

AN EVALUATION OF SFAS No. 71: REGULATED ENTERPRISES

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ABSTRACT

In December 1982, the Financial Accounting Standard Board [FASB] issued SFAS No. 71 which became effective in fiscal years beginning after December 15, 1983. This statement regulates the accounting practices of regulated enterprises. The major controversial aspects of SFAS No. 71 are: (1) requiring special accounting for regulated industry, (2) capitalization of future revenues, (3) treatment of refund, and (4) impacts of SFAS No. 71 on financial reporting and rate cases. (1) Given these controversies and new developments in the electric utility industry, the FASB has issued an exposure draft to revise some of the provisions of SFAS No. 71. The revisions as stipulated in the December 19, 1985 exposure draft amend the accounting treatment of phase-in-plan, abandonments, and disallowances of costs of newly completed plants. Questions such as, whether Generally Acceptable Accounting Principle [GAAP] should be formulated for each industry [e.g. regulated/nonregulated], impact of SFAS No. 71 on financial reporting and rate cases, and accounting treatments of refund are not forcefully addressed in the exposure draft.

As an input to current deliberations on SFAS No. 71, this study explores investor owned utility company's opinions concerning the controversial aspect of the statement specified above. In addition, the study reviews major issues addressed in the exposure draft amending SFAS No. 71.

Sample

To evaluate SFAS No 71, the financial controllers of 98 investor-owned electric utility firms operating in different states across the United States were surveyed. These firms are listed in the Catalogue of Investor-Owned Electric Utility Companies Operating in the United States, published by Edison Electric Institute. The survey instrument we developed and pre-tested with a small group of financial analysts who work in the Rate Regulation Section of utility firms. Their comments were used to modify the questionnaire. The final questionnaire was mailed to all the 98 utilities listed in the Edison Electric Institute's Catalog of Investor Owned Utilities. Efforts were made (after the responses were received) to ensure that the respondents were not different from non-respondents. We called a few of the nonrespondents, and their responses were compared to those received from the earlier responses. No significance difference was found

between the two groups. We feel that the results obtained are representative of the utility industry. A response rate of forty percent was achieved. The principal data requested are (1) opinions of the controllers about requiring special or separate accounting for regulated industry, (2) impacts of SFAS No. 71 on financial reporting, and (3) effects of SFAS No. 71 on regulators' decisions. Copy of the questionnaire used in the study can be obtained from the authors.

Results

SFAS No. 71 was adopted by the affirmative votes of four [out of seven] members of the FASB. The members of the board, in their dissent to the statement, were critical of allowing rate making process to determine cost capitalization and loss recognition. They concluded that regu-

latory environments are not sufficiently unique to warrant special accounting requirements. This conclusion is consistent with the opinions of the utility companies reported in table 1. Eighty percent of the respondents agreed that the purpose of SFAS No. 71 should not be to establish a separate accounting model for regulated industries. However, thirty-three percent of the respondents agreed that a few limited exceptions to GAAP is desirable. SFAS No. 71 is not the first attempt by the FASB to address the accounting problems of specific industries. For example, SFAS No. 15 focuses on banking industry,

SFAS No. 19 on oil and gas industry, SFAS No. 33 on large firms, and SFAS No. 52 on multinational corporations. The implication of this is that the current GAAP is a misnomer. The GAAP consists of standards which target different industries and groups. Thus, it should not be surprising that SFAS No. 71 focused on rate regulated industry. The real question is whether the focus on rate regulated industry is justified by the differences in economic environments. The FASB apparently feels that the existence of regulated rates and nonsubstitutability of products offers enough justification for the special

Table 1
EVALUATION OF SFAS NO.71 BASED ON
ITS CONCEPTUAL UNDERPINING

Basis for Evaluation	Degree of Agreement	
	Agree	Disagree
No.	%	%
1. The purpose of SFAS No. 71 should be to establish a separate accounting model for regulated industries.	5	85**
2. The purpose of SFAS No. 71 should be to provide a few limited exceptions to GAAP in general.	33	50
6. The regulatory environment existing currently does not provide the necessary assurance of realization of future revenues to justify the accounting requirement of SFAS No. 71	10	40
15.Changes currently being considered by the FASB will allow the industry to account more realistically for what is going on (exposure draft).	10	56**

No. = Question number in the questionnaire.

