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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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RELEASED

B-114839

MAY 17 1976

Chairman
Committee on Merchant Marine and Fisheries
House of Representatives
Chairman
Subcommittee on the Panama Canal
Committee on Merchant Marine and Fisheries
House of Representatives

AGC 00356
00318

In your letter of February 2, 1976, you asked us to comment on several questions relating to certain accounting and other financial practices of the Panama Canal organization; i.e., the Panama Canal Company and the Canal Zone Government. Your questions and our comments thereon are presented below.

I. Accounting changes in fiscal years 1973 through 1975.

1. What would the impact on fiscal year 1973 through 1975 Canal finances have been if the Canal organization had not made the various accounting changes that were implemented during those years?

The effect of the various accounting changes on the Canal organization's expenses for fiscal year 1973 through 1975 is shown in enclosure I. We estimate that the accounting changes had the effect of increasing the Canal organization's expenses by about $30 million over the 3-year period. Since the Company absorbs the net cost of the Canal Zone Government and the effect of the government's accounting changes is thereby generally reflected in the Company's financial statements, we have consolidated the effects of the various accounting changes for our reply.

It is noted, however, that, although the accounting changes increased expenses by about $30 million over the 3-year period, their impact on the operating losses of the Company was not in the same amount. In computing the increased toll rates which were implemented in fiscal year 1975, the Company included the estimated effect of the various accounting changes. Thus the additional expenses resulting from the changes were recovered, to a certain extent, through the increase in tolls revenue in fiscal year 1975.

2. Does the GAO believe that the Canal organization has revised its accounting practices appropriately to make changes leading to decreased current expenses as well as increased ones?

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In reviewing the various accounting changes of the Canal organization, our objective was to determine whether the changes would improve compliance with generally accepted accounting principles applicable to regulated businesses and the principles and standards of accounting which the Comptroller General prescribes for Federal executive agencies. We concluded that the accounting changes did improve the Canal organization's compliance with the generally accepted and prescribed principles, and we therefore concurred in the changes. Furthermore, the change having the greatest impact on the Canal organization's expenses (depreciation of the cost of treaty rights, the cost of excavations of channels, etc.) was one that we had been generally advocating the Company implement since fiscal year 1952, the first year that the Company was in operation in its present form. For further detail see our letter to the Chairman of the House Committee on Merchant Marine and Fisheries of August 30, 1974 (B-114839).

Thus whether a change increased or decreased expenses was not a factor in our agreeing with the accounting changes the Canal organization made. As shown on enclosure I, however, several of the changes did have the effect of decreasing expenses.

3. How many other U.S. Government corporations use the following listed accounting techniques?

   a. Depreciation on titles, treaty rights, excavations of channels, harbors and basins and other works.

   b. Allowance of doubtful accounts.

   c. Reserve for casualty losses.

   d. Expensing minor plant assets.

   e. Normalizing costs of locks overhauls.

   f. Changing from a unit basis of depreciation for certain items to a composite basis.

A table showing the Saint Lawrence Seaway Development Corporation's and the Tennessee Valley Authority's utilization or nonutilization of accounting techniques similar to the six listed above is included as enclosure II. We limited our comparison to these two U.S. Government corporations because their operations, at least in some respects, are comparable to those of the Canal organization.

Additional comments regarding the general utilization of accounting principles are presented in response to your last question which is item IV.

II. Connections, if any, between ongoing treaty negotiations and the Canal organization's accounting changes.

In referring to the Company's plans to commence depreciating titles, treaty rights, etc., GAO stated in its report on the fiscal year 1973 examination of the Canal organization that "Specifically, we have noted the trend toward constructing larger ships that cannot go through the Canal and the evolving U.S. policy in its continuing treaty negotiations with the Republic of Panama." What is the meaning of the latter part of this statement?

As we indicated in our August 30, 1974, letter, the referenced terminology was used to refer to only one of several factors that we considered in agreeing with the Company's selected period for depreciating the assets. The treaty negotiations were not a factor to our decision or, to our knowledge, to the Company's decision on the need for implementing the accounting principle involved. As previously stated, we had generally advocated implementing this accounting treatment since fiscal year 1952, long before the current treaty negotiations were initiated.

III. Legal requirements for the Company to absorb the net cost of the Canal Zone Government.

Does GAO believe that tolls revenue should fully cover the net cost of the Canal Zone Government?

In view of a 1958 Supreme Court decision on this matter and the subsequent conclusion expressed by the Panama Canal Subcommittee, House Committee on Merchant Marine and Fisheries, it seems clear that the net cost of the Canal Zone Government can be allocated to tolls revenue in amounts determinable at the discretion of the Company.

Section 412(b) of title 2 of the Canal Zone Code (1963), which establishes the formula for imposing tolls, states, in part that:

"Tolls shall be prescribed at rates calculated to cover, as nearly as practicable, all costs of maintaining and operating the Panama Canal, together with the facilities and appurtenances related thereto, including interest and depreciation, and an appropriate share of the net costs of operation of the agency known as the Canal Zone Government."

