Rate Case Auditing – Part 2

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INSTITUTE OF PUBLIC UTILITIES | MSU

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Course Information

- **Course Overview** – In this course, attendees will learn about regulatory auditing. It covers the foundation of auditing in general, and approaches and methods unique to regulatory accounting. This course also covers the regulatory challenges that are faced by auditors in the collection and analysis of public utility financial and operating data. This course is intended for students with an interest in regulatory audits their purpose and use by regulatory agencies.

- **Intended Audience** – Accountants and analyst that need a broader understanding of the process of regulatory auditing.

- **Learning Objectives** – After this course the student will have a foundational understanding of the foundations of general auditing and how distinctive approaches and techniques are used when reviewing the books and records of an economically regulated entity.

- **Course Level** – Advanced

- **Course Prerequisites** – A working understanding of accounting and regulatory reporting standards and report forms.

- **Advance Prep** – None

- **Delivery Method** – Online Group Live

- **NASBA National Registry Statement** -- The Institute of Public Utilities is registered with the National Association of State Boards of Accountancy (NASBA) as a sponsor of continuing professional education on the National Registry of CPE Sponsors. State Boards of Accountancy have the final authority on the acceptance of individual course for CPE credit. Complaints regarding registered sponsors may be submitted to the National Registry of CPE Sponsors through its website: [www.nasbaregistry.org](http://www.nasbaregistry.org).  

- **This course is eligible for CPE credit.**
“...the problem of ratemaking is one which has taxed, and will continue to tax, the ingenuity of man to the extent of time.”

Commissioner John V. Smith of Alabama July 16, 1903, to the fifteenth annual convention of NARUC
CWIP in Rate Base vs AFUDC
Construction Work in Progress (CWIP)
- Includes costs of construction for projects that extend for more than a year and are not considered Used and Useful.
- **Audit issue: Financing Costs**

Regulatory Methods of handling Financing Costs
- **AFUDC** – Allowance for Funds used During Construction.
  - Financing costs are accrued and added to CWIP
  - Includes both Equity and Debt costs
  - **ISSUE**: Deferred Financing Costs earn a return, so there is a compounding impact that is also deferred for later recovery.

Regulatory Methods of handling Financing Costs
- **Include CWIP account balance in Rate Base**
  - Financing costs are recovered currently in rates and no financing costs are accrued and added to CWIP
  - Includes both Equity and Debt costs
  - **ISSUE**: Rate Payers are paying for plant that is not providing service.
  - Some states prohibit this approach (used and useful)
Use of allowance for funds used during construction (AFUDC)

• The auditor should become familiar with the formula used by the utility to compute AFUDC to assure the utility has computed the rate correctly.

• The utility most likely uses the FERC approach or some approach similar found in the USoA Plant instructions (17).

**Audit Issue:** AFUDC stops when the project is complete Not when the project is (a) put into service or (b) recognized in rate base
## Impact of AFUDC vs. CWIP

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
<th>Year 8</th>
<th>Year 9</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>AFUDC (no CWIP in rate base)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capitalized cost (cumulative)</td>
<td>$1,000</td>
<td>$2,070</td>
<td>$3,215</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AFUDC (7%)</td>
<td>$70</td>
<td>$145</td>
<td>$225</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total CWIP</td>
<td>$1,070</td>
<td>$2,215</td>
<td>$3,440</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>$573</td>
<td>$1,147</td>
<td>$1,720</td>
<td>$2,293</td>
<td>$2,867</td>
<td>$3,440</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rate base</td>
<td>$2,867</td>
<td>$2,293</td>
<td>$1,720</td>
<td>$1,147</td>
<td>$573</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ROR (7%)</td>
<td>$201</td>
<td>$161</td>
<td>$120</td>
<td>$80</td>
<td>$40</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>$573</td>
<td>$573</td>
<td>$573</td>
<td>$573</td>
<td>$573</td>
<td>$573</td>
<td></td>
<td></td>
<td></td>
<td>$573</td>
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<tr>
<td>Rate impact</td>
<td>$774</td>
<td>$734</td>
<td>$694</td>
<td>$654</td>
<td>$613</td>
<td>$573</td>
<td></td>
<td></td>
<td></td>
<td>$4,042</td>
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</table>

