INCOME DISTRIBUTIVE CONSEQUENCES OF THE ACCOUNTING FOR THE PRIVATIZATION OF THE NIPPON TELEGRAPH AND TELEPHONE PUBLIC CORPORATION

By Satoshi DAIGO*

I Accounting for Business Reorganizations and its Dramatic Effect on Income Distribution

Today's accounting for going concern is primarily based on the periodical allocation of acquisition cost. In this system, the periodic income may vary depending on the method of allocating cost. But, the choice of any method is intrinsically neutral as to income distribution to interested parties for all the allocation periods so long as there is no significant changes in constitution of the interested parties or in the coefficient of financial contracts applying profit/loss as a variable. In contrast with this, accounting for business reorganizations such as corporate merger or separation, restructuration, nationalization or privatization, not only marks the new accountability for the proterty concerned but often determines in a dramatic way the manner in which the company's cumulative profit/loss at the reorganizations is distributed among the interested parties. For instance, if the "purchase" method is applied to corporate merger, unrealized appreciation or depreciation as well as retained earnings of merged company are liquidated at the merger. But, if the "pooling of interests" method is applied, those appreciation or depreciation are carried over to merging company. Such different distributive result from the alternative accounting methods for corporate reorganizations is due to the fact that reorganization is usually accompanied with recapitalization, and in that event, there is frequently a major change in pro-rata ownership of various kind of equity.

In the recent years, we have seen privatization of major public corporations in Japan such as The Nippon Telegraph and Telephone Public Corporation (the former NTT) which became The Nippon Telegraph and Telephone Corporation (the present NTT or the new NTT). In this paper, then, the author attemts to consider the issue regarding treatment of the customers' contribution for construction (CCC) at the time of the privatization of the former NTT in order to demonstrate how the accounting policy for privatization could determine the income/burden distribution among the interested parties through its effects on the amount of the proceeds from the public sale of the new NTT shares and the rate making at the new NTT. In addition, the author proposes to demonstrate how income/burden distribution would change if the deferred revenue approach which the author advocates or the cost reduction method had been consistently adopted for the CCC.

* Associate Professor, Faculty of Economics, Kyoto University.

II Alternative Methods of Accounting for Privatization and its Effects on the Disposition of CCC —A Hypothetical Analysis—

When we look at the closing balance sheet of the former NTT, it strikes our mind that the balance of CCC is equal to 23.7% of the total asset and 49% of the net asset, and that the balance is shown as capital surplus.[1)]

Inasmuch as the privatized NTT is a joint stock company, it is subject to the Commercial Code and to the Corporation Income Tax Law along with the Security Exchange Law under which financial statement must be prepared based on the Business Accounting Principles (BAPs). However, both the Japanese Commercial Code and the Corporation Income Tax Law do not accept so-called "non-legal capital surplus" and they treat CCC as an income. Furthermore, the Japanese BAPs, due to the revision in 1974, require CCC either to be applied to reduce the cost of the related assets (note 24), or to be treated once as income and then transferred to voluntary earned surplus reserve on condition of shareholders' vote (note 2-2). In consequence, the present NTT was obliged to reverse the capital approach adoped by the former NTT anyway in opening its book. Yet, in view of the quantitative materiality of CCC as indicated above, it was clear that the reversal of accounting policy would have the effect of 1) adding an extremely large tax burden on the present NTT, and 2) causing a large difference in the amount of capital contribution in kind to be made by the former NTT to the privatized entity, and hence in the number of the present NTT shares which were to be issued to the Government as the owner of the former NTT. Furthermore, assuming that the present NTT would adopt in near future the rate base formula for rate making under which a fixed percentage of the book value of the assets is included into the rate as fair return, it was clear that the rate level of the new NTT would change dramatically depending on whether or not CCC balance of the former NTT were to be applied to reduction of the book value of the related assets at the time of the privatization.