As defined in section 62(g) of title 2 of the Canal Zone Code (1970) and as historically recorded by the Canal Zone Government, the net cost of the government equals the total cost of operating that agency, including depreciation, less recoveries from charges made to other U.S. Government agencies and individuals for services rendered. The Company reimburses the U.S. Treasury for the net cost of the Canal Zone Government and accounts for the resulting expense as part of its general corporate expense.

After the Company adopted the tolls formula in 1950, this office took the position that the terminology in section 412(b) of title 2 of the Canal Zone Code required allocating a fixed share of the Company's general corporate expenses, including the net cost of the Canal Zone Government, to the Company's various supporting activities. This requirement appeared to be needed so as to require an increase in the prices charged by the supporting activities and a resultant surplus in tolls revenue over and above operating expenses. The Company disagreed with our construction of the statute. In 1955 several steamship lines brought suit against the Company to require it to prescribe lower toll rates based on our construction of the statute. However, in an April 28, 1958, decision (Panama Canal Company v. Grace Line, Inc., et al, 356 U.S. 309), the U.S. Supreme Court ruled that the construction of the tolls formula in the statute (i.e., the proper method of allocating general corporate expenses between the toll and support activities) was itself an exercise of discretion best left to the expertise of the agency (the Company) burdened with the responsibility for decision.

Following the decision of the Supreme Court in the Grace Line case, a bill was introduced in the 86th Congress "To require Panama Canal tolls to be prescribed in accordance with the tolls formula provided in section 412 of Title 2 of the Canal Zone Code and pursuant to the provisions of the

Administrative Procedure Act." 1/ At the hearings on the bill, the Company presented its construction of the tolls formula and the rationale for its pricing policy for support activities based on that construction in the light of the issues and decision in the Grace Line case. 2/ This office concurred in the validity of the Company's policies but recommended amendment of section 412 in such manner as to adopt expressly the Company's construction of the statute. 2/ In an unnumbered report dated June 9, 1960, the Panama Canal Subcommittee of the House Merchant Marine and Fisheries Committee reached the conclusion on H.R. 10968 that:

> "After examining the language of Section 412(b) of Title 2 of the Canal Zone Code [of 1934], which establishes the formula for imposition of tolls, and after considering its legislative history and the views of the General Accounting Office, the Subcommittee is of the opinion that the present practice of the Panama Canal Company in allocating the major part of overhead of supporting services to the account of tolls is proper and is in full compliance with the law as it now reads."
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> * * * * *
>
> "Accordingly, there is no need for enactment of this bill since it would merely spell out in greater detail what is in the Subcommittee's view the present requirement of law." 3/

Therefore in view of the Supreme Court's decision and the Subcommittee's conclusion, it seems clear that operating costs of services, such as the net cost of the Canal Zone Government, can be allocated to tolls in amounts determinable at the discretion of the Company. Furthermore, without a change in the Company's charter requiring the Company to be self-sustaining, the unrecovered cost of an activity of the Company has to be recovered through tolls, the Company's principal source of revenue.

1/H.R. 8983, 86th Congress.

2/Hearings on H.R. 8983 and H.R. 10968, 86th Congress.

3/The report is quoted in a note following 2 C.Z.C. 412 in the annotated edition of the Canal Zone Code.

Also it is noted that not all the net cost of the government is recovered from tolls revenue. The net cost of the government is a part of the Company's general corporate expenses. Thus these costs are included in the Company's general overhead rate which is used in establishing prices charged other U.S. Government agencies and commercial activities for such items as materials and electrical power.

IV. <u>Accounting principles observed by the Canal organization.</u>

> Does the Canal organization observe all the standards of accounting procedure used by the Federal Government?

There are numerous generally accepted accounting principles and standards for the Federal Government and private businesses. However, only a certain number of such principles and standards are applicable to any single entity or organization. Such an entity as the Canal organization selects and implements only those accounting principles and standards which are necessitated by the nature of its operations. For example, a U.S. Government corporation's sales on account may all be to other U.S. Government corporations or agencies. Since such receivables are generally considered 100 percent collectible, there would be no need for that Government corporation to sustain a loss on its receivables and therefore no reason to establish an allowance for doubtful accounts.

One objective of our examination of the Canal organizations' financial statements is to determine whether the statements are presented in accordance with generally accepted accounting principles and the principles and standards of accounting prescribed for executive agencies by the Comptroller General. In the report on our examination of the Canal organization's financial statements for fiscal year 1973 (B-114839, Mar. 6, 1974), we expressed our opinion that, except for the Company's failure to depreciate certain assets, the financial statements were presented in conformity with generally accepted accounting principles and the principles and standards of accounting prescribed by the Comptroller General. We anticipate a similar opinion, excluding the exception, in the report which is in process on our examination of the Canal organization's financial statements for fiscal years 1974 and 1975.

