

Exhibit No.:

Issue: Accounting Authority Order (AAO)

Witness: Janis E. Fischer

Sponsoring Party: MoPSC Staff

Type of Exhibit: Rebuttal Testimony

Case No.: WO-2002-273

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**MISSOURI PUBLIC SERVICE COMMISSION**

**UTILITY SERVICES DIVISION**

**REBUTTAL TESTIMONY**

**OF**

**JANIS E. FISCHER**

**FILED<sup>3</sup>**

**APR 09 2002**

**Missouri Public  
Service Commission**

**MISSOURI-AMERICAN WATER COMPANY**

**CASE NO. WO-2002-273**

**Jefferson City, Missouri**

**April 2001**

**\*\*Denotes Highly Confidential Information\*\***

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**JANIS E. FISCHER**

**MISSOURI-AMERICAN WATER COMPANY**

**CASE NO. WO-2002-273**

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1 distribution system from Kansas Power and Light Company, predecessor company of  
2 Western Resources, Inc. After the acquisition, I compiled asset records for the natural  
3 gas distribution system for the utility, nominated gas supplies for the municipal power  
4 plant, monitored gas transportation customer loads and billed transportation customers.  
5 I was appointed by the Board of Public Works (Board) to the Nebraska Public Gas  
6 Agency (NPGA) Board and later was elected Vice Chairperson of the Board. NPGA is  
7 comprised of members from municipal natural gas systems who collectively purchase  
8 natural gas and acquire natural gas wells to supply gas to municipal gas systems and  
9 power plants at reduced costs.

10 I also was employed as a staff accountant with the accounting firm of  
11 Cuneo, Lawson, Shay and Staley, PC, in Kansas City, Missouri, for approximately two  
12 years. While employed as a staff accountant, I assisted in various audits, compilations  
13 and reviews of corporations and prepared individual and corporate state and federal tax  
14 returns. I researched tax issues, assisted with compliance audits and interacted with  
15 various clients.

16 Q. What has been the nature of your duties with the Commission?

17 A. I have directed and assisted with various audits and examinations of the  
18 books and records of public utilities operating within the state of Missouri under the  
19 jurisdiction of the Commission.

20 Q. Have you previously filed testimony before this Commission?

21 A. Yes. Please refer to Schedule 1, attached to this rebuttal testimony, for a  
22 list of the major audits on which I have assisted and filed testimony.

1           Q.     With reference to Case No. WO-2002-273, have you examined and  
2 studied the books and records of Missouri-American Water Company (MAWC or  
3 Company) in conjunction with MAWC's application for the issuance of an Accounting  
4 Authority Order (AAO) relating to its Missouri water operations?

5           A.     Yes, in conjunction with other members of the Commission Staff (Staff).

6           Q.     What is the purpose of your rebuttal testimony in this proceeding?

7           A.     The purpose of my rebuttal testimony in this proceeding is to present the  
8 Staff's current position regarding the Commission's issuance of AAOs and how it  
9 specifically relates to MAWC's request for an AAO that would allow it to defer certain  
10 security-related costs. In doing so, I will also address the direct testimonies of MAWC  
11 witnesses Frank L. Kartmann and Edward J. Grubb earlier filed in this proceeding.

12           **DISCUSSION OF ACCOUNTING AUTHORITY ORDERS**

13          Q.     What is an Accounting Authority Order?

14          A.     An AAO is a Commission order granting a utility the authority to depart  
15 from normal accounting treatment by deferring recognition of costs associated with an  
16 extraordinary event that under normal circumstances would require immediate  
17 recognition as an expense.

18          Q.     How does the Staff define "extraordinary event"?

19          A.     The Staff would define "extraordinary event" as an event that is  
20 distinguished both by its unusual nature and by the infrequency of its occurrence. To be  
21 classified as extraordinary, the event should possess a high degree of abnormality and it  
22 should be a type of event that is clearly unrelated to, or only incidentally related to, the

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1 ordinary and typical activities of the utility. Further, the event should be of a type that  
2 would not reasonably be expected to recur in the foreseeable future.

3 This general definition is very close to that utilized by the Federal Energy  
4 Regulatory Commission (FERC) to denote extraordinary events for electric and gas  
5 utilities, as well as the definition that is used for financial accounting purposes. The  
6 FERC definition comes from the Uniform System of Accounts (USOA) general  
7 instructions for Extraordinary Items. The definition in the April 1, 1996 revised USOA  
8 states:

9 Those items related to the effects of events and transactions which  
10 have occurred during the current period and which are not typical  
11 or customary business activities of the company shall be  
12 considered extraordinary items. Accordingly, they will be events  
13 and transactions of significant effect which would not be expected  
14 to recur frequently and which would not be considered as recurring  
15 factors in any evaluation of the ordinary operating processes of  
16 business.

17 Q. Why should an item or event have to be considered extraordinary before it  
18 can be eligible for AAO treatment?

19 A. The ratemaking process is premised upon normality and regularity as the  
20 basis for setting rates. Accounting and ratemaking rules and conventions are presumed to  
21 be capable of adequately reflecting the ongoing and normal changes to revenues,  
22 expenses and rate base which a utility will experience over time. Only infrequently do  
23 extraordinary events occur which justify changes to normal utility accounting and  
24 ratemaking practices and procedures. Only truly extraordinary items and events justify  
25 extraordinary accounting and ratemaking treatment, such as the deferral and amortization  
26 of items that would normally be charged to expense when they are incurred.

27 Q. Has the Commission supported this position in past orders?

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1           A.     Yes, on numerous occasions. The Commission in Case No.  
2     WR-2000-281, MAWC, in its Order Concerning Non-Unanimous Stipulation and  
3     Agreement, Denying Motion to Modify, stated on page 8:

4                     The items deferred are booked as an asset rather than as an  
5                     expense, thus improving the financial picture of the utility in  
6                     question during the deferral period. Id. AAOs should be used  
7                     sparingly because they permit ratemaking consideration of items  
8                     from outside the test year:  
9

10                    The deferral of cost from one period to another period for the  
11                    development of a revenue requirement violates the traditional  
12                    method of setting rates. Rates are usually established based upon a  
13                    historical test year which focuses on four factors: (1) the rate of  
14                    return the utility has an opportunity to earn; (2) the rate base upon  
15                    which a return may be earned; (3) the depreciation costs of plant  
16                    and equipment; and (4) allowable operating expenses. State ex.  
17                    Rel. Union Electric Company v. PSC, (UE), 765 S.W. 2d 618, 622  
18                    (Mo. App. 1988).

19           Q.     Does a utility benefit from the deferred cost recognition provided by an  
20     AAO?

21           A.     Yes. A regulated utility's rates are established based on the recovery of its  
22     normal cost of providing service to its customers. The benefit to a utility of deferring the  
23     cost recognition of extraordinary events can be summarized as follows:

24                    (1)     The deferred recognition of the costs caused by an extraordinary  
25                    event provides an opportunity for a utility to earn a higher rate of return as a result  
26                    of not recognizing the immediate cost impact of a significant, extraordinary event  
27                    or the expenses related to an extraordinary capital project.

28                    (2)     The deferred cost recognition for depreciation expense and  
29                    carrying costs associated with an extraordinary capital project or event under an  
30                    AAO enhances cash flow if the utility is allowed to recover these costs in its next  
31                    rate case.

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1           Normal construction accounting for utilities allows the booking of a  
2 deferred return, known as allowance for funds used during construction (AFUDC),  
3 during an asset's construction period, to compensate for the carrying costs (financing  
4 cost) of the asset. After the asset is placed into service, accrual of AFUDC ceases, and  
5 the AFUDC that were booked during the construction period become part of the overall  
6 cost of the asset, to be recovered by the utility through depreciation charges over the life  
7 of the asset. However, once accrual of AFUDC on an asset ceases, the asset is placed in  
8 rate base for the purpose of calculating the utility's return, and depreciation on the asset  
9 begins to be recorded, even if the utility's rates have not changed to reflect the asset  
10 going into service. The increase in the required return attributable to the new asset, as  
11 well as the increase in the depreciation charges, causes the utility's earnings to decline as  
12 a result of the new asset being placed in service, all other things being equal.

