COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

THE APPLICATION OF GILBERT CONSTRUCTION SERVICES, INC., [GRAHAM ESTATES SUBDIVISION SEWER FACILITY] FOR AN ADJUSTMENT OF RATES PURSUANT TO THE ALTERNATIVE RATE FILING PROCEDURE FOR SMALL UTILITIES	)	CASE NO. 9391

<u>O R D E R</u>

IT IS ORDERED that:

1. The Staff Audit Report for Gilbert Construction Services, Inc., Graham Estates Subdivision Sewer Facilities ("Graham Estates") attached hereto as Appendix A shall be included as a part of the record in this proceeding.

2. Graham Estates shall have until the close of business October 30, 1985, to file written comments concerning the contents of Appendix A.

Done at Frankfort, Kentucky, this 21st day of October, 1985.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

ATTEST:

Commissioner

Secretary

APPENDIX A

REPORT ON LIMITED AUDIT DATED 10/21/85

of

GRAHAM ESTATES SUBDIVISION SEWER FACILITY

PREFACE

On August 1, 1985, Gilbert Construction Services, Inc., Graham Estates Subdivision Sewer Facility ("Graham Estates") filed, pursuant to 807 KAR 5:076 (Alternative Rate Filing), an application seeking an increase in rates. The proposed rates would generate $8,178 annually in additional revenues.

The Commission staff, concerned with the likelihood that the operations of other commonly-owned enterprises were not accounted for separately from the operations of Graham Estates, sent Graham Estates Information Request No. 1 on August 28, 1985. In that request, Graham Estates was asked to offer evidence that the accounting for the operation was maintained on a separate basis. The response from Graham Estates did address the issues but offered little additional information. In order to expedite the processing of the case, the Commission staff chose to perform an audit, limited in scope, on the operations of Graham Estates. The audit was conducted by Mr. Aaron Greenwell of the Division of Rates and Tariffs on September 25 and 26, 1985, at the offices of Graham Estates.

SCOPE

The scope of this audit was limited to ascertaining whether the operating expenses, as reported in the 1984 Annual Report, were accounted for in accordance with the Uniform System of Accounts for Sewer Utilities and were properly allocated. The primary focus was to assure proper allocation. Each test-year expenditure was reviewed and the invoices of potential improper charges were examined.

FINDINGS

Graham Estates has neither been audited nor requested any increases prior to the present application. However, the owner was put on notice in Case No. 8127[1] that accounting records were to be maintained in accordance with the Uniform System of Accounts for Sewer Utilities and that he would be required to provide detailed information sufficient to permit thorough analysis of the test-year expenses in future filings. A review of the accounting system revealed minor mathematical and posting errors, two outlays of a capital nature which were expensed rather than capitalized, and several minor items of a personal nature that were charged to utility expenses. Further examination revealed that the operations of Graham Estates were not accounted for on a separate basis, and that a stockholder-loan, called a Capital Improvement Loan Account by the owner, was established and operated in a manner that allows comingling of both personal and other business expenses.

The owner often pays expenses out-of-pocket and increases the balance of the stockholder-loan account. The balance of the

1 Final Order dated August 5, 1981, Case No. 8127, An Adjustment of Rates of the Sewage Treatment Plant Serving Wright Acres Subdivision, p. 3.

stockholder-loan account is decreased by frequent payments made directly by Gilbert Construction Services for goods and services that are personal in nature. Examples of these personal items are: payments to grocery stores, payments for cable television, payments for a personal loan, payments for personal insurance, payments of a personal nature made to individuals not involved with the utility operations and payments for various personal items.

Following is a discussion of the allocation of joint costs and recommended adjustments:

Allocation

Gilbert Construction Services allocates joint costs on a basis of 50 percent to Graham Estates and 50 percent to Wright Acres. The operating accounts charged with expenses based on this allocation are: Chemicals, Miscellaneous Supplies and Expenses-Treatment and Disposal, Maintenance of Treatment and Disposal Plant, Office Supplies and Other Expenses, Insurance Expense, Transportation Expenses, Miscellaneous General Expenses, and Rents. Based on the operation and the bookkeeping requirements of the stockholder-loan account and the owner's non-utility activities, including a venture into solar energy, it has been determined that Office Supplies and Other Expenses, Insurance Expense, and Rents should more properly be allocated 1/3 to Graham Estates, 1/3 to Wright Acres and 1/3 personal.