### CWIP in rate base

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
<th>Year 8</th>
<th>Year 9</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total CWIP</td>
<td>$1,000</td>
<td>$2,000</td>
<td>$3,000</td>
<td>$3,000</td>
<td>$3,000</td>
<td>$3,000</td>
<td>$3,000</td>
<td>$3,000</td>
<td>$3,000</td>
<td></td>
</tr>
<tr>
<td>Plant in service</td>
<td>$1,000</td>
<td>$2,000</td>
<td>$3,000</td>
<td>$3,000</td>
<td>$3,000</td>
<td>$3,000</td>
<td>$3,000</td>
<td>$3,000</td>
<td>$3,000</td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$500</td>
<td>$1,000</td>
<td>$1,500</td>
<td>$2,000</td>
<td>$2,500</td>
<td>$3,000</td>
<td></td>
</tr>
<tr>
<td>Rate base</td>
<td>$1,000</td>
<td>$2,000</td>
<td>$3,000</td>
<td>$2,500</td>
<td>$2,000</td>
<td>$1,500</td>
<td>$1,000</td>
<td>$500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ROR (7%)</td>
<td>$70</td>
<td>$140</td>
<td>$210</td>
<td>$175</td>
<td>$140</td>
<td>$105</td>
<td>$70</td>
<td>$35</td>
<td></td>
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<tr>
<td>Depreciation expense</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$500</td>
<td>$500</td>
<td>$500</td>
<td>$500</td>
<td>$500</td>
<td>$500</td>
<td></td>
</tr>
<tr>
<td>Rate impact of CWIP in RB</td>
<td>$70</td>
<td>$140</td>
<td>$210</td>
<td>$675</td>
<td>$640</td>
<td>$605</td>
<td>$570</td>
<td>$535</td>
<td>$500</td>
<td>$3,945</td>
</tr>
</tbody>
</table>
Audit Issue:
If CWIP is allowed to be included in Rate Base, the auditor should confirm the capitalization of financing costs through the allowance for funds used during construction (AFUDC) stops once rates are effective.
Understanding Hypothetical Capital Structure
If the utility’s proportion or cost of debt is significantly different than that indicated as industry averages, the auditor may wish to consider using a *hypothetical* capital structure, in lieu of the actual capital structure. In doing this, one would look to base the capital structure on industry averages for similarly situated utilities, in effect, using a more normal capital structure for rates than that indicated by the actual capital structure. This is sometimes done when either the proportion of debt or proportion of equity is an unusually large portion of the capital structure.

*Source: NARUC Rate Case and Audit Manual*

<table>
<thead>
<tr>
<th>Accumulated Deferred Income Taxes</th>
<th>77,783</th>
<th>69,500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee Benefit Plans</td>
<td>-</td>
<td>11,290</td>
</tr>
<tr>
<td>Regulatory Liabilities</td>
<td>46,734</td>
<td>49,431</td>
</tr>
<tr>
<td>Other</td>
<td>919</td>
<td>1,086</td>
</tr>
<tr>
<td><strong>TOTAL OTHER LIABILITIES</strong></td>
<td>150,524</td>
<td>159,203</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>CONTRIBUTIONS IN AID OF CONSTRUCTION</th>
<th>113,375</th>
<th>127,863</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>TOTAL CAPITALIZATION AND LIABILITIES</strong></td>
<td>$ 1,074,450</td>
<td>$ 1,020,015</td>
</tr>
</tbody>
</table>

See Notes to Consolidated Financial Statements.
# Capitalization and Liabilities

<table>
<thead>
<tr>
<th>CAPITALIZATION:</th>
<th>Common Stock, No Par Value</th>
<th>$</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>233,054</td>
<td>221,919</td>
</tr>
<tr>
<td></td>
<td></td>
<td>167,274</td>
<td>145,807</td>
</tr>
<tr>
<td></td>
<td></td>
<td>400,328</td>
<td>367,726</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2,084</td>
<td>2,084</td>
</tr>
<tr>
<td></td>
<td></td>
<td>290,280</td>
<td>306,520</td>
</tr>
<tr>
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<td>692,692</td>
<td>676,330</td>
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<table>
<thead>
<tr>
<th>CURRENT LIABILITIES:</th>
<th></th>
<th>$</th>
<th>$</th>
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</thead>
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<tr>
<td></td>
<td>17,462</td>
<td>6,731</td>
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<tr>
<td></td>
<td>55,500</td>
<td>13,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>24,847</td>
<td>21,125</td>
<td></td>
</tr>
<tr>
<td></td>
<td>12,162</td>
<td>8,621</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2,535</td>
<td>1,986</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1,365</td>
<td>1,330</td>
<td></td>
</tr>
<tr>
<td></td>
<td>3,988</td>
<td>3,826</td>
<td></td>
</tr>
<tr>
<td></td>
<td>117,859</td>
<td>56,619</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>COMMITMENTS AND OTHER LIABILITIES:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Other Liabilities:</td>
<td></td>
<td></td>
</tr>
<tr>
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<td>159,203</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>OTHER LIABILITIES:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributions in Aid of Construction:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>TOTAL CAPITALIZATION AND LIABILITIES</td>
<td>$1,074,450</td>
<td>$1,020,015</td>
</tr>
</tbody>
</table>

See Notes to Consolidated Financial Statements.
## CAPITALIZATION AND LIABILITIES

### CAPITALIZATION:
- Common Stock, No Par Value: $233,054
- Retained Earnings: $167,274
- Total Common Equity: $400,328
- Preferred Stock: $2,084

