording income taxes (income tax expense is identical to cash paid for income taxes) and reported a net income of $1.52 per share.[3] Had income been normalized, reported earnings would have been only $.99 per share. Another utility in the same state normalized income and reported a net income of $.77 per share. The flow-through method, had it been followed, would have resulted in earnings of $.98 per share. The average investor is not capable of adjusting financial statements, but must rely on the reported earnings. How much reliance can be placed on financial statements that permit such wide variations in reported earnings?

Approximately twenty-four states require or favor the normalization method, while fifteen state regulatory bodies prefer the flow-through method.[4] The remaining states permit either procedure to be followed. A footnote to the financial statements of Consumers Water Company illustrates how varying regulatory requirements can give an ulcer to financial analysts:[5]

> "In some jurisdictions, in compliance with requirements of rate making bodies, income tax expense is recorded on the basis of the amount of tax payable."

A statement such as this only gives the analyst a warning; it says nothing about how the financial statements can be made comparable with those of other firms.

The situation with respect to income tax expense is compounded by the alternative procedures for reporting the investment tax credit. Again, the state commissions generally establish reporting requirements that differ from those used by non-regulated companies.

The most recent problem relating to the reporting of income tax expense has been brought about by the emergence of the Asset Depreciation Range (ADR) method of recording depreciation. Some utilities have already adopted the ADR method for tax purposes. The effects of ADR's use on reported earnings is still unclear.

The variances in reported earnings caused by alternative reporting methods for income taxes and the investment tax credit are the primary sources of criticism of public utility financial reporting. These are accounts that appear on the books of all regulated companies and are, as a result, the areas of most concern to financial analysts who are attempting to compare financial statements. There are numerous other accounting problem areas that do not affect all companies, but still are critical to the correct analysis of many firms.

Interest During Construction

Unlike non-regulated companies a regulated public utility may capitalize an amount equivalent to the economic cost of the temporarily unproductive capital that is tied up in construction projects. This amount is recorded by debiting an asset account and crediting a revenue account entitled "Allowance for Funds Used During Construction." This allowance is provided for both debt and equity capital.

The addition of this allowance to the cost of new projects is well-founded in theory since the foregone returns that could be earned on these funds are a legitimate cost of completing a productive asset. In practice, the justification for utilities using such procedures is based upon the practice of regulatory agencies of omitting construction projects from the rate base. The reasoning for such omission is that consumers should not have to pay for non-productive assets.

If stockholders are not permitted to earn a return on projects under construction, it is only reasonable that there should be some means for them to receive a greater return in future years. The stockholders of non-regulated firms are not limited as to future returns and thus do not need the protection of an increment in fixed asset accounts.

The problems in this area arise for numerous reasons. The ordinary investor has difficulty comparing the statements of a regulated company to those of a non-regulated firm when the regulated firm shows an income item that bears no resemblance to anything that is normally considered as a generally accepted accounting principle. Depending on the manner in which the Allowance for Funds account is shown on the financial statements, even the most sophisticated financial analyst may have difficulty in computing interest coverages. Some financial analysts compute the interest coverage both before and after considering the Allowance for Funds account.[6]

It might also be noted that the income reported as the Allowance for Funds does not produce any current cash flows. As a result cash dividends as a percentage of net income may fluctuate widely from year to year.

Non-regulated companies do not capitalize interest during construction. Most regulated companies do capitalize such interest, but to add confusion to the situation, some public utilities in a few states do not capitalize interest during construction.[7]

In years past, the differences caused by these variations were usually considered immaterial, but recent high interest costs and massive expansion programs have resulted in questionable comparability among financial statements.

Investments — Cost Versus Equity

There has been much controversy among accountants in recent years over whether investments in unconsolidated subsidiaries should be accounted for on a cost or equity basis. This is one area of financial reporting where regulated public utilities have been consistent with each other since they apparently have all used the cost method. This consistency is ending, however, as the Federal Power Commission has recently permitted utilities to account for subsidiaries on the equity basis, at least for financial statement purposes.[8] The utilities will still use the cost method for rate-setting purposes. The reasoning for this change relates to the effects such a change will have on balance sheet valuations. Since the parent company is permitted to include its pro-rata share of subsidiary earnings as income, whether received as dividends or not, the assets are increased on the balance sheet.

The Federal Power Commission feels that the additional assets will make it easier for the utility firm to obtain additional equity and creditor capital at reasonable costs. This justification in fact relies on the naivete of the financial analyst.

Whether or not cost or equity should be used is not the debate in this section. What is important is the consistency with which the procedure is used and whether an adequate rationalization exists for a particular method.

Other Problem Areas

There are several other areas in which the accounting for regulated companies differs from that of non-regulated firms. Since an investor is normally more familiar with the recommendations of the AICPA than with the regulatory requirements of the separate states, any differences usually go unnoticed. If the different requirements result in material amounts of misinformation, the investor will be hurt.

An example of a minor area of difference is goodwill acquired upon purchase of a subsidiary. The AICPA position is that goodwill should be amortized over a period not to exceed forty years. The regulatory agencies suggest that it be written off in the year of purchase. Obviously, balance sheets could be materially affected by such write-offs.

The Federal Power Commission, apparently feeling that utility financial reporting is not confusing enough, has recently stipulated that utilities in all jurisdictions may either capitalize or expense research and development costs at the discretion of the company.[9] The same method does not have to be used for tax purposes as for book purposes, thus creating a deferred income tax account. This allocation of taxes is to be permitted even though the firm may be required to follow the flow-through method for other types of tax differences. Surely it will complicate financial statements to state that taxes are reported on the flow-through basis and then show a deferred income tax account which arises from a firm normalizing income.

