

KENTUCKY-AMERICAN WATER COMPANY
CASE NO. 2004-00103
PUBLIC SERVICE COMMISSION DATA REQUEST NO. 1
ITEMS 1 – 34

Witness Responsible:

M. Miller

2. Provide a copy of all Kentucky-American's internal accounting manuals, directives, policies and procedures.

Response:

Please see attached.

For electronic version, see [KAW_R_PSCDR1#2_052004.pdf](#)

**American Water
Accounting
Policies**

08/22/2003 12:04 PM

Subject: 2.01 Property, Plant, and Equipment (Additions, Retirements)
Category: 2. Assets

Owner:
Robert D
Sievers/ADMINICORPIAWWSC

PROPERTY, PLANT, AND EQUIPMENT

Accurate records will be maintained of the cost and accumulated depreciation of property, plant, and equipment. Control will be maintained over capital assets and their related records to ensure that all recorded assets exist and are in use for operations. Disposal of capital assets will occur only after proper authorization has been given, to preserve the accuracy of the records, and to ensure that assets are safeguarded.

Continuing property records (CPR) are to be maintained. The CPR ledgers are to be documented with a degree of detail that enables the individual continuing property items to be identified and physically located.

ADDITIONS:

All additions to property, plant, and equipment will be properly authorized. This includes the proper approval of costs that are greater than the original estimate for a task order. This approval shall be by the Vice President of Operations and the Region President. Additions to utility plant and replacements of retirement units of property are capitalized. Costs include material, direct labor and such indirect items as engineering and supervision, payroll taxes and benefits, transportation and an allowance for funds used during construction. The costs incurred to acquire and internally develop computer software for internal use are capitalized as a unit of property.

- A capitalized fixed asset is property such as land, buildings and equipment with a cost equal to or greater than \$1,500.
- The capitalized fixed asset is expected to have a useful life greater than 1 year.
- The capitalized fixed asset must be trackable. If the asset cannot be tracked and removed from the books when it's no longer in service then it does not meet the criteria for a fixed asset.

Additionally:

- Certain equipment will last longer than 1 year and are hackable, but do not meet the cost criteria. Examples of such items include, Fax machines, PC's, and jackhammers. These items can be grouped under one task/asset for each year.

- Other equipment may be part of an asset if purchased as part of a larger unit of property. However if the item is purchased separately it is not capitalized. Items of this nature include, Modems, keyboards, and truck engines. These purchases are generally purchased to maintain the usefulness of a larger unit of equipment and therefore are not capitalized.
- Along with the item above, upgrades or renovations to existing equipment must serve to extend the life of the asset or enhance its functionality.

Charges that are not directly attributable to specific projects and orders will be allocated as follows:

- Charges related to routine investment items:
Investment items are charged by local operations and construction departments. These charges can be allocated based on current month charges to the district's routine investment items (A-H).
The routine allocations will zero out the deferred account monthly.
- Charges related to investment projects:
Investment projects are generally charged by engineers. In the beginning of the year, each subsidiary will advise shared services of projects they want to charge indirectly. The subsidiary will provide estimated labor and expenses for each project so that shared services can develop a standard allocation rate by state. Charges in the deferred account will be allocated monthly based on actual current month charges. The investment project deferred account will be reviewed periodically and the allocation rate will be adjusted in order to zero out the account by year-end.

RETIREMENTS:

The cost of property units retired in the ordinary course of business plus removal cost (less salvage) is charged to accumulated depreciation.

Acceptable methods to price retirements (i.e. original cost) are as follows:

Blankets

- Meters, services, meter installations, mains including valves and hydrants including valves, use CPR records to obtain unit price based on vintage year and size.

Non-blankets/specific assets

- Use CPR records when sufficient information available
- If sufficient detail is not available, use Handy Whitman index to trend back from cost of installing item today.

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08/22/2003 12:04 PM

Subject: 2.02 Depreciation
Category: 2. Assets

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

DEPRECIATION

The cost, less salvage value, of all capitalizable assets are to be depreciated over the estimated useful lives in a rational and systematic manner.