### LIABILITIES:

#### Hypothetical Capital Structure Example

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
<th>Percent</th>
<th>Cost</th>
<th>Weighted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>402,412</td>
<td>42%</td>
<td>11.5%</td>
<td>4.8%</td>
</tr>
<tr>
<td>Debt &amp; Other Cr.</td>
<td>558,663</td>
<td>58%</td>
<td>6.5%</td>
<td>3.8%</td>
</tr>
<tr>
<td>Total Capitalization</td>
<td>961,075</td>
<td>100%</td>
<td>8.6%</td>
<td>82,590</td>
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</table>

#### Capital Structure Computation

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
<th>Percent</th>
<th>Cost</th>
<th>Weighted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>402,412</td>
<td>45%</td>
<td>11.5%</td>
<td>5.2%</td>
</tr>
<tr>
<td>Debt &amp; Other Cr.</td>
<td>558,663</td>
<td>55%</td>
<td>6.5%</td>
<td>3.6%</td>
</tr>
<tr>
<td>Total Capitalization</td>
<td>961,075</td>
<td>100%</td>
<td>8.8%</td>
<td>84,094</td>
</tr>
</tbody>
</table>

- LT Debt: $290,280
- Current Liab: $117,859
- Other Liab: $150,524
- Liabilities and Other Cr: $558,663
- Total Capitalization: $961,075

#### Change in Earnings
- 1,504

#### Revenue Conversion Factor
- 1.32

#### Change in Revenue Requirement
- 1,978

### Other Liabilities:
- 919
- 1,086
- Total Other Liabilities: $150,524

### Contributions in Aid of Construction:
- 113,375
- 127,863
- Total Capitalization and Liabilities: $1,074,450

See Notes to Consolidated Financial Statements.
## CAPITALIZATION AND LIABILITIES

### CAPITALIZATION:
- Common Stock, No Par Value: $233,054
- Retained Earnings: $167,274
- Total Common Equity: $400,328

### CURRENT LIABILITIES:
- Current Liabilities: $367,726

### COMMITMENTS AND CONTINGENCIES:

### OTHER LIABILITIES:
- Total Other Liabilities: $150,524

### CONTRIBUTIONS IN AID OF CONSTRUCTION:
- Contributions: $113,375
- Total Capitalization and Liabilities: $1,074,450

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**Hypothetical Capital Structure Example**

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
<th>Percent</th>
<th>Cost</th>
<th>Weighted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>402,412</td>
<td>65%</td>
<td>11.5%</td>
<td>7.5%</td>
</tr>
<tr>
<td>Debt &amp; Other Cr.</td>
<td>558,663</td>
<td>35%</td>
<td>6.5%</td>
<td>2.3%</td>
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<tr>
<td>Total Capitalization</td>
<td>961,075</td>
<td>100%</td>
<td>9.8%</td>
<td>93,705</td>
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</table>

<table>
<thead>
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<th></th>
<th>Amount</th>
<th>Percent</th>
<th>Cost</th>
<th>Weighted</th>
</tr>
</thead>
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<tr>
<td>Equity</td>
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<td>55%</td>
<td>11.5%</td>
<td>6.3%</td>
</tr>
<tr>
<td>Debt &amp; Other Cr.</td>
<td>558,663</td>
<td>45%</td>
<td>6.5%</td>
<td>2.9%</td>
</tr>
<tr>
<td>Total Capitalization</td>
<td>961,075</td>
<td>100%</td>
<td>9.3%</td>
<td>88,899</td>
</tr>
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</table>

**Change in Earnings**
- (4,805)

**Revenue Conversion Factor**
- 1.32

**Change in Revenue Requirement**
- (6,323)

---

See Notes to Consolidated Financial Statements.
Types of Adjustments
Adjustments

What does adjustments have to do with auditing?

Regulatory auditors are not financial auditors. The purpose of a regulatory auditor is to provide assurance to rate payers, companies and the regulators themselves that the rates approved will provide the company with a reasonable opportunity to earn a return on its investment while providing rate payers service at the least cost. Adjustments are one of the tools that the regulatory auditor uses to achieve that goal.
Regulatory Adjustments

• Various adjustments are needed to adjust a test year to reflect costs and revenues that are reasonably expected to be incurred in the rate year. This is especially true when working with small companies.

• Adjustments are required when working with a historically-based pro forma test year as well as when preparing a partial or fully projected test year.

• Future changes in the economic environment must be recognized in order to develop a forward-looking income statement and rate base.
Regulatory Adjustments
— Small Companies

In audits of small companies it's not uncommon to find personal expenses while at the same time finding no costs for other items such as personal vehicles used in the business.

- Review of a small company’s income taxes may provide addition information such as milage claimed for income taxes,
- Add regulatory costs such as legal costs of filing a case or expert consultant – not known at time of filing,
- Adjust for other reasonably estimated, costs that will be incurred in its rate year.

*Remember, small companies serve small communities which deserve safe and reliable utility service.
Restating Adjustments

- Out-of-period
  - Auditors when reviewing invoices must be aware of transactions that took place prior to the beginning of the year but paid during the test year.
    - **Issue**: Are rates being set using a modified cash-basis of accounting or full accrual?
  
