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Subject: Change in Accounting Treatment for Federal Investment Tax Credits

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To: File

This memo documents accounting considerations specific to AEP's policy change related to the accounting treatment for federal investment tax credits (ITC).

INTRODUCTION

Under current tax regulation, qualifying renewable energy projects are eligible for federal ITC. AEP historically accounted for ITC under the flow-through method, except where regulatory commissions reflected ITC in the rate-making process on a deferral basis. Beginning in the third quarter of 2016, AEP changed its election and started accounting for ITC under the deferral method. Both the flow-through and deferral accounting methodologies are discussed in further detail below.

ACCOUNTING ISSUES

Does the change represent a preferred accounting methodology for ITC? What additional considerations need to be made in the quarter an accounting principle/policy change is made?

ACCOUNTING DISCUSSION

ITC ACCOUNTING METHODOLOGIES

Per Accounting Standards Codification (ASC) 740-10-25-45, "An investment credit shall be reflected in the financial statements to the extent it has been used as an offset against income taxes otherwise currently payable or to the extent its benefit is recognizable."

Two acceptable methodologies exist when accounting for ITC:

1) The *flow-through method* – the tax benefit from an ITC is treated as a reduction of federal income taxes and recorded immediately in the period that the credit is generated.

2) The *deferral method* – the tax benefit from an ITC is deferred over a period of time (two methodologies noted below).

Per ASC 740-10-25-46, "While it shall be considered preferable for the allowable investment credit to be reflected in net income over the productive life of acquired property (the deferral method), treating the credit as a reduction of federal income taxes of the year in which the credit arises (the flow-through method) is also acceptable."

Under the deferral method specifically, two sub-methodologies also exist:

1) The *statement of financial position sub-method* – allowable investment credit is recorded as adjustment to the qualifying asset, resulting in less depreciation over the life of the asset.

2) *The income statement sub-method* – allowable investment credit is recorded in income tax expense over the life of the asset.

Guidance from ASC 740-10-45-27 and 740-10-45-28 confirm presentation matters related to the deferral method:

> Per ASC 740-10-45-27 *(statement of financial position sub-method)*, "The reflection of the allowable credit as a reduction in the net amount at which the acquired property is stated may be preferable in many cases. However, it is equally appropriate to treat the credit as deferred income, provided it is amortized over the productive life of the acquired property."
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> Per ASC 740-10-45-28 *(income statement sub-method)*, "It is preferable that the statement of income in the year in which the allowable investment credit arises should be affected only by the results which flow from the accounting for the credit."

With AEP's strategic decision to start pursuing investments in qualifying renewable energy projects, management decided to change AEP's accounting methodology for the recognition of ITC and elected to apply the deferral method/income statement sub-method beginning in the third quarter of 2016. Credits will be recorded as a deferred credit and amortized to income tax expense over the life of the asset. In accordance with regulatory requirements, deferred ITC is amortized over the average life of the related asset with amortization normally applied as a credit to reduce income tax expense on the statements of income.

CHANGE IN ACCOUNTING PRINCIPLE/POLICY

Per ASC 250-10-45-2(b), “A reporting entity shall change an accounting principle if the entity can justify the use of an allowable alternative accounting principle on the basis that it is preferable.”

As noted above, ASC 740-10-25-46 states the deferral method is considered preferable while the flow-through method is acceptable. In the third quarter of 2016, AEP changed its election and started accounting for ITC from the acceptable flow-through method to the preferred deferral method of accounting.

In addition and per ASC 250-10-45-5, “An entity shall report a change in accounting principle through retrospective application of the new accounting principle to all prior periods, unless it is impracticable to do so.” Per ASC 250-10-45-14, “A change in accounting principle made in an interim period shall be reported by retrospective application.”