However, accounting treatment of CCC is not only governed by the rule of distinction between capital and income under the legal financial accounting, but also by the general framework of accounting for reorganizations to be selected. In other word, because the former NTT's assets and liabilities are transferred to the new NTT and the latter's shares are in return issued to the Government as the owner of its predecessor, there are two approaches applicable to the accounting for CCC: one is the pooling of interests approach under which the assets of the former NTT are carried over to the new NTT at book

1) In 1984, the author made a survey of 20 tokushu hojins (public or quasi-public entity) for their accounting treatment concerning the construction subsidies and customers' contributions for construction. According to the survey, four of them (the former Japanese National Railways, the Water Resources Development Public Corporation, the Japanese Railway Construction Corporation, and the New Tokyo International Airport Corporation) treated the CCC as deferred revenue, while the Nippon Telegraph and Telephone Public Corporation alone treated it as capital surplus.

value and the earned surplus accounts of the former NTT are trasferred to the new Company as they stand except for the portion of changes caused by inequality of convertion rate of the previous ownership into new ones. The second approach is the purchase method under which the assets of the former NTT are carried over to the new NTT at fair value and the net assets of the former NTT are converted to paid-in surplus to the extent that the contribution in kind made by the former NTT is not capitalized in the opening balance sheet of the new NTT. However, inasmuch as the valuation of the assets to be transferred to the new NTT is outside of the subject of the present paper, we accept as a given condition the de facto transfer of the assets at their book value according to the article 2 of the Enforcement Ordinance concerning the Nippon Telegraph and Telephone Corporation Law.

Yet, regardless of the approach—pooling of interests method or purchase method—to be adopted, initial capital of the new NTT is determined by the ratio of convertion of the former ownership into the new ownership, or by the number of the shares of the successor (50, 000 yen at par) to be issued, and this also affects upon the disposition of CCC.

For the purposs of the present study, therefore, we shall asssume two cases: first, that the old and new ownership is exchanged at the par (1:1), thus making the initial legal capital of the privatized entity equal to that of its predecessor, and second, in which shares of the new company are to be issued for the entire amount of the net assets of the former NTT but only the amount equivalent to the total par value of these shares is to be capitalized by the new NTT. By combining these two hypothetical cases with two alternative accounting methods as explained before, we could conceive four cases and see how CCC is to be treated in each case.

Ratio of equity holding conversion / Accounting Method	1:1	$1:\dfrac{\text{Net asset of the former NTT}}{\text{Par Value}}$
Pooling of interests	Case I	Case II
Purchase	Case III	Case IV

First, if the Case I is adopted, by dividing the legal capital of the former NTT—approx. 18, 848 million yen—by the par value of the new NTT share, there are 377, 000 shares of the new Company which are to be issued to the Government as the sole owner of the former NTT. Furthermore, because the exchange ratio is 1:1, surplus of the former NTT is passed on to the new entity as it stands. This would mean that CCC, treated by the former NTT as capital surplus, should be transferred as such to the opening balance sheet of the privatized NTT. However, because the concept of "non-legal capital surplus" is rejected not only by the Commercial Code and the Corporation Income Tax Law but also by the BAPs, CCC can no longer be left intact as capital surplus. To comply with these statute or rule, the new entity is now forced either 1) to apply the balance of CCC to reduce the book value of the related assets, or 2) to carry it back once to unappropriated earned surplus. Should the new NTT opt for the latter approach, then the tax law would identify a taxable income of 2. 5 trillion yen. If the first approach is selected, the balance of CCC would become taxable income over the future accounting periods as a result of the reduction of depreciation expense equal to the CCC balance. In addition, in either case it is possible that the balance of CCC after tax is distributed to shareholdes or officers of the new entity as dividends or bonuses.

As to Case II, the total amount of the net asset of the former NTT is capitalized by the new entity, and there is no surplus or balance of CCC to be transferred to the new entity, even though the approach itself can be considered as pooling of interests. This means that the Government, whose capital contribution is less than 0. 4 per cent of the total capital of the former NTT, would legally be entitled to gain all of the net asset including earned surplus and CCC balance in the closing balance sheet of the former NTT.

