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Some accounting implications of the Federal Power Commission's uniform system of accounts

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SOME ACCOUNTING IMPLICATIONS
of the
FEDERAL POWER COMMISSION'S
UNIFORM SYSTEM
of
ACCOUNTS

by

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CHAPTER I

VIEWS CONCERNING THE 
UNIFORM SYSTEM OF ACCOUNTS 
AS PRESCRIBED BY 
THE FEDERAL POWER COMMISSION

In 1935 the Congress of the United States passed the Federal Power Act. This act gave the Federal Power Commission increased control over utilities engaged in interstate commerce in electrical energy. One of the major fields of control authorized in this act was control over the accounting practices of the electric utilities. Section 301(a) of that act states:

Every licensee and public utility shall make, keep, and preserve for such periods, such accounts, records of cost-accounting procedures, correspondence, memoranda, papers, books, and other records as the Commission may by rules and regulations prescribe as necessary or appropriate for purposes of the administration of this act, including accounts, records, and memoranda of the generation, transmission, distribution, delivery, or sale of electric energy, the furnishing of services of facilities in connection therewith, and receipts and expenditures with respect to any of the foregoing: Provided, however, that nothing in this act shall relieve any public utility from keeping any accounts, memoranda, or records which such public utility may be required to keep by or under authority of the laws of any State. The Commission may prescribe a system of accounts to be kept by licensees and public utilities and may classify such licensees and public utilities and prescribe a system of accounts for each class. The Commission, after notice and opportunity for hearing, may determine by order the accounts in which particular outlays and receipts shall be entered, charged, or credited. The burden of proof to justify every accounting entry questioned by the Commission

1 49 Stat. 838.
shall be on the person making, authorizing, or requiring such entry, and the Commission may suspend a charge or a credit pending submission of satisfactory proof in support thereof.

Under the authority of this provision, the Federal Power Commission prescribed a uniform system of accounts for electric utilities under its jurisdiction. This system of accounts became effective January 1, 1937. Although the Federal Power Commission has jurisdiction over only those utilities engaged in interstate commerce in electricity, many of the various state public utility commissions have adopted the Federal Power Commission's Uniform System of Accounts for those utilities under state jurisdiction. Therefore, at the present time, the Power Commission's Uniform System of Accounts is used by nearly all of the electric industry.²

Since the inception of the Uniform System of Accounts for electric utilities, there has been a growing amount of discussion concerning the accounting principles involved in this System.³ There seems to be a growing divergence of opinion between certain members of the accounting profession


and the Federal Power Commission concerning these accounting principles. This disagreement appears to be more in connection with the interpretation of the system than with the system itself. This discussion has extended to many phases of the System of Accounts; however, the main points of disagreement appear to be in connection with the following question: Should plant assets be recorded at "original cost" or at their "cost to the utility"?

This will be the main question that this paper will attempt to answer. In order to show some of the conflict in this area, a few quotations will be given in the remaining pages of this chapter.

The instructions of the prescribed Uniform System of Accounts defines "original cost" in the following manner: "'Original cost' as applied to electric plant, means the cost of such property to the person first devoting it to public service." "Person" in the proceeding definition, means, according to the instructions: "an individual, a corporation, a partnership, an association, a joint stock company, a business trust, or any original group of persons whether incorporated or not, or any receiver or trustee. Using these definitions, the instructions for recording of fixed assets states:

Electric Plant to be Recorded at Cost.

A. All amounts included in the accounts for tangible
electric plant consisting of plant acquired as an operating unit or system shall be stated at the original cost incurred by the person who first devoted the property to utility service. All other tangible electric plant shall be included in the accounts at the cost incurred by the utility.

B. All amounts included in the accounts for intangible electric plant shall likewise be stated on the basis provided in paragraph A above except as otherwise provided in the text of the intangible accounts.

Herein seems to lie the greatest amount of conflict between the Commission and certain members of the accounting profession. Normally, in accounting, the cost of fixed assets is recorded at cost to the present owner, not at the cost to a preceding owner. Many of the differences of opinion concerning accounting principles involved in "original cost" were revealed in an investigation of the electric operations of the Arkansas Power and Light Company by the Arkansas Department of Public Utilities. This hearing was concluded in 1944. Mr. Charles W. Smith and Mr. Fred Kleinman testified as witnesses for the Arkansas Department of Public Utilities. Mr. Charles W. Smith is the Chief of the Bureau of Accounts, Finance, and Rates of the Federal Power Commission. Mr. Fred Kleinman is Chairman of the National Association of


Railroad and Utilities Commissioners' Committee on accounts and statistics for public utilities.

The respondent in this case offered in evidence the expert testimony "of several witnesses who have gained national reputation and who are conceded to be among the leaders in the accounting field." Among these men were Mr. George O. May, former senior partner and chief executive of the firm Price, Waterhouse & Company; Mr. William A. Paton, professor of accounting in the School of Business Administration at the University of Michigan; and Mr. Joe Bond, a Certified Public Accountant of Little Rock, Arkansas, who "has considerable experience in the regulatory field."7

The findings of the Department in this hearing include the following:

The expert accounting authorities heard in this proceeding agree that the correct basis of accounting for recording fixed assets is cost. They are also in agreement that this cost should be cost to the accounting company. This accounting principle being accepted, it seems that there should be little difference of opinion as to the proper method of accounting for the fixed assets of a public utility. Such is not the case, however. Charles W. Smith and Fred Kleinman, who are two of the nation's foremost proponents of the "original cost" concept, take the view that any cost incurred by the accounting utility in the acquisition of utility property, which costs exceeds the original cost thereof, should be amortized. They base their views upon the theory that sound accounting principles require the

6 Ibid., p.344
7 Loc. cit.
amortization of such items. Mr. Smith stated...

"When it comes to public utilities it seems to me that the case for amortizing intangibles is conclusive. While there may be some doubt about this matter in the case of industrials, I do not see how there could be any doubt in the case of public utilities which depend for their existence upon franchises given by the public which is subject to regulation, whose intangibles are really created by the public, and whose intangibles would disappear overnight if the franchises were withdrawn or if the regulatory commission would fix rates so low as to yield an inadequate return thereon. Accordingly, instead of offending sound principles of public-utility accounting, sound principles of accounting and public policy require the amortization of such items, in my opinion."

Mr. George O. May was asked the following question during the proceedings:

Would or would not a requirement by a regulatory commission that all amounts in excess of original cost be written off, without consideration of the cost to the utility of existing values, constitute a departure from the generally accepted principles of accounting for fixed assets?

He answered with the following:

Such a requirement would constitute a definite and unwarranted departure from the generally accepted principle of accounting for fixed assets, because it would make original cost the sole basis of accounting and would completely ignore the naturally significant basis which is cost to the present accounting unit—corporation or enterprise.

Paton in a later article in The Journal of Accountant stated the following: "However, I think that it is

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8 Loc. cit.
9 Loc. Cit.
10 Ibid., p. 345.
desirable to make it entirely clear that there is no shred of support in the field of accounting principles or practices for this novel procedure ["original cost" accounting] 11 required by the Commission." 12

Attacking the question from a little different view, Joe Bond in a later article in the Accounting Review stated:

The "original cost" provision for plant accounts, now incorporated in the uniform system of accounts published for most electric utilities, was advanced by certain regulatory authorities as a "requirement of sound accounting practices" and as an "expedient to effective rate regulation." The present program of the Federal Power Commission as revealed in "original cost" proceedings which followed the initiation of this system of accounts, together with the arguments advanced for its adoption, were, to this authority, a well-planned Trojan horse, within the shell of which was concealed an economic philosophy entirely foreign to the American system of private enterprise. 13

Purpose of This Paper.

From the foregoing, it may be seen that there is considerable divergence of opinion as to the correct accounting procedure for recording fixed assets on the books of electric utilities. The commission on the one hand insists that it is abiding by accepted accounting prac-

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11 Material in brackets not included in the original.


tices and on the other hand many accountants insist that the Commission has instituted a set of regulations which do not encompass correct accounting procedure.

Therefore, it is the object of this paper to explore these differences of opinion with the hope of arriving at a partial picture of the problems of accounting for electric utilities. It is hoped that this may be accomplished by presenting the following material: (1) A portion of the Uniform System of Accounts prescribed by the Federal Power Commission, the pertinent instructions of the Commission for the use of these accounts, and the interpretation that the Commission has placed on the accounts and the instructions therein. (2) The reaction of several practising accountants in regard to the various phases of "original cost" accounting and depreciation accounting as prescribed by the Commission.

15 Faton, op. cit., p. 433.
CHAPTER II

A DEFINITION OF A PUBLIC UTILITY
AND A BRIEF DISCUSSION OF THE
ELECTRIC POWER INDUSTRY PRIOR TO 1935

Before attempting to show the elements of the controversy mentioned in Chapter I, it may be well to examine the background of this controversy. It would seem necessary to determine just what a public utility is before it is possible to determine why the Federal Power Commission has felt it necessary to prescribe a system of accounts for one type of public utility, namely, electric utilities. Further than this, the background of the regulation of utilities may shed light on the present requirements of the Commission.

What is a Public Utility?

There seems to be no one definition that will completely delineate a public utility. In general, they are businesses that supply services essential to the public well-being, services which have become practically indispensable in our modern society. The late Mr. Justice Brandeis of the United States Supreme Court gave, in a dissenting opinion, a definition which may be said to cover the subject in a general way. He stated:

The public's concern about a particular business may be so pervasive and varied as to require a constant detailed supervision and a very high degree of regulation. Where this is true, it is common to speak of the business as being a "public" one, although it
is privately owned. It is to such businesses that the designation "public utility" is commonly applied; or they are spoken of as "affected with a public interest." 1

But what are some of the inherent characteristics of a public utility that cause the publics' concern to be "so pervasive and varied as to require a constant detailed supervision and a very high degree of regulation"? The very type of activities which are usually thought of as public utilities indicate a partial answer to this question. The average person would likely list electricity, gas, and water—those utilities with which he comes in daily contact—as the main utilities. These activities, and others, have so basic an effect on the everyday lives of the citizens of a community that the citizens, through their governments, have felt it necessary to regulate these activities. There are other characteristics that likewise indicate that control is necessary. Perhaps the outstanding feature of a utility other than that of supplying such basic needs, is its usual position as a monopoly. Public utilities are usually thought of as "natural monopolies." That is, because of the large investments in fixed assets, it has been found that it is usually wasteful and uneconomical to have more than one utility of a particular type serving any one area. If two

1 New State Ice Co. v Liebmann, Justice Brandeis' dissent, 285 U.S. 262.
utilities of the same type were to operate in one area, there would be wasteful duplication of fixed assets. As an example, if two electric utilities were to operate in competition, there would be wasteful duplication of the expensive power plant, transmission lines, and all such equipment. This duplication would be wasteful since the one utility could supply the power needs, within limits, of the community served. In other words, once the utility plant and equipment have been installed, the cost of that plant remains whether the volume of the utility is large or small. Since it has been found uneconomical to have utilities operate in competition with one another, governments have insured a monopolistic position by requiring each utility to obtain a franchise. The governmental unit will then issue only one franchise to a utility of a particular type operating in one particular area. Certain types of utilities are "natural monopolies" from yet another angle. The telephone system is an example. It is hard to visualize several telephone utilities operating either locally or on a national basis. If such were the case, a subscriber to telephone service would either have to have a bank of phones, one for each system, or would have to confine his use of the telephone to other subscribers of the same system.