13           For a utility with a sizeable construction program, the impact of regulatory  
14 lag associated with new plant additions can be significant, unless the company's other  
15 costs are declining or it is experiencing growth in revenues which would offset or  
16 mitigate this impact.

17           Q.   How do deferrals of expenses that are not capital-related work  
18 mechanically?

19           A.   When an expense is incurred that is deemed to be extraordinary, an AAO  
20 allows the utility to book the expense to an asset account, (Account 182.3, Deferred  
21 Debits) on the balance sheet instead of charging the amount to an expense account, as  
22 would normally be done, lowering the utility's earnings. Capitalizing the cost through a  
23 deferral allows a utility to both seek rate recovery of the costs in a subsequent rate

1 proceeding and avoid any negative impact on earnings in the interim period until a rate  
2 proceeding is initiated.

3 Q. How does a capital cost deferral work mechanically?

4 A. As previously discussed, when a capital addition goes into service,  
5 depreciation expense begins accruing on the addition immediately, and the addition is  
6 added to the utility's rate base. Both of these results also have the effect of lowering the  
7 utility's rate base. Both of these results have the effect of lowering a utility's earnings,  
8 all other things being equal, if rate recovery for the capital addition is not granted  
9 concurrently with the capital addition going into service.

10 When an AAO is granted for an extraordinary capital addition, the  
11 depreciation amounts associated with that addition that are normally expensed are instead  
12 capitalized on the balance sheet, in Account 182.3 At the same time, to compensate the  
13 utility for reduced earnings due to the new addition being placed in rate base, carrying  
14 costs on the new addition are deferred and capitalized on the balance sheet as well.  
15 Deferral of carrying costs is equivalent to continuing to accrue AFUDC on an asset after  
16 it goes into service. Deferral of extraordinary capital-related costs allows the utility to  
17 seek rate recovery of the deferred amount in a subsequent rate proceeding.

18 **DESCRIPTION OF MAWC'S PROPOSED AAO**

19 Q. What extraordinary event has caused MAWC to file for an AAO?

20 A. According to the direct testimony of MAWC witness Frank L. Kartmann,  
21 the terrorist attack on the United States, which took place on September 11, 2001, was the  
22 extraordinary event that caused MAWC to file for the AAO. Mr. Kartmann, beginning  
23 on page 2 of his direct testimony, states: "This event caused an increased focus on

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1 security as the result of external pressures and internal decision.” The internal decisions  
2 made by MAWC’s management to upgrade plant facilities throughout Missouri have  
3 purportedly led to increased security capital expenditures, increased ongoing security  
4 expenses and the incurrence of some one-time non-recurring security expenses.

5 Q. Please describe the costs MAWC is requesting to recover in its proposed  
6 AAO.

7 A. MAWC is requesting deferral of costs associated with upgrades to security  
8 at its Missouri facilities, as listed in the Highly Confidential Schedule FLK-3, attached to  
9 Mr. Kartmann’s direct testimony. In summary, the costs can be separated into three  
10 categories:

<u>Description of Expenditure</u>	<u>Amount</u>
** _____ **	** _____ **
** _____ **	** _____ ** (Heightened alert status)
** _____ **	** _____ ** (Heightened alert status)

15 Q. Does Mr. Kartmann’s Schedule FLK-3 require further explanation?

16 A. Yes. \*\* \_\_\_\_\_

17  
18 \_\_\_\_\_ \*\*

19 It is important to know that the deferral of capital costs under the AAO, as described  
20 above in my rebuttal testimony, should only include depreciation and carrying cost  
21 calculations, not the gross plant dollar amount included in Kartmann Schedule FLK-3  
22 and above in this testimony.

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4           Q.     Please describe the conditions to the AAO deferral requested by MAWC.

5           A.     Mr. Grubb, on pages 4-5 of his direct testimony, provides suggested  
6 language for the Commission to use if they approve the AAO request:

7                   a)     MAWC is authorized to maintain on their books a  
8 regulatory asset which represents the operation and maintenance  
9 expenses, carrying costs, and depreciation expenses associated  
10 with the adoption of new procedures, updating existing procedures,  
11 and installation of facilities to further safeguard its water plant  
12 continuing until the effective date of a Report and Order in  
13 MAWC's next general rate proceeding, a period of no longer than  
14 four (4) years from the issuance of this AAO; and

15  
16                   b)     That the Commission intends that rates established in  
17 MAWC's next general rate case will include, among other things,  
18 treatment of MAWC's prudently incurred costs pertaining to  
19 security of water plant, as described above, and, if amortized, an  
20 amortization of MAWC's prudently incurred costs deferred  
21 pursuant to this AAO, over a period of time ending no later than  
22 three years after rates become effective in MAWC's next rate case.  
23 [Emphasis added.]

24                   I will present the Staff's recommendations on these points later in this  
25 testimony.

26     **PROPOSED STAFF CRITERIA FOR AAOS**

27           Q.     Is the Staff recommending, in this Case No. WO-2002-273, that the  
28 Commission expand its traditional criteria for the approval of deferred cost recognition  
29 under an AAO?

30           A.     Yes. Continuation of the policy, which requires only that expenses be  
31 extraordinary for an AAO to be approved, may subject the Commission to AAO requests

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1 that do not reasonably merit consideration. MAWC's application for the issuance of an  
2 AAO in this case is an example of such a request.

3 Q. What criteria does the Staff recommend be used by the Commission in  
4 considering whether to grant an AAO?

5 A. The Staff recommends requiring that the application show that the  
6 following four conditions have been met before the Commission considers granting an  
7 AAO:

8 (1) The costs resulting from the event must be extraordinary and  
9 material. The Staff is recommending that the costs that are subject to deferral  
10 must represent at least 5% of the utility's regulated Missouri net income,  
11 computed before extraordinary items. This percentage should be applied to the  
12 company's most recent twelve months of earnings without reflecting the alleged  
13 extraordinary event. This requirement is consistent with the materiality  
14 requirement for deferral of costs that is found in Account 182.3 of the USOA, as  
15 defined in the seventh General Instruction, "Extraordinary Items," Subchapter C,  
16 Part 101 of the Code of Federal Regulations, Title 18. The USOA is the  
17 prescribed method used by FERC and adopted by the Commission for  
18 bookkeeping purposes pursuant to 4 CSR 240-20.030. (It should be noted,  
19 however, that 4 CSR 240-20.030(4) states, in part, that "the Commission does not  
20 commit itself to the approval or acceptance of any item set out in any account for  
21 the purpose of fixing rates...").

22 The Staff, of course, realizes that FERC has no regulatory  
23 responsibility over water utilities. However, the Staff believes the FERC's

1 materiality standard in the USOA for electric and gas utilities is reasonable and  
2 should also be used for water and sewer companies by the Commission.

3 (2) The utility's current rates must be inadequate to cover the event. If  
4 the Commission can determine, by examining surveillance reports and other  
5 information provided by the utility, that existing rates appear sufficient to cover  
6 the extraordinary cost and still provide the utility with a reasonable expectation of  
7 earning its authorized rate of return, then the AAO request should be rejected.

8 (3) The extraordinary expenses that the utility is seeking to defer must  
9 result from either:

10 (a) an extraordinary capital addition, such as the gas service  
11 line replacement program, that is required to insure the continuation of  
12 safe and adequate service, in which unique conditions preclude recovery  
13 of these costs through a rate case filing, or

14 (b) an extraordinary event that is beyond the control of the  
15 utility's management. Examples of such events include a major flood or  
16 ice storm.