We now consider the Case III, in which shares of the former NTT and those of its successor are exchanged one for one and in which accounting for privatization is based on the purchase method. In this case, the initial capital stock of the new Company is same as that of the former NTT in its closing balance sheet, and the portion of capital contribution in kind made by the former NTT that exceeds the capital stock of the new Company is stated as a sort of paid-in surplus. In this instance, it could be said that the balance of CCC is "frozen" into paid-in capital of the new Company, except that the new Company may be able to declare the gratuitous issue of its shares to the shareholders. In this case, thus, accounting treatment of CCC as capital to be maintained is completed on its own through the application of purchase method.

As for the remaining Case IV, it will be seen that capital structure of the privatized entity as well as the disposition of CCC balance are identical to those in Case II if we assume that assets of the former NTT are transferred to its successor at the book value.

III Actual Disposition of CCC Balance

A comparison between the closing balance sheet of the former NTT and the opening balance sheet of the new NTT as regards the liabilities and owner's equities shows, among other things, that:

(1) The new NTT has set up provision for employees' retirement payment which did not exist in the former NTT,

(2) Capital stock of the new NTT has increased enormously from 18. 8 billion yen of the former NTT to 780 billion yen at the start of the new entity,

(3) Earned surplus of the former NTT amounting to 2. 5 trillion yen has disappeared completely from the new entity's balance sheet,

(4) The new entity's balance sheet shows no trace of CCC carried by its predecessor, and

(5) Shareholders' equity of the new NTT includes a legal capital reserve of 2. 5

trillion yen.

Now, then, how did these changes occur through the privatization of the former NTT, and how were they related to each other? If we find the precise answer to these questions, then we are likely to ascertain the actual disposition of CCC balance at the privatization.

First, the fact that the opening balance sheet of the present NTT reported the provision for employees' retirement payment suggests that at the time of the privatization, an amount to be set up as such was transferred from some item or another in the creditor side of the closing balance sheet of the former NTT. The provision had to be set up on the privatization because the provision which would have been required if the former NTT adopted the usual accrual basis accounting was in fact not set up by it, and this resulted in a corresponding understatement of expense or in an overstatement of income of the former NTT. Under these circumstances, it would be reasonable to think that the provision for employees' retirement payment shown on the opening balance sheet of the present NTT was created by reducing earned surplus of the former NTT to the extent that it equalled the overstatement of income for the preceding years. In other words, out of the former NTT's earned surplus of 2, 482. 6 billion yen, 1, 682. 5 billion yen was very likely transferred to the provision for employees' retirement payment at the privatization.

Second, because the ratio of conversion of the old owner's equity to the new was higher than one to one, initial capital stock of the new Company increased by 76. 12 billion yen over the closing legal capital of the former NTT. On the other hand, the fact that legal capital reserve is reported in the opening balance sheet of the present NTT indicates that the portion of capital contribution in kind by the former NTT was treated as paid-in surplus to the extent that it was not capitalized. The reason for the consequence is, needless to say, that the new entity adopted the purcase accounting for the privatization. We must, therefore, try to see how much amount was actually transferred from each of surplus accounts of the former NTT to initial capital stock as well as to legal capital reserve of the new NTT. This should be generally no more than a purely technical issue concerning the subdivision of paid-in capital, but in considering the prevailing Japanese practice to show dividends as a percentage of par value of each share (or capital stock), both the new Company as well as its shareholdes must have strong interest in the amount of capital contribution in kind to be capitalized. Furthermore, in this case, how much amount was actually capitalized in the new Company determines the volume of shares of the Company to be issued to the Government in consideration of the capital contribution in kind.