It seems obvious then, that since utilities are usually "natural monopolies," they must be regulated.
With respect to industrial firms, the public is in a position to see that they get equitable service through the workings of competition. If a particular firm is out of line on prices or services, the public will usually shun that firm. The firm will then either have to change its policies or go out of business. But since the utility is not subject to competition, it would appear that governmental control must be substituted for competitive control. This governmental control usually includes regulation of several phases of the utility's activities. Since there is to be only one utility of a type in a community, it is necessary for regulatory governmental units to require the utility to serve all who desire service. Moreover, this service must be on a basis of uniform charge for uniform service, with no discrimination. Because of the monopoly position, utilities may not discontinue service without the prior approval of the regulatory authority. If there is only one utility, and it discontinues service, the citizen of the community formerly served by the utility would have no place to turn for service. Perhaps the most important feature of governmental control over utilities has been in the field of rate-making. This rate-making function stems, again, from the position of a utility as a monopoly. It is felt that since there is no competitive control over prices for services rendered by utilities, it is the function of the government to regulate the prices.
At this point it may be of interest to note that many diverse activities have been subjected to governmental control under the classification of public utilities. A list of the more important of these and the agencies through which this control has been effected follows:

Railroads-Steam---------Interstate Commerce Commission
Railroads-Electric-------Interstate Commerce Commission
Motor Carrier-Freight-----Interstate Commerce Commission
Motor Carrier-Passenger-Interstate Commerce Commission
Sleeping Car Companies----Interstate Commerce Commission
Express Companies--------Interstate Commerce Commission
Carriers by Water--------Interstate Commerce Commission
Pipe Line Companies------Interstate Commerce Commission
Telephone Companies------Interstate Commerce Commission
Telegraph and Cable
Companies-------Interstate Commerce Commission
Radiotelegraph Carriers-Federal Communication Commission
Air Carriers-------------Civil Aeronautics Commission
Electric Utility
Companies-------States, Federal Power Commission
Gas Utility Companies---States
Natural Gas Companies---States, Federal Power Commission
Heating Companies-------States
Water Companies---------States
Public Utility Holding
Companies--Securities and Exchange Commission
Public Utility Service
Companies--Securities and Exchange Commission

Other types of business which in some of the states, have been declared public utilities are: warehouses and grain elevators, wharves, bridges, canals, irrigation projects, cotton gins, ice, and sewerage.2

In reviewing this list, it is possible to find exceptions to the general characteristics of utilities as

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2 W. M. Hammond, Public Utility Accounting (Chicago: LaSalle Extension University) p. 2. This is from a chapter on public utility accounting included in the Higher Accountancy text of the LaSalle Extension University.
outlined in this chapter. For instance, in many cases the railroads are not free from competition. The parallel lines of the Northern Pacific Railroad and the Chicago Milwaukee St. Paul and Pacific Railroad in Montana are an example of the non-existence of monopoly in certain fields usually thought of as public utilities. The railroads and other carriers are examples of regulated competition rather than monopoly. It would seem, then, that there is no possible definition which will include all utilities and at the same time exclude certain businesses which appear to have most of these characteristics but which have not been generally thought of as public utilities. Perhaps, the only final way of determining whether a particular enterprise is a utility or not is to determine whether that enterprise has been subjected to "a constant detailed supervision and a very high degree of regulation" by some governmental unit. It seems that there is no clear-cut line of demarcation between utilities and ordinary business enterprises. In speaking of the regulation of utilities by states, a book on the subject states:

The right of a state to regulate a given industry as a public utility, therefore, is conditioned upon the determination by the Supreme Court of the United States that the business is so "affected with public interest" as to justify the regulation proposed, a decision that will in no small degree reflect the political and social
Even though it is probably impossible to finally and adequately define a public utility, it is possible to draw certain conclusions from the general characteristics mentioned in this chapter. These characteristics should also indicate some of the reasons for governmental control of utility activities. In summary, the main characteristics of a utility which delineate it from other business activities and which should indicate some of the reasons for the need for governmental control appear to be: (1) the utility furnishes services basic to the everyday needs of our modern economic society; (2) the utility is usually a "natural monopoly"; and (3) the utility, being a monopoly, has been regulated by governmental action rather than the action of competition in its various spheres of activity.


The early development of the electric power industry was quite slow. By 1900, after twenty years of existence, there were only two million kilowatts installed capacity in the plants of the United States and the total output of

electric energy for that year was approximately two billion kilowatt hours. The first thirty-five years of the twentieth century witnessed tremendous growth in the industry. By 1934, the installed capacity had risen to over forty-five million kilowatts and ninety billion kilowatt hours were produced and consumed in that year.4

Historically, the regulation of electric light and power utilities has been left in the hands of the states or local authorities since the business of distributing power was usually a local one. However, since the beginning of the twentieth century there has been an increasing integration of power systems. With the advent of this interconnection of power systems, there has been a large increase in interstate commerce in electricity. This interstate commerce in electric energy has been regulated to an increasing extent by the Federal Government under the "Commerce" clause of the Federal Constitution which provides that the Congress shall have the power "to regulate commerce with foreign Nations and among the several states."5 Prior to 1935 the main control that the Federal Government exercised was the control over licensees of hydroelectric projects in the navigable waters of the United States. One of the


5 Article I, Section 8.
first avenues of control available to the Federal Government was through the Rivers and Harbors Act\(^6\) passed by Congress in 1890. This Act prohibited the building of obstructions such as dams and bridges in navigable rivers without the prior approval of Congress. Congress and the Presidents attempted to use this act as a measure of control over the hydroelectric industry by attempting to prevent construction of projects which would be operated against the public interest. The General Dam Act of 1906\(^7\) extended the powers of the government in this control of hydroelectric projects.

Not until 1920, after many years of controversy, did the government pass an act with real regulatory provisions. This was the Federal Water Power Act of 1920.\(^8\) This Act set up the Federal Power Commission to be composed of three ex officio members: the Secretary of Agriculture, the Secretary of War, the Secretary of the Interior. The duties of this commission were to collect data on water power resources and their utilization and to grant licenses for the development of water power on navigable streams or waters on the public lands of the United States. The licenses were to be granted to both governmental and private organizations,

\(^6\) 26 Stat. 454.
\(^7\) 34 Stat. 262.
\(^8\) 41 Stat. 280
and could not be granted for more than fifty years. At the expiration of the license, the government could take over the properties of the licensee, could allow them to be taken over by another, or could issue a new license to the original licensee.\(^9\) The Commission was given the authority to prescribe a uniform system of accounts for the utilities under its jurisdiction.

It has been said of the Commission during this period of its operation:

The Federal Power Commission, though having sole authority concerning authorization of licensees and types of structures to be built, was given only conditional authority over the regulation of rates, services, and security issues of licensees. Only in the event that the states in which the project should be located did not regulate it or in the event that the several interested states could not agree was the Federal Power Commission given regulatory jurisdiction.\(^{10}\)

The organization of the Commission greatly hampered its activities. Rather rapid turnover of its ex officio members did not allow long-term planning to take place. Inadequate budgets and the lack of trained personnel further hampered its effective work. Some of the detriments were overcome in an amendment to the Federal Water Power Act in 1930 by providing for appointment by the President of a five-


\(^{10}\) Ibid., p. 401.
man, independent Commission; however, no additional authority was granted and when the crash of 1929 came and the holders of utility stocks and bonds were exceedingly hard hit there arose a demand for more effective control over the activities of public utilities. As a result of the clamor, the Federal Trade Commission conducted an extensive investigation, at the request of Congress, of the electric utility industry. That Commission examined eighteen top holding companies, forty-two subsidiary holding companies, and ninety-one operating companies. The aggregate capital assets of these companies were $3,116,207,926 for the top holding companies, $2,186,302,222 for the subsidiary holding companies, and $3,306,893,610 for the operating companies.11

The Federal Trade Commission's report summarized the baneful practices and conditions of the electric power industry as exposed by their investigation. They were:

1. Pyramiding companies owning or controlling the operating companies for the purpose of enabling a minimum of investment to control a maximum of operating facilities, involving a greedy and highly speculative type of organization detrimental to the financial and economical welfare of the Nation.

2. Loading the fixed capital account of public utilities with arbitrary or imaginary amounts in order to establish a base for excessive rates.

(3) Writing up the fixed assets without regard to the cost thereof, with the result of watering the stock or creating a fictitious surplus.

(4) Engaging in transactions of purchase and sale of property or securities with controlled or subsidiary companies for the purpose of recording arbitrary profits or fixing valuation unjustified by market values.

(5) Exaction of payments from affiliated or controlled companies for services in excess of cost or value of such services.

(6) Gross disregard of prudent financing in excessive issues of obligation, imperiling the solvency of the company and involving excessive charges for interest, discount, commissions, redemptions, etc.

(7) Manipulating the security market to deceive stockholders, bond holders, or potential purchasers of its securities.

(8) Putting funds in the call-loan market with the result of greatly stimulating speculation.

(9) Excessive use of conversion privileges for bonds and preferred stocks and of purchase warrants and options with the effect of inducing investors to part with the conservative investment for speculative ones.

(10) Misstatement of earned surplus, or failure to distinguish earned from capital surplus, and making payments of dividends from the latter.

(11) Deceptive and illusory methods of dividing, or pretending to divide, earnings or profits.

(12) Including imaginary (or "putative") interest in construction costs of a public utility and counting it as a part of earnings.

(13) Deceptive or unsound methods of accounting for assets and liabilities, costs, operating results and earnings, including write-up, unrealized of fictitious profits, stock dividends, etc.

(14) Corporate organization which gives powers inconsistent with a just division of responsibilities and emoluments, as between various groups or parties.
furnishing capital and loan or contribution, either
directly or indirectly by purchase, succession, or other-
wise.

(15) Issuing special voting or management stock
giving control at small cost in order to promote the
interest of selfish cliques, against the interest and
safety of general stockholders.

(16) Unsafe or mischievous methods of securing loans
to the detriment of the lender.

(17) Intercompany financing on a basis disadvantageous
to operating company borrowers or lenders.

(18) Evasion of state laws in effecting sales of
security issues.

(19) Effecting pretended corporate reorganization
principally for the purpose of evading the payment
of Federal Income Taxes. 12

The Chairman of the Federal Trade Commission, Erwin
L. Davis, added his views of the facts disclosed by that
Commission's investigation:

(1) That as a result of technological advances
there had developed a large and increasing amount of
interstate commerce in electrical energy;

(2) That this had been accompanied by an enormous
expansion of interstate commerce in stocks, bonds, and
other securities of companies engaged therein;

(3) That huge holding companies had gained and were
exploiting their monopolistic control of such commerce
carried on by their operating subsidiaries, not only in
production, transmission, and sale of electric current,
but in the flotation and sale of securities on a widely
speculative basis;

(4) That the resulting inflation of the capital
structure of the industry had operated to inflate the
rate base and the amount paid by the consuming public

for electricity; and

(5) That all these unwholesome developments were beyond effective reach of regulation by state utility commissions.\textsuperscript{13}

In the Federal Power Act of 1935 the Congress attempted to remedy these existing practices and conditions as shown by the Federal Trade Commission's report.

CHAPTER III

THE UNIFORM SYSTEM OF ACCOUNTS
FOR ELECTRIC UTILITIES AS PRESCRIBED
BY THE FEDERAL POWER COMMISSION

One aspect of the Public Utility Act of 1935 was the attempt to remedy the unsound practices in electric utility accounting. That Act is really two acts in one. Title I deals with gas and electric holding companies, Title II deals with the regulation of interstate transmission in electric energy. It is Title II, commonly known as the Federal Power Act, with which this paper will deal. The Federal Power Act amended and broadened the powers of the Federal Power Commission. These new and extended powers may be summarized as follows:

1. Division of the country into regional districts for the voluntary interconnection of generating and transmission facilities to assure an abundant supply of electricity throughout the United States with the utmost economy.

