COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

* * * * *

In the Matter of:

APPLICATION OF EAST KENTUCKY UTILITIES, INC., FOR (1) ORDER AUTHORIZING A RATE INCREASE; (2) INTERIM ORDER TO IMMEDIATELY IMPLEMENT ITS PROPOSED RATES ON AN EMERGENCY BASIS; (3) ORDER AUTHORIZING THE BORROWING OF $2,114,834 TO BE USED TO PAY ITS INDEBTEDNESS AND TO CONSTRUCT AND UPGRADE ITS UTILITY FACILITIES; (4) ORDER GRANTING A CERTIFICATE OF CONVENIENCE AND NECESSITY TO RECONSTRUCT AND RENOVATE ITS GAS SYSTEM; (5) INTERIM ORDER GRANTING PERMISSION TO BORROW $50,000 AS AN EMERGENCY TO PAY WHOLESALE GAS PURCHASES; (6) ORDER FIXING A HEARING DATE AS REQUIRED BY KRS 278.300	CASE NO. 9236

O R D E R

IT IS ORDERED that the staff Audit Report for East Kentucky Utilities, Inc., ("EKU") attached hereto as Appendix A shall be included as a part of the record in this proceeding.

IT IS FURTHER ORDERED that EKU shall have until the close of business June 5, 1985, to file written comments concerning the contents of Appendix A.

Done at Frankfort, Kentucky, this 20th day of May, 1985.

PUBLIC SERVICE COMMISSION

Richard D. Heman Jr.

For the Commission

ATTEST:

Secretary

APPENDIX A

AUDIT REPORT

East Kentucky Utilities, Inc.

A limited audit of EKU's financial statements for the year ending September 30, 1984, was conducted by Commission staff in connection with Case No. 9236. The objective of the audit was to assist the utility in documentation of its revenue and expenses and reduce the need for written data requests thus reducing the rate case expense to the utility. Members of the Commission's staff conducting the audit were Mr. Gary L. Forman, Ms. Mary Anne Gill and Mr. Tom Wells of the Division of Rates and Tariffs. The audit was performed on February 25-28, 1985, and March 6 and 7, 1985, at EKU's office located in Prestonsburg, Kentucky.

A limited audit was conducted of the balance sheet and income statement of EKU for the 12-month period ended September 30, 1984. This audit was limited in that it did not include management representation letters, a search for undisclosed or contingent liabilities, verification from independent sources of receivables or liabilities, nor did the audit include price testing of inventories or physical plant. Furthermore, the audit included only the balance sheet and income statement which omits a statement of changes in financial position, a statement of changes in owners' equity and omits substantially all disclosures which could influence decisions otherwise.

The limited audit included a qualitative review of the system of internal control and substantive testing of selected balance sheet and income statement accounts. The income accounts selected for substantive testing comprised 97 percent of the expenses and 100 percent of revenues. The balance sheet items selected for examination comprise 77 percent of current assets, 23 percent of gross plant, and 61 percent of total assets, 98 percent of current liabilities, 100 percent of long-term liabilities and 84 percent of total equity and liabilities. The audit also included a qualitative review of the articles of incorporation, the minutes of the directors' meetings, and bond indentures.

Internal Control

There were material weaknesses in the system of internal control which the audit disclosed. There existed no visual evidence that disbursements were pre-authorized, that pricing and extentions of invoices were verified, that footings were totaled, that goods were actually received. Cash receipts were not deposited on a daily basis, resultingly receipts from one period would be commingled with another, producing inaccurate receivable and cash balances. There was no visual evidence that paid remittance advices were reconciled independently to cash deposits or postings to accounts receivable. Additionally, postings to the accounts receivable control account were done by totaling postings to subsidiary records. Such a method always reconciles and offers no opportunity to identify errors, absent a complaining customer, and correct internally. Being that all cash receipts, all cash disbursements, all cash reconciliations, all receivable postings, all financial statement compilations, all billings were performed or supervised by related parties, there is no system of internal control that can provide independently verifiable evidence of sufficient quality to base any meaningful reliance on that system.

Accounting Basis

The Uniform System of Accounts requires an accrual basis of accounting. EKU chose a modified cash basis of accounting for the initial input into the accounting system. The modified nature of the cash system existed in varying states of modification for interim reporting prior to 1984 and afterwards.