Obviously, total market value of the present NTT shares owned by the Government should not have anything to do with the size of the Company's capital stock (or the number of shares to be issued) if market value of each share changes in correspondence with per share data (earnings per share, net assets per share, etc.) which are inversely proportional to the number of the outstanding shares. However, the privatized NTT was unique in that market value of the shares was derived from the process of privatization to offer to the public for listing at the stock exchange. Moreover, the Company itself was foreseen to hold a position as a star performer. Under these circumstances, it was clear from the beginning that market value of the new NTT shares would become totally out of proportion to any theoretical estimation. Therefore, the question as to how much of capital contribution in kind should be capitalized, i. e., how many shares were to be issued in exchange for the former ownership, was a very important one to the Government who craved for maximum proceeds from the public offering of the NTT shares.

Let us assume now that 76 billion yen was capitalized at the organization of the new Company out of CCC balance of 2. 5 trillion yen. This should result in a situation halfway between the Case III and Case IV already mentioned, but in either case, this means that the usual accounting treatment under which CCC was credited to capital surplus, is completed without any application of the related stipulations of the BAPs or the Commercial Code under which CCC be ultimately reflected on profit.

On the other hand, if we take a view that the increase of approx. 760 billion yen in capitalization of the present NTT at the organization occurred as the result of appropriating the same amount from earned surplus of approx. 800 billion yen which remained after transferring to provision for employees' retirement payment, we can see that as the Case II or Case IV shows, the capitalized portion of earned surplus was distributed to the Government in the form of the shares of the new NTT, and that CCC balance of the former NTT was transferred en bloc to legal capital reserve of the new NTT.

Nevertheless, we do not have any data at present to correlate each item of net asset accounts in the former and present NTT, we propose, for the purpose of our discussion to follow, to use the simple term of "capitalization of the CCC balance" to denote both of the possibilities—the one in which the CCC balance was partly capitalized and the rest was converted to the legal capital reserve, and the other in which full amount of the CCC balance was converted to the legal capital reserve on the occasion of privatization.

In any event, it is a indisputable fact that the full amount of the CCC balance of the former NTT was converted to paid-in capital to be maintained. This means that the opportunity was lost forever to apply to the CCC balance the provision of Article 8 of the Accounting Rules for Telecommunication Enterprises under which the CCC may be deducted from the acquistion cost of the related fixed asset. We are, therefore, urged to pass our explicit judgement on the question whether or not the accounting policy adopted by the former NTT was proper in treating CCC consistently as capital surplus.

In this respect, the author has long maintained that (1) CCC in public utilities is a lump sum charge to be made to a new customer when the installation work necessitated by his demand exceeds the average cost which is used as computation basis of rate making, and (2) the purpose of CCC is to avoid the effect of such costly work for specific new customer on the rate applicable to existing customers, and (3) in this context, CCC cannot be a contribution of capital to be maintained, but in fact it must be considered as an advance payment (or deferred revenue received by company) for the extra cost which would otherwise charge to existing customers through rate increase.[2)]

Thus, in the following section, we will see why capitalization of CCC at the privatization of the former NTT had to result in a marked unfairness in distribution of income or burden on the criterion of the deferred revenue theory.

IV Income Distributive Consequences of Capitalization of the CCC Balance

The present NTT adopted such an inconsistent accounting policy under which the balance of the CCC at the time of the privatization is capitalized through the adoptation of purchase method while the CCC received hereafter is to be applied to cost reduction of the related assets. The capitalization of the CCC balance has two immediate economic consequences. First, the capital contribution in kind by the former NTT to the new NTT had to increase to the extent that the balance of the CCC was not appropriated to reduce the cost of assets, and as a result of this the number of shares of the new Company issued to the Government in consideration of the capital contribution also swell as much. Second, the book value of the assets which would be used as rate base inflated to the amount of the CCC balance. As it is, we shall now try to see the ultimate consequences of these immediate effects of the capitalization of the CCC balance upon the distribution of income or cost burden to the parties concerned in the former and present NTT.