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In addition to the report on our examination of the Canal organization's financial statements for fiscal years 1974 and 1975, we also have a report in process to the Secretary of the Army covering our review of hospital and electrical rates charged by the Canal organization. Both reports, which we expect to issue soon, include our comments on several matters that could affect the financial position of the Canal organization. One suggested change would increase recoveries of expenses; others would either decrease or increase expenses. For example, in our report to the Secretary of the Army we have tentatively concluded that changes should be made in the hospital rate area that would (1) increase the Canal Zone Government's recoveries of hospital cost and (2) decrease the expense incurred by other U.S. Government agencies for hospital cost relating to civilian employees and their dependents. On the other hand we have tentatively concluded that changes should be made in the electrical rate area that probably would decrease costs incurred by other U.S. Government agencies but increase the Canal organization's electrical cost. In our financial examination report, we acknowledge the Company's opinion that it should be allowed a benefit on its cash deposited with the U.S. Treasury and present several alternative ways of obtaining this benefit. Copies of these reports will be furnished to the Panama Canal Subcommittee.

Comptroller General
of the United States

Enclosures - 2

ESTIMATED EFFECT OF THE VARIOUS ACCOUNTING CHANGES IMPLEMENTED

BY THE CANAL ORGANIZATION DURING FISCAL YEARS 1973 AND 1974

Accounting changes	Increase or decrease (-) in expenses						
	FY 1973		FY 1974		FY 1975		Total
	(000 omitted)						
Depreciation of titles, treaty rights, excavations of channels, etc.		$ -		$ 8,276		$ 8,276	$16,552
Change in service life of Thatcher Ferry Bridge		-		116		116	232
Allowance for doubtful accounts:							
Current year charges	$ 632		$ 194		$ 387		
Amortization of portion deferred (note a)	1,000		1,003		1,003		
Total effect		1,632		1,197		1,390	4,219
Reserve for casualty losses		350		123		-15	458
Expensing minor plant assets, i.e., items costing less than $1,000:							
Current year charges	-		701		1,039		
Assets on hand at 6/30/73 (note b)	1,034		1,034		1,034		
Total effect		1,034		1,735		2,073	4,842
Normalizing costs of locks overhauls (note c)		1,247		954		1,464	3,665
Changing from a unit basis of depreciation to a composite basis	-700		-673		-617		
Changes in service lives of certain assets	1,000		1,000		617		
Net effect		300		327		-	627
Allowance for losses on obsolete and excess materials and supplies inventories		500		152		-16	636
Deferring cost of major studies and extraordinary maintenance projects until completion and then amortized over a 5-year period		-508		-193		-162	-863
Total net effect on expenses		$4,555		$12,687		$13,126	$30,368

a/The Company, in essence, recognized a loss of accounts receivable totaling about $5.6 million in fiscal year 1973. However, due to the large amount involved, the Company properly elected to amortize that part of the allowance applicable to years before fiscal year 1973 over 5 years beginning with fiscal year 1973. At the end of fiscal year 1975, about $2 million remained to be charged to operations.

b/The service lives on items in the plant accounts that met the former capitalization criterion were adjusted so that those assets would become fully depreciated over a 5-year period ending June 30, 1977.

c/Only changed the method of computing the annual accrual, not the principal involved. The Company has used the accrual method rather than the deferred or actual expenditure method for recognizing cost of locks overhauls since fiscal year 1952.

ENCLOSURE I

SELECTED U.S. GOVERNMENT CORPORATIONS

IDENTIFIED AS UTILIZING ACCOUNTING TECHNIQUES

SIMILAR TO THOSE USED BY THE CANAL ORGANIZATION

Does agency use these accounting techniques?	Saint Lawrence Seaway Development Corporation	Tennessee Valley Authority
Depreciation of titles, treaty rights, excavations of channels, etc.	Yes. Depreciation of land rights, relocations, and channels and canals (note a).	No. For land rights and relocation and clearing costs. Yes. For channel improvements and shoreline adjustments.
Allowance for doubtful accounts	Yes. Has established such an account but balance was zero at 12/31/75 (note b).	Yes. Applies basically to fertilizer sales by the Division of of Chemical Operations.
Reserve for casualty losses	No (note c).	No. Policy is to amortize cost of any such losses over a reasonable future period.
Expensing versus capitalizing of minor plant assets	No. Capitalizes both plant and equipment items having useful lives of over 1 year. No dollar criterion is used.	Yes. Expenses minor plant items but generally identifies them by description, not by dollar criterion.
Accruing cost of locks overhaul to normalize cost	No. Has undertaken one extensive lock rehabilitation program which cost about $9 million incurred over a 5-year period. These costs were treated as extraordinary expense items in the years incurred.	No. The Authority does not make periodic locks overhaul; when locks are worked on the cost is expensed or, if appropriate, capitalized.
Composite basis of depreciation for certain assets	Yes. Uses a composite-rate basis for calculating depreciation.	Yes. The trend in recent years has been toward changing to a unit basis.

a/Land rights are easements on land held by others; relocation costs refer to the cost of moving property, such as railroad facilities and power lines, incurred during lock construction.

b/The balance is normally low since, unlike the Canal organization's revenue, only a small percent of the Corporation's revenue is derived from sources other than tolls. As does the Panama Canal Company, the Corporation considers tolls revenue to be 100 percent collectible because ship operators post security deposits.

c/The Corporation considered buying liability insurance covering damages to ships and injuries to visitors but decided against it because of its high cost.

ENCLOSURE II