Agree refers to strongly agree and agree cases.

Disagree refers to strongly disagree and disagree cases.

***Percentage above 50% for agree.**

****percentage above 50% for Disagree.**

Asterisk implies significant values.

accounting treatment given to regulated enterprises. Forty percent of the executives believed that the regulatory environment provides the necessary assurance of realization of future revenues to warrant the accounting requirement of SFAS No. 71. The possible court decision against recovery of abandoned assets, indefinite deferral of recovery of plant costs, technological advances, and shift in political sentiment of the regulators are threats to realization of future revenues.

Table 2 shows that over fifty percent of the respondents expected SFAS No. 71 treatment of leases, abandonments, and impairments to have

significant impacts on financial statements. The December 1985 exposure draft, an amendment of SFAS No. 71, did not address the accounting treatment of leases and plant impairments for regulated industry. The exposure draft requires that the cost of abandoned assets be removed from assets except if the cost is expected to be recovered from future revenue.

The results in Table 2 also show that the requirement to charge refund to current year income is not expected to have significant effect on current income. This not consistent with the view expressed in financial press⁽²⁾ However, eighteen percent of the respondents expected the

Table 2
EVALUATION OF SFAS NO.71 BASED ON
ITS IMPACT ON FINANCIAL REPORTING

SFAS No. 71 has Significant Effect on your Financial Reporting	Degree of Agreement	
	Agree	Disagree
No.	%	%
3. Because of the requirement to charge refunds to current year instead of retroactive adjustment of affected prior period income	18	70**
8. Because of the change with respect to the accounting treatment of leases	57*	30
11. Because of the change in treatment of abandonments, suspensions, and impairments, which will impact your firm significantly	59*	29
12. Because of pressures placed on your firm by your public accounts in relation to 1984 financial statements	0	66**

No. = Question number in the questionnaire.

Agree refers to strongly agree and agree cases.

Disagree refers to strongly disagree and disagree cases.

***Percentage above 50% for agree.**

****percentage above 50% for Disagree.**

Asterisk implies significant values.

treatment of refund to have significant effect on financial statements. The accounting treatment of refund is not discussed in the proposed amendment of SFAS No. 71.

Kenneth Mory argues that SFAS No. 71 may have unintended influences on rate request decision's of the regulators.⁽³⁾ The results in table 3 below show that SFAS No. 71 has not influenced the regulator's decisions.⁽⁴⁾ To validate the conclusion of this study, the rate request applications of the firms surveyed were examined. No differences in rate increase approval were observed in pre and post SFAS No. 71 periods. This finding is consistent with the results presented in table 3.

The December 1985 exposure draft amending SFAS No. 71 seems to have a narrow focus.⁽⁵⁾ It does not address most of SFAS No. 71 problems specified in this study. For example, the issue of requiring special accounting for regulated industry, accounting treatment of assets impairments and leases were not discussed. The exposure draft focuses primarily on accounting for phase-in-plan, abandonments, and disallowances of costs of newly completed plants. Accounting for phase-in-plan was not addressed in SFAS No. 71. A phase-in-plan is any plan that defers, for future recovery, current operating costs related to a new plant.

Table 3
EVALUATION OF SFAS NO.71
BASED ON ITS IMPACTS ON THE RESULTS
OF RATE INCREASE REQUEST

Basis for Evaluation	Degree of Agreement	
	Agree	Disagree
No.	%	%
4. Accounting recognition of contingent liabilities for revenues subject to refund has resulted in the use of this information to justify disallowance of the amount by regulators	6	53**
9. Rate increase request made subsequent to the effective date of SFAS No. 71 have been more conservative with respect to costs expected to be incurred in the future.	0	82**
10. The granting of rate increase requests has declined or partially declined since SFAS No. 71 went into effect	0	64**

No. = Question number in the questionnaire.
Agree refers to strongly agree and agree cases.
Disagree refers to strongly disagree and disagree cases.
***Percentage above 50% for agree.**
****percentage above 50% for Disagree.**
Asterisk implies significant values.