Consequence on the Proceeds Received by the Government from the Sale of the New NTT Shares

To begin with, we shall compare two hypothetical cases. In the first case, CCC is treated as capital surplus, and the total amount of the capital contribution in kind which corresponds to the book value of the net asset of the former NTT, including such capital surplus (NAy, after the deduction of earned surplus appropriated to the provision for employees' retirement payment) is capitalized in the new Company. In the second case, CCC is applied to the cost reduction of the related assets at the time of the privatization in accordance with Article 8 of the Accounting Rules for Telecommunication Enterprises, and the new Company capitalized the total amount of the capital contribution in kind which corresponds to the book value of the net asset of the former NTT after the deduction of the CCC balance (CCy) ($NAy' = NAy - CCy$; note that here also, after the deduction of the earned surplus transferred to the provision for employees' retirement payment). We shall then notice that the first case has the consequence of increasing the number of shares of the new Company issued to the Government because the capital contribution in kind is larger compared with the second case.

To explain this point more in detail, the number of shares of the new Company issued to the Government, or Nx', according to the second case, will be calculated as follows:

2) Satoshi Daigo, *Kōkigyō Kaikei no Kenkyu* (A Critical Study of the Accounting for the Public Enterprises) Tokyo, Kunimoto Shobo, 1981, Ch. 8 and 9.

$$Nx'=\frac{NAy'}{Px}=\frac{NAy-CCy}{Px}=15,464,960$$

Px: Par value of the share of the new NTT (¥50,000)

Whereas the number of shares issued to the Government (Nx), in the first case, will be:

$$Nx'=\frac{NAy}{Px}=66,521,520$$

As it is, the first approach has the effect of increasing the number of shares by 4.3 times.

Thus, if the Government decided to offer the maximum number of shares of the new Company for public allowed under the provision of Article 4, paragraph 2 of the Nippon Telegraph and Telephone Corporation Law (two-thirds of the outstanding shares, or 44,347,680), the Government, as the sole owner of the former NTT (here, we must remember that the ownership is based on a ridiculously small investment corresponding to 0.2% of the total asset or less than 0.4% of the net asset), could recover all the net asset of the former NTT including the CCC balance of 2.5 trillion yen, as long as the public offering price was in excess of the net asset at book value of the former NTT divided by 44,347,680 shares or 117,565 yen (or in excess of 79,626 yen if appropriation of the earned surplus to the provision for employees' retirement payment is excluded from the net asset). It goes without saying that as the number of shares increase, per share performance indices of the new Company (such as earnings per share) decrease in inverse proportion. If market value of the new Company's share reflects precisely and instantaneously these per share data, then the total market value of the new Company held by the Government, i.e. the total proceeds received by the Government from the sale of these shares, should not be dependent on the accounting treatment of the CCC balance.

In reality, however, there is no simple and direct relationship between the per share data derived from the past and actual stock price on the market. We know that subscription price of initial public offering is often estimated using average performance data for existing listed companies or the data for comparable companies as coefficient, because of uncertainty of future performance of the company to be offered to the public. Thus, in the case of public offering of the new NTT share also, many institutional investors elected to use the method of rating on comparable company data (an approach to determine the initial public offering price by comparing the company's data with those of comparable companies already traded on the market).[3] Therefore, if we use the comparative data for Tokyo Electric Company which served to determine reasonable price for public offering of NTT at 1.19 million yen per share, the formula to be used is as follows:[4]

$$MVx=MPk\times\frac{1}{3}\left(\frac{Ax}{Ak}+\frac{Bx}{Bk}+\frac{Cx}{Ck}\right) \quad \cdots\cdots\cdots(1)$$

3)4) *The Nihon Keizai Shimbun*, October 1, 1986.

where:

x: The company to be appraised (the new Company)
k: The comparable company
MPk: Market price of a share of the comparable company
MVk: Reasonable public offering price of a share of the appraised company
A: Dividend per share
B: Earnings per share
C: Net assets per share

In the case where CCC is included in capital contribution in kind and capitalized in the new Company, the public offering price (MVx) is:

$$MVx=81.6\times\frac{1}{3}\left(\frac{5}{5}+\frac{2.1}{9.9}+\frac{52.1}{87.4}\right)=492,000 \text{ yen} \qquad \cdots\cdots\cdots(2)$$