Prior to 1984, interim expenses were reported solely on a cash basis as well as all changes in balance sheet accounts. The major exceptions being accumulated depreciation (and related depreciation expense) and gross billings. At the annual statement date, invoiced expenses incurred prior to year-end but not paid were totaled and classified to provide adjusting entries for accounts payable and related expenses. Cash disbursements and invoices were then reviewed for capital expenditures and reversed. After 1983, the accounting system was further modified to include an approximated monthly accrual of accounts payable and monthly review of capital expenditures. As inherent in the basic nature of each method of accounting and inherent in the change-over process from one method to the other, certain systematic errors described later were discovered.

Residential Sales--Account No. 480

Generally, the intent of a financial audit is to gather sufficient competent evidential material in order to render some degree of assurance on the "fairness" of financial statements taken as a whole. In practice, for small family-run businesses which lack meaningful internal control, this fairness translates into not being misleading. The income tax structure and the profit motive in a competitive market are powerful external influences which the auditor can rely upon to support the economic reality of the basic accounting information. Effectively, to avoid being misleading, the auditor adopts a conservative approach to the audit. The auditor strives to prove that revenues are at least what is reported, that expenses are no more than reported, that assets are not overstated, and that liabilities are not understated so as not to mislead outside investors and creditors. However, this strategy may not be appropriate where revenue receipts are dependent upon expenses and not demand-regulated as in competitive markets. The obvious incentive is to reduce reported revenues and exaggerate expenses. Given the constructive non-existent internal control over meter reading, billing, and cash receipts, the major tool remaining to provide some assurance that revenues are not understated is the relationship of metered gas sales into and out of the system. However, the reported test-period line loss of 29 percent renders this relationship useless as a means for verifying the accuracy of reported revenues.

In an effort to achieve some measure of assurance of the amount of revenues reported, a billing analysis (summary attached to this report) was performed from the meter books which substantiates the reported test-period revenues of approximately $798,335.

Natural Gas Purchases--Account No. 730

During the test period, EKU purchased 167,643 Dth of natural gas for $655,965 and 37,826 Mcf of natural gas for $17,395 for a total test-period gas purchase of $673,360. This amount reconciles with the reported test-period level of gas purchases. There were no accounting exceptions found in this account.

Service, Supplies and Expenses--Account No. 761

Test-period reported expenses were $6,807. Due to the nature of the accounting, $889 of the total expenses for the test period was actually attributable to the prior period. The actual test-period expense restated for the error mentioned is $5,918.

Office Supplies and Expenses--Account 921

Reported test-period office supplies and expenses were $9,361. Of this amount, $1,004 was expended for the lease purchase of a Xerox copier, and $56 was expended for sales taxes. EKU is exempt from being charged sales tax on its purchases and should endeavor to take full advantage of its tax-exempt status in order to avoid unnecessary costs. The amounts expended for the Xerox copier should be capitalized and an appropriate amount of depreciation expense recognized.

Transportation Expense--Account No. 933

EKU reported $13,327 in test-period transportation expense. Due to the systematic error in the accrual of accounts payable, $337 of this expense was incurred prior to the test period.

EKU's employees are permitted to drive company vehicles home. The vehicles are not marked, contemporaneous mileage records are not kept, and employees charge gas, oil and minor repairs at their own discretion and under their own signature at various locations. Furthermore, individual charge invoices were not retained and could not be verified. Being that under this arrangement there is no independently verifiable control of after-hours use of vehicles and charge cards, the employees are constructively encouraged to divert utility resources for their personal use. However, in an interview with the maintenance employees, each stated that the vehicles were not used for personal purposes.

The light duty trucks driven by the maintenance employees are provided to EKU under a net-lease agreement with Computer and Utilities Services, an Allen family-owned business. The lease payments totaled $5,550 during the test period, from $400 per month from October through April, $500 per month from May through August, and $750 in September. Upon casual visual inspection, the trucks appeared to be in good repair and serviceable.

Employee Pensions and Benefits--Account No. 926

The reported amount of test-period pensions and benefits was $16,660. Of this amount, $657 was expended for holiday gifts, and $475 in death benefits was expended to the survivors of a deceased employee. No accounting exceptions existed.

Interest Income--Account No. 419

Reported test-period interest income was $4,212. This was interest income attributable to the working cash account.