2. Denial of public utilities subject to the Federal Power Commission of the privilege of selling, leasing, or otherwise disposing of property whose value is in excess of $50,000 or of merging or consolidating without first getting an authorization from the Federal Power Commission to the effect that the proposed action is consistent with public interest.

3. Exercise of jurisdiction over security issues and assumption of corporate liabilities of public utilities that are engaged in interstate transmission and sale of electric energy and that are not regulated by a state commission.

4. Supervision over rates and charges for electric energy transmitted across state lines and sold wholesale for resale by utilities under the jurisdiction of the Federal Power Commission.
5. Cooperation with state commissions in investigating the cost of production and transmission by means of interstate facilities beyond jurisdiction of the requesting state.

6. Provision of a plan for cooperation with state Commissions, including procedure for joint hearings and the creation of joint boards, to consider matters of mutual interest arising under the Federal Water Power Act.

7. Revision of the Uniform System of Accounts for public utilities and licensees subject to the jurisdiction of the Federal Power Commission. In so far as is practicable, federal agencies engaged in the generation and sale of electric energy for ultimate distribution to the public are to be subject to these accounting rules.

8. Requiring public utilities to carry adequate and proper depreciation accounts and giving the Federal Power Commission authority to determine and fix rates of depreciation to be charged against the property of licensees.

9. Provisions against interlocking directorates in utilities and financial or other institutions handling their securities.¹

One of the main avenues afforded the Commission through which it could regulate utilities was the authority to prescribe a uniform system of accounts. If the Commission were to remedy the unsound financial procedures which the utilities had indulged in, it would appear necessary to allow the Commission to prescribe a system of accounts from which it could obtain the information necessary not

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only to curb the utilities in their financial dealings, but also to assure consumers of electric energy fair prices, and satisfactory service.

In *Public Utility Regulation*, the authors indicate the place of accounting in regulatory control by stating that:

Accounting control is thus an essential part of regulatory procedure not for the sake of regulating accounting practices, but as a means of guaranteeing that there will be available the factual data necessary to regulate rates, services, and capitalization.

In this connection it should be emphasized that the accounting system, records, and practices cannot determine any legal and economic facts. Value, depreciation, fair return, working capital, going value, appreciation, etc., are legal and economic in character and are not fixed in the accounting records. However, the accounting records do provide facts upon which determination of these questions may be used. Because of this, it has been stated that:

"The success of regulatory statute must depend upon the commission's having full and accurate information of the utility's operations. Thus courts, commissions, and companies alike have recognized that uniform systems of accounts and a broad control over accounting methods are essential to proper commission regulation."^2

The Federal Power Commission has given its views concerning a uniform system of accounts, which may be summarized as follows:

The Uniform System of Accounts was established for the purpose, among other things, of removing the sub-

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substantial amounts of inflation known to be recorded in utility plant accounts, to effect appropriate classification of large unclassified amounts among classes of plants according to utility department and function to supply regulatory agencies and others with important information and to establish accounting control as a material aid in preventing financial abuses in the future.\(^3\)

Trachsel adds a different view on the need for a uniform system. He stated that:

> Under a uniform system of accounts, it is possible to compare the operations and finances of different companies, and also to compare the operations of the same company over a period of years. If the accounts are not uniform, one company may charge a certain expenditure to one account, and others may charge it to a different account. Such a procedure makes comparisons impossible. Under a uniform system, the terms will mean the same thing, wherever and whenever used. The system will disclose a relatively high cost of operation in a particular plant and the regulatory body should be in a position to discover the cause and correct it.\(^4\)

These points give some indication as to the importance of a uniform system of accounts in the regulation of public utilities. At this point the portion of the Uniform System of Accounts prescribed by the F. P. C. which pertains to the Commission's required treatment of fixed assets will be given.\(^5\)

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Since the main discussion of this paper concerns fixed asset accounting, it is felt that it is necessary to show only those accounts which deal with plant assets and the income accounts. The latter are given so that the disposition of the asset adjustment accounts may be shown. It is hoped that the presentation of these accounts and the requirements of the Commission concerning them will show how the Commission has attempted, through the system of accounts, to alleviate some of the difficulties uncovered by the Federal Trade Commission's investigation. Further than this, it is hoped that this paper will indicate the divergences from generally accepted accounting principles incorporated in the system and in the interpretation of the System by the Commission.

A Portion of the Uniform System of Accounts.

Under the provision of the Federal Power Act authorizing the Federal Power Commission to require utilities under its jurisdiction to use a Uniform System of Accounts, the Commission was also authorized to classify utilities according to their size. The electric utilities were classified by the Commission into the following classes:

Class A. Utilities having either (1) annual electric operating revenues of $750,000 or more, or (2) the original cost of whose electric plant amounts to $4,000,000 or more;

Class B. Utilities having annual electric operating revenues of more than $250,000 but less than $750,000
and the original cost of whose electric plant amounts to less than $4,000,000.

Class C. Utilities having annual electric operating revenues of more than $100,000 but not more than $250,000.

Class D. Utilities having annual electric operating revenues of more than $25,000 but not more than $100,000.6

The controlling plant accounts, the subsidiary plant accounts and the income statement of the Uniform System follow. These are the accounts which apply to a Class A Utility. The controlling utility plant accounts are:

100. Electric Plant.
   100.1 Electric Plant in Service.
   100.2 Electric Plant Leased to Others.
   100.3 Construction in Progress.
   100.4 Electric Plant Held for Future Use.
   100.5 Electric Plant Acquisition Adjustments.
   100.6 Electric Plant in Process of Reclassification.
108. Other Utility Plant.

The electric plant accounts are to be kept in detailed subsidiary accounts according to the following functional classes:

I. INTANGIBLE PLANT

301. Organization.
302. Franchises and Consents.
303. Miscellaneous Intangible Plant.

II. PRODUCTION PLANT

(A) Steam Production

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310. Land and Land Rights.
311. Structures and Improvements.
312. Boiler Plant Equipment.
313. Enginges and Engine Driven Generators.
314. Turbo-Generator Units.
315. Accessory Electric Equipment.
316. Miscellaneous Power Plant Equipment.

(B) Hydraulic Production

320. Land and Land Rights.
321. Structures and Improvements.
322. Reservoirs, Dams, and Waterways.
323. Water Wheels, Turbines, and Generators.
324. Accessory Electric Equipment.
325. Miscellaneous Power Plant Equipment.
326. Roads, Railroads, and Bridges.

(C) Internal Combustion Engine Production

331. Structures and Improvements.
332. Fuel Holders, Producers, and Accessories.
333. Internal Combustion Engines.
334. Generators.
335. Accessory Electric Equipment.

III. TRANSMISSION PLANT

342. Structures and Improvements.
343. Station Equipment.
344. Towers and Fixtures.
345. Poles and Fixtures.
346. Overhead Conductors and Devices.
347. Underground Conduit.
348. Underground Conductors and Devices.
349. Roads and Trails.

IV. DISTRIBUTION PLANT

351. Structures and Improvements.
352. Station Equipment.
353. Storage Battery Equipment.
355. Overhead Conductors and Devices.
357. Underground Conduits and Devices.
358. Line Transformers.
359. Services.
360. Meters.
361. Installations on Customers' Premises.
362. Leased Property on Customers' Premises.
363. Street Lighting and Signal Systems.

V. GENERAL PLANT

370. Land and Land Rights.
371. Structures and Improvements.
372. Office Furniture and Equipment.
373. Transportation Equipment.
374. Store Equipment.
375. Shop Equipment.
376. Laboratory Equipment.
378. Communication Equipment.
379. Miscellaneous Equipment.
381. Electric Plant Sold.
382. Donations In Aid of Construction--Credit.

The controlling accounts for the recording of income and expense of the utility follow. These also are segregated into functional classes of income and expense. However, since the income accounts are to be used only to show the disposition of the asset adjustment accounts, it was not thought necessary to include the subsidiary accounts. The controlling accounts for income recording are:

INCOME ACCOUNTS

Utility Operating Income

Electric Operating Income:
501. Operating Revenues.
      Operating Revenue Deductions;
502. Operating Expenses.
503. Depreciation.
504. Amortization of Limited-Term Electric Investments.
505. Amortization of Electric Plant Acquisition Adjustments.
506. Property Losses Chargeable to Operations.
507. Taxes.
   Total Operating Revenue Deductions.
   Net Operating Revenues.
508. Income from Electric Plant Leased to Others.
   Electric Operating Income.
509. Other Utility Operating Income.
   Total Utility Operating Income.

OTHER INCOME

520. Income from Merchandising, Jobbing, and Contract Work.
521. Income from Non-Utility Operations.
522. Dividend Revenues.
524. Interest Revenues.
525. Revenues from Sinking and Other Funds.
526. Miscellaneous Non-Operating Revenues.
527. Non-Operating Revenue Deductions.
   Total Other Income.
   Gross Income.

INCOME DEDUCTIONS

530. Interest on Long-Term Debt.
531. Amortization of Debt Discount and Expense.
532. Amortization of Premium on Debt—Credit.
533. Taxes Assumed on Interest.
534. Interest on Debt to Associated Companies.
535. Other Interest Charges.
536. Interest Charged to Construction—Credit.
537. Miscellaneous Amortization.
538. Miscellaneous Income Deductions.
   Total Income Deductions.
   Net Income.

DISPOSITION OF NET INCOME

540. Miscellaneous Reservations of Net Income.
   Balance Transferred to Earned Surplus.

The Requirements of the System.

As stated in Chapter I, the electric plant instructions of the Uniform System of Accounts require that "all amounts included in the accounts for tangible electric plant consist–
ing of plant acquired as an operating unit or system shall be stated at the original cost incurred by the person who first devoted the property to utility service. All other tangible electric plant shall be included at the cost incurred by the utility." Just what does this requirement mean in reference to the accounts just presented? It means that the "original cost" of the utility's property will be included in the functionally classified, detailed, subsidiary plant accounts. These subsidiary accounts, account number 301 through account number 393, are summarized for balance sheet purposes and included in accounts 100.1, Electric Plant in Service, 100.2, Electric Plant Leased to Others, and 100.4, Electric Plant Held for Future Use. But what of the much discussed difference between "original cost" and cost to the utility? The Uniform System of Accounts requires this difference to be recorded in two different accounts. The nature of the excess indicates which of the two accounts will be used. These two accounts are 100.5, Electric Plant Acquisition Adjustments, and 107, Electric Plant Adjustments. The definition of these two accounts follows:

100.5 Electric Plant Acquisition Adjustments.

A. This account shall include the difference between (a) the cost to the accounting utility of electric plant acquired as an operating unit or system by purchase, merger, consolidation, liquidation or otherwise, and (b) the original cost, estimated if not known, of such
property, less the amount or amounts which may be credited to the depreciation and amortization reserves of the accounting utility at the time of acquisition with respect to such property. This account shall be so subdivided when practicable as to show the amounts applicable to electric plant in service, electric plant leased to others, and electric plant held for future use.

B. Whenever practicable, this amount shall be subdivided according to the character of the amounts included herein for each property acquisition.

C. The amounts recorded in this account with respect to each property acquisition shall be depreciated, amortized, or otherwise disposed of, as the Commission may approve or direct.

107 Electric Plant Adjustments.

A. This account shall include the difference between the original cost, estimated if not known, and the book cost of electric plant, at the effective date of this system of accounts, to the extent that such difference is not properly includible in Account 100.5, Electric Plant Acquisition Adjustments. Write-up of electric plant prior to the effective date of this system of accounts shall be recorded herein.