Utility plant is generally depreciated using the straight-line method over the services lives of assets used to establish rates for utility service. Depreciation is recorded on individual or groups of assets based on the depreciation rate on the respective account. Existing assets are depreciable at a full rate and cost is spread evenly throughout the year. New assets are charged depreciation at a ½ rate (1/2 year) spread evenly from month in service through December. In the first full year of life the asset is considered existing and is charged a full rate spread evenly throughout the year. Disposed assets are charged a ½ rate and this is accomplished by an entry to adjust to the ½ year amount for depreciation in the month of disposal.

Example: Additions: ½ year of depreciation spread evenly throughout remaining of year.

Acquired item in September
Asset cost = \$ 1,000
Annual rate = 10%
Depreciation = \$5014 (September-December) or \$12.50 per month in first year.

Example: Disposed in September

Asset cost = \$ 1,000
Annual rate = 10%
Depreciation = \$8.33 (\$100112months), Jan-Aug for a total of \$66.64
Disposed in September, September entry to credit depreciation expense for \$ 16.64 (back out July-Aug) therefore the depreciation recorded \$50.

If the depreciation rate changes during the year,

- New assets get %year rate in affect at time depreciation, spread evenly throughout remaining months of year.
- Disposed assets get ½ year rate in affect at time of disposal.

(1) There is an exception to this policy in New Jersey American. Treatment Plants at *Delran*, *Howell*, and *Logan Wells* use Units of Production as the method of depreciation. When acquired *the* treatmentplants were evaluated and a totalplant (life of asset) Unit of Production, removal and salvage costs were estimated. Each month the actual Units of Production are captured and used to calculate depreciation for the current period.

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08/22/2003 12:04 PM

Subject: 2.03 Blanket Orders
Category: 2. Assets

Owner

Robert D
Sievers/ADMIN/CORP/AWWSC

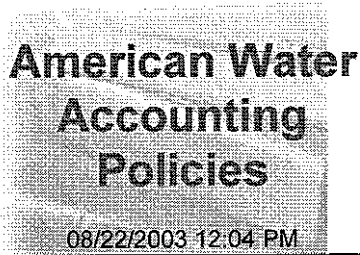
BLANKET ORDERS

Blanket investment and retirement orders are used to collect the cost associated with certain sizes of meters, services, main replacement (50' in length or less), hydrant replacements and hydrant valve replacements. This alleviates the need to write individual orders for each of these investment or retirement activities.

Blanket orders, however, do not capture all of the necessary information for our reporting requirements. For every work order we are required to determine specific assets and maintain the record of these assets for as long as the asset lasts. Since we are using virtual assets on blanket orders the shared services center needs a way to obtain the specific assets. The following provides the process for capturing the asset information for blankets.

- Investment blankets for meters - will be obtained from inventory issues.
- Investment blankets for meter installations - will be obtained from inventory issues (needs clarifications).
 - Retirement blankets for meters - will be obtained from the mirror pond system.
 - Retirement blankets for meter installations – provide form monthly.
 - Investment blankets for services - provide form monthly.
 - Retirement blankets for services - provide form monthly.
 - Investment blankets for main replacements - provide form monthly.
 - Retirement blankets for main replacements - provide form monthly.

Investment blankets are to be used for the sizes identified. Retirement blankets for meters and services are to be used for the retirement of all meters and services (not just two inches and under anymore). The retirement blanket for main replacements is to be used for the related retirements associated with the investment blanket main replacements. The retirement blanket for hydrant replacements is to be used for related retirements associated with investment blanket hydrant replacements.



Subject: 2.04 Unitization of Mass Assets
Category: 2. Assets

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

UNITIZATION OF MASS ASSETS

Unitizing mass assets provides a means to allocate common costs and split mass assets into individual assets by property unit.

Mass Property items include the following:

- Mains
- Hydrants
- Services
- Meters
- Meter installations

Mass assets are used to capture costs related to multiple property units as follows:

- Mains - Main or Pipe, and Valves
- Waste Water Mains - Main or Pipe, and Manholes
- Hydrants - Hydrants, Valves, and Laterals
- Services
- Meters
- Meter Installations

Allocation of costs to the respective property units is based upon the following:

- Inventory dollars and Units are captured at the Order/Asset level and provide the basis for determining cost allocation
- Work Hours to perform installation of property unit

Work hours to install one unit of each type of property to be unitized are obtained from the Dodge Unit Cost Book published by Marshall & Swift, L.P. This lists the work hours required to install one unit of every size and type of pipe, valves, hydrants and services based on a U.S. national average.