- Auditors must also look for transactions that belong in the test year but were paid outside the test year.
  - **The rental cost of a backhoe for a water main repair that was paid two months after the end of the test year.**
Deferral Adjustments

Auditors routinely find expenses in a test year that are material but not expected to be recurring.

Auditors must decide to:
  a) Disallow the expense for future recovery or
  b) Defer and amortize, allowing recovery in the future

What is a possible problem with a disallowance?
What if there is a large one-time loss from flood damage, which, without recovery of the cost, may simply bankrupt the company?
Deferral Adjustments

Auditors routinely find expenses in a test year that are material but not expected to be recurring.

Auditors must decide to:
   a) Disallow the expense for future recovery or
   b) Defer and amortize, allowing recovery in the future

What is a possible problem with the deferral option?
A company normally requires authorization from its regulatory agency to defer costs incurred in one period to recovered in a later period.

The Problem: [Possible] Retroactive Ratemaking
Deferral Adjustments

Retroactive Ratemaking

The courts have described the Retroactive Ratemaking prohibition as “... imposing a rate increase for [electricity] already sold.” (Arkla, 453 U.S. at 578)

- That is, the company gets a second bit of the apple to recover costs of providing utility services in a prior period.

- **For Example:** Expenses that were allowed in a company’s prior case which were uncollected or incorrect cannot be recovered in a current case. Same regarding excess revenue cannot be “clawed back.”

- **DEPENDING on commission policy:** The question for the auditor: Is a deferral of a utility’s costs associated with a company’s response to catastrophic events, such as windstorms, earthquakes, etc., be considered retroactive recovery?
Projected or Pro Forma Adjustments

Annualization Adjustment

An auditor should be able to recognize changes in revenues or expenses through comparables. If a material change is identified, the auditor should consider:

• Is the change durable, will it continue?
• If it will continue, is the cost measurable or reasonably predicted?

5% insurance premium increase
Projected or Pro Forma Adjustments

Normalization Adjustment

- Auditors must be able to think through the impact of unusual or abnormal events on revenue or expenses on the company’s test year,

  During the test year, there was a drought that dramatically increased the cost of electric power for a six-month period. The drought has ended, and hydro-provided power has returned to normal.

- Auditors need to adjust revenues or expenses in the test year to smooth variable annual data.

  weather normalization
Projected or Pro Forma Adjustments

The auditor will want to look for seasonality in the revenue data. If seasonality exists, it may be important to then determine whether the data has been normalized, or whether normalization is needed.

- If usage is seasonal or driven by weather…then any unusual weather patterns that occurred during the test year will skew the data to either under or over report revenues.
- This can be corrected by adjusting the usage to reflect normal weather patterns, based on historical weather data and either heating degree days or cooling degree days. *(NARUC Rate case & Audit Manual)*

August through July averages ascribed to the year of the January Mean 10.5 C
Projected or Pro Forma Adjustments

Statistical Modeling to find trends or relationships

Linear Regression
Linear regression is a tool that is used to model the relationship between two variables (independent and dependent) by fitting a linear equation to observed data.

The most common method for deriving a regression line is the least-squares method.
Types of Adjustments

Poll Question

Is there a difference between Precision and Accuracy?

1. Yes
2. No
3. Sometimes
4. Only Mammals
Types of Adjustments

Poll Question

Is there a difference between Precision and Accuracy?

1. Yes
2. No
3. Sometimes
4. Only Mammals
**Precision vs Accuracy**

Do not confuse Precision with Accuracy.

\[ \sqrt{562} = 36.32546526 \]

is precise

But incorrect.

\[ \sqrt{562} = 23.7 \]

23.7 is less precise but much more accurate!
## Audit of the Income Statement

<table>
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<th></th>
<th>2022</th>
<th>2021</th>
<th>2020</th>
</tr>
</thead>
<tbody>
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<td>Revenue</td>
<td>(2,824.7)</td>
<td>(3,049.2)</td>
<td>(2,729.8)</td>
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<tr>
<td>Expenses</td>
<td>(181.0)</td>
<td>(158.5)</td>
<td>(186.4)</td>
</tr>
<tr>
<td></td>
<td>440.1</td>
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<td>511.4</td>
</tr>
<tr>
<td></td>
<td>(108.2)</td>
<td>(354.3)</td>
<td>(166.1)</td>
</tr>
<tr>
<td>Profit</td>
<td>(2,673.8)</td>
<td>(3,167.3)</td>
<td>(2,570.9)</td>
</tr>
<tr>
<td>Revenue</td>
<td>(186.5)</td>
<td>(117.5)</td>
<td>260.6</td>
</tr>
<tr>
<td>Expenses</td>
<td>1,417.2</td>
<td>2,284.9</td>
<td>1,267.3</td>
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<tr>
<td></td>
<td>(695.4)</td>
<td>(962.8)</td>
<td>(3,333.9)</td>
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<tr>
<td></td>
<td>(1,777.8)</td>
<td>(2,615.1)</td>
<td>(3,333.9)</td>
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<tr>
<td>Profit</td>
<td>(3,114.6)</td>
<td>(2,896.6)</td>
<td>(2,609.7)</td>
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<tr>
<td>Revenue</td>
<td>92.6</td>
<td>142.3</td>
<td>112.9</td>
</tr>
<tr>
<td>Expenses</td>
<td>(11.8)</td>
<td>(13.6)</td>
<td>(10.6)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>
Review of the results of operations

Look at a multi-year comparison of annual revenue to obtain a view of the trend for the utility.
• Is it growing and if so, is the growth relatively consistent?
• Is the growth related to new customers or additional usage of existing customers?