B. The amounts included in this account shall be classified in such manner as to show the nature of each amount included herein and shall be disposed of as the Commission may approve or direct.

An example may aid in illustrating the use of these accounts. Assume that in 1900, Utility A built a plant at a cost of $100,000. In 1920, Utility A sold this plant to Utility B for $200,000 cash. At that time Utility A had built up a retirement reserve of $25,000 on the plant. After Utility B acquired the plant it arbitrarily wrote up the value of the plant to $250,000. The original accounting entries that would have been made were likely a debit to
Plant and a credit to Cash at the time of the purchase. The write-up would probably have been recorded by a debit to Plant and a credit to some type of surplus, perhaps an appraisal surplus. With the inception of the Uniform System of Accounts, the utility would be required to adjust its accounts in the following manner:

1. Account 100.1, Electric Plant in Service, would be debited with $75,000, ("original cost" less accrued depreciation).

2. Account 100.5, Electric Plant Acquisition Adjustments, would be debited with $125,000 (excess of "cost to the utility" over "original cost").

3. Account 107, Electric Plant Adjustments, would be debited for $50,000 (the write-up).

There seems to be no real departure from accepted accounting procedures in these requirements in themselves. Even the requirement as to the analysis and segregation of this cost into the accounts outlined does not constitute an outright violation of accepted accounting practices.  

The System defines cost as "the amount of money or the cash value at the time of the transaction of any considera-

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tion other than money." This appears to be in accord with the accepted accounting concept of cost. Wherein, then, lies the basis for the disagreement concerning the accounting for plant assets as outlined in Chapter I? It would appear to be in the interpretation as to whether cost, as defined above, is cost to the present owner or cost to a previous owner. The latter appears to be the interpretation of the Federal Power Commission. This interpretation of the Commission has lead to the requirement by the Commission that the excess of "cost to the utility" over "original cost" shall be deleted from the books of the utility. This deletion of the adjustment accounts will be discussed in the next chapter.
CHAPTER IV

THE EFFECT OF "ORIGINAL COST"
ON THE UTILITY'S PLANT ACCOUNTS

As stated in the last Chapter, accountants have not taken too much issue with the segregation of the accounts into "original cost" and adjustment accounts. Rather they take issue with the Commission's insistence that the "original cost" concept be the dominant factor in recording fixed assets.¹

The Commission appears to insist that it does use cost as the basis for asset recording. Mr. Charles W. Smith has said that, "The basic principle of plant accounting according to the System of Accounts is cost; that is 'legitimate and bona fide cost to the accounting utility'."²

This, [Mr. Smith's statement]³ is mere camouflage, designed to avoid an obvious break with the most dominant rule of accounting. Actually, the basic principle of plant accounting adopted by the F. P. C. system is "original cost," not cost to the present owner. It is "original cost" which is emphasised throughout the system; it is "original cost" which is set up in the detailed plant accounts; it is "original cost" which is subject to depreciation. "Acquisition Adjustments," on the other hand, are dealt with as a necessary evil. They are set

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³ This material in brackets not included in original statement.
up in an "adjustments" account; they are excluded from the detailed plant ledger; they are subject to amortization, not depreciation; they may be disposed of at any time as the Commission may direct, and a part or all of the resulting charges may be excluded from revenue deductions.⁴

The question may now arise as to whether this disagreement is not after all a tempest-in-a-teapot. Before attempting to show the disposition of the adjustment accounts, account 100.5 and 107, it may be well to determine whether or not the amounts involved are large enough to justify the hue and cry that has been raised concerning them. The following resume of the effect on the industries' plant accounts may help to answer this question.

**Effects of this System of Recording on the Utilities.**

On May 11, 1937, the Federal Power Commission issued an order to all the utilities under its jurisdiction to the effect that those utilities must make cost studies of their plant accounts. In making this study they were required to analyze their plant accounts and classify them according to the "original cost" interpretation on or before January 1, 1939. The Commission required the utilities to submit for approval the accounting entries that would be required to carry out the instructions.

After the utilities had filed their cost analyses,

⁴ Paton, loc. cit.
the Commission undertook the task of making field examina-
tions of the utilities to determine the correctness of these
cost analyses. By June 30, 1947, field examinations of
filed "original cost" studies had been completed by the
Commission with respect to 165 companies having plant ac-
counts which aggregated $6,377,088,062 of which $807,869,208
was classified in adjustment accounts by the companies. As
a result of the field examinations, the staff of the Com-
mission increased the plant adjustments to $1,389,190,817,
or $581,321,307 more than the adjustments set forth in the
"original cost" studies filed by the companies. These
adjustments were equal to 27.85 per cent of the initial
cost as compared with 14.74 per cent reported by the com-
panies. The "original cost" and related adjustments of these
165 companies examined were equal to 77.6 per cent of the
aggregate plant and adjustments reported by the 311 com-
panies which had filed "original cost" studies by June 30,
1947. The Commission, to June 30, 1947, had issued orders
with respect to 164 public utilities authorizing the disposi-
tion of excess cost aggregating $1,237,293,339. This amount
was segregated between the two adjustment accounts in the
following manner: (1) 100.5, Electric Plant Acquisition
Adjustments, $408,497,750, and (2) 107, Electric Plant Ad-
justments, $828,795,609.5

5 Twenty-seventh Annual Report of the Federal Power
Commission, 1947, p. 81.
The question now arises as to the Commission's requirements concerning the disposition of these amounts. As was stated earlier, if the amount in accounts 100.5 and 107 were merely segregations of the cost to the utility and if they were treated in the same manner as "original cost" accounts, there would be little argument with this course of action. However, such is not the case. What, then, is required?

Disposition of the Adjustment Accounts.

The instructions relative to the operation of the System concerning account 100.5 state that, "The amounts recorded in this account with respect to each property acquisition shall be depreciated, amortized, or otherwise disposed of as the Commission may direct." The System itself opens the way for this disposition through the following accounts:

(1) 505. Amortization of Electric Plant Acquisition Adjustments.

(a) This account shall be debited or credited, as the case may be, with amounts includible in operating revenue deductions for the purpose of providing for the extinguishment of the amount in account 100.5, Electric Plant Acquisition Adjustments, pursuant to approval or order of the Commission.

(b) Amounts recorded in this account shall be concurrently debited or credited, as the case may be, to Account 283, Reserve for Amortization of Electric Plant Acquisition Adjustments.

(2) 537. Miscellaneous Amortization.
This account shall include amortization expenses, not elsewhere provided for in this system of accounts, and also such amounts as the Commission may, by order require to be included herein, such as amortization amounts in account 100.5, Electric Plant Acquisition Adjustments.

(3) 414, Miscellaneous Debits to Surplus.

This account shall include amounts chargeable to earned surplus not provided for elsewhere.

The distinction between the first two of these accounts should be made clear. Account 505, Amortization of Electric Plant Acquisition Adjustments, is included under Operating Revenue Deductions in the income statement, while account 537, Miscellaneous Amortization, is included as an Income Deduction. It is the Operating Revenue Deductions which are legitimate charges to operations and thus recoverable in consumer rates. The items included in Income Deductions are not so recoverable. If, then, the amortization is made through account 537, the consumer is required to pay rates that yield a fair return, not on owner investment, but on "original cost." It should also be noted that depreciation expense is not based on the amount in account 100.5. The instruction for depreciation under Operating Revenue Deductions states:


7 Loc. cit.
503. Depreciation.

This account shall include the depreciation expense applicable to electric plant in service (account 100.1) for the period covered by the income account.

The Uniform System itself then, provides three accounts through which the adjustment accounts may be amortized. But what has the Commission required in actual practice? In an order issued July 11, 1939, the Commission ruled that the utilities could charge off such items in either of the following two ways without further authorization: (1) by a direct charge to surplus, or (2) by periodic amortization through a charge against revenue. Thus the Commission appears to completely by-pass account 505, Amortization of Electric Plant Acquisition Adjustments, in favor of account 537, Miscellaneous Amortization, or 414, Miscellaneous Debits to Surplus. Use of the two last accounts causes a charge nonrecoverable through earning. LeBoeuf, in referring to the above situation, stated that:

The Commission has passed on over four billion dollars of plant accounts. This included many millions of dollars classified in account 100.5, as actual bona fide cost in excess of defined "original

8 Carter, loc. cit.


10 This was published in 1945. As indicated earlier, the amount had become over six billion dollars by June 30, 1947.
cost." Yet, it is believed that every dollar so classified has been ordered written off and all at the expense of the investors.

It is inconceivable that in no single instance did this excess represent, in the language of the Supreme Court a "true increment of value," and in no case would it have a factual integrity sufficient to justify the reimbursement out of operating expenses to the investors whose monies paid for the properties.

Thus while the System itself does open the way through account 505, Amortization of Electric Plant Acquisition Adjustments, to a charge to Operating Revenue and thus reimbursement through the rate paid by consumers, the Commission appears to have chosen to require amortization through an Income Deduction account, or through a direct charge to Surplus. In neither of these cases is the charge recoverable through rates. LeBeouf goes on to say:

This startling contrast between what the Commission prescribed in its own System of Accounts and its actual performance in specific cases has given rise to the charge that the language of the accounts was designed to meet the requirements of the Supreme Court in the Telephone case, but that since its adoption a change of policy had taken place which has not been expressed by an amendment of its accounting classification.\(^{11}\)

\(^{11}\) This statement refers to a case decided by the Supreme Court in connection with an account, similar to account 100.5, which is included in the Uniform System of Accounts prescribed for Telephone Companies by the Federal Communications Commission. In that case, American Telephone and Telegraph Company v U. S., 229 U. S., 1936, the Court upheld the similar account on the stipulation by the Attorney General that there was no duty to write off amounts in this account "if the difference between 'original cost' and present cost is a true increment of value."

\(^{12}\) LeBeouf, op. cit., p. 188.
Amortization periods prescribed by the Commission have varied from one to fifteen years depending upon the facts in each case.\textsuperscript{13} The Commission appears to admit its by-pass of the Operating Revenue Deduction account, 505, Amortization of Electric Plant Acquisition Adjustments by stating that, "Amortization charges are usually made to account 537, Miscellaneous Amortization, although in a few instances account 271, Earned Surplus, had been used upon the request of utilities."\textsuperscript{14}

It would seem that accountants might have a real basis for their concern relative to account 100.5, when it is seen that the Commission is requiring utilities to write off over $400,000,000 classified in account 100.5 of plant assets at the expense of the stockholders.

The Uniform System of Accounts, in the section dealing with utility plant, states the following concerning account 107, Electric Plant Adjustments: "The amount included in this account shall be classified in such manner as to show the nature of each amount included herein and shall be disposed of as the Commission may approve or direct." The System sets up no special account for the amortization of

\textsuperscript{13} Twenty-seventh Annual Report of the Federal Power Commission, p. 82.