- Total work hours required to install each type of unitized property will be determined by multiplying total units installed by work hours per unit for each item.
- Non-unitized costs (miscellaneous materials, labor, overhead) will be allocated to each unitized property based on a percentage of total work hours multiplied by total non-unitized costs.

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08/22/2003 12:04 PM

Subject: 2.05 Allowance For Funds Used During Construction
Category: 2. Assets

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

ALLOWANCE FOR FUNDS USED DURING CONSTRUCTION (AFUDC)

AFUDC is a non-cash credit to income with a corresponding charge to utility plant which represents the cost of borrowed funds and a return on equity funds devoted to plant under construction. The utility subsidiaries record AFUDC to the extent permitted by the regulatory authorities.

AFUDC is recorded on all construction projects with the following exceptions:

- Blanket Investment Orders
- Retirement, Maintenance of M & J Orders
- Construction financed by Customer Advances or Contributions
- That portion of construction work in progress which has been included in a company's current rate base.
- Purchases not requiring installation.

Construction work paid for by someone else, Customer Advances (refundable and non-refundable) and Contributions, is not subject to AFUDC. In some situations the Company requests an upgrade to the new facilities. Work funded by the Company is charged with AFUDC and this is accomplished by creating a second investment order to capture the Company's share of the costs.

When CWIP is included in rate base, AFUDC is not to be reported on any portion of CWIP on which current rates are based. AFUDC is to continue on that portion of CWIP not considered in current rate-base. Separate Investment orders are required to properly account for this situation. The Rates and Revenue function is responsible for communicating these situations to Fixed Assets so that the appropriate action is taken with regard to AFUDC.

When special financing is secured for a project it may impact whether AFUDC is calculated. The Rates and Revenue function is responsible for communicating these situations to Fixed Assets so that the appropriate action is taken with regard to AFUDC.

AFUDC is calculated until a project is placed into service. As such, Project Managers are responsible to complete individual investment orders that make up a project when appropriate. E.g. the purchase of land for a project requires an investment order, the order is not completed once the sale is closed but remains open until the project is completed and continues to accrue AFUDC. The installation of a Utility Plant that is placed into service can appropriately be completed, and stops accruing AFUDC.

AFUDC accrued on land is transferred to the related facilities once the project is completed. This is accomplished by a review of transfers made to the land account and identifying the AFUDC portion of expense.

The calculation of AFUDC may be stopped on projects that are suspended

All costs currently incurred relative to Design, Preliminary Survey and Investigation (PSI) of Comprehensive planning studies (CPS) are subject to AFUDC. Design costs and PSI are directly related to a project and will continue to take AFUDC once construction begins. CPS is related to several projects and is treated as a project to itself. AFUDC stops on the CPS project once it is complete.

Computation of Allowance for Funds Used During construction:

The percentage to be applied to qualified capital expenditures as a charge for AFUDC shall be based upon either; the weighted cost of capital determined by the regulator in the most recent rate order or some other method identified by the regulator, such as Short Term Debt.

Upon receipt of a rate order, the Director of Rates and Revenue will calculate the percentage for AFUDC and communicate with fixed Assets. Fixed Assets will verify the rate and place it into effect for computing and recording AFUDC in the same month as the order. This rate will remain in effect until superseded by a subsequent rate order.

When the calculation is based upon other than a rate order, the rate will be calculated, as needed, by the SSC in conjunction with information provided by the Rates and Revenue function.

Standard procedures in the use of AFUDC during the life of a construction project requires the calculation of (1112) month-rate, half-month rate (1/24) and a quarter-month rate (1148) applicable as follows:

- Month rate (1112) – applied to prior month charges
- Half-month rate (1/24) – applied to current month charges, except first and final months
- Quarter-month rate (1/48) – applied to charges in first and final months

Prior month charges include all charges to date up through the previous month-end, including AFUDC. This results in a compounding of AFDUC.

Amounts relating to contract retention, accounts payable, or accruals are excluded from the AFUDC calculation. This is accomplished by recording an accrual to a specific CWIP object

account.