(NARUC Rate case & Audit Manual)

The auditor will also want to make sure that any other rate changes that occurred during the test year are reflected in the adjusted revenues.
Review of the results of operations

Fire Protection – should fire departments pay for water?

Ready-to-Serve – Service line installed

Stand-by – No Service line installed

Auditors should be aware of the policy for ready-to-serve and stand-by service. It could require a limited group of people to pay for a common system.
Review of the results of operations

601. Salaries and Wages - Employees
This account shall include the compensation (salaries, bonuses and other consideration for services) paid or accrued to employees of the utility company for work related to operation and maintenance of that utility.

NARUC Water USoA
Review of the results of operations

Salaries and Wages

- Closely review wage increases which will become effective during or outside the test year.
  - During the test year – annualization of the increase must be accounting for in the calculation of labor costs
  - Look for *slippage* – when a highly paid individual retires or otherwise leaves and is replaced by a lower paid individual.
Review of the results of operations

An auditor may wish to look at the percentage of overtime worked during the past few years and compare it to the percentage of overtime in the test year.

If there is a large difference between the historical numbers and the test year numbers, one will want to obtain an explanation.

(NARUC Rate case & Audit Manual)

- Look for dis-proportionate effects in the computations relative to the change in the test year.

Consider using a multiple-year average percentage of overtime to use in the computation of the revenue requirement in order to normalize any test year [overtime] anomalies. (NARUC Rate case & Audit Manual)
Review of the results of operations

Salaries and Wages - Officers

- Owner Wages and Expenses

  - An owner that works in the company wears two hats
  - When reviewing questions of compensation for owners the auditor must clearly understand the role the person is in relative to the cost.
    - Owners do not get pension plans paid by ratepayers – employees do.
    - Disallowed owner-based costs are NOT prohibited from being incurred!
Review of the results of operations

**Salaries and Wages - Officers**

- Officer or management
  - What is the officer’s salary and bonuses based on?
    - Economic benchmarks associated with the value of the company should be looked at closely since they normally benefit shareholders
    - Service satisfaction or other reliability operating benchmarks such as SAIDI and SAIFI normally benefit ratepayers.

System Average Interruption Duration Index (SAIDI) and System Average Interruption Frequency Index (SAIFI).
Review of the results of operations

Salaries and Wages - Officers

- Officer or management
  - Determination of Salaries and other compensation?
  - Transparency in reporting
    - Ratecase filing / Data Requests
    - Shareholders Proxy statement
      - Will always contain the breakdown of Salaries,
      - Stock awards,
      - Bonuses
Review of the results of operations

Rental of Building / Real Property

- Arms-Length transaction
  - Is rent market value?
  - Location?
    - Is the location reasonably priced area?
    - Growth be due to facility

- Non Arms-Length (major shareholder owns property)
  - Is rent market value?
  - Imputed Asset approach
    - Impute depreciation expense
    - Impute return on Original Cost less Depreciation

Lower cost or market?
Review of the results of operations

403. Depreciation Expense
   A. This account shall be charged with depreciation credited to account 108 - Accumulated Depreciation of Water Plant and credited with amortization debited to account 272 - Accumulated Amortization of Contributions in Aid of Construction. Depreciation shall be accrued on a straight-line remaining life basis or straight-line basis, as required by the Commission. A single composite depreciation rate may be used if approval from the Commission is obtained.
Depreciation Expense (Water)

Journal Entry:  

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation Expense – Straight Line</td>
<td>XXX</td>
</tr>
<tr>
<td>Accumulated Amortization of CIAC</td>
<td>XX</td>
</tr>
</tbody>
</table>

Accumulated Depreciation  
Amort. of CIAC

To record regulatory basis depreciation expense
Depreciation Computation - Water

Analysis of Depreciation Expense

- Plant in Service - Year End: $54,240
- Less:
  - Non-depreciable Plant e.g., Land: $(2,500)
  - Advances for Construction: $(460)

Depreciable Plant: $51,280

Composite Depreciation Rate: 2%

- Composite Depreciation: $1,026

Contribution in Aid of Construction: $(1,100)

Composite Amortization Rate: 2%

- Composite Amortization: $(22)

Net Regulatory Depreciation Expense: $1,004

OR

Average Plant in Service

Recoverable Plant
Depreciation Computation

272. Accumulated Amortization of Contributions in Aid of Construction

A. This account shall reflect the amortization accumulated on account 271 - Contributions in Aid of Construction, if recognized by the Commission.