\textsuperscript{14} Loc. cit.
this account. The Commission appears to assume that the amounts in this account are write-ups of plant and therefore should be immediately charged directly to surplus.\textsuperscript{15} However, they have in instances allowed the write-off to be over a limited number of years.\textsuperscript{16}

\textbf{Summary of the Commission's Requirements.}

At this point the following facts seem to be apparent. In the first place, the Commission has required the utilities under its jurisdiction to classify their plant accounts in accordance with an "original cost" policy. Second, in accordance with this policy the Commission so far has required the electric utilities to include an amount of over $4\text{,}088,000,000 in account 100.5, Electric Plant Acquisition Adjustments, and over $828,000,000 in account 107, Electric Plant Adjustments. Third, the Commission is now requiring the adjustment accounts to be written off over a period of one to fifteen years at the expense of the utility investors. The question now arises as to whether the Commission has followed accepted accounting procedure in arriving at the decisions concerning those policies which have

\textsuperscript{15} Federal Power Commission Report, \textit{loc. cit.}

\textsuperscript{16} For one method of amortization prescribed for the elimination of this account see "Elimination of 'Write-up'," Official Decisions and Releases, \textit{The Journal of Accountancy}, 77:334-336, April 1944.
created the situations outlined above. In other words, can the Commission justify the write-off at the expense of the investors, of over a billion dollars in plant assets on the basis of accepted accounting procedure?

The following chapters will be devoted to an attempt to show that while accepted accounting principles may allow certain elements of the adjustment accounts to be written off to surplus, those principles do not indicate that the entire amount included in the adjustment accounts should be so charged.
CHAPTER V

THE ELEMENTS OF THE EXCESS OF "COST TO THE UTILITY" OVER "ORIGINAL COST"

In the last chapter, it was shown that the Commission has required the excess of "cost to the utility" over "original cost" to be recorded in two adjustment accounts depending upon the nature of the excess. That is, if the excess is due to "the difference between (a) the cost to the accounting utility of electric plant acquired as an operating unit or system by purchase, merger, consolidation, liquidation, or otherwise, and (b) the original cost, estimated if now known, of such property..." the excess will be included in account 100.5, Electric Plant Acquisition Adjustments; if, however, the excess is "the difference between the original cost, estimated if not known, and the book cost of electric plant ... to the extent that such difference is not properly includible in account 100.5, Electric Plant Acquisition Adjustments, the excess will be included in account 107, Electric Plant Adjustments. Further, the Commission's required treatment of these accounts was shown. If then, the Commission does require a write-off of these items, it would seem appropriate to attempt to determine whether these amounts are really "bona fide" plant cost and thus should be retained in the accounts of the utility, or whether they should be written off as the Commission has directed.
The Elements of Account 100.5, Electric Plant Acquisition Adjustments.

According to Paton, "a debit balance in account 100.5 may be said to include three main elements: first, the excess of the actual cost of land, water-rights, and other natural resources over the "original cost" of such factors; second, the excess of the actual cost of structures and equipment--depreciable assets--over their original cost, resulting primarily from advancing prices for equipment and higher cost of construction, after taking into account the effect of accrued depreciation; third, an amalgam of intangibles." The first two of these may be dealt with at the same time. The intangible elements will require separate discussion.

The exclusion of the excess of actual cost of a utility's unit of purchased property over the defined "original cost" appears to be one of the least defensible requirements of the Commission. From the standpoint of accepted accounting standards, there seems to be little argument with recording this excess cost as legitimate cost of acquired facilities.

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Carter has said:

There can be no doubt in the mind of one acquainted with accounting theory that the element of the purchaser's cost which is attributable to rising production cost should be assigned to the physical asset, and should be charged into operations at the same rate as the construction costs in account 100.1 to which it is related. The cost of account 100.5 which is assigned to the physical component plus the figure recorded in account 100.1 represent the investment of the owner in the physical structure, exclusive of intangible value, and as such are prepaid cost of operations, which are to be apportioned through periodic depreciation charges against the future flow of income.3

The Commission, however, appears to feel that such increase in value is quite unusual. Paton quotes Mr. Smith as saying that the amounts in 100.5 "usually represent the cost of intangibles," and also that "except in the case of land, appreciation is rare" and that he "could not expect the fair value of physical properties as such to exceed the gross original cost."4 If the utility plant had been purchased in the past few years, the statements of Mr. Smith would seem indeed to be at variance with the facts. Certainly, when prices are as they are at the present time, it appears quite within the realm of possibility that the physical assets would have appreciated to a considerable extent. This would seem even more true, when it is realized that the Commission does not allow "gross original

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3 Carter, op. cit., p. 224.
cost" to be included in account 100.1 but rather "original cost" less any depreciation taken on the "original cost."

Thus from the point of view of accepted accounting theory and also from the point of view of the facts of the case, the increase in value of tangible assets due to an increase in the price level, when such increase is reflected in the purchase price, would appear to be properly included in the tangible plant asset accounts. However, the Commission appears to take the view that account 100.5, Electric Plant Acquisition Adjustments, contains largely not an increase in tangible values due to an increase in the price level but a payment only for intangible values. This seems to be an entirely too narrow a view of the composition of this account. However, even assuming the main element of this account does represent intangible values, does accepted accounting practice either require or condone the write-off of such intangibles? Before it is possible to answer this question, it would appear necessary to determine what intangibles are, not only in reference to public utilities but also in reference to standard accounting terminology and practice.

Paton says of intangibles in general:

Intangibles emerge for accounting purposes, then, when expenditures are made for conditions and factors

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5 Carter, op. cit., p. 224.
which have economic significance to the business enterprise viewed as a whole, but which are not readily classified in terms of particular trucks, desks, meters, and other physical facilities. They are generally just as significant as other classes of costs incurred in good faith with reasonable exercise of commercial intelligence. Indeed, they are just as "tangible" in a broad sense, as they definitely attach to a particular enterprise and the physical framework in which that enterprise exists and operates. But they attach broadly rather than specifically; they are somewhat analogous to the indirect or burden costs of manufacturing as compared with those costs which are very directly traceable and assignable. They permeate the very fabric of the business as a functioning entity, and are not conveniently and accurately described in terms of parcels of land, particular buildings, or particular units of equipment.  

The Accountants' Handbook states in reference to the cost to be used in recording intangibles:

The general rule to which accountants widely subscribe with respect to the recognition of goodwill and other intangibles in the accounts may be stated as follows:

Goodwill and other intangibles should not be recognized except where they are supported by costs actually incurred, in terms of transactions between essentially independent parties, and then only to the extent of the cash or equivalent cost. Intangible value so recognized should never be appreciated, but should be amortized as circumstances indicate.

Paton in his Advanced Accounting textbook says on the question as to whether the actual cost of intangibles may be charged to surplus or capital:

In principle this is just as improper as the recognition of nominal and questionable values as good assets.

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6 Paton, op. cit. p. 440.

The amount invested in intangibles is a part of the actual capital of the enterprise making the commitment and has a bearing upon subsequent income accounting, including the question of the rate of return. The actual cost of intangible property, therefore, should be recognized at the outset as an asset, and the later treatment of the account—as in the case of other assets—should depend upon the conditions obtaining.  

The Committee on Accounting Procedure of the American Institute of Accountants presents the following relative to the recording of intangibles:

The Committee has heretofore taken the position that the accounting for tangible fixed assets should normally be based on cost, which may be defined generally as the price paid for or consideration given to acquire the asset in question. Attention is now directed to the fact that the same principle is applicable to intangibles.

In the same bulletin, the Committee gives the basis for amortizing intangibles:

The cost of tangible assets having a limited term of usefulness is dealt with by depreciation accounting, which the committee on terminology has defined as a system of amortization which aims to distribute the cost or other basic value of tangible capital assets, less salvage value (if any) over the estimated useful life of the unit (which may be a group of assets) in a rational manner. In like manner the cost of intangible assets having a limited term of usefulness should be dealt with under amortization accounting. To this end the committee has classified intangibles as between type (a) which includes those having a term of existence limited by law, regulation, or agreement, or by their nature; and type (b) which includes those to which there is, at the time of acquisition, no evidence of

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limited life. The Committee recognizes that there may be cases in which it is difficult to make such a classification.

The cost of intangibles classified as type (a) should be amortized by systematic charges in the income statement over the period benefitted...

The intangibles classified as type (b) may be carried continuously at cost unless and until it becomes reasonably evident that their term of existence has become limited, or that they have become worthless. In the former event they should be reclassified as type (a) and thereafter amortized by systematic charges in the income statement over the estimated remaining period of usefulness...

In the event of complete loss of an investment in type (b) intangibles, a charge may be made either in the income statement or to earned surplus as, in the circumstances, may be appropriate.10

From these statements it would appear that there is nothing in accepted accounting procedure that would either require or condone the write-off to surplus of all intangible items included in the various asset accounts. In the words of the last quotation, even in the event that an intangible asset has become worthless, "a charge may be made either in the income statement or to earned surplus as, in the circumstances, may be appropriate." Thus it may be seen the accounting procedure, far from requiring intangibles that are not worthless to be charged to surplus, allows even intangibles that have become worthless to be charged through the income account. This leads to the question of whether

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10 Ibid., pp. 198-199.
accepted accounting procedures which have been recognized for industrial firms hold equally true for public utilities. It has been claimed that intangible assets are not properly included in utility accounts. The assumption here seems to be that intangibles, in the case of public utilities, are created by the public and therefore, the public should not have to pay rates based in part on those intangibles which they have created. The people who propound this philosophy say, for instance, that goodwill has no place in public utility accounts. Paton has quoted Mr. Smith as saying:

It [capitalization of superior earning power as intangible value] would mean that every time excess earnings are realized, the business could sell out, the excess earnings capitalized through the purchase price, and the rate payer charged with the increased capitalization. In other words, the rate payers, by reason of the fact that they are good customers, would be penalized by having charged against them the excess of earnings which they have contributed.¹¹

There appears to be two fallacies in this line of thought. In the first place, the Commission appears to take the unwarranted position that account 100.5, Electric Plant Acquisition Adjustments, is made up of only intangibles and that these intangibles comprise only goodwill. Secondly, that goodwill has no place in the consideration of the purchase price of utilities. That there is good evidence that

account 100.5 does not entirely consist of intangibles has already been discussed. In reference to what is included in the intangible element of account 100.5, Paton says:

It [the intangible element] may represent in whole or in part the cost to the present owner of the organization, financing, and development work accomplished under predecessor ownership. It may represent in whole or in part the cost to the present owner of particular franchises or other specific rights. It may represent in whole or in part the cost to the present owner of superiority of earning prospects arising from many economic and technical conditions which are so interwoven that it would be impracticable to appraise them separately or to array them in terms of definite relation to superior earning power to the cost of such superiority.

The above quotation would seem to shed some doubt as to whether goodwill is the entire intangible element of account 100.5. As indicated above, it may include the cost to the present owner of the organization expense, franchise or other rights, or goodwill. Again, however, assuming that the main element in account 100.5 represents intangibles and that this intangible element does in fact represent mainly goodwill, does it follow that goodwill has no place in utility accounting? At this point it may be well to determine what goodwill is and how it arises. Mr. Bond has given what appears to be a sound discussion of goodwill

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12 See pp. 47-49 of this chapter.

13 The material in the brackets not in original material.

as it refers to the American system of free enterprise.

In the Accounting Review, he writes as follows:

"Private enterprise" or, as it is sometimes called, the "profits system" recognizes four basic contributors to production, these being land, labor, capital, and enterprise. As an incentive to these basic contributors and as compensation for their contributions, land receives rent, labor receives wages, capital receives interest, and enterprise receives profits. The basic or distinguishing feature of this system of economy is the incentive, or compensation assigned to enterprise, or the "profits" feature. The inducement offered to enterprise is in the nature of a reward, measured and influenced by the wisdom with which the other three factors are coordinated and used. The contribution of enterprise is a product of brain not of brawn, and the value of this contribution can be measured only by the results obtained. Being always contingent on results, it is measured or influenced not by "toil or effort" and "sacrifice or cost," but solely by such intangible attributes as wisdom, ability, ingenuity, foresight, etc.