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08/22/2003 12:04 PM

Subject: 2.06 Accrual For Paving
Category: 2. Assets

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

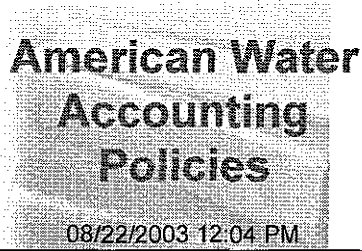
ACCRUAL FOR PAVING

When a section of pavement is opened, the company is responsible to restore the pavement. For accounting purposes, the company must accrue for the costs or record a liability using an estimate.

There are two situations that require separate treatment; the first being restoration for main breaks, the second for on-going construction and projects.

- Restoration costs for **non-capital** work that will exceed \$5,000 and which will not be invoiced in the current month must be accrued.

Restoration costs for **capital** work that will exceed \$500 at the time of order completion must be accrued.



Subject: 2.07 Capitalization Of Engineering Costs
Category: 2. Assets

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

CAPITALIZATION OF ENGINEERING COSTS

Engineering Costs are incurred to plan, design, prepare estimates, supervise, inspect, or give general advice and assistance in connection with construction work. These costs of construction are properly included in the utility plant accounts.

All salaries, expenses, and overheads of Engineers and Draftsmen at the local, corporate, and regional offices are to be capitalized. Engineering costs should be charged directly to the applicable work orders to the extent practicable. Any engineering costs not charged directly to work orders should be allocated to open work orders each month. This treatment will be consistent with the way engineering costs at the Voorhees office are accounted for.

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Subject: 2.08 Comprehensive Planning Studies
Category: 2. Assets

Owner
Robert D
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COMPREHENSIVE PLANNING STUDIES

Current procedure is to record the cost of Comprehensive Planning Studies (CPS) in utility plant and depreciate the cost over the interval of time that passes until a new study has been completed, generally five years. If that treatment is not acceptable to the regulator the costs are to be set up as a deferred debit and amortized as a cost of service.

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Subject: 2.09 Repairs
Category: 2. Assets

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

REPAIRS

Repairs, maintenance and minor replacements of property are charged to current operations.

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08/22/2003 12:04 PM

Subject: 2.10 Scrap Materials
Category: 2. Assets

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

SCRAP MATERIALS

Materials removed from service that are not reusable are to be accumulated in the stockyard in a separate pile. Scrap items are to be periodically sold at the highest amount possible. Sales of these items are to take place not less than once a year. Amounts received are to be immediately given to a teller and recorded on a miscellaneous invoice. The amount received is in some cases salvage on retired utility plant, and in other instances could be viewed as a reduction in maintenance costs for such items as mains, services, etc. As it would be impractical to separate items among these categories and the amount is generally immaterial, Account 108100, Accumulated Depreciation will be uniformly used as the distribution recorded on the related miscellaneous invoice.

The following are the internal control principles which should be adhered to, whenever possible, with regard to the sale of scrap. If adherence to these principles is not possible at any given location, the reason for any deviations should be documented.

- Companies should deal with more than one scrap dealer and should get two price quotes at the time of a scrap sale.
- Companies should request that payments for scrap be made by check rather than in cash.
- The miscellaneous invoice that needs to be created for the amount due should be done on the date of the sale rather than the date the funds are received, if the dates are different.
- The miscellaneous invoice should be supported by weight tickets.
- Proceeds from the sale of scrap should be credit to accumulated depreciation rather than an income statement account.

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08/22/2003 12:04 PM

Subject: 2.11 Utility Plant Acquisition Adjustments
Category: 2. Assets

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

UTILITY PLANT ACQUISITION ADJUSTMENTS

Acquired plant is recorded on the balance sheet at its depreciated original cost. The excess of the replacement cost new less depreciation (RCNLD) over depreciated original cost is recorded as a Utility Plant Acquisition Adjustment (UPAA). The UPAA will be depreciated over the remaining life of the associated utility plant. The purchase price is the amount paid (including increment out-of-pocket costs paid for outside services) plus the liabilities assumed. Any remaining amount, purchase price less fair value of assets (depreciated original cost plus the UPAA), is an intangible asset or goodwill.

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08/22/2003 12:04 PM

Subject: 2.12 Nonutility Property
Category: 2. Assets

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

NONUTILITY PROPERTY

Nonutility property consists primarily of buildings and equipment utilized by American Water Works Service Company which provides various services to affiliated companies and by American Water Services in its unregulated management services business. This property is stated at cost, net of accumulated depreciation calculated using the straight-line method over the estimated useful lives of the assets.