B. Specifically, balances in account 271 which represent contributions of depreciable plant shall be amortized by charges to this account over a period equal to the estimated service life of the related contributed asset. A group or overall composite rate may be used for contributed balances that cannot be directly related to a plant asset.

C. The concurrent credit for the amortization recorded in this account shall be made to account 403 - Depreciation Expense.

D. If a regulatory body allows the amortization of any portion of the monies collected to pay the tax obligation caused by the receipt of CIAC, such amortization shall also be reflected in a sub-account of this account. Specifically, balances in account 271 which represent monies collected for the gross-up of CIAC (See Definition 15.) shall be amortized by charges to this account over a period determined by the regulatory body.

Net Regulatory Depreciation Expense $1,004
Review of the results of operations

421. Nonutility Income
This account shall contain all Revenue not includible in operating revenue.

NARUC Water USoA
Review of the results of operations

Gross income from nonutility operations
Nonutility income is an audit item because there is a regulatory question that must be answered. Is any of the ratepayer funded resources (plant or services) being used to subsidize the nonutility income?

The auditor should review prior workpapers to determine if there has been a prior determination as to cross-subsidy. Should consider talking to prior staff assigned to the case. If resources are being used than allocations must be derived to remove costs used for the nonregulated activity. The company may agree to include the nonutility revenue in revenue requirement in exchange of not allocating costs. This works only if there is positive income for the nonutility activity.
Review of the results of operations

Net gain on sale of nonutility property
When a utility that sales nonutility property any gain is not shared with the rate payer since the property was never dedicated to public service. The audit question is, is it true that the property was never utility property. IF it was, then rate payers may be entitled to all or a portion of the gain.

The auditor should review prior workpapers to determine if there was any record of a transfer of the property out of regulation. Confirm that it was never included in rates. The account that could be useful is the Plant Held for Future Use account (103) NARUC (105) FERC
Gain on reacquired Debt
When a utility reacquires high interest debt and replaces it with lower cost debt it can realize a gain on the transaction. GAAP allows the gain to be (1) amortized over the life of the original issuance (2) amortized over the life of the replacement debt or (3) flow-through the gain in the year of the transaction.

Regulatory accounting does not allow the flow-through of the gain in the year of the transaction since the rate payer would not see the benefit of the gain.

The auditor should review prior GAAP based annual reports (10-K) since last rate filing to confirm either there were no retirements or that any gain is being amortized consistent with regulatory accounting.
Review of the results of operations

426. Miscellaneous Nonutility Expenses

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Income Accounts

Income taxes shall be recorded in account 409.20, Income Taxes, Other Income and Deductions.

419. Interest and Dividend Income

This account shall include interest revenues on securities, loans, notes, advances, special deposits, tax refunds and all other interest bearing assets and dividends on stocks of other companies, whether the securities are carried as investments or included in sinking or other special funds accounts.

420. Allowance for Funds Used During Construction

This account shall include concurrent credits for allowance for funds used during construction based upon the net cost of funds used for construction purposes and a reasonable rate upon other funds when so used. Appropriate regulatory approval shall be obtained for "a reasonable rate" (See Accounting Instruction 19).

421. Nonutility Income

In this account is entered all income not includable in operating revenue accounts 460 through 474 or in account 419 - Interest and Dividend Income. Items in this account shall include:

1. Gross income from nonutility operations, and
2. Net gain on sale of nonutility property.

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Review of the results of operations

426. Miscellaneous Nonutility Expenses
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NARUC Water USoA
Review of the results of operations

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<td>Operating Revenue</td>
<td>company filing</td>
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</tr>
<tr>
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<td>634,252</td>
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**Review of the results of operations**

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**Disallowed Expenses from prior cases**

The auditor should review prior orders of the commission related to the audited company to prevent the inadvertent allowance into rates of costs that have been disallowed in a prior preceding. This is especially true when it has been a number of years since the last preceding.

utility operations and interest expense.

*NARUC Water USoA*

The auditor should also consider talking to prior staff assigned to the case. It is not unusual that a prior auditor that has been reassigned will remember any issues or disallowances.
Review of the results of operations

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Review of the results of operations

Amortization into operating income of unauthorized acquisition adjustments.
If a company has on its regulatory books an acquisition adjustment for a prior purchase of a regulated system, it MAY NOT show up on its accounting records if it is a smaller system. Many small systems will have a local accountant, which is not familiar with regulatory accounting maintain the company books on either a tax basis or GAAP. It that case the acquisition adjustment will not be reflected.

The Auditor should confirm no purchases of other systems. If there is a purchase was an acquisition adjustment determined and if so, was the recover allowed or disallow.
Review of the results

descriptions

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<tbody>
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Company filing
### Review of the results of operations

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</tr>
<tr>
<td>4</td>
<td>Fire Protection Revenue</td>
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<td>5</td>
<td>Ready to Serve</td>
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</tr>
<tr>
<td>6</td>
<td></td>
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</tbody>
</table>

#### Miscellaneous

**Nonutility Expenses**

This account shall contain all expenses other than expenses of utility operations and interest expense.