However, additional interest income of $2,017, and $5,539 attributable to cash sinking fund and cash depreciation fund was credited directly to reserve accounts. This may be in accord with the bond resoltuion; however, it does not conform with the uniform system of accounts for Class C natural gas utilities. Therefore, EKU should restate interest income for the additional interest earned of $7,556.

Utility Plant--Account No. 107

Nearly all disbursements from the depreciation fund were accumulated into this account, construction work in progress. The examination of invoices supporting the disbursements indicates that the amount, $36,980, and nature, line replacements, are significant enough not to be considered ongoing normal maintenance. However, from an examination of invoices, it is not possible to determine whether these expenditures significantly improve the existing utility plant. An engineering evaluation should be performed to determine whether these expenditures promote the efficient long-run life of the utility plant in service or are merely short-run, temporary expenditures which should not be capitalized.

Cash Funds--Account Nos. 125, 131 and 132

All cash accounts are held in interest-bearing checking accounts. Cash receipts are first deposited into the operating cash fund. Transfers are then made to the bond and interest sinking fund to meet the anticipated debt service requirements. Ten percent of revenue cash receipts, after sinking fund requirements, are deposited into the remaining depreciation fund. The cash balances as of September 30, 1984, were $25,590, $25,648 and $87,489, respectively, which reconcile with reported amounts.

Accounts Receivable--Account No. 142

No individual accounts were confirmed, nor were transactions traced between cash receipts and entries to the subsidiary ledger. Confirmation of the receivables was considered impractical due to the lapse of time since the September 30, 1984, balance sheet date. Transaction testing between cash receipts and credits to the subsidiary ledger was considered impractical, as cash deposits were not supported by detailed remittances. Furthermore, alternative auditing procedures and billing analysis were available that approximate the aggregate accuracy of transaction testing in this instance; however, these alternative procedures cannot verify individual account balances as these procedures test only the debit side of the account balance. Furthermore, in this instance, the reliability of available auditing procedures is bounded by the reliability of the system of internal control which is very inadequate. As mentioned previously, due to the accounting methods used, the subsidiary ledger agreed with the accounts receivable control account. However, in a footing of subsidiary account, $6,176 in credit balances was found. These credit balances may represent over-payments by customers or misclassified credit entries as might be anticipated by the accounting methods used by EKU. As can be noted from the attached brief on the billing audit, the billings contain no opening statement of previous balance.

Resultingly, there is little assurance, if any, that can be placed on the test-period amount of accounts receivable.

Long-Term Bonds--Account No. 221

As of the test-period balance sheet date, EKU had $210,000 of the $230,000-5 percent-1979-serial revenue bond issue outstanding. The portion ($10,000) of the long-term bonds due within 1 year of the balance sheet date was correctly classified as a current liability.

Miscellaneous Operating Reserves--Account No. 265

The bond indenture requires a principle and interest sinking fund at an amount sufficient to retire the current portion of the principle and the coincidental interest expense. This fund is kept in a separate bank account and is used exclusively for bond and interest payments. As of the balance sheet date, EKU was in full compliance of this requirement. Additionally, a depreciation fund is required by the bond indenture. To meet this requirement, EKU deposited 10 percent of gross receipts after sinking fund requirements into a separate bank account. Disbursements of $36,980 during the test period were accounted for exclusively as construction in progress. All reserve accounts as promulgated by the Uniform System of Accounts for Class C and D gas utilities are intended to recognize monies advanced to meet probable but unestimable loss contingencies. The use of a reserve account by EKU is not appropriate, as the depreciation fund and the sinking fund expenditures do not represent unestimable losses, but are disbursements necessary for daily ongoing operations. It is the opinion of this report that these funds should be accounted for as Appropriated Retained Earnings, Account No. 215, as this account is intended by the Uniform System of Accounts to classify funds segregated from accumulated earnings for specific purposes. Furthermore, as these funds are increased or decreased, the appropriation should likewise be increased or decreased. This has apparently not been EKU's practice, since the special funds test-period balance was $113,172 and the reserve accounts balance was $106,428. EKU should reclassify its reserve accounts as an appropriation of retained earnings and reconcile the appropriations to the respective special funds.