**American Water
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08/22/2003 12:04 PM

Subject: 2.13 Cash Receipts
Category: 2. Assets

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

CASH RECEIPTS

Control is to be established over all cash and checks received, and they should be deposited promptly in the company's bank accounts. Cash receipts are to be protected from misappropriation. Physical access to cash receipts and cash receipt records should be limited to authorized personnel. Additionally, cash receipts will be recorded in the appropriate period.

It is important to ensure that funds taken in at American System offices are actually deposited in the bank. Therefore, it is necessary to have in place a positive control procedure that will confirm that all deposits have been credited to an American System account.

Procedures currently in effect in various operations of the American System include a supervisor initialing the deposit slips "receipt stamped" by the bank, a log of the "receipt stamped" deposit slips maintained by someone otherwise independent of the deposit procedures, and daily electronic notification of deposits from the bank. The specific type of control procedure should be dictated by local circumstances.

It is also necessary to ensure timely follow-up on reconciling items that arise during the bank account reconciliation process.

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08/22/2003 12:04 PM

Subject: 2.14 Cash Disbursements
Category: 2. Assets

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

CASH DISBURSEMENTS

Disbursements from bank accounts are to be made only for valid transaction. The payment for goods and services, whether accompanied by check or bank transfer, will be organized to ensure that no unauthorized payments are made, that complete and accurate records are made of each payment, and that payments are recorded in the appropriate period. Additionally, access to cash and unissued checks must be restricted to authorized personnel.

ELECTRONIC PAYMENTS:

Non-repetitive wire transfers require written approval by an authorized individual other than the person initiating the wire transfer.

Repetitive wire transfers require a Document D to be completed, signed by a financial officer, sent to PNC and inputted into their system prior to being processed out of the Treasury Workstation.

Document C-2, granting wire transfer authorization to an individual needs to be completed and signed by a financial officer and sent to PNC.

The Treasury Workstation Administrator needs to give wire transfer capability to a user prior to their processing any transfers.

**American Water
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08/22/2003 12:04 PM

Subject: 2.15 Bank Reconciliations
Category: 2. Assets

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

BANK RECONCILIATIONS

Adequate steps will be taken to confirm the accuracy of the bank balances shown in the general ledger. Monthly, data on receipt and disbursement journals should be compared with the details reported on bank statements, unmatched and mismatched data will be used to reconcile the book and bank balances, and any checks outstanding greater than 180 days will be stale dated. Only associates with no other cash duties may perform bank reconciliations. Directives to the banks will be issued from the Finance, Treasury or Cash Management areas only, not by associates performing the bank reconciliations.

Payroll bank account reconciliations should be prepared by an employee independent of all other payroll processing activities to minimize the possibility of covering unauthorized transactions through falsified reconciliations.

Most bank statements indicate a disclaimer for liability if timely reconciliations are not made and the bank notified of any irregularities within a period of time. It is therefore imperative that all bank accounts be reconciled on a timely basis, by responsible personnel, at all operating and non-operating locations, wherever bank accounts are maintained.

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08/22/2003 12:04 PM

Subject: 2.16 Petty Cash
Category: 2. Assets

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

PETTY CASH

Petty cash needs to be established using a fund amount that is substantial enough so that it limits reimbursement of the fund to only once a month.

Petty cash is to be recorded within a balance sheet account and appear on the general ledger.

Petty cash receipts must have adequate support for reimbursement.

Petty cash receipts must be properly approved for payment.

Petty cash receipts must be signed by the individual receiving the petty cash.

Petty cash is to be kept within a locked box and the key to the locked box is to be kept by the petty cash custodian. The petty cash box should then be stored, when the office is closed and when petty cash is not being distributed, in a secure and protected place.

Petty cash reimbursement checks are to be made payable to the Petty Cash Custodian (i.e., Jane Doe – Petty Cash Custodian).

No other cash funds other than tellers' drawers, where applicable, should be maintained.

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08/22/2003 12:04 PM

Subject: 2.17 Cash Equivalents
Category: 2. Assets

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

CASH EQUIVALENTS

The Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. Cash equivalents are stated at cost plus accrued interest which approximates market value.