17 (4) There must be a sufficient reason why the utility could not file a  
18 rate case to recover the costs resulting from the extraordinary event.  
19 Alternatively, the utility must file a rate case within 90 days of the AAO approval  
20 to allow for prompt rate treatment of the deferred costs. If the utility intends to  
21 seek rate recovery and defer amortization of the AAO balance until the effective  
22 date of rates for a future rate case, the utility should be required to file a rate case  
23 soon after approval of the AAO. The Commission stated on pages 8 and 9 of its

1 Report and Order in Case No. EO-91-358: "The Commission finds that a time  
2 limitation on deferrals is reasonable since deferrals cannot be allowed to continue  
3 indefinitely. The Commission finds that a rate case must be filed within a  
4 reasonable time after the deferral period for recovery of the deferral to be  
5 considered." It is the Staff's position that if the impact of an extraordinary event  
6 is so significant as to require rate recovery, then the only logical justification for  
7 delaying the filing of the rate case would be that the extraordinary event is  
8 ongoing, such as a gas service line replacement program. Normal construction  
9 projects should not be afforded special AAO deferral treatment.

10 (Please note that these criteria apply only to AAOs for which any amortization of  
11 deferred amounts is to be delayed until the effective date of rates for a future rate case. A  
12 delay in amortizing deferrals is consistent with MAWC's position in this case, as stated  
13 in the direct testimony of Company witness Grubb, pages 4-5.)

14 Q. Please summarize why the Staff believes the AAO that MAWC has  
15 requested does not meet its recommended AAO criteria.

16 A. The AAO requested by MAWC does not meet the Staff's recommended  
17 AAO criteria for the following reasons:

- 18 • The event (the terrorist attacks of September 11, 2001) should not  
19 be considered extraordinary from the perspective of MAWC. The  
20 capital costs and expense deferrals requested result from decisions  
21 made by management to upgrade facility security. The costs to be  
22 deferred under the proposed AAO are entirely under the control of  
23 management, as regards the amount and timing of the

1 expenditures. Capital costs for upgrades to facilities are typical  
2 costs recovered by utilities in rate case proceedings. The ongoing  
3 expenses to implement the upgrades to security, which make up  
4 the other component of the AAO deferrals, also are typical costs of  
5 service that are reflected in rates.

6 • \*\*

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- 10 • There is no reason that the costs proposed to be deferred under the  
11 proposed AAO cannot be recovered through a normal rate case  
12 filing.

13 **WHY MAWC'S PROPOSED AAO SHOULD BE REJECTED**

14 **Security Costs Are Not Extraordinary**

15 Q. Does the September 11, 2001 terrorist attack represent an extraordinary  
16 event, from MAWC's perspective that meets the AAO criteria set by the Commission?

17 A. No. While no one could disagree that the event of September 11, 2001 was  
18 a tragic event for our country, which led to great loss of life and property, that alone does  
19 not make the event an extraordinary item for MAWC.

20 Q. Are security costs associated with utility operations extraordinary?

21 A. No. Security costs are standard expenses that are generally included in a  
22 utility's cost of service. An increase in security costs related to the September 11, 2001  
23 attack is not inherently extraordinary. By definition, extraordinary costs should be

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1 eligible for deferral because they are not normally provided for in rates, and because they  
2 are nonrecurring. Security costs are recurring. MAWC was incurring security related  
3 expenditures prior to September 11. Changes in the level of security-related costs  
4 between rate filings are no different in concept than changes in the level of salary  
5 expense or maintenance expense.

6 The security improvement measures adopted by MAWC since  
7 September 11 represent business decisions that will be largely recurring and ongoing in  
8 nature.

9 Q. Have any of the federal or state agencies that MAWC listed in the direct  
10 testimony of Mr. Kartmann mandated changes to the level of security at MAWC  
11 facilities?

12 A. No. The determination of changes to upgrade security at MAWC facilities  
13 has been made by MAWC management alone. The amounts and timing of the  
14 expenditures have been the decision of management, and not mandated by the  
15 Commission or any other governmental or regulatory entity.

16 Q. Has the issue of the September 11, 2001 attack been addressed by the  
17 accounting profession?

18 A. Yes. The Emerging Issues Task Force (EITF) of the Financial Accounting  
19 Standards Board has discussed the appropriate disclosure of the event of September 11,  
20 2001 for financial reporting purposes. The EITF acknowledged the fact that many  
21 companies directly impacted by the September 11 events may require accounting  
22 recognition in financial statements of those events for the period ended September 30,  
23 2001. EITF Abstracts Issue No. 01-10, page 1392, states:

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1 Task Force members expressed mixed views about whether losses  
2 and costs incurred as a result of the September 11 events meet the  
3 Opinion 30 (APB) criteria to be classified as an extraordinary item  
4 in the statement of operations. Some Task Force members  
5 expressed the view that none of the losses and costs incurred as a  
6 result of the September 11 events meet those criteria. Those Task  
7 Force members suggested that although the September 11 events  
8 were unusual in nature (as described in paragraph 21 of  
9 Opinion 30) for many businesses, those events did not meet the  
10 infrequency of occurrence criterion (in paragraph 22 of  
11 Opinion 30). Those Task Force members noted that terrorist acts  
12 have occurred in the United States in the past and believe that,  
13 unfortunately, they can reasonably be expected to recur in the  
14 United States in the foreseeable future...The Task Force agreed  
15 that despite the incredible nature of the September 11 events,  
16 extraordinary item financial reporting treatment would not be an  
17 effective way to communicate the financial effects of those events  
18 and, therefore, should not be used in this case.

19 I have included a copy of the EITF Abstract, Issue No. 01-10 as Schedule

20 JEF-2 attached to my rebuttal testimony.

21 Q. Why is the Staff raising here the matter of the designation of  
22 September 11 costs by financial accounting authorities as non-extraordinary?

23 A. The Staff is not addressing this matter because it believes the Commission  
24 must or should accept the decisions made by financial accounting authorities in this area  
25 or in other matters as binding on its deliberations in any way. However, the Staff  
26 believes it is interesting that, while MAWC is claiming extraordinary status for  
27 expenditures that it has made in response to the September 11 events, financial  
28 accounting authorities have denied extraordinary status to costs incurred by entities that  
29 were directly damaged and that suffered losses due to those events.

30 Q. Is the AAO an attempt by MAWC to reduce regulatory lag and remove the  
31 risk of under-recovering the total costs of the security upgrades from ratepayers?

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1           A.     Yes. MAWC's parent company, American Water Works Company, Inc.  
2 (AWWC) summarized its position regarding the recovery of security costs in its  
3 September 30, 2001, 10-Q report, Note 6-Security Issues, to the Securities Exchange  
4 Commission:

5                     In the aftermath of the tragic events of September 11, 2001, all  
6 aspects of how the Company secures its facilities in order to  
7 protect the safety of its customers and associates are being  
8 reviewed and additional security measures are being implemented.  
9 It is anticipated that these additional measures will result in a  
10 significant increase in spending on security.

11                     The regulated utility subsidiaries are seeking recognition of these  
12 increased security costs in the rates charged for utility service. At  
13 this time the Company plans to defer these additional costs because  
14 it believes that it is probable that they will be recovered in rates,  
15 and therefore expects no significant impact on the Company's  
16 financial position or results of operations.  
17

18                     AWWC used this note to its quarterly financial statements to reassure  
19 shareholders that there would be no adverse financial impact resulting from the additional  
20 security costs. All costs for additional security are expected to be recovered in rates from  
21 ratepayers. The AAO would allow MAWC to defer all costs associated with the security  
22 upgrade, thus removing the expense and the financial impact of the costs from the income  
23 statement.