If CCC is appropriated to reduce the costs of related assets, the price (MVx') can be calculated as follows:

$$MVx'=81.6\times\frac{1}{3}\left(\frac{5}{5}+\frac{14.6}{9.9}+\frac{64.7}{87.4}\right)=874,000 \text{ yen} \qquad \cdots\cdots\cdots(3)$$

Thus, MVx (2) is much lower compared with MVx' (3), although the difference is far smaller than the ratio of increase in number of the shares to be issued (Nx/Nx'). As it is, under the rating method on the basis of comparable company, total proceeds from the public offering of the shares held by the Government ($MVx'\times Nx'$) amounts to 13, 516. 4 billion yen if the CCC is used to reduce costs of the related assets, whereas the amount of total proceeds will increase to 32, 728. 6 billion yen if the CCC is capitalized ($MVx\times Nx$), or by 2. 4 times of $MVx'\times Nx'$.

We know already, however, that the actual accounting treatments were quite different from these assumptions. As was explained in Section III, out of the capital contribution in kind by the former NTT (3, 326 billion yen) only 780 billion yen was capitalized by the new Company, and the balance of 2, 546 billion yen was treated as the legal capital reserve. Because of this, the number of shares of the new Company issued to the Government (Nx'') was no more than 15, 600, 000. It will be seen that the number is less than 25% of the shares which would have been issued if the CCC were treated as capital surplus and included in the capital contribution in kind (Nx), and the number of shares actually issued about the same as in the case where the CCC balance is applied to reduce the cost of the related assets (Nx').

On the other hand, if we apply these actual figurers to the foregoing equation in comparison with Tokyo Electric Company, the reasonable public offering price of the new share (MVx'') will become as follow:

$$MVx''=81.6\times\frac{1}{3}\left(\frac{5}{3}+\frac{9.01}{9.9}+\frac{205.9}{87.4}\right)=1,210,000 \text{ yen} \qquad \cdots\cdots\cdots(4)$$

This price is almost as high as the actual public offering price of the new NTT share, allowing the Government to hold the equity valued at 18, 876 billion yen. By offering two thirds of the shares to the public, therefore, the Government can received the full amount of the former NTT's net asset at book value and to realize the capital gain of 7, 370 billion yen.

From the preceding analysis, we can conclude that regardless of the accounting treatment of the CCC balance, the privatization of the former NTT had the economic consequence of converting the Government equity in the former NTT into marketable security at the price for above the book value of the former equity.

However, as the equations (3) and (4) show, the accounting policy adopted to the privatization had also promotive effect upon the process by avoiding the dramatic drop of the net asset per share and pushing up the reasonable public offering price of the new NTT share.

Consequences on the Rate Making of the New Company

It is not yet clear what will be the rate making policy of the privatized NTT. However, we can safely assume that the new NTT will hold a monopolistic position in the supply of the telecommunication service at least for some time to come and consequently that the Company will follow the rate base method as generally adopted by privately-owned monopolistic utility companies. According to this method, the rate is determined by adding to the operating expenses a fair return calculated by applying a given rate to the company's assets devoting to the utility business.

In fact, the Research Study Group on the Rate Making Principles of the Telecommunication Services organized in the Ministry of Posts and Telecommunication has published a report titled "A Study Concerning Rate Making for Telecommunication Services" in June, 1983, and the Report contains the following statements:

"In determining the rate levels of telecommunication services, we shall adopt a lump sum formula which consists of operating expenses under efficient management plus a fair return,"[5] and "the return will be calculated by a rate base method, or by applying a given rate to the assets employed in the business."[6] Although the Report suggests such principles of rate making formula assuming the public ownership of telecommunication business (i. e. Public Corporation) to be continue, the Report says, "regardless of the ownership aspects, and as long as the telecommunication services would be supplied by monopolistic entity, our position should remain validity in essence."[7] Therefore, it is clear that the Study Group was confident of the applicability of the rate base method to the privatized NTT.