- **Depreciation associated with plant not used and useful in the public service**
  - OR Depreciation of Nonutility Plant.

Rates should not include the cost of either. Any plant purchased and on the books of the company that is not providing some form of service to the rate payer should be disallowed and charged to Account 426. This is the same with any form of nonutility plant.

These adjustments are commonly found in a site visit to the company. If possible, an auditor should schedule a site visit to a company any time there has been a number of years since the last review or if there has been a major change in asset or operating costs.
Review of the results of operations

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Review of the results of operations.

**Disallowance of imprudent expenses.**

Imprudent expenses are expenses that are lacking discretion, wisdom, or good judgment and can be one of the most difficult to detect in an audit. An auditor challenging an expense as imprudent must have a sound basis which can be documented. Salaries are a common expense found imprudent.

Imprudent costs can be detected in a site visit to the company. However, cost awareness is the best audit tool. Know the going costs can give the auditor clues as to spending abuses. If possible, if a company must make a large investment, an open sealed bidding process should be followed to assure a reasonable cost to the ratepayers.
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<tbody>
<tr>
<td>44</td>
<td>Net Operating Income</td>
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</tbody>
</table>
Review of the results of operations

Donations for charitable, social or community welfare purposes. One of the most common small company audit adjustments. Charitable contributions are normally easy to find (income tax reasons) and auditors normally should have not difficulty in determining the amount. The real issue normally is what the company would say is a lack of fairness on the auditor's side. It is not the intent to direct where the utility can spend its money, but rather, to decide how much of that expense should be paid by ratepayers rather than shareholders.

(NARUC Rate case & Audit Manual)

...it would be easy to get lost in the political sensitivities of trying to eliminate donations and political expenditures that regulators may consider to be offensive, but in doing so, one could overlook the larger expense of special pensions for the Board of Directors that may also be inappropriate. By identifying the big-ticket items – those that really matter to the overall level of rates – one can determine the issues about which to inquire first, and those that can wait or move to the bottom of the list.

(NARUC Rate case & Audit Manual)
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Life insurance on officers and employees where utility is beneficiary
“Key Person” life insurance is a policy that will provide funds to the company if in the unfortunate event a senior level manager or employee dies allowing the company funds to continue operations will filling the position. Also called Corporate owned life insurance. The premiums are not recoverable in rates.

Although the premiums are disallowed, and amounts received by the company are not used to off-set revenue requirement. *This treatment is consistent with IRS income tax treatment of the cost.*
Review of the results

de

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Review of the results of operations

670. Bad Debt Expense

This account shall be charged with amounts sufficient to provide for losses from uncollectible utility revenues.

NARUC Water USoA

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>-</td>
</tr>
<tr>
<td>2017</td>
<td>-</td>
</tr>
<tr>
<td>2018</td>
<td>-</td>
</tr>
<tr>
<td>2019</td>
<td>57,540</td>
</tr>
<tr>
<td>2020</td>
<td>-</td>
</tr>
<tr>
<td>2021</td>
<td>53,613</td>
</tr>
</tbody>
</table>

Total Write-off Amount: 111,153
Average: 18,526

percent of revenue: 3,075,000, 0.60%
Review of the results of operations

Penalties or fines for violations of statutes pertaining to regulation
Penalties and fines are not allowed because they are not in the public interest and not used and useful. The disallowance “flows through” the cost to the shareholders maintaining the intent of the penalty or fine. (change behavior?)

utility operations and interest expense.

NARUC Water USoA

Penalties or fines of the commission are easily found in the record of the company. However, payments to other agencies may be found in a regulatory debit account (407) FERC or Regulatory Expense (667) NARUC. An auditor’s due diligence research may also find issues (penalties) with other regulators.
Review of the results of operations

426.4 Expenditures for certain civic, political and related activities.

This account shall include expenditures for the purpose of influencing public opinion with respect to the election or appointment of public officials, referenda, legislation, or ordinances (either with respect to the possible adoption of new referenda, legislation or ordinances or repeal or modification of existing referenda, legislation or ordinances) or approval, modification, or revocation of franchises; or for the purpose of influencing the decisions of public officials, but shall not include such expenditures which are directly related to appearances before regulatory or other governmental bodies in connection with the reporting utility’s existing or proposed operations.

经营收入

<table>
<thead>
<tr>
<th>线号</th>
<th>经营收入</th>
<th>公司账面金额</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>经营收入</td>
<td>公司账面金额</td>
</tr>
<tr>
<td>2</td>
<td>未计水费收入</td>
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<td>3</td>
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<td>4</td>
<td>消防费收入</td>
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<td>5</td>
<td>准备服务</td>
<td>2,222</td>
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<td>6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
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</table>