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08/22/2003 12:04 PM

Subject: 2.18 Customer Accounts Receivable
Category: 2. Assets

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

CUSTOMER ACCOUNTS RECEIVABLE

Accounts Receivable records will be accurate, complete, and maintained in a manner to indicate the length of time the debt has been outstanding.

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08/22/2003 12:04 PM

Subject: 2.19 Allowance For Uncollectible Accounts
Category: 2. Assets

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

ALLOWANCE FOR UNCOLLECTIBLE ACCOUNTS

Accounts Receivable are to be stated at its net receivable value on a company's balance sheet. In order to accomplish this, a contra asset (Allowance for Uncollectible Accounts) is established to reduce Accounts Receivable to its estimated realizable value. All regulated utility companies are to conform to this procedure in calculating an allowance for uncollectible accounts on Customer Accounts Receivable. All other companies should be aware that changing circumstances may require the recording of a similar allowance when the certainty of collecting any receivables, earned by providing services to that company's customers or clients, becomes questionable.

CALCULATION OF BOOK ALLOWANCE:

A factor is to be determined by dividing the total charge-offs, net of recoveries for the four preceding calendar quarters, by the total billed water and sewer service revenues for the same period. This percentage factor is to be applied to an appropriate amount of billed revenues and the unbilled revenue asset.

The billed revenues to which the factor is applied will relate to the number of days which pass prior to that American Water System company typically charging-off its accounts. As an example, if the company charges off after ninety (90) days then a three-month period of billed revenues is to be used. If charge-offs are made after forty-five (45) days then a month and a half of billed revenues are used. The billed revenues used in the calculation will be for the period immediately preceding the date of the balance sheet being reported.

This factor is then to be applied to the Unbilled Revenue Asset as of the balance sheet date and added to the amount determined by applying the factor to billed revenues. The sum provides the "Allowance for Uncollectible Accounts".

Formulas used to make accounting estimates may not consider relevant facts and circumstances which may be atypical. When calculating the allowance for uncollectible accounts consideration is to be given to changes in the economic climate, the stability of larger customers, significant changes in the aging of accounts receivables, etc. Such factors may warrant a discretionary allowance in addition to that determined by the standard formula.

UNCOLLECTIBLE ACCOUNTS – TAX:

For tax reporting purposes, the deduction related to uncollectible accounts currently is limited to the amount of uncollectible accounts actually written-off, net of recoveries, in the tax year (Internal Revenue Code § 166). An analysis of the "Allowance for Uncollectible Accounts", is to be made to arrive at the appropriate adjustment.

**American Water
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08/22/2003 12:04 PM

Subject: 2.20 Unbilled Revenues
Category: 2. Assets

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

UNBILLED REVENUES

To conform to the accrual method of accounting, at the close of each accounting period an asset is to be recorded by all regulated utility companies for the estimated amount of revenues from utility service, which has been provided but not billed. Unbilled revenue will be recorded by debiting Accrued Utility Revenue with an offsetting credit to the appropriate unbilled water revenue account segregated by customer classification. The unbilled revenue asset is to be calculated as follows:

Accrued Utility Revenue for each customer class is determined by aggregating the unbilled revenue for each route within the class. The unbilled revenue associated with each route is calculated by multiplying actual unbilled days for a route by the average budgeted revenues per day for that same route.

AVERAGE UNBILLED DAYS:

For each route compute average unbilled days by multiplying the actual number of customers per meter reading route by the number of days in the accounting period since the last reading of that route (or the date service was originated) resulting in unbilled customer days. Total the unbilled customer days for each route and divide this amount by the total number of customers in that route.

AVERAGE REVENUES PER DAY:

The average rate per day is to be determined based on budgeted usage and current rates. Therefore, if there has been a change in rates, or an anticipated rate increase has not been obtained, the average revenue per day, as budgeted, must be recalculated. For each route, divide the estimated billed revenue for the month (or quarter) subsequent to the closing by the estimated billed days for that route.

CALCULATION ADJUSTMENTS:

Abnormal weather conditions or changes in the economic climate may result in differences between the budgeted consumption and actual usage. When a Vice President of Finance believes that budgeted consumption and actual amounts will generate a materially misstated accrual for any system operating company as a whole, appropriate changes in these estimates are to be made after consulting with the Service Company Vice President & Comptroller. Estimates in these circumstances may require consideration of actual system delivery amounts or interim meter readings of very large industrial customers. Appropriate action is to be considered on a case-by-case basis.