Amortization of the cost of pollution equipment is destined to become a problem area in utility accounting. Regulatory agencies are permitting immediate or

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ferent from an audit. The Statement describes the nature, timing, and extent of procedures that the independent CPA should apply to interim information when the accountant has been engaged to make a limited review of that information.

The objective of such a limited review of interim data is to provide the accountants with a basis for reporting to the Board of Directors on matters that they think should be brought to its attention. A limited review does not provide a basis for the expression of an opinion. (The reader is referred to the complete statement.)

Procedures for the limited review are described. They consist primarily of inquiries and analytical procedures concerning significant accounting matters. The procedures that the accountant should apply would ordinarily be limited to the following: (Paragraph 10).

1. Inquiry concerning the accounting system and any significant changes in the system of internal control to ascertain their potential effect on the preparation of interim financial information.
2. Analytical review of interim financial information by reference to internal financial statements, trial balances, or other financial data to identify and inquire about relationships and individual items that appear to be unusual.
3. Reading the minutes of stockholders, board of directors, and committees of the board of directors to identify actions that may affect the interim financial information.
4. Reading the interim financial information to consider . . . whether the information to be reported conforms with GAAP.
5. Obtaining letters from other accountants, if any, who have been engaged to make a limited review of the interim financial information of significant segments of the reporting entity, its subsidiaries, or other investees.
6. Inquiry of officers and other executives having responsibility for financial and accounting matters concerning preparation and content of interim statements.

Performance of the above procedures satisfies the SEC and permits the independent CPA to designate the required footnote disclosure on interim data included in the financial statements covered by the auditor's report as "unaudited". They also constitute the appropriate standards and procedures that should be followed when the accountant is requested to make a review of Form 10-Q when the client desires to state in the 10-Q that a limited review of the information has been made by an independent CPA.

The Next Round

What is happening while the contenders pause in their corners? Many problems are surfacing. Should interim financial reporting periods be considered as separate ones that stand alone, or as ones that are integral parts of the annual report? Also, particularly troublesome items in APB Opinion No. 28 concern the provision for income taxes and seasonal operations. Other problems brewing are: 1. those surrounding SAS No. 1 requirements regarding the disclaimer of an opinion when the accountant's name is associated with an unaudited report; 2. the potential conflict between the auditor's role in assisting management in the preparation of interim statements; 3. the fear that investors may rely on auditor's unaudited interim statements by failing to understand the significance of the limited review of the auditor; and, 4. the possibility that the auditors may be widening the scope of their potential liability by their association with the statements.

On April 28th the FASB announced the appointment of a twelve-member task force on interim financial reporting. The project will involve reconsideration of APB Opinion No. 28. "Stated broadly, the objective of the project is to determine appropriate accounting and reporting standards for interim financial statements and summarized interim financial data issued for internal reporting purposes."

The April 26th issue of *The CPA Letter* reported that a proposed statement on auditing standards to guide accountants in reporting publicly on a limited review of interim financial information has been agreed upon by AudSEC and will be mailed in the first week of May. The report form included in the draft that will be authoritative on the issuance of the statement is:

> "We have made a limited review in accordance with standards established by the AICPA, (describe the information or statements subjected to such review) of ABC Company and consolidates subsidiaries as of September 30, 19x1 and for the three-month and nine-month periods then ended. Since we did not make an audit, we express no opinion on the (information or statements) referred to above."

The interim financial statement bout between the accounting profession and the SEC is far from over. With the outcome unpredictable, financial statement users and preparers await the next round.

Notes

[1]APB Opinion No. 28 states: Interim financial information may include current data during a fiscal year on financial position, results of operations, and changes in financial position. This information may be issued on a monthly or quarterly basis or at other intervals and may take the form of either complete financial statements or summarized financial data.

[2]FASB Standard No. 3 amended APB Opinion No. 28 with respect to reporting types of accounting changes. The reader is referred to this standard issued in December, 1974, effective for interim periods ending on or after December 31, 1974.

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quick write-offs of such equipment, while generally accepted accounting principles would say the costs should be allocated over the life of the equipment.

To date, analysts and investors have not been materially harmed by the contents of utility financial statements. Public utilities have always been permitted to make a profit, thus allowing stockholders a return on their investments. Though the return to stockholders has often been small, there have been very few bad losses. Were a rash of bankruptcies among public utilities to occur, there might arise a hue and cry among the populace demanding uniform accounting so that such bankruptcies could be predicted in the future.

Just what should be the ideal accounting system for public utilities is still unclear. Also unclear is whether or not the system for utilities should be the same as is used by unregulated firms. The only thing certain is that one consistent nationwide system is needed.

Notes

[1]Consolidated Natural Gas Company, 1971 Annual Report, p. 24.

[2]Accounting Principles Board, *Accounting for Income Taxes* (New York: American Institute of Certified Public Accountants, 1967), p. 12.

[3]Alfred L. Burke, "The Investor Looks at Accounting Problems in the Utility Industry," *Financial Analysts Journal*, XXI (September-October, 1965), p. 27.

[4]*Ibid.*, p. 28.

[5]Consumers Water Company, 1971 Annual Report, p. 15.

[6]Arthur L. Litke, "Allowance for Funds Used During Construction," *Public Utilities Fortnightly*, LXXX (September 28, 1972), p. 21.

[7]Homer E. Sayad, "Consistency in Utility Financial Statements," *Public Utilities Fortnightly*, LXXX (September 14, 1967), p. 23.

[8]John H. Bickley, "Cosmetic Accounting and Financial Reporting," *Public Utilities Fortnightly*, LXXXVII (January 21, 1971), p. 21.

[9]Arthur L. Litke, "Impact of FPC Reporting and Accounting Changes," *Journal of Accountancy*, CXXXII (December, 1971), p. 61.