<table>
<thead>
<tr>
<th>线号</th>
<th>经营及维护费用</th>
<th>公司账面金额</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>经营及维护费用</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>其他税费</td>
<td>341</td>
</tr>
<tr>
<td>3</td>
<td>监管费用</td>
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<tr>
<td>4</td>
<td>邮费</td>
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<tr>
<td>5</td>
<td>事务服务 - 会计师</td>
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<td>6</td>
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<td>事务服务 - 工程</td>
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<td>8</td>
<td>议会费用</td>
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<td>9</td>
<td>慈善捐款</td>
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<td>11</td>
<td>修理及维护</td>
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<td>电话</td>
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<td>费用及税费</td>
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<td>供应品及材料</td>
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<td>17</td>
<td>水处理及检测</td>
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<td>22</td>
<td>纯经营收入</td>
<td>7,854</td>
</tr>
</tbody>
</table>
Expenditures for certain civic, political and related activities

The auditor should identify two types of expenditures. Expenditures for direct lobby activities which includes payments to politicians or lobbyist. But there are also expenditures to organizations that spend a portion of the funds they receive on lobbying. Trade organisations or labor groups can be included in this category. The question the auditor must answer is what portion of dues or assessments from those organizations are reasonably included in rates relative to the provision of service.

Dues to trade organizations routinely support the provision of utility service but invoices should be reviewed for the dues paid, since they normally indicate what portion of the dues is for the support of political activity. 

*(NARUC Rate case & Audit Manual)*
ACRONYMS

Poll Question

Which of the below is NOT an acronym?

1. NARUC
2. GAAP
3. AFUDC
4. All of the above are acronyms
ACRONYMS

Poll Question

Which of the below is NOT an acronym?

1. NARUC
2. GAAP
3. AFUDC
4. All of the above are acronyms
acronym  noun

Definition of acronym

: a word (such as NATO, radar, or laser) formed from the initial letter or letters of each of the successive parts or major parts of a compound term

Frequently Asked Questions About acronym

What is the difference between an acronym and an initialism?

Both acronyms and initialisms are made up of the first letter or letters of the words in a phrase. The word acronym typically applies when the resulting thing can be read as a word; for example, radar comes from "radio detection and ranging" and scuba comes from "self-contained underwater breathing apparatus." The word initialism only applies when the resulting thing is read as an abbreviation; for example DIY, which comes from "do it yourself," is pronounced by saying the names of the letters.
Final Steps – Finishing Up

Small Companies

• A regulatory audit should result in an analysis and unbiased assessment of the information and collected evidence of filing before the commission.

  • Organize your workpaper making sure to remove anything not used. A bunch of papers may look impressive but are worthless when the workpapers are reviewed in two or three years.

  • Consider a “top of file” memo that describes (to the next auditor) issues or things to follow up on in the next case.

  • Meet with the company to share your recommendation –

    • Before the final report is submitted the auditor. It is common to have a closing discussion with the utility representatives at the end of the audit. During the meeting the audit team needs to straight with the company and voice any concerns that might exist.

    • The company should already be aware of the adjustments recommended by the auditor since they should have already had the opportunity to rebut the individual conclusions of the auditor.

• Discuss what the issues are and what options are available!
Final Steps – Finishing Up

Large Companies

• A regulatory audit should result in an analysis and unbiased assessment of the information and collected evidence of filing before the commission.
  • Begin the process of writing testimony and preparing exhibits.
  • Begin organizing the audit workpapers by labeling and indexing. – The workpaper structure may be a standard agency arrangement or you may have to create a system that works for your issues.
  • Any controversial adjustments should be supported by the audit workpapers.
  • Recognized that your workpapers associated with any controversial position that is contrary to any of the other parties in the case will be requested through data requests once your testimony is filed.
  • In large cases, the auditor will likely be assigned a relatively small portion of the total case, but it may have a material impact on the final results.
  • **STAY ORGANIZED!** Especially if you are responsible for confidential material. During settlement stages, positions and requests for information moves fast. Being organized from the start puts you on solid footing.
Regulatory audit Exercises
Exercise - Capital

A company files a case that includes an addition to plant in service that will come on line three months into the rate year. The project is currently using AFUDC to account for financing costs. The contractor is on schedule to completion and assures the auditor that it will meet the scheduled completion date. If the new plant is not included rates, it may cause a sharp drop in both the company’s credit rating and possible drop in stock price.

Discuss what the issues are and what options are available

Issues:

• Completion is not 100% assured
• Used and useful (state law)
• AFUDC stops accruing once the plant is complete.

Options:

• Continue the use of AFUDC until next case
• Include only 9/12 (3/4) of the expense and return in rates
• Surcharge
Exercise - Expenses

A water company finds out that a local asphalt plant has been storing asphalt over the local watershed and the company fears that the asphalt byproducts may, over time, leach into its water supply. The company has hired the top ecology law firm in the state to file a cease-and-desist order with the courts and prepare a case for damages. It has also hired a national engineering firm to test for contamination.

The company has filed to recover the costs of both the law firm and the engineering studies. After research, the auditor has found that the county has also begun its own legal actions and water contamination studies along with a local environmental protection group.

Issues:

• Does the company have a duty to protect the water shed?
• Did they need to hire the most expense available representation?
• Others are already doing the work to address the water contamination

Options:

• Disallow all expenses
• Allow a portion of the expense
Questions or Comments?
Thank You!