



TECHNIQUES FOR AUDITING BALANCE SHEET ITEMS

RATE CASE AND AUDIT MANUAL

- Prepared by regulators for regulators on how to audit a traditional rate case
- Adopted by U.S. National Association of Regulatory Utility Commissioners (11/03)
 - Available on the internet (or contact me, and I'll send electronically)

"AUDIT" DEFINED

- Not discussing a financial audit
- Discussing
 - A regulatory review
 - A field investigation
 - Appropriateness of financial presentation for regulatory purposes

Versus

"AUDIT" DEFINED

- INDEPENDENT FINANCIAL AUDIT
 - An examination of financial statements conducted by an outside certified public accountant (one not employed by the firm being examined) according to generally accepted auditing standards for the purpose of expressing an opinion as to whether the statements are a fair presentation in accordance with generally accepted accounting principles.
- ATTESTATION AUDIT
 - One in which a certified public accountant who is in the practice of public accounting is contracted to issue a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party.

THINGS TO REMEMBER

- Different People use Different Methods
- Different Methods may be Necessary with Different Companies
- Learn from Prior Experiences
- Judgment and Common Sense Go a Long Way

PRELIMINARIES

- Determine the scope of the audit
- Determine resource constraints
- Understand the Company's basic accounting system
- Historical data analysis
- Focusing the audit
- Initial data review

HISTORICAL DATA ANALYSIS

- 3-5 years of data (spreadsheet format)
- 12 months of data from test year
- Take from annual reports, trial balances, other available documents
- May include:
 - Specific items of the balance sheet
 - Detailed revenue categories
 - Sales units
 - Number of customers
- Alternative or Supplement:
 - Do comparison on expense ratios
 - Expenses per unit of revenue
 - Expenses per average customer
 - Expenses per unit of output

HISTORICAL DATA ANALYSIS

- Look for Revenue Trends
 - Increasing number of customers and calls
- Seasonal Expenses
 - Tree trimming expenses
- Expense Anomalies
 - Impacts of Labor Strike
- Lumpy Investment Changes
 - Major plant retirements or investments

FOCUSING THE AUDIT

- Use historical data analysis
 - Look for most significant items (largest unexpected changes, largest expense categories)
- Politically-sensitive items
 - Items of concern to the public or policy makers
- Understanding the unregulated / regulated line
 - Be sure you have a clear understanding of what you will be allowed to examine in terms of regulated and unregulated items

INITIAL DATA REVIEW

- Publicly available financial / other reports
 - Reports to taxing authorities, reports to shareholders, regulatory annual reports, other
- Audit reports of others
 - Internal audit reports, external auditor reports, minutes of the Audit Committee, more
- Policies and Prior Decisions of Your State
 - Many times a policy or direction for similar issues has already been established

INITIAL DATA REVIEW

- Reports, Information, Decisions of Neighboring States
 - Many issues are common to a region or a company that serves multiple jurisdictions
 - Regulators can learn from each other (as we are today)
- Information from Colleagues within Your Own Agency
 - Those who are familiar with equipment, licenses, services
 - Those who are familiar with complaints and quality of service
- Review the Accuracy of the Application / Request

COORDINATING THE AUDIT

- Determine if you will do “desk” audit or “on-site” audit (or some of each)
- Determine if you will want to only look at records and receive data, or will you also want to do *interviews*.
- Determine if you will want to do any *field trips* during your on-site audit time.
- Determine what confidentiality agreements are needed, if any.

POSSIBLE RECORDS TO REVIEW

Affiliate Agreements	Audit Committee Minutes
Billing Records	Board of Director Minutes
Chart of Accounts	Construction Work Orders
Construction Budgets	Continuing Property Records
Depreciation Studies	Organizational Charts
Property Tax Statements	Risk Committee Minutes
General Ledger	Lead-Lag Studies
Subsidiary Ledgers	Income Tax Returns
Invoices	List of Property Units
Monthly Financials	Quarterly Financials
Trial Balances	Payroll Records
Customer Bills	

WHAT ARE YOU LOOKING FOR?

- Errors in calculations
- Lack of supporting documentation
- Adjustments that are not “known and measurable”
- Costs incurred for abnormal conditions or non-recurring costs
- Costs incurred out-of-period
- Significant cost decreases not reflected
- MISSING ITEMS

PLANT IN SERVICE

- Is the plant used and useful?
 - Many believe that plant should be functioning and necessary to be included in the rate computation.
 - When determining its usefulness, need to consider the concept that asset additions may be lumpy
 - Need to consider that investment may be lumpy, since it is often cost effective to add larger increments of plant at one time.

PLANT IN SERVICE

- Look at major additions since the last rate case or review
 - Type of Project (New or Replacement)
 - Need for Project (Growth, Quality of Service, New Services)
 - Cost of the Project (Work Order Details)
 - Start and Completion Dates
 - Comparison of Cost Estimates to Actual Costs (Cost Overruns)

PLANT IN SERVICE

- Examine Trends in Plant Investment
 - If net plant is increasing, is there a reason? (More customers, increased usage)
 - If net plant is decreasing, is quality of service still being maintained?
 - Is adequate capital available to the utility in light of corporate structures and affiliates?
 - Are there new corporate policies being reflected? (lease rather than build)

PLANT IN SERVICE

- Leased Plant
 - Is property recorded appropriately as either a capital item or an expense?
 - Are there any affiliate issues related to the lease price?
- Sale of Assets
 - What treatment is proposed for the gain or loss on the sale? (Any sharing between customers and investors?)

PLANT HELD FOR FUTURE USE

- Is there a definite plan for use?
- Is there a specific time frame by which the property will be used?

CONSTRUCTION WORK IN PROGRESS

- Each jurisdiction has its own policy on whether or not to include these costs in the rate computation prior to the time the assets are actually in service.

ACQUISITION ADJUSTMENT

- Represents the different between the original cost of the plant and the purchase price
 - Very judgmental
 - What benefit is there to customers by allowing recovery of more than original cost?
- Compromise: allow a return on the unamortized balance but not the amortization expense (or the reverse)

CASH WORKING CAPITAL

- Any allowance will generally be driven by other factors and changes -- amounts allowed generally change as modify the permitted expense levels

CUSTOMER DEPOSITS

- Represents a source of non-investor supplied capital
 - Reduce rate base by the balance but allow interest as an operating expense, or
 - Include the customer deposits as a source of financing and include in capital structure at zero cost
- Become familiar with deposit policies – are they minimizing uncollectibles and minimizing necessary deposits?

PREPAYMENTS

- What is the nature of the item?
 - Does it relate to utility service
 - Does any portion relate to the unregulated businesses?
- May consider levelizing (smoothing) the account balance by taking a 13 month average

MATERIALS AND SUPPLIES

- What is the company policy on inventory levels?
- What is the purchasing practice? (Competitive bids?)
- What is the policy on spare parts?
- Balance repair needs with Quality of Service demands

OTHER RATE BASE (BALANCE SHEET) ITEMS

- What are they?
- What is their purpose?
- Do they benefit ratepayers?
- Did investors put up funds, or were they provided at cost free capital or by customers?

CONTACT INFORMATION

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