The private enterprise or profits system of economy assigns the role of enterprise to the private owner or to the individual, and offers to such owner the opportunity to profit, from his own individual initiative and wisdom in the coordination and productive use of the other three factors of production. The opportunity offered to the entrepreneur to create this additional value, and judicial recognition throughout the past of such value as a property or property right of the wreator, together with the faith and confidence of the American investor in his ability to create such values, has been the incentive to the growth and development of our whole American economy. To the extent that the entrepreneur contributes capital, he is also entitled to interest compensation. A mere fair return on his capital contribution, however, does not take away his established right to the profit accruing from the wise use of the total combined factors of land, labor, and capital. It does not constitute compensation for his contribution as an entrepreneur which, under this economic system, is always represented by such intangible attributes as are built into or are inherent in an established successful "going concern."
Under this system, value, as such, is a property or property right, and right of the individual to possess and use those values arising from intangible attributes, created or acquired by such individual, has been and is now the very tap root of the private enterprise system of economy. It must be apparent therefore, that the "original cost" rate-base philosophy, which denies to the private owners of public utility properties the right to benefit from intangibles and restricts such owners to a mere fair return on the capital contribution of some predecessor in title, is utterly foreign to the "private enterprise" system of economy.15

Mr. Bond goes on to state the basis of transactions for purchase and sale of property as it applies in our economy:

Everyone concerned with the everyday problems of business knows that every single acquisition of an earning concern throughout the history of our capitalistic or free enterprise system of American economy recognized the fact that the actual property or property acquired was the right to the future earning power of such concern. Every purchase price represented an agreed estimate, as between the seller and the purchaser, of the present value of such future earning power. Under the American system of economy both buyer and seller knew that the actual value would be determined by the wisdom and efficiency with which the property was used, and that it would be affected by many economic factors, the influence of impact of which could at the moment only be a matter of estimate. Each knew that the purchase price did not represent an actual measure of value, that the transaction itself evidenced the seller's opinion that the actual value was less than the price received, and the buyer's opinion that the actual value was greater than the price paid or the sacrifice made to obtain possession. If the purchase price actually established a "legal yardstick" of value, they would both be wrong. Under a private enterprise system of economy, value is not established by cost, original or

actual, but instead by use of utility, and the opportunity offered to the individual to profit by a wise use of cost has been the incentive to the growth and development of our whole economy. These are economic facts as they actually exist in an established economic system.16

Even if the above statements are presumed to be true, does it follow that they apply equally well to public utilities, or are intangibles really created by the public as Mr. Smith has stated?17 In an earlier chapter of this paper, the idea was developed that governmental regulation of public utilities is for the purpose of providing a substitute for the competition that exists in non-regulated fields. If this is to be the one and only reason for regulation, then it would seem that goodwill would enter into the purchase price of a utility just as it does in the purchase price of unregulated industry. If, on the other hand, the purpose of regulation is to socialize public utilities, then it would seem that goodwill should not be included.

Relative to this question, Mr. Bond has stated that:

It [the regulatory policy of "original cost"] 18 therefore limits the property or property rights of the individual to the cost of physical property, and by such limitation assigns the benefits arising from all intangible attributes to society as social values or as a social advantage. It denies the validity of

16 Ibid., pp. 188-9

17 See page 6, Chapter I.

18 Material in brackets not in original statement of Mr. Bond.
use or utility as an economic factor, and relegates ownership to a mere credit relationship to a "publicly owned" enterprise. It refuses to recognize the distinguishing feature of a capitalistic economy, that is, the right of the individual to possess and benefit from intangible attributes created or acquired by the individual and by such refusal it reverts to the Karl Marx philosophy of frozen or crystallized labor.19

Thus it would seem from this statement of Mr. Bond, and his discussion of goodwill already quoted, that if it is presumed that utilities are the same as any other industrial activity, with the exception of the substituted control factor, goodwill is a legitimate factor in the purchase price of a utility, a factor which is just as legitimate, just as valid as any other cost. This statement naturally presumes that such goodwill was determined on a reasonable basis. Such a conclusion appears to challenge Mr. Smith's statement that intangibles are really created by the public.20 His reasoning appears to be entirely opposed to our present profit, free-enterprise system and assumes that utilities are really publicly owned in addition to publicly controlled.

This paper does not attempt to consider the arguments of public ownership as against private ownership of utilities or other industries. However, at the present time, the utilities of our country are privately owned to a large extent,

19 Bond, "Accounting Policy or Economic Philosophy?", op. cit. p. 28.
20 See p. 6, Chapter I.
and have been financed mainly by private capital. It would seem then, that private capital is entitled to a fair return on its investment just as well as if the investment were in a non-regulated industry. On this subject Paton states that:

Those who contend that there can be no sustained intangibles in the utility field under conditions of adequate regulation are simply closing their eyes to the realities of the situation. Sound regulation is an area or bend of negotiation and adjustment, not a knifelike edge on which a utility is precariously balanced... It follows that a particular property may operate indefinitely in the upper part of the area of regulatory reasonableness and thus retain indefinitely the cost of the special factors about the favorable position of the business, for which payment was made at date of acquisition.21

Perhaps it would be fairer to the consumers of electrical energy to require the write-off of intangibles, assuming as the Commission appears to do that these consist mainly of goodwill, over a reasonable length of time. However, accounting principles would appear to require this amortization to be charged to operating expense and not to Surplus. Carter suggested such a course of action when he stated that:

Although "goodwill" may often be recorded as an enduring asset on the books of a nonregulated industry, it is doubtful whether cost incurred for the possession of potential earning power should be permanently

maintained in the accounts of a public utility. Such costs represent a conjectural and subjective determination of value—a price on which consumers should not indefinitely be required to pay a return... This outlay for intangible assets, as previously stated, should be retired through amortization charges to operations, and thus borne by the consumers. The Federal Power Commission policy of treating such costs as revenue deductions rather than operating expenses does not have a good foundation in accounting theory. 22

In summary, the Commission appears to have taken the position that the entire excess of the "cost to the utility" over "original cost" which the commission requires to be included in account 100.5, Electric plant Acquisition Adjustments, consists of intangibles, that such intangibles are composed mainly of goodwill, and that goodwill is not to be considered as a legitimate cost to the utility. However, it would seem that the excess may be made up of several factors such as an increase in value of tangible plant and the intangible elements of cost to the present owner of the organization expense, franchises and other rights, and goodwill. It would also seem that, according to accepted accounting procedure, these are legitimate costs and therefore, should be considered as part of the rate base and thus the investors in utilities would be allowed to receive profits commensurate with a fair return on their investment.

22 Carter, op. cit., p. 224.
The last chapter was devoted to a discussion of the import of account 100.5, Electric Plant Acquisition Adjustments; in connection with the elements of the account and the accepted accounting principles involved in its amortization. This chapter will include a similar discussion of account 107, Electric Plant Adjustments. As was seen in Chapter IV, the Federal Power Commission is of the opinion that the amounts included in account 107 are of very dubious value and therefore should be immediately written off to surplus. The Commission requires this since the account is presumed to include only arbitrary "write-ups" in plant accounts. Accountants have generally taken the view that "write-ups" should not occur, particularly "write-ups" which have no increase in value behind them. The Committee on Accounting Procedure, of the American Institute of Accountants states in a Research Bulletin, "Accounting for fixed assets should normally be based on cost, and any attempt to make property accounts in general reflect current values is both impracticable and inexpedient. Appreciation normally should not be reflected on the books of account of corporations."2

1 See p. 44.
Carter seems to agree with this interpretation when he states that:

There can be very little objection to the assignment into a special account, 107, of the excess of book cost over actual cost to the owner. The items in this account include illegitimate write-ups that set up unrealized appreciation. These items as assets usually serve no purpose other than to overexpand the rate base and match assets with securities issued. Accountants and the Commission agree that these "costs" should be removed with all possible speed from the asset accounts, preferably by a direct charge to the surplus which was created by their recordation on the books. 3

There indeed seems to be no justification to require utility rate payers to pay rates based on some arbitrary value. In the last chapter it was stated that rates should be set so that the investor in a utility is allowed a fair return on his investment. This, then, should apply with equal force in regard to "write-ups." It would seem then, that at least in regard to account 107, Electric Plant Adjustments, there would be little disagreement between the Commission and practicing accountants. Such is not the case, however. The Commission has used the argument that all write-ups should be immediately written off the books as an entering wedge and from this has decided that all profit on fixed assets sold by an associated company to the present accounting utility likewise represent "write-ups" and therefore that profit must be expunged from the plant

accounts of the present owner through account 107. They appear to make no distinction between affiliated companies, ownership of which is complete, and associated companies, ownership of which is less than a 100 per cent. As LeBoeuf states:

The staff has taken the unyielding position, that if there was any affiliation between two companies in a transaction, the difference between the actual cost to the accounting company and the defined original cost must go into account 107 for immediate write-off out of the investors' pockets. This is its position even if the price actually paid was determined at the time by independent and impartial appraisers; the price paid was fixed by state law or by its regulatory bodies; the state authorized the issuance of securities to the public against the price paid; the price paid to an affiliated construction company including any profit, was reasonable and less than would have been paid an independent contractor, or the circumstances of the selling company were such that it would have been a fraud on the creditors to have transferred property at less than its then true value.  

Paton seems to be just as definite in his refusal to accept the procedures concerning account 107, Electric Plant Adjustments, as he was to accept the procedures involved in account 100.5, Electric Plant Acquisition Adjustments. He has written that:

With respect to transactions between associated companies the F. P. C. is sponsoring and attempting to enforce the doctrine that such transactions are nominal rather than real business occurrences, that they have only significance of departmental transfers within a

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single business entity, and that the basis of recording such a transaction on the books of the acquiring company is recorded cost to the furnishing company, or to the last preceding party affiliated with the purchaser. The Commission is not merely attempting to establish this extraordinary kind of accounting for transactions occurring since its prescribed system of accounts was adopted in 1957; it also seeks to apply such accounting retroactively throughout the entire history of the companies under its jurisdiction.5

The Commission appears to base its reasoning in these matters on the consolidated balance sheet prepared by accountants in which intercompany profits are eliminated.

Mr. Smith has been quoted by Paton as stating:

In preparing consolidated balance sheets, public accountants eliminate intercompany profits...on the theory of economic units. But when I was with the Income Tax Department, handling such matters, particularly under the 1917 Act, when companies could not file consolidated returns unless they were in the same or a similar line of business, the argument made to me by public accountants that the affiliated company transactions which resulted in a profit were merely fictitious has never left my understanding. It made a deep impression on me and I have always believed it. Such transactions, in my opinion, are fictitious.6

But are profits between associated companies fictitious and does elimination of profits on a consolidated balance sheet indicate that such profits should be eliminated on the book of the company which owns the property? As far as the elimination of intercompany profit is com-


cerned it would seem that the Commission has taken an unrealistic point of view concerning consolidated statements.

In the first place, consolidated statements are supplementary to the individual statements of the separate companies. They are secondary rather than primary. Not only this, but there are limitations as to when consolidated statements may be prepared. The Handbook states:

Since consolidated statements are designed to reflect business units they should not be prepared unless the assumption of an economic entity can be justified.

The exact percentage of stock ownership which should obtain before the statements of the controlled company are to be included in consolidation cannot be stated. The only points on which there seems to be agreement are: (1) all wholly owned subsidiaries should be included (assuming that dissimilarity of operation does not make this inadvisable); (2) all companies in which ownership is below 50% should, ordinarily, be excluded. Between these two limits each case must be decided on its merits.