24 **Proposed Security Upgrade Costs Are Not Material**

25           Q.     Do MAWC's estimated security-related costs meet the Staff's materiality  
26 criteria in this filing?

27           A.     \*\* \_\_\_\_\_  
28 \_\_\_\_\_  
29 \_\_\_\_\_  
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Q. Does the Company's net income for calendar year 2001 reflect the impact  
of enhanced security measures after the September 11 attack?

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A. No, because MAWC has been deferring such costs on its books since it  
began incurring the additional costs late in 2001.

7

8

Q. Has the Staff reviewed MAWC witness Grubb's workpapers to see if they  
support his response, on page 7 of his direct testimony, that the \*\*

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\*\*\*?

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A. Yes. MAWC's response to Staff Data Request No. 16 provided the  
information for the Staff to determine the validity of MAWC's materiality analysis.  
Based on these workpapers, the Staff believes MAWC's materiality analysis is flawed.

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Q. Please explain why.

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1 Q. Has the Staff performed its own analysis of the materiality of the security-  
2 related costs?

3 A. Yes. \*\* \_\_\_\_\_

4 \_\_\_\_\_ \*\* The Staff believes its analysis uses the same  
5 methodology as was used by St. Louis County Water Company to calculate its previous  
6 infrastructure AAO deferrals.

7 Q. Please explain how the Staff performed its analysis.

8 A. The Staff's analysis of materiality is attached hereto as Highly  
9 Confidential Schedule JEF-3. MAWC provided in response to Staff Data Request No. 4  
10 the actual and estimated timing by month for additions of security-related plant. The  
11 Staff's analysis incorporated these estimated in-service dates in its analysis. Because the  
12 Staff does not have the actual and estimated dates when MAWC will incur security-  
13 related expenses, the Staff assumed an "even" incurrence of non-capital expenses over a  
14 twelve-month period \*\* \_\_\_\_\_ \*\*. The carrying costs  
15 were calculated using the latest MAWC AFUDC rate, as provided in response to Staff  
16 Data Request No. 5. The depreciation rate for each division of MAWC was weighted to  
17 determine the composite rate for each entity's security-related additions.

18 The Staff's analysis properly reduces the amount of deferred carrying  
19 costs to account for the simultaneous deferral of depreciation expense on the capitalized  
20 plant assets. The deferral balance is also reduced to account for benefits MAWC receives  
21 in the form of deferred taxes from any capitalization of security-related costs. To be  
22 consistent with the concept of deferring carrying costs on plant assets, the deferral is also  
23 reduced to recognize the "time value" of the deferred tax benefit MAWC enjoys as a

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1 result of the deferral. The Staff's analysis has estimated the total deferral to be

2 \*\* \_\_\_\_\_ \*\*.

3 Q. Why does the Staff's materiality analysis cover the period September 2001  
4 to August 2002?

5 A. This is the most recent twelve-month period following the alleged  
6 extraordinary event, occurring September 11. Any detrimental impact of the  
7 September 11 events on MAWC's earnings that could not be reasonably mitigated by a  
8 prompt rate case filing would be reflected in the earnings impact in the first year  
9 following the event.

10 Q. Is the Staff recommending that its methodology in determining the AAO  
11 deferral be ordered by the Commission?

12 A. Yes. If the AAO is approved, MAWC should be ordered to calculate the  
13 deferral using the method advocated by the Staff.

14 **The Costs Could be Recovered in an Ordinary Rate Case**

15 Q. Has the Commission denied AAO requests when companies have had  
16 opportunities to file a rate case to recover the costs, rather than deferring the costs?

17 A. Yes. The Commission's Report and Order in Case No. EO-2000-845,  
18 St. Joseph Light and Power Company, stated:

19 However, the simple fact that an expense is extraordinary and  
20 nonrecurring is not enough to justify the deferral of that expense.  
21 Implicit in the Commission's previous orders regarding requests  
22 for AAOs is a requirement that there must be some reason why the  
23 expense to be deferred could not be immediately included for  
24 recovery in a rate case. [Emphasis added.]

**NP**

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1 Q. Does the Staff know of any reason why MAWC cannot file a rate case at  
2 this time, or \*\* \_\_\_\_\_

3 \_\_\_\_\_ \*\*?

4 A. No. The Staff knows of no reason why MAWC cannot file a rate case in  
5 this time frame. MAWC witness Grubb, on page 5 of his direct testimony, states that  
6 MAWC tentatively plans to file its next rate case in June 2003.

7 The Staff would propose that if the costs associated with MAWC's  
8 security upgrades are significant enough to justify an AAO request, then a rate case  
9 should be filed, so prompt recovery of these costs can be sought.

10 Q. If the Commission wishes to continue the precedent it established in Case  
11 No. EO-2000-845 of not allowing deferrals when utilities cannot justify their failure to  
12 seek rate relief for the extraordinary item, what decision should it make in this  
13 proceeding?

14 A. The Commission should deny MAWC's AAO request.

15 Q. By its position in this proceeding, does the Staff intend to in any way  
16 criticize MAWC's responses to the September 11 event?

17 A. No. A detailed review of MAWC's actions in response to the  
18 September 11 events will be performed when MAWC seeks rate recovery of the costs  
19 associated with its actions. In general, the Staff believes that it is prudent for both  
20 regulated and non-regulated businesses to seriously consider the adequacy of their  
21 security measures in light of the September 11 attacks, and enhance those measures as  
22 appropriate. However, even if increases in costs of this kind are shown to be well  
23 justified and prudent, that does not necessarily make them extraordinary in nature.

1           On pages 5-6 of his direct testimony, MAWC witness Grubb requests  
2 approval of language that would, in effect, have the Commission decide ratemaking  
3 issues in this proceeding. Mr. Grubb attempts to justify this approach by stating,  
4 "MAWC was hoping that the Commission would use this opportunity to express its  
5 support for public security efforts...". The Staff believes AAOs should not be issued for  
6 purposes of establishing "support" for certain initiatives. Instead, the Commission should  
7 focus on whether the costs for which deferral is sought are extraordinary, and whether  
8 certain other fundamental conditions for use of the extraordinary mechanism of an AAO  
9 are present, before issuing an AAO.

10   **EXAMPLES OF AAOS MEETING COMMISSION REQUIREMENTS**

11           Q.     Can the Staff identify contrasts between the AAO being requested by  
12 MAWC and earlier Commission-approved AAOs?

13           A.     Yes. The Staff will provide examples of two types of Commission-  
14 approved AAOs that meet the criteria for extraordinary expense, thereby identifying the  
15 deficiencies of MAWC's request for an AAO.

16           The first example concerns AAOs that were issued to allow deferral of gas  
17 service line replacement capital related costs. The Commission required that gas utilities  
18 replace service lines because of safety concerns related to natural gas explosions  
19 occurring on natural gas distribution systems. The AAOs related specifically to gas line  
20 replacements that were mandated by order of the Commission. The implementation and  
21 completion of the replacement program is ongoing. The replacement program was  
22 expected to be completed over a ten-year time period, though certain gas utilities have  
23 requested and received additional time to implement the replacement program. Since the

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1 Commission mandated the costs associated with the replacement program, it is  
2 appropriate for these costs to be deferred for recovery from customers.

3 In contrast, the changes in MAWC's security operations, however, are the  
4 direct result of management decisions. Neither the Commission nor any other state or  
5 federal agency has required the security measures that MAWC has implemented. While  
6 MAWC has received suggestions and guidance for enhancing its security operations, the  
7 choice of which suggestions to follow is a management decision of MAWC.

8 \*\*

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10  
11  
12  
13  
14 \*\* In contrast, the gas service line replacement program was planned to take ten  
15 or more years, as discussed earlier.