Exhibit 1
SUMMARY OF DECEMBER 1985
EXPOSURE DRAFT AMENDING SFAS NO. 71

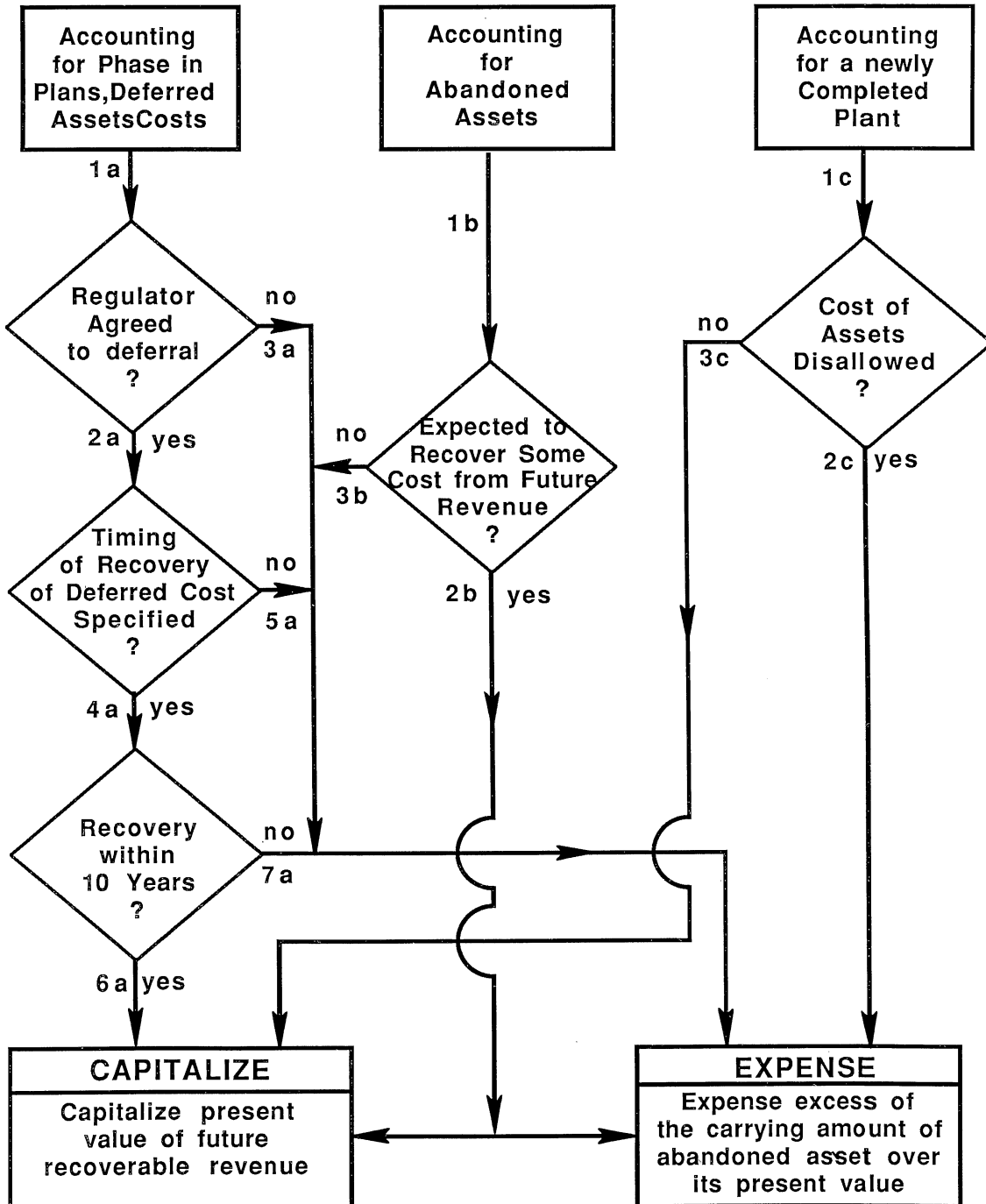


Exhibit I summarizes the accounting requirements of December 1985 exposure draft amending SFAS No. 71. The exposure draft requires that phase-in plans be capitalized provided criteria 1a, 2a, 4a, and 6a are met. When criteria 1b and 2b are met, the present value of the future revenue expected to be provided to recover the cost of abandoned assets is capitalized. Any excess of the carrying amount of abandoned assets over its present value is expensed. If condition 3b holds, the cost of abandoned assets is expensed. For newly completed assets that met condition 2c, the disallowed portion of the assets is expensed while the allowed cost is capitalized.

Conclusion

An area of concern for utility firms is the effect of FASB's SFAS No. 71 on revenues, profits and ultimately stockholder returns. This study sheds some light on this issue through a survey of individual directly involved in the rate regulation process. This will, hopefully aid the FASB in their deliberations of the special accounting requirements for the regulated industry.

Footnotes

1. See *Public Utility Survey*, Investment Research Goldman Sachs, Dec. 19, 1984; Electric Utility Financial Issues Needing Regulatory attention SFAS 71, Salomon Brother Inc., Nov. 1985; SFAS No. 7.
2. SFAS No. 71, pp. 9-10, Review of SFAS No. 71, Investment Research Goldman Sachs, Dec. 19, 1984; *Barrons*, Jan. 1985, pp. 14-33.
3. Kenneth Mory, "Accounting for Regulated Operations: FASB Statement No. 71," *Journal of Accountancy*, pp. 84-90.
4. Financial Accounting Standards Board, *Statement of Financial Accounting No. 71*, Accounting for the Effects of Certain Types of Regulation, Dec. 1982, FASB, Stamford, CT.