Routine Maintenance Service Fee

A review of the general ledger and related documents revealed that $38 had been expensed but not included in the Annual

Report. Therefore, this account has been increased by $38 to $1,118.

Maintenance of Treatment and Disposal Plant

Graham Estates reported test-year charges of $1,293. Upon examination of the invoices and accounting records, it was found that $452 had been improperly expensed to this account. A disbursement of $399 to Lanham Electric for a pump motor should have been capitalized. In addition, expenses totaling $53 were excluded. The $53 was Graham Estates' portion of outlays to build storage facilities at the home of Mr. Gilbert's mother. These storage facilities were never utilized and, thus, were determined to be personal in nature. Therefore, this account has been reduced to $841.

Office Supplies and Other Expenses

The general ledger charges to this account totaled $2,672. After excluding improper charges of $435, it was determined that the proper charge to Graham Estates, based upon an allocation of 1/3 of the remaining $2,237, should be $746. The $435 improperly charged is comprised of $210, paid to a CPA, more properly classified to Outside Services Employed, and $225 paid to Dickens Upholstery, which should have been capitalized with the related depreciation allocated to Graham Estates on a 1/3 basis.

Outside Services Employed

This account has been charged with $105 which represents Graham Estates' portion of a payment to Linda Williams, CPA, for preparation of Annual Reports.

Insurance Expense

The charges to this account included a charge of $130 for auto insurance which has been eliminated, as discussed under Transportation Expenses, and a charge for 50 percent of the bookkeeper's cancer insurance of $360. Based on a 1/3 allocation of the cancer insurance, the proper charge to Insurance Expense should be $120.

Transportation Expense

The expense attributed to Graham Estates was based on a mileage charge and an allocation of vehicle maintenance expenses. The deduction of Transportation Expense is allowed for tax purposes; however, the deduction is limited to a computation based either on mileage or on actual cost. Because of the impropriety of both a mileage and a vehicle maintenance charge, and because of the detailed records required for the computation based on actual cost, it has been determined that the maintenance expenses and auto insurance expense are not proper. As a result, the proper charge to Graham Estates for Transportation Expense should be limited to the mileage charge of $594. This cost is based on 2,700 miles at $.22 per mile.

Miscellaneous General Expenses

This account has been restated to $21. The original general ledger charges totaled $4,557, of which $3,638 was personal and expensed to Utility Operations. The remaining $919, less $30 bank service charges and $360 for insurance, was allocated on a 50/50 basis to Graham Estates, resulting in a total charge of $280, including $15 for bank service charges. The charges reclassified to Wright Acres, to other accounts and as personal are as follows:

Check No.	Amount	Description	Reclassified to:
508	$ 12.00	Charitable Contribution	Other Deductions - Charitable Contributions and Gifts ("OD-CC&G")
519	7.50	Charitable Contribution	OD-CC&G
523	4.00	Sewer Operators License	Wright Acres
534	25.00	Kroger	Personal
538	9.75	Charitable Contribution	OD-CC&G
539	91.56	Gift	OD-CC&G
571	10.00	Charitable Contribution	OD-CC&G
579	45.09	Leased Storage	Rents
603	58.00	Leased Storage	Rents
611	8.00	Charitable Contribution	OD-CC&G
630	20.00	Leased Storage	Rents
661	9.75	Charitable Contribution	OD-CC&G
674	92.00	Leased Storage	Rents
675	2.00	Sludge Publication	Office Supplies and Other Expense
102	98.00	Leased Storage	Rents
	30.00	Bank Service Charges	Office Supplies and Other Expense
	< 2.69>	Finance Charges	Other Interest Expense
Total	$519.96		

Rents Expense

Prior to August, Gilbert Construction operated out of the owner's apartment. Graham Estates was charged for $232, 1/8 of the rental, which has been determined to be a proper allocation. From August through December, Gilbert Construction leased private office space at $150/month. Based on a 1/3 allocation, the proper charge to Graham Estates should be $250. In addition, Graham Estates leased a small warehouse for use as a storage facility. Because this warehouse is presently used for storage of personal and utility items, an allocation of 1/3 of the $313 expense is deemed proper and would result in a charge of $104 to Graham Estates. The preceding adjustments indicate the rent expense for Graham Estates should be $586.