16 The second example of the type of AAOs that meet the Commission's  
17 criteria pertains to natural disasters such as ice storms or floods (sometimes referred to as  
18 "acts of God"). When these situations occur, the utility providing service has no choice  
19 but to incur the costs to restore safe and adequate service quickly. Costs to repair  
20 extraordinary outages are not normally included in setting rates. The utility must very  
21 quickly determine how best to implement restoration of service. The prudence of its  
22 business practices and its management decisions in this regard are subject to review and  
23 audit in the next rate case.

NP

**\*\***

control of all decisions related to additional security expenditures. The Staff does not believe the situation faced by MAWC and other utilities after September 11 is analogous to the situation faced by utilities impacted by "acts of God".

## SUMMARY AND CONCLUSION

Q. Please summarize the Staff's recommendation regarding MAWC's request for AAO deferral treatment in this case.

A. The Staff is recommending that the Commission modify its policy regarding the approval of AAO deferral treatment, to incorporate the following criteria:

(1) The event must be extraordinary and material. The amount to be deferred must be at least 5% of the utility's regulated Missouri net income for a recent twelve-month period not reflecting the impact of the event.

(2) The utility's existing rates must be inadequate to cover the event.

(3) The extraordinary costs must be related to either:

(a) an extraordinary capital project, such as a gas service line replacement program, that is required to insure the continuation of safe

1 and adequate service and that, because of unique circumstances, cannot be  
2 recovered in a normal rate case filing, or

3 (b) an extraordinary event that is beyond the control of  
4 management. Examples would include a major flood or ice storm.

5 (4) The utility must show sufficient reason why it cannot recover the  
6 costs through the normal rate case process. Alternatively, the utility must file a  
7 rate case within 90 days of the AAO approval.

8 With regard to MAWC's request in this case, the Staff is recommending  
9 that the AAO request be denied because MAWC did not experience an extraordinary  
10 event. This AAO request does not meet the criteria established by the Commission of an  
11 extraordinary event.

12 \*\*

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13  
14 \*\* Also, MAWC has not presented  
15 the Commission with any explanation of why it would not file a rate case to recover  
16 additional security-related costs, in lieu of seeking an AAO.

17 Q. Does the Staff have any recommendations for the Commission if it  
18 chooses to approve MAWC's requested AAO?

19 A. Yes. If the Commission decides to approve the AAO request, the Staff  
20 would recommend it impose the following conditions:

21 (1) that no ratemaking findings be included in the approval.

22 Determination of the prudence of the expenditures and the decisions to allow  
23 return on and/or return of the capital expenditures' carrying costs should be

Rebuttal Testimony of  
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1           postponed until MAWC's next rate case. Also, a decision regarding the length of  
2           any amortization period ordered for recovery of any deferral is a rate decision that  
3           should not be made outside of a rate proceeding.

4                   (2)     that MAWC be required to file a rate case within 90 days of the  
5           issuance of the AAO. In the event such a rate case is not filed, MAWC should be  
6           required to end the deferral and write-off to expense any amounts deferred to that  
7           point.

8           Q.     Does this conclude your rebuttal testimony?

9           A.     Yes, it does.

**BEFORE THE PUBLIC SERVICE COMMISSION**

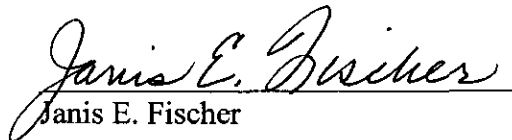
**OF THE STATE OF MISSOURI**

In the Matter of the Joint Application of )  
Missouri-American Water Company, St. Louis County )  
Water Company d/b/a Missouri-American Water )  
Company and Jefferson City Water Works Company ) Case No. WO-2002-273  
d/b/a Missouri-American Water Company )  
For an Accounting Authority Order Relating to )  
Security Costs )

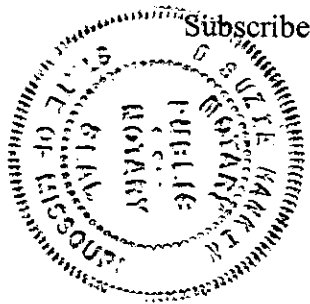
**AFFIDAVIT OF JANIS E. FISCHER**

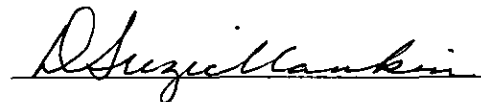
STATE OF MISSOURI )  
 ) ss.  
COUNTY OF COLE )

Janis E. Fischer, being of lawful age, on her oath states: that she has participated in the preparation of the foregoing Rebuttal Testimony in question and answer form, consisting of 25 pages to be presented in the above case; that the answers in the foregoing Rebuttal Testimony were given by her; that she has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of her knowledge and belief.

  
Janis E. Fischer

Subscribed and sworn to before me this 9<sup>th</sup> day of April 2002.





**D SUZIE MANKIN  
NOTARY PUBLIC STATE OF MISSOURI  
COLE COUNTY  
MY COMMISSION EXP. JUNE 21, 2004**

**SUMMARY OF RATE CASE TESTIMONY FILED**

**Janis E. Fischer**

<b><u>COMPANY</u></b>	<b><u>CASE NO.</u></b>
Empire District Electric Company	ER-97-81
Union Electric Company (AmerenUE)	GR-97-393
Osage Water Company	WA-98-236/ WC-98-211
Western Resources/Kansas City Power & Light Company	EM-97-515
UtiliCorp United, Inc./St. Joseph Light & Power Company	EM-2000-292
UtiliCorp United, Inc./Empire District Electric Company	EM-2000-369
KLM Telephone Company	TT-2001-120
Empire District Electric Company	ER-2001-299
Missouri Gas Energy, Division of Southern Union Company	GR-2002-292
Missouri Public Service, Division of UtiliCorp United, Inc.	ER-2001-672/ EC-2002-265

# EITF Abstracts

Issue No. 01-10

**Title:** Accounting for the Impact of the Terrorist Attacks of September 11, 2001

**Dates Discussed:** September 20 and 28, 2001; November 14–15, 2001

**References:** FASB Statement No. 5, *Accounting for Contingencies*  
FASB Statement No. 13, *Accounting for Leases*  
FASB Statement No. 43, *Accounting for Compensated Absences*  
FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*  
FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits*  
FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*  
FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*  
FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*  
FASB Statement No. 142, *Goodwill and Other Intangible Assets*  
FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*  
FASB Interpretation No. 30, *Accounting for Involuntary Conversions of Nonmonetary Assets to Monetary Assets*  
FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*  
FASB Concepts Statement No. 6, *Elements of Financial Statements*  
APB Opinion No. 17, *Intangible Assets*  
APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*  
APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*  
AICPA Statement of Position No. 94-6, *Disclosure of Certain Significant Risks and Uncertainties*  
AICPA Statement of Position No. 96-1, *Environmental Remediation Liabilities*  
AICPA Accounting Interpretation No. 1, *Illustration of the Application of APB Opinion No. 30*

SEC Staff Accounting Bulletin No. 67, *Income Statement Presentation of Restructuring Charges*

SEC Staff Accounting Bulletin No. 100, *Restructuring and Impairment Charges*

## ISSUE

1. The terrorist attacks of September 11, 2001 (the September 11 events), resulted in a tremendous loss of life and property. Secondly, those events interrupted the business activities of many entities and disrupted the U.S. economy at many levels. In the past, businesses have incurred losses as a result of catastrophes such as earthquakes, hurricanes, and even other terrorist attacks. However, the September 11 events were unprecedented in the United States in terms of the magnitude of the losses incurred and the number of entities affected. In fact, as a direct result of the September 11 events, the U.S. Secretary of Transportation issued a federal ground stop order that closed the U.S. air travel system for over 24 hours. The Task Force noted that for many companies the effects of the September 11 events may require accounting recognition in financial statements for the period ended September 30, 2001. Because the importance of the accounting for the impact of those events pales in comparison to the gravity of the events themselves, the Task Force was initially reluctant to address this Issue. However, the Task Force observed that timely accounting guidance would help companies in capturing data, planning how to communicate with investors, and so forth. The Task Force also noted that without such guidance, financial statement preparers and auditors would be faced with individually resolving the difficult questions in this Issue. Accordingly, the Task Force concluded that it should expeditiously address and resolve this Issue.