Thus it would seem that accounting practices in regard to consolidated balance sheets would not be an indication that all intercompany profit should be eliminated from the plant accounts. In the first place, a consolidated balance sheet in no way replaces the statements of the individual companies. In the second place, a consolidated statement is

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8 Ibid., p. 1061.
9 Ibid., p. 1062.
not even prepared unless the control is represented by at least a majority of the outstanding stock of the subsidiary. If the Commission is to find authority for its requirements concerning the elimination of intercompany profit, it would appear that it must look elsewhere besides the practices of accounting in respect to consolidated statements.

What should the Commission do to handle this profit in accordance with accepted accounting procedures? In the first place, it would seem that the Commission should differentiate between transactions between two companies which are closely affiliated and those where the degree of association is smaller.\(^\text{10}\) If the degree of control is large, the Commission would seem to have accounting authority to back it. H. A. Finney says in his *Principles of Accounting, Advanced*, in connection with the elimination of intercompany profit for consolidated balance sheet purposes\(^\text{11}\) when one

\(^{10}\) For a case where the Federal Power Commission has required the elimination of profit where the degree of control was very limited, see a discussion of the St. Croix Falls Minnesota Improvement Co. and the St. Croix Falls Wisconsin Improvement Co. case as discussed by William A. Paton, "Accounting Policies of the Federal Power Commission--A Critique," op. cit., p. 448

company produces fixed assets for another related company and makes a profit on the construction, a reserve should be created to eliminate the parent company's proportion of such profit and reduce the fixed assets to cost. 12 However, he goes on to say, "...the cost may properly include the profit applicable to the minority interest of the selling company." 13

Mr. Finney shows two methods of producing the required result:

(1) The parent company may write down the asset to intercompany cost by debiting surplus and crediting the asset account instead of crediting a reserve for intercompany profit. Depreciation will then be computed on the carrying value of the property as shown by the asset account. This procedure will produce satisfactory results from a consolidated standpoint, but not from the standpoint of the parent company as a separate corporate entity, because it will not reflect the cost of the property to the parent company.

(2) The parent company may carry the reserve and compute depreciation for consolidated balance sheet purposes on the carrying value of the property as measured by the debit balance in the asset account minus the credit balance in the reserve for intercompany profits. 14

Thus while accepted accounting principles would seem to allow the elimination of intercompany profit where there is a majority control, it does not indicate the elimination of such profit where the stock ownership represents a minority. Nor does it eliminate the minority interest's share

13 Loc. cit.
14 Ibid., 279.
of the profit in controlled companies. On this point Finney states:

As already shown in connection with inventories, the cost, recorded fixed asset cost, may properly include the profit applicable to the minority interest of the selling company. The parent company cannot equitably ask the minority stockholders of its subsidiary to forego their share of the profit on work done for a company in which they have no interest; nor can the parent company reasonably be called upon to set up a reserve for the total profit made by a subsidiary...15

Thus if the degree of affiliation between the two companies is 100% or slightly less, it would seem logical and in accordance with accounting principles to eliminate such profit on the consolidated balance sheet. This does seem to have only the significance of an inter-departmental transfer. However the Commission's position becomes weaker and weaker as the degree of control becomes less and less. It is also to be remembered that even if a considerable amount in the stock of another company is held, the parent company may only share in the profits of that company if and when the subsidiary company declares dividends.

There seems to be no authority in the Uniform System of Accounts for this seemingly novel treatment of inter-company profit. As stated before, the System defines cost as, "'Cost' means the amount of money actually paid for property or services or the cash value at the time of the

15 Ibid., 278.
transactions of any consideration other than money." Paton says of this, "This is a clear-cut statement, squarely in accord with established accounting concepts and standards. No exception or qualifications are listed or implied either in connection with this definition or at any point throughout the system."

In addition to this, the Commission appears to take the position that transactions between associated companies are not carried out according to prudent business policies. It would seem that according to the Commission a transaction must be at arm's length before it may be considered to be according to prudent business practices. Paton says of Mr. Smith's testimony in the previously cited Arkansas investigation, "On cross examination, Mr. Smith makes it perfectly plain that he cannot conceive of a transaction between associated companies as being on a fair commercial basis, and that even if he could conceive of such an idea he would insist that transfers between associates at fair market value are improper."

But does the fact that companies are associated, indicate that there is necessarily skullduggery in trans-


action between them? It would appear that the accounting
point of view would be that such transactions are valid
unless it can be shown that there is reasonable doubt as
to whether the transaction was consummated on a sound basis.
Certainly, such transactions should be viewed with extreme
care, but it seems unwarranted to assume that they cannot
be sound. Paton says on this matter, "Barring clear evidence
of collusion, incompetence, or fraud, the stated price is
accepted by the accountant for entry in the accounts." 18
This position would appear to be just as true for transactions
between affiliates as between non-affiliates. If the
transaction was on a strict cash basis, and in accord with
existing market values, accounting principles would seem to
require that the purchase price be used as the basis for the
recording of the new asset. In reference to the profits on
intercompany sale of fixed assets, Mr. Carter has said that:

Intercompany profits between affiliates are right-
fully assigned to this account 107 if parent invest-
ment constitutes complete ownership of subsidiary
securities. Payments made in the purchase of property
from a corporate associate do not properly go into this
account, transactions between associates should be
treated as being at arm's length unless there is con-
clusive evidence that such payments are excessive in
amount. 19

Mr. Paton appears to be even more dogmatic in his

18 Loc. cit.
19 Carter, op. cit., p. 230
beliefs on this question. He stated that:

The most objectionable and unwarranted accounting policy of the Commission is found in the determined effort to remove from the cost of property all amounts representing profits to vendor where the vendor was in any degree affiliated with the buyer. This policy is in no way required by the provisions of the uniform system of accounts and is directly contrary to established accounting principles and practices.20

Therefore, in summary, it may be seen that the Federal Power Commission has taken a stand on transactions between affiliates which appears to be contrary to accepted accounting practice. The Commission, on the one hand, appears to insist that all such transactions are fictitious and have only the significance of inter-departmental transfers within a single business entity.21 Further, the Commission seems to hold to this line of reasoning regardless of the degree of ownership. Accounting practice, on the other hand, appears to require such transactions to be regarded as legitimate unless there is definite proof to the contrary. Accepted accounting practice sanctions the elimination of such profit only on consolidated statements and thus only in the cases where consolidated statements would logically be prepared. Thus, if the Commission were to require the elimination of intercompany profit on fixed


21 See page 64 of this chapter.
assets only in those cases in which consolidated statements would normally be prepared instead of on all transactions between associates it would appear that the Commission's requirements would be in accord with accepted accounting procedure.
CHAPTER VII
SUMMARY AND CONCLUSIONS

LeBoeuf has cited the example of accountants who claim the "original cost" accounting for fixed assets is equivalent to reverting to the legendary twenty-four dollars paid the Indians for Manhattan Island. They have dubbed it "aboriginal cost." On the other hand, regulatory authorities have maintained that this principle is essential to the effective regulation and they offer three bases of justification. First, they contend that both the original and the purchase price to the present accounting company are significant in determining the adequacy of a given rate level. The second claim made is that only in this way can there be any assurance that integrity might first be restored and then maintained in the property accounts of utility companies. A third claim which the regulatory authorities make for the principle of "original cost" is that the procedure can render invaluable aid in determining the rate base of a utility. Paton concedes that a Uniform System is necessary but does not agree with

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"original cost" when he states:

The importance of prescribed accounting as one means of securing effective regulation has long been recognized, and there can be no objection to the reasonable use of this means by the Federal Power Commission. The principle weakness of the F. P. C. uniform system, from the point of view of established accounting principles, is the shift in emphasis from the commonplace concept of actual cost to the present owner to the concept of "original cost," in the special sense of cost to the party by whom property is first devoted to public service. 3

Who, then, seems to be right on the question of "original cost?" This paper has attempted to show what the Commission requires in regard to the recording of fixed assets and the divergence from accepted accounting procedure in such requirements. It was stated earlier in this paper that the Federal Power Act, from which the Federal Power Commission derives its authority to prescribe a Uniform System of Accounts, attempted to remedy the bad practices that many electric utilities had engaged in, those practices which had been disclosed in the Federal Trade Commission's report. 4 It cannot be denied that the Federal Power Commission has done much to eradicate these unsound financial policies. Certainly the public utility field during much of its growth has seen nearly every type of financial skulldugery practiced. Properties have been sold back and forth


4 For a summary of that report see pp. 19-22, Chapter II.
so many times and through so many interlocking companies that any attempt at determining their true cost is a terrific, if not impossible, task. In many cases the only payment for property was in the form of securities. The securities were issued at par, which might or might not have any relation to the true market value of the property involved. It does seem that the Federal Power Commission has taken a step in the direction of returning and maintaining integrity in the plant accounts of the utilities under its jurisdiction. The Wall Street Journal has been quoted by E. L. Kohler as stating that "the fundamental position of the electric utility industry has been strengthened by the Federal Power Commission program of eliminating intangible items and write-ups from the property accounts of many companies."5

However, it seems to this writer that the Federal Power Commission has over-stepped not only the bounds of good accounting but also the bounds of fair and equitable treatment. That is, in its attempt to remedy the admittedly unsound plant accounting of utilities, it has taken the extreme position that all companies have engaged in nefarious practices and, therefore, the plant accounts

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must be reduced to the lowest possible figure. As an example, the treatment of the excess of actual cost over "original cost" indicates that the Commission can conceive of no case in which this excess is legitimate. Any accounting definition that may be found for the cost of fixed assets has as a basic tenet the cost to the present owner. This, however, does not mean that if that cost is out of all proportion to market values that it is the cost to be used. Certainly the accounting profession and the Commission could arrive at a common agreement if the Commission insisted that the recorded cost should be the reasonable one. Accountants do not worship cost as the one and only indication of value. They merely say that it is usually the best guide to value since it is presumed that a reasonable man will not part with property unless he receives in return what he considers to be property of equal value. No one would argue with the Commission if it required careful inspection of transfers to see that they were conducted as if "arm's length" transactions and thus, under the above assumption, sound commercial transactions.

Likewise, no accountant will condone the indiscriminate write-ups of plant either through direct increases or through the medium of transfers between controlled companies. But here again, the Commission appears to take the extreme view that all such transactions are devoid of
reasonableness. The Commission has gone to the expense and trouble of making field examinations to insure that all companies are adhering to their "original cost" requirements. It would seem that these studies should have produced, to a large extent, the necessary data on which to base constructive accounting adjustments in the plant accounts of the utilities examined. If these were the practice of the Commission rather than its insistence on "original cost," accountants would not have felt that it was necessary to denounce the Commission's stand. But, as has been shown, such is not the case.

As has already been pointed out, the Commission has insisted that its "original cost" scheme is a requirement of sound accounting practice, yet it has been shown that the accounting profession cannot accept the ideas of the Commission. What are some of the results of "original cost" which would indicate that accountants have a basis for their disagreement with "original cost"? It has been shown that "original cost" is not compatible with accepted accounting practice. Has the accountant any basis for his insistence that accepted accounting procedures apply to public utilities? A partial answer to this question may be found by looking at some of the situations that occur

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6 See p. 73
under "original cost." In the first place, use of "original cost" denies to the utility the right to possess or benefit from intangibles which have been created by private capital.

As Mr. Bond Says:

An economic philosophy which limits the benefits of possession to private ownership of an earning entity to the mere cost or sacrifice made to obtain possession, after purging such costs of all amounts incurred in recognition of intangible attributes inherent in such entity, has as a basic principle the same concept of value as that which underlies every socialistic or communistic form of economy. The distinguishing difference between capitalism and communism is the recognition by capitalism of intangible values or attributes created or acquired by an individual, or by the recognition of use or utility as an economic factor.