Notes Payable--Account No. 231

As of the test-period balance sheet date, EKU had $33,886 of notes payable outstanding. The portion ($11,992) of the long-term notes payable due within 1 year of the balance sheet date was correctly classified as a current payable. The outstanding balance of $33,886 is comprised of $8,580 remaining of a 12 percent-36-month-$11,269 installment note to GMAC issued in April, 1983, to acquire through the assumption of the GMAC loan a 1983 Buick from John Allen, and $25,306 remaining principle balance of a 10 percent-36-month-$33,600 installment note issued November, 1983, to purchase a trenching machine from Ditch Witch Trenching Company. Both purchases and the resulting notes payable were approved by the directors, David Allen, Steve Allen and Mary Leslie. The automobile purchased does not carry an EKU insignia.

Accounts Payable--Account No. 232

Accounts payable were reviewed and reconciled to the amount of $135,713.80 existing at the test-period balance sheet dated

September 30, 1984. Due to the method choosen by EKU to compile its financial statements, the beginning balance of accounts payable was understated $3,138, however, $1,505 of this amount was capitalized during the test period and was not included in test-period operating expenses. An additional $890 expended for various items was noted earlier under service supplies and expenses. Of the remaining amount of $743, $277 was erroneously charged to Account No. 765--Miscellaneous Distribution Expense, and $466 was charged to Account No. 933--Transportation Expenses.

Customer Meter Deposits--Account No. 235

EKU reported $26,434 of customer deposits on the test-period balance sheet. EKU's current policy is to collect $150 deposit on each new account connecting to the system. Refunds are made on the discontinuance of service if requested by the customer. No attempt is made to estimate annual consumption and base the deposit on the formula as promulgated by KAR 5:006, Section 7. EKU pays 6 percent simple interest at the time of refund; the interest should be compounded annually.

The subsidiary accounts exist in two separate monthly files. The manually-prepared file dates to the 60's. The computer-prepared file has existed since 1981. As cash deposits were not itemized nor were serialized copies of customer receipts kept, absent direct confirmation from EKU customers, there is no method to verify the reasonableness of this account. Furthermore, as there are no customer service work orders to verify disconnects and reconnects, and given EKU's current lack of internal control, there is no time or cost effective method to verify that customer deposits were actually entered into the accounting system. Customer confirmation based on the "subsidiary ledgers" would at best only verify what has been recorded and, as refunds of deposits are made only on request by the customer upon termination of service, confirmation letters could be expected not to confirm a significant amount of this liability.

<u>Wages and Salaries</u>

EKU reported $94,197 in test-period wages and salaries. EKU has no formal sick leave or vacation policy. During the test period, EKU applied approximately 6,668 labor hours to meter reading labor, and mains and services labor. Of these labor hours, 4,594 were permanent employee labor hours and 2,074 were part-time non-permanent hours. All employees received a 7 percent wage increase in September, 1984. A schedule of labor hours, job descriptions and rates of pay appears attached to this report.

For the test period, labor costs were not proportioned to labor accounts according to the Uniform System of Accounts for Class C and D gas utilities. EKU should accumulate and classify labor hours for a representative time period to estimate the portion of labor cost devoted to mains and services, and meter reading. This classification could be a potentially important cost control tool for management. Otherwise, no exceptions existed to wages and salaries.

Employee Schedule

Employee	Job Description	Wage Rate 9/30/84	Hours Worked: Time Record(*) No Time Record(+)
Full-Time Permanent:			
Mr. David Allen	President	$2,445/mo	2,080.0(+)
Ms. Mary Leslie	Office Person	1,294/mo	2,080.0(+)
Mr. John Allen	Legal Counsel	642/mo	DNA
Mr. Legoy Gibson	Labor	1,235/mo	2,007.0(*)
Mr. Harold Case	Labor	1,235/mo	960.0(*)
Mr. Thomas Thompson	Labor	1,235/mo	1,627.0(*)

Note: Mr. Harold Case became full-time permanent in May, 1984.

Employee	Job Description	Wage Rate 9/30/84	Hours Worked: Time Record(*) No Time Record(+)
Part-Time Non-Permanent:			
Various	Labor	$4.00/hr	550.5(*)
Various	Labor	4.50/hr	1,323.5(*)
Various	Labor	4.28/hr	120.0(*)
Various	Labor	4.82/hr	80.0(*)
			2,074.0

RECOMMENDED ADJUSTMENTS

Service Supplies and Expenses--Account No. 761

Check Number	Amount	Dr.	Cr.
417	$ 600		
420	22		
422	139		
423	32		
424	17		
442	80		
	$ 890		
Dr. Retained Earnings.		$ 890	
Cr. Service Supplies and Expenses			$ 890

To restate test-period expenses.