Then, if the new Company will adopt the recommendation, the capitalization of the CCC balance at the privatization of the former NTT has possible consequences of pushing up the rate level of the telecommunication services in future.

---

5)6) The Research Study Group on the Rate Making Principles of the Telecommunication Services, *Denki-Tsūsin Sābisu no Ryōkin no Arikata ni kansuru Kenkyū* (Research Report on the Rate Making Principles of the Telecommunication Services), Ministry of Posts and Telecommunications, 1983, p.9.

7) *Ibid.*, p. 2.

First of all, there is no doubt that unless special counter measures are taken, new subscribers to the NTT services will be unreasonably forced to bear the aforementioned extra installation cost which they have already paid as the CCC. This is because the cost of fixed assets corresponding to the balance of CCC is regarded as the cost to be recovered, and the depreciation amount of these fixed assets will be included in the operating expenses just like that of any other fixed assets for the purpose of rate making.

The unreasonable situation could be avoided through the adoption of the cost reduction approach under which the cost to be recovered is reduced by the amount of CCC. On the other hand, if the new NTT adopts the deferred revenue approach, the cost of fixed assets related to the CCC will not be reduced by the CCC balance but transferred to the new Company at the book value, and depreciation amount of these fixed assets will be treated as operating expense for the purpose of income determination.[8] However, this does not mean that the depreciation amount of the cost of fixed assets related to the CCC is actually included in operating expenses for rate making purpose, because under this approach CCC is treated as an advance payment of the cost which otherwise should be recovered through rate.

The second and more dramatic impact of the capitalization of the CCC balance on rate making of the new NTT is found in the fact that it inflates the book value of fixed assets as a part of rate base much above the level based on the cost reduction method. In this respect, the Research Study Group Report mentioned earlier states that "the valuation of fixed assets [as a part of rate base] will be made on the book value of the assets which is based on the acquisition cost,"[9] but "while the CCC as a part of capital account is the capital contributed by the subscribers for the purpose of equipment installation, its unique characteristic would justify to set the return on CCC as an element of rate at a level lower than the return on capital stock or earned surplus."[10]

Notwithstanding, the Report makes no attempts to explain why CCC should be considered a "capital contribution of unique character." Unlike shareholders' equity, contributors of CCC have no claim on profit. To regard CCC as capital contribution and to realize a return on the investment if at a lower rate is tantamount to allow the shareholder to enjoy a return on investments made by others (subscribers).[11]

8) See, Satoshi Daigo, *op. cit.*, pp. 128-129, 179-180.

9) The Research Study Group on the Rate Making Principles of the Telecommunication Services, *op. cit.*, p. 11.

10) *Ibid.*, p. 16.

11) In the United States, the rate base method was adopted fairly early as the principle of rate making for public utilities. It is a prevailing practice for the federal and state agencies to require the public utilities to deduct any CCC from the rate base so that the CCC-related assets should not be a part of the fair return charged to the customers. In this respect, refer to J. Rhoad Foster and Bernard S. Rodey, *Public Utility Accounting*, 1951, p. 188 : Public Service Commission of Wisconsin, *Depreciation, A Review of Legal Accounting Problems*, 1933, p. 152 : U. S. Federal Power Commission, *Federal and State Commission Jurisdiction and Regulation of Electric, Gas and Telephone Utilities*, 1973, pp. 26-29, 61-62a : James E. Suelflow, *Public Utility Accounting : Theory and Application*, 1973, pp. 183-184 ; Robert L. Hahne, Gregory E, Aliff, and Deloitte Haskins and Sells, *Accounting for Public Utilities*, 1984, p. 4-30. Also, "Recent Cases on Customer Contributions", ↗

V Policy Proposal

Because of the unfair consequences of the capitalization of CCC as already explained, the author believes it necessary to prevent occurrence of the situations by applying certain measures to the overall financial and rate making policies of the present NTT as proposed below.