The record is replete with findings and orders of the Federal Power Commission which deny to private ownership the right to possess or benefit from such intangible values or attributes, even when they were acquired or created by expenditures of private funds. These orders imply that all such values arise from the "possession of a franchise," and are therefore social values, the benefit from which must accrue to society not to the individual. Under such a philosophy the property right is erased, in spite of the fact that such values accrue to all successful enterprises, and that the opportunity to create and possess such values has been the incentive to the growth and development of our whole American economy. 7

Thus the accountant may back up his insistence that intangibles are properly included in the utility asset accounts not only because it conforms to accepted accounting procedure, but also because such intangibles are inherent in American system of free enterprise. In other words, the

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accepted accounting principle is not an arbitrary statement, but one which is based on full recognition of the American concept of value and of property rights. It would seem then, that the Commission in its insistence on the exclusion of intangibles, violates an accounting provision based on our American concept of value. The Commission thus seems doubly wrong in its insistence on excluding intangibles. American industry is based on the profit system, not socialism; therefore, it would seem that the Federal Power Commission should keep its accounting on that basis.

The second place where the Commission's requirements ran afoul of accepted accounting procedure is in the case of its insistence that property rarely appreciated in value. This idea leads to some inequitable situations and also situations which are contrary to the facts. On the latter point, it has already been pointed out that in a period of rising prices, such as the United States has just witnessed, there can be little doubt that property has appreciated in value to a considerable extent. Anyone who has recently purchased a home can bear testimony to this fact. In this respect, it will be interesting to note what attitude the Commission will take when and if prices start down again. Will they still insist on "original cost"? As an example, presume that a utility plant had been built in 1948, at the height of the inflationary spiral, for $300,000. Also
presume that by 1955, the price level had descended into a depression period. If the price level were to descend to such an extent that the plant were sold at a loss of $150,000, will the Commission still insist that the $300,000 (original cost) less any accrued depreciation be the basis for recording the plant on the books of the acquiring company and thus become part of the rate base? It hardly seems that the Commission would find such a practice fair to the consumers of electrical energy. Yet, this would appear to be the logical conclusion arrived at from the Commission's present requirements that "all amounts included in the accounts for tangible electric plant consisting of plant acquired as an operating unit or system shall be stated at the original cost incurred by the person who first devoted the property to utility service." One of the basic accounting rules is that the accountant should be consistent from time to time in his treatment of a particular accounting problem. Certainly, here it would seem that the Commission is moving into a situation where it must indeed become inconsistent.

It was mentioned above that the Commission's requirements lead to some inequitable and unfair situations. What are some of these? In the first place, the system would seem to discriminate against the utility which purchased its property as against the utility which built its plant. In fact, it would seem that in times of high prices
it would be nearly impossible for a utility to purchase property if that property had been built in a period of low prices. The utility cannot afford to purchase a plant at a high price and then write off a good share of the cost of that plant at the expense of its investors. This would also mean that the utility would earn a rate of return on the basis of "original cost." As Carter states:

The "original cost" provisions are almost prohibitive if an enterprise desires to acquire a "going concern" during a period of high prices, unless initial construction cost was also incurred during a time of equally high prices. If current replacement cost far exceeds cost to the original owner, the purchasing utility is faced with the fact that the part of purchase price which reflects the enhanced value of the plant due to increased cost of materials will not receive fair treatment as bona fide cost.\(^8\)

One wonders if the commission is not forcing the utilities into a position where exchange of property will not become impossible.

While the Federal Trade Commission's report showed many ways in which combinations of utilities had been against the public good, it cannot be denied, that in many instances the interconnection and consolidations of existing utilities has lead to more economical and better service. Yet the Commission appears to discriminate against such mergers. Even a disciple of "original cost" agrees that

\(^8\) Prickett Carter, "Some Issues Involved in 'Original Cost'," \textit{op. cit.}, p. 227.
this point may be valid; Mr. James C. Bonbright in the
direct testimony before the Public Service Commission of
Maryland stated that:

My preceding statement in support of original cost
as the measure of the rate base is subject to one im-
portant qualification or exception. This exception
applies to situations where a utility property has
been acquired by new owners as a necessary step in
improving the public service, by making a better, more
efficient unit through the combination of existing
utility properties. In such a case, if the new owner
was compelled to pay more than original cost in order to
accomplish this socially desirable objective, and if
the public benefit resulting from the acquisition of
the property is more than enough to offset the public
burden of the higher rate base, the inclusion in the
rate base of the necessary purchase price seems to
me in harmony with the "prudent investment" principle.
Even here, however, in my opinion, the excess price
should be amortized over a reasonable period of time
instead of being allowed to stand as a perpetual bur-
den on the rate payers.9

Yet, the Commission does not allow even such excess to be
includible in the plant accounts. In connection with the
above quotation, it is interesting to note what seems to
be the recurrence of the idea that utilities are actually
publicly owned, the idea of public benefit would seem to
bear this statement out. Mr. Bond also bears this point
out when he says, concerning Mr. Bonbright's testimony that:

It is apparent therefore that the yardstick which
the author [Mr. Bonbright] advocates for the measuring
of the property rights of private owners of public
utilities would be valid or proper only under an
established socialistic economy. His advocacy of

9 James C. Bonbright, "Original Cost As a Rate
"original cost" as a legal measure of the property or property rights of the private owners of public utilities can only mean that he considers the power to regulate as the authority to socialize, and dedication of property to public service as the surrender of such property to public ownership.¹⁰

It thus seems that the Commission has fostered an accounting practice which not only is not in accord with accepted accounting practices but also is discriminatory against various utilities and does not conform to our American system of profits. What suggestion could be offered which would remedy all three of these situations?

As was stated earlier, accepted accounting "provisions for the recording of the cost of acquisition of a going concern or an earning entity were developed in full recognition of the American concept of value and of property and property rights, that is, in conformity with the fundamental or basic principles underlying our capitalistic form of economy."¹¹ Therefore, it would seem that if the system of accounts can be made to fit into accepted accounting standards, it will also conform to the accepted basis for our economy. What, then could be done to make the system conform to accepted accounting procedure? The various


¹¹ Joe Bond, "Accounting Policy or Economic Philosophy?,” The Accounting Review, op. cit., p. 27.
property accounts will be discussed in an attempt to analyze the changes needed. At the outset, it may be stated that most of the changes which would be required are more in the realm of the interpretation of the accounts by the Commission than in the accounts themselves.

The first account to be discussed will be 100.1, Electric Plant in Service. This account should be altered so that the reasonable cost to the present owner of the purchased tangible plant would be included. This account would then include the investment of the owners in tangible plant as far as purchased plant is concerned. This would be in accord with the accepted accounting principle as outlined by the Committee on Accounting Procedure of the American Institute of Accountants when it stated "The Committee has heretofore taken the position that the accounting for tangible fixed assets should normally be based on cost, which may be defined generally as the price paid or consideration given to acquire the asset in question."12 This cost would then also be apportioned to operations through the periodic charges to depreciation in the same manner that "original cost" is apportioned to operations under the present system. The undepreciated cost should then con-

stitute an important factor in the determination of the rate base. The Commission, through its field examinations, should have the basis for judging whether the amounts to be included in this account, as increase in value due to the price level, are reasonable. These changes would seem to bring this account into line with established accounting procedures.

The next account to be considered will be account 100.5, Electric Plant Acquisition Adjustments. This account should include the excess of the purchase price over the amount reasonably assignable to tangible assets. This excess cost would thus include the value of the intangible elements, including capitalization of future earnings or goodwill. The Committee on Accounting Procedure recommends for intangibles that, "The initial carrying value of all types of intangibles should be cost, in accordance with the generally accepted accounting principle that assets should be stated at cost when they are acquired. In the case of non-cash acquisitions, cost may be determined either by the fair value of the consideration given or by the fair value of the property acquired."13 This gives the basis for recording the cost of intangibles. It should also be mentioned that good accounting would require the intangibles

13 Ibid., p 196.
to be segregated according to their individual qualities, i.e. goodwill, franchise, development costs, etc. Again, the Commission should now have available the information necessary to arrive at a fair and just cost at which the intangibles should be included for transactions which took place in the past. Since the Commission must approve all future purchases of electric plant where the amount involved is over $50,000, the Commission could refuse to allow transactions in which the acquisition price was unreasonable and, therefore, suppositionally included too much for intangibles. The amounts included in account 100.5 should then be amortized through account 505, Amortization of Electric Plant Acquisition Adjustments, and since this account is an operating revenue deduction account, the investors would be able to recoup the write-off of their investment through the rates charged consumers of electric energy. As was stated at an earlier point, it would probably be well to amortize goodwill over a fairly short period of time. However, such intangibles as development cost would appear to have value as long as the utility is in existence and on this basis, such intangibles may be carried on the books of the company throughout its existence.

The last account to be considered is account 107, Electric Plant Adjustments. As far as the eliminating arbitrary write-ups in the plant accounts, this account
does conform to accepted accounting principles. Except in special cases, most accountants have looked with ill-favor upon attempts to inflate property values through mere book entries. The Committee on Accounting Procedure states that, "Appreciation normally should not be reflected on the books of account of corporations."\textsuperscript{14} Appreciation seems particularly reprehensible in connection with utilities. The consumers of electrical energy should be required to pay rates which give a fair return on legitimate cost, not on some arbitrarily inflated value. Therefore, the Commission's requirement that such write-ups be deleted from the books by a charge to Surplus seems entirely equitable and in keeping with accepted accounting principles. However, as was indicated in the last chapter, such a statement cannot be made concerning the Commission's inclusion of all profits on fixed assets to associated companies as write-ups. Such an interpretation seems to be a far cry from accepted accounting principles. The accounting treatment of such profits was shown in the last chapter. In summary, the correct procedure would seem to be for the Commission to distinguish between affiliated companies where the degree of stock ownership is large and associated companies where stock ownership is small. For the former, the Com-

\textsuperscript{14} Committee on Accounting Procedure, "Depreciation on Appreciation," Accounting Research Bulletin No. 5, The American Institute of Accountants, April, 1940, p. 37.
mission would seem to be correct in requiring intercompany profits to be eliminated. In the latter case, the Commission should treat these as any other transaction unless there is evidence that the transaction has not been consummated on a sound commercial basis. Here again, the Commission should be in a position to make quite accurate determinations on past transactions through its cost studies. As to future transactions, when authorizing the purchase, the Commission may refuse to authorize the purchase or else require the excess to be written off through account 107, if it feels that the transaction will not be in accordance with "arm's length" considerations.

With these changes, the Uniform System of Accounts, as it applies to the phases of plant accounting herein discussed, would appear to conform more closely to accepted accounting principles, to discriminate no longer against utilities which purchase their plant, and to conform more closely to our American idea of free enterprise. These changes would eliminate the requirement of the Commission that substantial "bona fide" investments be wiped off the books of utilities. Yet these changes would still allow the Commission to eliminate, to a large extent, the amounts that are included in the utilities' accounts due to past financial finagling. It would seem that in attempting to relieve these admittedly unsound conditions, the Commission
has gone to the opposite extreme. As Paton has said, "As one contemplates the activities of the Commission and its staff along the accounting front, there is some ground for feeling that the theme of the wicked 20's has been worn rather threadbare and that a shift of attention to the pressing problems of the bustling 40's would be desirable."^{15}

The changes suggested would assure that "integrity might first be restored and then maintained in the property accounts of utility companies." But the property accounts would reflect good accounting treatment, as well as equity, rather than the reverse as they do under the present requirements of the Federal Power Commission.

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