Retrospective application is not necessary for reporting periods prior to 2016 as AEP did not materially benefit from new ITC since the law change in 1986 and through 2015. At the end of 2015, AEP would have restored $27 thousand in unamortized deferred ITC related to nonregulated generation assets where the ITC had been taken to income when the assets were no longer regulated in 2001. For 2014, AEP reported $108 thousand in ITC on its federal income tax return related to nonregulated activity. The ITC for nonregulated activity was originally accounted for under the flow-through method, treated as a reduction of federal income taxes in 2015 on the statement of income, but not retrospectively adjusted since AEP deems the $108 thousand and historic, unamortized $27 thousand immaterial. The impact to stand-alone AEP subsidiary reporting is also deemed immaterial for prior reporting periods. Additionally, $1.4 million was reported on AEP’s 2015 federal income tax return, but related to ITC for regulated activity which was already deferred. In the third quarter of 2016, however, AEP made an adjusting accounting entry related to ITC for year-to-date 2016 activity originally accounted for under the flow-through method to reflect the newly applied deferral methodology (see Accounting Entry section below).

Per Securities and Exchange Commission (SEC) Regulation S-K 601(b)18 (SEC Exhibit 18 - Letter Regarding Change in Accounting Principles), “Unless previously filed, a letter from the registrant's independent accountant indicating whether any change in accounting principles or practices followed by the registrant, or any change in the method of applying any such accounting principles or practices, which affected the financial statements being filed with the Commission in the report or which is reasonably certain to affect the financial statements of future fiscal years is to an alternative principle which in his judgment is preferable under the circumstances.”

With AEP's strategic decision to start pursuing investments in qualifying renewable energy projects, management believes AEP and subsidiary financial statements in future fiscal years will be impacted. However, the filing of an Exhibit 18 with the Third Quarter 2016 SEC Form 10-Q is deemed unnecessary as changing to the deferral methodology to account for ITC is explicitly preferred as outlined in ASC 740-10-25-46.

ACCOUNTING ENTRY

In the third quarter of 2016, AEP made an adjusting accounting entry related to ITC for year-to-date 2016 activity originally accounted for under the flow-through method to reflect the newly applied deferral methodology. The impact to net income in the third quarter of 2016 is $1.3 million as detailed in the table below.

Account			
Name	Number	Debit	Credit
Investment Tax Credit Expense	4114001	1,591,873	
Accumulated Deferred Investment Tax Credit - Federal	2550001		1,591,873
Accumulated Deferred Federal Income Tax - Other	1901001	557,156	
Deferred Federal Income Tax Expense	4111001		557,156
Deferred Federal Income Tax Expense	4101001	289,431	
Accumulated Deferred Federal Income Tax - Property	2821001		289,431

Additionally, the Tax department will make the applicable Staff Accounting Bulletin (SAB108) entries for the first and second quarters of 2016 to reflect the ITC accounting methodology change.

DISCLOSURE FOR ACCOUNTING POLICY CHANGE

The following disclosure should be included in the Third Quarter 2016 SEC Form 10-Q and the 2016 SEC Form 10-K due to the policy change:

"Investment tax credits (ITC) were historically accounted for under the flow-through method, except where regulatory commissions reflected ITC in the rate-making process. In the third quarter of 2016, AEP and subsidiaries changed accounting for the recognition of ITC and elected to apply the preferred deferral methodology. Retrospective application is not necessary for reporting periods prior to the third quarter of 2016 as the financial impact to AEP and subsidiaries was immaterial.

Deferred ITC is amortized to income tax expense over the life of the asset. Amortization of deferred ITC begins when the asset is placed into service, except where regulatory commissions reflect ITC in the rate-making process, then amortization begins when the cash tax benefit is recognized."

CONCLUSION

AEP historically accounted for ITC under the flow-through method, except where regulatory commissions reflected ITC in the rate-making process on a deferral basis. Beginning in the third quarter of 2016, management decided to change AEP's accounting methodology for the recognition of ITC and elected to apply the deferral method/income statement sub-method.

AEP made accounting entries in third quarter of 2016 related to ITC for 2016 activity originally accounted for under the flow-through method to reflect the newly applied deferral methodology. A new accounting policy disclosure will be included in the Third Quarter 2016 SEC Form 10-Q filing scheduled on November 1, 2016 and the 2016 SEC Form 10-K.

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