2. The Air Transportation Safety and System Stabilization Act (the Act) was enacted prior to September 30, 2001, in direct response to the September 11 events and the disruption caused by them. The Act provides for the following:

- a. Compensation to air carriers and victims for direct and incremental losses incurred resulting from the September 11 events
- b. U.S. government loan guarantees provided to air carriers
- c. Reimbursement of increases in certain insurance premiums incurred by air carriers and certain other entities
- d. Limitations on liabilities incurred or to be incurred by air carriers as a result of the September 11 events.

The Act compensates air carriers for direct and incremental losses incurred during the period from September 11, 2001 to December 31, 2001. Each air carrier is entitled to receive the *lesser of* its direct and incremental losses for the period *or* its allocation of

the aggregate compensation available under the Act. The Act does not specifically define the terms *direct* or *incremental*, but states that “the term ‘incremental loss’ does not include any loss that the President determines would have been incurred if the terrorist attacks on the United States . . . had not occurred” (Section 107(3)). Initial estimates of an air carrier’s losses as a result of the September 11 events are determined by comparing the air carrier’s earnings forecast for the period from September 11, 2001, to December 31, 2001 (computed prior to the September 11 events), with its earnings forecast for the same period computed after the September 11 events.

3. This Issue provides accounting and disclosure guidance for losses and costs incurred as a result of the September 11 events, and for related insurance recoveries and federal assistance provided to air carriers in the form of direct compensation under the Act.

4. The issues are:

Issue 1—How losses and costs incurred as a result of the September 11 events should be classified in the statement of operations

Issue 2(a)—When asset impairment losses incurred as a result of the September 11 events should be recognized

Issue 2(b)—When liabilities for other losses and costs incurred as a result of the September 11 events should be recognized

Issue 3—How insurance recoveries of losses and costs incurred as the result of the September 11 events should be classified in the statement of operations and when those recoveries should be recognized

Issue 4—How federal assistance provided to air carriers in the form of direct compensation under the Act should be classified in the statement of operations and when that assistance should be recognized

Issue 5—What disclosures should be made in the notes to the financial statements regarding the losses and costs incurred as a result of the September 11 events, and related insurance or other recoveries.

## **EITF DISCUSSION**

5. The Task Force observed that the consensuses reached on this Issue with regard to the classification of losses and costs incurred and related insurance or other recoveries are limited to the September 11 events *and should not be applied by analogy in other*

cases. The Task Force observed that the income statement classification of other catastrophic losses incurred, whether as a result of terrorist attacks or other causes, should be determined after careful consideration of all facts and circumstances and the requirements of Opinion 30. In addition, while the remainder of this Issue prescribes classification in the statement of operations within *continuing* operations (as opposed to extraordinary classification), that guidance should not be interpreted to preclude classification of costs, losses, and related recoveries in *discontinued* operations when the requirements of Opinion 30, paragraphs 13–17, are met.

6. On Issue 1, the Task Force reached a consensus that losses and costs incurred as a result of the September 11 events should be classified as part of income from continuing operations in the statement of operations. The Task Force observed that if those losses and costs meet the criteria for disclosure of unusual or infrequently occurring items in paragraph 26 of Opinion 30, they should be reported as a separate component of income from continuing operations, either on the face of the statement of operations or in the notes to the financial statements.

7. Task Force members expressed mixed views about whether losses and costs incurred as a result of the September 11 events meet the Opinion 30 criteria to be classified as an extraordinary item in the statement of operations. Some Task Force members expressed the view that *none* of the losses and costs incurred as a result of the September 11 events meet those criteria. Those Task Force members suggested that although the September 11 events were unusual in nature (as described in paragraph 21 of Opinion 30) for many businesses, those events did not meet the infrequency of occurrence criterion (in paragraph 22 of Opinion 30). Those Task Force members noted that terrorist acts have occurred in the United States in the past and believe that, unfortunately, they can reasonably be expected to recur in the United States in the foreseeable future. They believe that the magnitude of the September 11 events is the only distinguishing factor that might cause one to conclude that certain losses and costs incurred as a result of those events should be classified as an extraordinary item in the statement of operations. However, based on the guidance in Opinion 30, the magnitude of an event has no bearing on whether the related losses and costs are classified as an extraordinary item.

8. Other Task Force members expressed the view that the magnitude of the September 11 events is an inseparable aspect of the evaluation of whether those events meet the criteria in Opinion 30 to be classified as an extraordinary item. Those Task Force members cited a number of facts to support their position that the September 11 events not only meet the unusual nature criterion (in paragraph 21 of Opinion 30) but also meet the infrequency of occurrence criterion (in paragraph 22 of Opinion 30). Those facts include (a) the magnitude of the losses incurred, (b) the number of entities affected, (c) the unprecedented federal ground stop order that closed the U.S. air travel system for over 24 hours, and (d) the unprecedented cooperative efforts being undertaken by the

United States and other nations to prevent future terrorist attacks. As a result of the foregoing considerations, those Task Force members believe that the September 11 events are of a type not reasonably expected to recur in the foreseeable future and that at least *some* of the losses and costs incurred as a result of those events qualify for classification as an extraordinary item in the statement of operations.

9. Opinion 30 provides for separate classification of the impact of certain events as extraordinary because the events are so unusual and infrequent that the statement of operations is more meaningful when the complete impact of those events is *distinguished* from the rest of the activity reflected in the statement of operations. The Task Force concluded that regardless of whether the September 11 events meet the criteria in Opinion 30 to be considered extraordinary, the effects of those events were so wide-ranging and had such a pervasive impact on U.S. businesses and the U.S. economy that the foregoing communication objectives of Opinion 30 with respect to extraordinary items could not be met. The Task Force agreed that despite the incredible nature of the September 11 events, extraordinary item financial reporting treatment would not be an effective way to communicate the financial effects of those events and, therefore, should not be used in this case. The Task Force noted that it would be impossible to isolate and therefore distinguish (in a consistent way) the effects of the September 11 events in any single line item on companies' financial statements because of the inability to separate losses that are directly attributable to the September 11 events from those that are not. For example, impairment of long-lived assets as a result of the September 11 events would in many cases be impossible to measure separately from impairment due to the general economic slowdown that was generally acknowledged to be under way. (The September 11 events probably contributed to the speed and depth of that economic slowdown, but determining the portion of the slowdown directly attributable to the September 11 events would be extremely subjective and difficult, if not impossible.) In addition, the Task Force observed that the most significant financial statement impact of the September 11 events to many companies might be lost or reduced revenues. The measurement of an extraordinary item under Opinion 30 does not reflect any estimate of lost or reduced revenues.

10. The Task Force noted that its primary objective in addressing this Issue was to provide financial statement users with decision-useful information about the financial effects of the September 11 events by providing preparers and auditors with operational guidance that would be straightforward and consistently applied. The Task Force observed that it might have been possible to create operational guidance by limiting the losses and costs classified as extraordinary to those that clearly meet the Opinion 30 criteria for extraordinary classification (that is, those that could be clearly measured and irrefutably attributed to the September 11 events). However, the Task Force agreed that investors and financial statement users would not be well served by separately reporting only that part of the effects of the September 11 events as an extraordinary item. Under

that approach, a possibly significant portion of the impact of the September 11 events would have been classified within income from continuing operations. That is, the amount presented as an extraordinary item would, in many cases, have been only a small part of the total financial statement impact of the September 11 events. The Task Force noted that financial statement users are interested in understanding the full economic impact of the September 11 events on each company and concluded that financial statement users would be better served by not separating a part of that impact and reporting it in a separate line item outside of income from continuing operations. That approach also is consistent with the broader objective of providing financial reports that communicate effectively and clearly.