Office Supplies and Expenses--Account No. 921

Check Number	Amount	Dr.	Cr.
421	$ 84		
470	84		
528	84		
583	84		
645	84		
696	84		
747	84		
827	84		
875	83		
920	83		
979	83		
1057	83		
	$1,004		
Dr. Depreciation Expense		$ 201	
Dr. Utility Plant		1,004	
Cr. Accumulated Depreciation			$ 201
Cr. Office Supplies and Expenses			1,004

To restate depreciation expense, office supplies and expenses for capitalized copier.

Interest Income--Account No. 419

Dr. Retained Earnings	$7,556	
Cr. Interest Income		$7,556

To restate test-period interest income.

Miscellaneous Distribution Expense--Account No. 765

Check Number	Amount	Dr.	Cr.
420	$ 72		
476	205		
	$ 277		
Dr. Retained Earnings		$ 277	
Cr. Miscellaneous Distribution Expense			$ 277

To restate test-period miscealleneous distribution expense.

Transportation Expenses--Account No. 933

Payee	Invoice Date	Amount	Dr.	Cr.
Ashland Oil	8/83	$ 41		
Gulf Oil	8/83	296		
Ashland Oil	9/83	129		
		$ 466		
Dr. Retained Earnings			$ 466	
Cr. Transportation Expenses				$ 466

To restate test-period transportation expense.

Miscellaneous Operating Reserves--Account No. 265

Dr. Miscellaneous Operating Reserves	$106,428	
Dr. Unappropriated Retained Earnings	6,744	
Cr. Appropriated Retained Earnings		$113,172

To reclassify test-period operating reserves.

DRAFT REPORT ON BILLING AUDIT

OF

EAST KENTUCKY GAS COMPANY

BRIEF

On December 7, 1984, East Kentucky Utilities, Inc., "East Kentucky" filed a request for an increase in rates as Case No. 9236. This filing joined a show cause proceeding against the utility in Case No. 9159, a temporary surcharge request in Case No. 9109 and East Kentucky's PGA Case No. 8114-J. In an attempt to comprehend the utility's situation in regard to these various cases, the Commission determined that a billing audit of East Kentucky would be appropriate. At this time plans were made for staff members to visit the utility. On March 4 and 5, 1985, the staff met with Mr. David Allen, President of East Kentucky, to discuss the policies and procedures of the utility and to review billing dates.

Members of the Division of Rates and Tariffs participating in the investigation on March 4 and 5, 1985, were Ken Ramey and Sheila Kuzma.

SCOPE

The meter books and monthly accounts receivable printouts for the one year period from October 1, 1983, to September 30, 1984, were examined in order to perform a random sampling billing audit. The scope of this report is limited to the billing during the 12 month period ending September 30, 1984.

FINDINGS

East Kentucky has 8 different meter books, each for a different geographic area, into which entries are made around the 15th of every month. These readings are entered into a computer by an outside service and the appropriate rates are then applied to the usage to determine the amount to be billed. The computer printout shows the meter number, the previous and present reading, monthly consumption, rates applied and the total bill. Any refund or tax amounts are also printed and monthly totals are given. Staff reviewed approximately 1,300 bills. Each meter book was reviewed in its entirety for a difference one month period. Of the bills examined, there were 2 in which the Mcf usage was not the same as was recorded in the meter books. One customer was underbilled by 10 Mcf and the other was overbilled by the same amount.

The Mcf sales and revenue billed for all months matched precisely with documents submitted by East Kentucky in Case No. 9236. In accordance with testimony given in this case at the January 10, 1985, hearing, the rates charged in the months of July and August, 1984, were incorrect. Through conversation with Mr. David Allen, it was determined that a refund has not yet been made for this error but will be made after a decision has been rendered by the Commission in this proceeding.

The utility did not prorate bills during the months in which there was a rate change. Mr. David Allen stated that they tried to alternate the effective dates of these rate changes in favor of the consumer. A review of 3 rate changes during the months of November 1983, January and May, 1984, revealed that the utility did alternate the effective dates of these rate changes. Using this method of proration over time the result should be approximately the same as prorating the bills on a monthly basis.

CONCLUSION

The staff is of the opinion that East Kentucky Utilities, Inc., employed generally accepted accounting procedures in performing the monthly billing activities for the test period.