5. _____ Exposure Draft of the Proposed Statement of Financial Accounting Standards, *Regulated Enterprises*, Dec. 1985, FASB, Stamford, CT.

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ENDNOTES

1. A variation on the bank-customer relationship is the credit rationing model which posits that, during periods of credit tightening, banks accommodate their best customers while rationing credit to other customers. In this view, the total supply of loans is not necessarily greater than that dictated by short-term profit maximization considerations, it is simply allocated differently. For a discussion, See Santamero (13) pp. 599-602.
2. After 1980, Wood observed a change in the bank-customer relationship due to increasing interest rate volatility and the phasing out of Regulation Q. (See 16, p. 509)
3. The 2SLS results are:

$$LD = -2.98 - 1.00 LR + 0.61 CPR + 1.30 GNP + 0.11 MUL$$

$$(7.72) \quad (2.05) \quad (2.28) \quad (8.59) \quad (0.90)$$

$$LS = 0.24 + 0.79 LR - 0.30 IR + 0.98 AA + 1.20 DC$$

$$(0.61) \quad (4.63) \quad (1.84) \quad (13.75) \quad (4.68)$$
4. Buschman and Goldberg, in an unpublished manuscript (3), interpreted the accommodation view to imply an outward shift in the bank loan supply curve whenever the difference between the loan rate and market rates decrease. The tested a short-run (monthly data were employed), disequilibrium model and found that a decrease in the spread between the loan rate and market rates did trigger outward shifts in the loan supply curve.
5. The 2SLS results are:

$$LD = -2.86 - 0.41 LR + 0.30 CPR + 1.20 GNP + 0.12 MUL$$

$$(14.32) \quad (2.88) \quad (3.56) \quad (16.99) \quad (1.71)$$

$$LS = 0.30 + 0.69 LR - 0.21 IR + 0.97 AA + 1.21 DC - 0.03 D$$

$$(0.84) \quad (4.34) \quad (1.39) \quad (14.92) \quad (5.08) \quad (1.38)$$
6. (16) pp. 506-507.