11. On Issue 2(a), the Task Force observed that Appendix B of Statement 121 includes a table listing the existing FASB and APB authoritative literature that, in addition to Statement 142, provides guidance relating to impairment of assets and disposal of assets. The Task Force agreed that the guidance in that literature should be used to determine when an asset impairment loss incurred as a result of the September 11 events should be recognized and how that impairment loss should be measured.

12. On Issue 2(b), the Task Force reached a consensus that liabilities for other losses and costs incurred as a result of the September 11 events should be recognized when the recognition criteria in paragraph 63 of Concepts Statement 5 have been met. That is, those liabilities should be recognized when:

- a. The item meets the definition of a liability. Paragraph 35 of Concepts Statement 6 defines liabilities as "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events" (footnote references omitted).
- b. The liability can be measured with sufficient reliability.
- c. The information about the liability is capable of making a difference in user decisions.
- d. The information about the liability is representationally faithful, verifiable, and neutral.

The Task Force further observed that the provisions of Statement 5 and other applicable literature (including Interpretation 14) should be followed in determining when to recognize losses and costs incurred. The Task Force noted that under that literature, many of the losses and costs that entities expect to incur as a result of the September 11 events will not qualify for immediate recognition as a liability. For example, the costs of restoring a facility (whether capitalizable or not) to a condition suitable for occupancy should be recognized as the restoration efforts occur. Thus, the fact that an entity intends to incur costs as a result of the September 11 events (or may even be compelled to incur those costs to stay in business) does not necessarily mean that those costs should be immediately recognized as a liability. The examples in Exhibit 01-10A provide additional guidance on when to recognize losses and costs incurred.

13. The Task Force observed that an entity may be required to continue making operating lease payments on equipment or facilities that are temporarily unusable<sup>1</sup> as a result of the September 11 events. The Task Force reached a consensus that under the requirements of Statement 5 (and Interpretation 14), an entity should recognize a liability as of September 11 for operating lease rentals on temporarily unusable equipment or facilities provided that the period of time that the equipment or facilities will be unusable can be reasonably estimated.

14. The Task Force also noted that as a result of the September 11 events, an entity may temporarily idle equipment or facilities that are *not* unusable. The Task Force reached a consensus that operating lease expense (if any) on temporarily idled equipment or facilities should be recognized in accordance with paragraph 15 of Statement 13 and related guidance during the period the equipment or facilities are idled. That is, no change in the recognition principles for operating rentals on such equipment or facilities is appropriate even though they have been temporarily idled.

15. The Task Force noted that the foregoing consensuses described above in paragraphs 13 and 14, respectively, with respect to recognition of operating lease expenses on temporarily unusable and temporarily idled equipment or facilities are subject to further consideration in Issue No. 99-14, "Recognition by a Purchaser of Losses on Firmly Committed Executory Contracts," and that it will not be constrained in that Issue by the consensuses reached in this Issue. The Task Force also observed that entities should continue to recognize depreciation expense on capitalized equipment or facilities that are temporarily unusable or temporarily idled. That is, no change in the recognition principles for depreciation of equipment or facilities is appropriate even if they are temporarily unusable or temporarily idled.

16. On Issue 3, the Task Force noted that in accordance with the guidance in paragraph 4 of Interpretation 30, any insurance recoveries of losses and costs incurred as a result of the September 11 events should be classified in a manner consistent with the related losses (that is, within income from continuing operations). With respect to the timing of recognition of those insurance recoveries, the Task Force reached a consensus that entities should follow the guidance in paragraph 3 of Interpretation 30 (for recoveries in connection with property and casualty losses) or paragraphs 140 and 141 of SOP 96-1 (for recoveries in connection with environmental obligations), as applicable. That guidance generally requires that an asset relating to the insurance recovery should be recognized only when realization of the claim for recovery of a loss recog-

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<sup>1</sup> *Unusable* refers to facilities or equipment that cannot be used due to physical damage or constraints imposed by government or other authoritative bodies. *Unusable*, in this context, does not refer to an asset that is idle due to a reduction in demand for goods or services.

nized in the financial statements is deemed *probable*<sup>2</sup> (as that term is used in Statement 5). In addition, under the requirements of paragraph 17 of Statement 5, a gain (that is, a recovery of a loss not yet recognized in the financial statements or an amount recovered in excess of a loss recognized in the financial statements) should not be recognized until any contingencies relating to the insurance claim have been resolved (see Examples 7 and 8 in Exhibit 01-10A for further guidance regarding recognition of insurance recoveries). The Task Force observed that in some circumstances, losses and costs may be recognized in the statement of operations in a different (earlier) period than the related recovery.

17. On Issue 4, the Task Force reached a consensus that federal assistance provided to air carriers in the form of direct compensation under the Act should be classified as part of income from continuing operations in the statement of operations. Further, the Task Force reached a consensus that when recognized in the statement of operations, such federal assistance should not be netted against losses and costs incurred by air carriers as a result of the September 11 events or reported as operating revenue (and thereby included in gross margin). That is, federal assistance provided to air carriers under the Act should be reported on a "gross" basis in air carriers' statements of operations; for example, as a separate line-item credit in operating expenses (other than cost of sales) or in other nonoperating income (such amounts may not be netted against any nonoperating expenses). With respect to the timing of recognition, the Task Force reached a consensus that federal assistance in the form of direct compensation provided under the Act should be recognized by air carriers when the compensated losses are incurred, provided that collection of (and the air carrier's right to retain) the federal assistance is probable (as that term is used in Statement 5). The Task Force noted that because the Act does not define direct and incremental losses, the question of *which* losses are eligible for compensation, and therefore the amount of federal assistance recognized as of any given date, depends on the facts and circumstances and how the Act is interpreted. The Task Force further noted that in any case, the amount of compensation recognized by an air carrier should not exceed the lesser of its actual direct and incremental losses incurred or its maximum allocation of the aggregate compensation under the Act.

18. On Issue 5, the Task Force reached a consensus that entities should follow the guidance set forth in paragraph 26 of Opinion 30 pertaining to presentation and disclosure of unusual or infrequently occurring items, if applicable. Additionally, all entities should, at a minimum, disclose the following information in the notes to the financial statements in all periods affected by the September 11 events:

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<sup>2</sup>In accordance with paragraph 140 of SOP 96-1, if the claim is the subject of litigation, a rebuttable presumption exists that realization of the claim is not probable.

- a. A description of the nature and amounts of losses and costs recognized as a result of the September 11 events and the amount of related insurance recoveries (if any) recognized
- b. A description of contingencies resulting from the September 11 events that have not yet been recognized in the financial statements but that are reasonably expected to impact the entity's financial statements in the near term<sup>3</sup> (for example, future losses or future insurance recoveries)
- c. Applicable disclosures pursuant to SOP 94-6
- d. Applicable disclosures about environmental obligations (and recoveries) pursuant to SOP 96-1.

The Task Force observed that the above disclosure requirements are intended to supplement relevant disclosures required by existing authoritative literature and are important to the transparency of the financial statements because of the pervasive effects of the September 11 events. For example, the disclosures required by Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)," should be made for any restructuring costs that are incurred, including those incurred as a result of the September 11 events. The SEC Observer reminded registrants of the requirements to provide disclosures identified in Item 303 (Management's Discussion and Analysis) of Regulations S-K and S-B. The SEC Observer also reminded registrants of the financial statement schedule requirements of Regulation S-X and the disclosures discussed in SAB 100.