Depreciation Expense

Graham Estates began operations in 1970 and was purchased June 4, 1980, for $15,000. No information was available regarding the original cost of the plant. The Uniform System of Accounts requires that utility plant be recorded at its original cost (estimated if not known). Thus, the plant now on the books of Graham Estates was recorded improperly when acquired by Gilbert Construction. In determining the appropriate level of depreciation expense, the useful life of the entire facility should be considered. Graham Estates erroneously selected three items of equipment with 5- and 10-year useful lives and assigned the entire cost of the plant to those three assets. Since the original cost records are not available, the proper depreciation expense should be based on an estimated 20-year life, with 10 years remaining from date of purchase. This results in a composite rate of 10 percent and depreciation expense of $1,524. In addition, a pump was purchased for $399. Based on a 3-year useful life, the additional depreciation charged, at an annual rate of 33 percent for 8 months, should be $89. The remaining adjustment to depreciation arises from a couch which was upholstered at a cost of $225. Based on a 5-year useful life and a 1/3 allocation, Graham Estates should be charged, at an annual rate of 20 percent for 3 months, $11. The resulting Depreciation Expense should be $1,624.

Interest on Debt to Stockholder

No adjustment has been made to the interest charge of $1,720. The owner established the stockholder-loan account in order to cover the operating losses of the utility. However, during 1984, $474 was used for the purchase of capital items and is properly recoverable through the rate-making process. This amount includes the motor at $399, and $75, which is 1/3 of the $225 cost to upholster the couch.

Other Interest Expense

Vendor finance charges of $196 on open accounts have been reclassified to this account from Miscellaneous General Expenses.

Other Accounts

Charitable contributions and gifts of $50 based on a 1/3 allocation of total general ledger charges have been reclassified to this account from Miscellaneous General Expenses.

SUMMARY

The effect of these adjustments on Graham Estates' 1984 operating statement is as follows:

	1984 Annual Report	Adjustments	Adjusted 1984
Operating Revenues	$ 3,408	$ -0-	$ 3,408
Operating Expenses:			
Sludge Hauling	$ 245	$ -0-	$ 245
Utility Service-Water Cost	75	-0-	75
Other-Testing & Analyzing	225	-0-	225
Fuel and Power	970	-0-	970
Chemicals	42	-0-	42
Treatment & Disposal Expenses	110	-0-	110
Routine Maintenance Service Fee	1,080	38	1,118
Maintenance of Treatment and Disposal Plant	1,293	< 452>	841
Agency Collection Fee	284	-0-	284
Office Supplies & Other Expenses	959	< 213>	746
Outside Services Employed	-0-	105	105
Insurance Expense	310	< 190>	120
Transportation Expenses	840	< 246>	594
Miscellaneous General Expenses	280	< 259>	21
Rents	794	< 208>	586
Depreciation	1,908	< 284>	1,624
Total Operating Expenses	**$ 9,415**	**$< 1,709>**	**$ 7,706**
Other Deductions			
Interest on Long-Term Debt	$ 1,003	$ -0-	$ 1,003
Interest on Debt to Stockholder	1,720	-0-	1,720
Other Interest Expense	-0-	196	196
Other Accounts	-0-	50	50
Total Other Deductions	$ 2,723	$ 246	$ 2,969
Net Income	$<8,730>	$< 1,463>	$< 7,267>

CONCLUSION

The operations of Graham Estates should be maintained separately from those of other commonly-owned enterprises with more care directed toward the proper allocation of expenses. Care should be taken that personal expenses and utility expenses are separated, particularly in the stockholder-loan account. That account should be viewed as a loan account and not used for the direct payment of personal expenses.