First, the new NTT must be regurated for the use of its legal capital reserve which has been converted from the most part of the CCC balance accumulated by its predecessor. At the time of the privatization, the former NTT carried the balance in the amount of 2, 555. 8 billion yen, and we already saw that of this huge amount, at least 1, 791. 6 billion yen was not capitalized by the new Company. This means that the Government did not receive maximum number of shares of the new Company in consideration of the capital contribution in kind.

Nevertheless, there still remains a posibility that the legal capital reserve fall to certain related parties in some future through the due process of the Commercial Code, that is, the capitalization of the reserve with gratuitous issuance of new shares. In this case, as we could hardly assume that the increase of the number of outstanding shares will have any material impact on the market price of the new NTT share, the accounting policy of the former NTT to treat CCC as capital surplus as well as its capitalization at the time of the privatization have the consequence of generating huge capital gain on the part of the new NTT's shareholders.

Furthermore, under the prevailing practice in Japanese business society to show the dividend performance as a percentage of the par value of the share (or capital stock), the capitalization of the legal capital reserve should have the effect of increasing the total dividend received by the new NTT's shareholders. It cannot be denied that these benefits enjoyed by the new NTT's shareholders represent the other side of the unreasonable burden of the excessive depreciation expense and unfair return incurred by the subscribers. As it is, the privatized NTT should take actions to return the CCC balance—which converted to the legal capital reserve—to its contributors (subscribers) rather than to the new Company's shareholders.

Within the framework of the present Commercial Code, this could be achieved by the decision to bar NTT from the appropriation of the legal capital reserve for capitalization with gratuitous issue of new shares and to allow the management to use the reserve only for the purpose of filling a deficit. Thus, the new NTT will not be able to justify any rate increase by reason of a deficit sustained during any single year of operation.

However, it is most unlikely for the new NTT to incur any deficit in foreseeable future and for this reason, there is hardly any chance that the legal capital reserve can be used as a buffer to such rate increase.

↘*Public Utilities Fortnightly*, Vol. 99, No. 10, May 12, 1977, pp. 48–49 : "Recent Cases on Customer Contributions". *Public Utilities Fortnightly*, Vol. 103, No. 4, February 15, 1979, pp. 45–46, both contain the tatest court decisions and rulings concerning the matter.

Then, instead of these measures, we could conceive another approach proposed below as more direct and effective ways to turn the CCC balance into the benefit of subscribers. One is to exclude the depreciation amount of the fixed assets related to the CCC from including in the operating expenses for the purpose of rate making. The other is to reduce the rate base by an amount equal to the CCC balance when in near future the new Company is going to adopt the rate base formula for rate making, because this should have the effect of avoiding the unfair distribution of income or burden to the investors and subscribers as mentioned above.

Closing Balance Sheet of the former NTT
(as of March 31, 1985)
—Liabilities and Capital Account—

	(million yen)
Current liabilities (total)	551, 056
Fixed liabilities (total)	5, 026, 938
Other liabilities (total)	2
Legal capital	18, 847
Capital surplus	2, 712, 256
(Customers' contribution for construction)	(2, 552, 828)
Earned surplus	2, 482, 641
Total liabilities and capital account	10, 791, 744

Source : *Seifu Kankei Kikan Kessansho* (Financial Statements of the Government-owned Public Institutions in Japan), Budget Bureau, Ministry of Finance, 1984.

Opening Balance Sheet of the new NTT
(as of April 1, 1985)
—Liabilities and Shareholders' Equity—

	(million yen)
Current liabilities	1, 227, 104
Fixed liabilities	6, 236, 729
(Provision for employees' retirement payment)	(1, 682, 559)
Capital stock	780, 000
Legal capital reserve	2, 546, 076
Earned surplus	—
Total liabilities and shareholdes' equity	10, 789, 910

Sorce : The Nippon Telegraph and Telephone Corporation, *Kessan Hōkoku* (Financial Report), March 1986.