## **STATUS**

- 19. No further EITF discussion is planned.

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<sup>3</sup>The meaning of the term *near term* as used in this Issue is the same as the meaning of that term in SOP 94-6.

**Exhibit 01-10A****EXAMPLES<sup>4</sup>****Example 1—Penalties Paid on Cancellation of Firmly Committed Executory Contracts**

On October 2, 2001, Airline A cancels a purchase order (issued prior to September 11, 2001) submitted under a firmly committed executory contract with an airplane manufacturer. Airline A's management attributes the cancellation to the events of September 11, 2001, and the resulting decrease in passenger traffic. In accordance with the terms of that executory contract, Airline A is required to pay a cancellation penalty of \$100,000 to the supplier.

**Evaluation**

Airline A should recognize a liability for the penalty as of October 2, 2001 (the date of cancellation), rather than as of September 11.

**Example 2—Operating Lease Payments on Temporarily Idled Equipment**

ABC Company leases certain production equipment under noncancellable operating leases. As a result of the decline in demand for ABC's product, which management of ABC attributes to the events of September 11, 2001, the production equipment is temporarily idled. ABC must continue making its operating lease payments during the period that the equipment is idled and anticipates using the equipment again once demand for its product approximates the levels experienced prior to September 11, 2001.

**Evaluation**

ABC should not accrue a liability at the date the equipment is idled. Instead, operating lease expense should continue to be recognized in accordance with paragraph 15 of Statement 13 and related interpretive guidance.

**Example 3—Operating Lease Payments on Temporarily Unusable Equipment**

XYZ Company leases certain office equipment under noncancellable operating leases. As a result of the September 11 events, XYZ's office building, which is in close proximity to the disaster site in lower Manhattan, has been temporarily closed by the New York City Government. Therefore, the equipment in the building is unusable. XYZ understands from engineers who have inspected the facilities that the equipment is still

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<sup>4</sup>The examples presented in this exhibit do not address the disclosure requirements of this Issue.

functional and only requires thorough cleaning in order to operate. However, XYZ cannot retrieve any of the equipment because access to the building has been denied by the New York City Government. XYZ must continue to make operating lease payments during the period that the equipment is not in use. The New York City Government has indicated that the building will be reopened no earlier than October 31, 2001, and may be closed for an even longer period of time.

**Evaluation**

XYZ should recognize a liability as of September 11, 2001, for its operating lease payments on the unusable office equipment provided that XYZ can reasonably estimate the period of time that the equipment will be unusable. In this case, XYZ should recognize a liability for its operating lease rentals through October 31, 2001 (the minimum period of time that the building will be closed and the equipment will be unusable). If, on the other hand, XYZ is unable to determine even a minimum period of time that the building will be closed, then XYZ would not recognize a liability for future operating lease payments because the period of time during which the equipment is unusable could not be reasonably estimated. This evaluation is also applicable for operating lease payments on temporarily unusable facilities.

**Example 4—Payments of Salaries and Employee Benefits While Operations Are Temporarily Suspended**

As a result of the September 11 events, Company Y's office building has been damaged and closed indefinitely as unusable. Computers, documents, and so forth are in the building and are not retrievable at the present time due to restrictions imposed by the New York City Government. As a result, 200 of Company Y's 500 employees are idle (that is, they are not even able to work from home) until documents and computers can be retrieved and alternative office space is located, which is expected to take at least 30 days. The remaining 300 employees of Company Y are able to work from alternative satellite office space or from their homes. Company Y agrees to pay all of its employees (including those who are idle) and not charge their vacation time for any down time they experience.

**Evaluation**

Company Y should recognize a liability for the salaries of the 200 idled employees if the criteria in paragraph 6 of Statement 43 are met. Otherwise, the salaries for all employees should be expensed as incurred. (Note: This guidance applies to both temporary absences due to unusable facilities and other compensated absences.)

**Example 5—Direct Compensation Received under the Air Transportation Safety and System Stabilization Act**

DEF Air Carrier forecasts that it will incur direct and incremental losses as stipulated under the Act for the period from September 11, 2001, to December 31, 2001, of \$100 million. DEF's maximum allocation of the aggregate compensation available under the Act is \$75 million, and its actual reimbursable losses for the period from September 11, 2001, to September 30, 2001, are \$50 million.

**Evaluation**

DEF should recognize direct compensation of \$50 million under the Act for the period ended September 30, 2001, provided collection of (and DEF's right to retain) the compensation is probable. However, if DEF's maximum allocation of the aggregate compensation available under the Act was \$45 million rather than \$75 million, the amount of direct compensation recognized for the period ended September 30, 2001, would be limited to \$45 million.

**Example 6—Employee Severance**

As a direct result of the September 11 events, a significant decline in the volume of air travel is expected for the foreseeable future. As a result, Airline X decides to reduce its workforce by 1,000 employees and announces its plan to lay off those employees. The severance plan meets all other applicable criteria in Issue 94-3 for recognition as a restructuring liability on September 30, 2001. Company A manufactures airplanes. Due to those expectations of reduced air travel, Company A expects a significant reduction in the demand for airplanes and airplane parts for the foreseeable future. As a result, Company A decides to lay off its entire Smalltown production plant workforce of 500 employees and announces its plan to lay off those employees. The severance plan meets all other applicable criteria in Issue 94-3 for recognition as a restructuring liability on October 2, 2001.

**Evaluation**

Airline X and Company A should recognize a liability for the severance costs when the applicable Issue 94-3 criteria are met. (Note: This example assumes that the severance costs are not incurred under an ongoing plan. If those costs were incurred under an ongoing plan, the accounting would be determined in accordance with the provisions of Statement 112.) That is, Airline X should recognize a liability on September 30, 2001, and Company A should recognize a liability on October 2, 2001.

**Example 7—Property and Casualty Insurance Recoveries**

Company Z's equipment was heavily damaged on September 11, 2001. Company Z maintains insurance on the equipment that provides for recovery of its replacement value. The equipment had a net book value of \$1,000 and an estimated replacement value of \$1,500 as of September 11, 2001. Prior to September 30, 2001, Company Z files a claim with its insurer for recovery of \$1,500. Based on its discussions with the insurer, Company Z concludes that it is probable that the insurer will settle the claim for at least \$1,200. However, the insurer has communicated to Company Z that the amount of final settlement is subject to verification of the identity of the equipment damaged and the receipt of additional market data regarding its value.

**Evaluation**

Company Z should recognize a reduction in the net book value of the equipment of \$1,000 and recognize an asset of \$1,000 for the probable recovery of its loss (in book value). Company Z should recognize any remaining recovery (that is, any excess over \$1,000) only when any related contingencies are resolved (for example, when the identity of the damaged equipment has been established and additional market data confirm its value).

**Example 8—Business Interruption Insurance Recoveries**

Company Y owns and operates a retail store in downtown New York City and maintains insurance to cover business interruption losses. The policy provides for Company Y to receive compensation for lost profits in the event of a business interruption. As of September 30, 2001, Company Y has filed a claim with its insurer to recover its estimated lost profit through September 30, 2001. Company Y has not previously filed a claim under its business interruption insurance policy and is uncertain of the final settlement amount (that is, Company Y believes there may be a dispute with regard to the scope of coverage under the policy). The parties have not agreed upon a settlement as of the date that Company Y issues its financial statements for the period ended September 30, 2001.

**Evaluation**

Company Y should not recognize a gain (that is, a recovery of a loss not yet recognized in the financial statements or an amount recovered in excess of a loss recognized in the financial statements) on the insurance recovery as of September 30, 2001, because contingencies with respect to the amount of the recovery remain unresolved. Company Y should recognize a gain when those contingencies are resolved.

**SCHEDULE 3**

**HAS BEEN DEEMED**

**HIGHLY CONFIDENTIAL**

**IN ITS ENTIRETY**