**American Water
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08/22/2003 12:04 PM

Subject: 2.21 Miscellaneous Receivables
Category: 2. Assets

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

MISCELLANEOUS RECEIVABLES

Miscellaneous invoices are created to bill for services or expenses other than water service.

Miscellaneous invoices are to be set up using a sequential numbering system.

Miscellaneous invoices are to be created when the underlying transaction occurs, whenever possible, rather than waiting for the funds to be received.

Miscellaneous invoices for recurring amounts due to the water company (space leased for antennas, etc.) should be set up in JD Edwards so they are prepared automatically.

Miscellaneous invoices should be followed up on in a timely manner and collection efforts are to be documented in writing. Collection efforts are the responsibility of the individual operating companies.

Associates with outstanding miscellaneous invoices should pay them within 30 days.

A reserve for miscellaneous accounts receivable must be set up when miscellaneous invoices are deemed likely to be uncollectible.

The General Accounting Manager or Team Lead will approve all miscellaneous invoices that are created.

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08/22/2003 12:04 PM

Subject: 2.22 Materials And Supplies
Category: 2. Assets

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

MATERIALS AND SUPPLIES

Materials delivered to job sites and meters are to be charged directly to task orders. All other materials are to be included in inventory.

Materials and supplies in inventory are to be stated at the lower of average purchased cost and net realizable value.

**American Water
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08/22/2003 12:04 PM

Subject: 2.23 Inventory
Category: 2. Assets

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

INVENTORY

CONTROL:

Procedures to provide physical security for all inventories will be established. Cost-benefit analyses considering relative value, likelihood of theft, and ease of removal/loss should be the determining factors.

PHYSICAL COUNTS:

Physical inventory of Stocks C and D are to be made on the last day of each month. A physical count of all Stock E inventories is to be made twice annually.

Physical inventory will be counted by operations staff with an independent party as the witness. The data from the count sheets will be entered into the JDE awards system by operations, and a copy made and sent to internal audit signed by the witness.

Variance reports generated by operations after count is entered,

Variances will be investigated by operations and any changes will be sent to the shared services center with an explanation of the change.

The shared services center enters approved changes, updates and posts the journal entry.

**American Water
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Policies**

08/22/2003 12:04 PM

Subject: 2.24 Prepaid Expenses
Category: 2. Assets

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

PREPAID EXPENSES

The company will establish a method to monitor and account for prepaid expenses. Detailed records of prepaid expenses will be reconciled periodically with the control account, to ensure accuracy.

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08/22/2003 12:04 PM

Subject: 2.25 Regulatory Assets
Category: 2. Assets

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

REGULATORY ASSETS

The utility subsidiaries have incurred various costs and received various credits which have been reflected as regulatory assets and liabilities on the Company's consolidated balance sheet. Accounting for such costs and credits as regulatory assets and liabilities is in accordance with Statement of Financial Accounting Standards No. 71 "Accounting for the Effects of Certain Types of Regulation" (SFAS 71). This statement sets forth the application of generally accepted accounting principles for those companies whose rates are established by or are subject to approval by an independent third-party regulator. Under SFAS 71, utility companies defer costs and credits on the balance sheet as regulatory assets and liabilities when it is probable that those costs and credits will be recognized in the rate making process in a period different from the period in which they would have been reflected in income by an unregulated company. These deferred regulatory assets and liabilities are then reflected in the income statement in the period in which the same amounts are reflected in the rates charged for service.

The accounting literature defines probable recovery as an area within a range of the likelihood that a future event or events will occur. That range is from probable to remote as follows:

- Probable. The future event or events are likely to occur.
- Reasonably possible. The chance of the future event or events occurring is more than remote but less than likely.
- Remote. The chance of the future event or events occurring is slight.

In addition to SFAS 71, the following guidance also needs to be considered when accounting for the effects of regulation:

- SFAS 90 "Regulated Enterprises – Accounting for Abandonments and Disallowances of Plant Costs"
- SFAS 92 "Accounting for Phase-in Plans" This standard also prohibits recording an allowance for earnings on shareholders' investment after plant has been placed in service.
- EITF 92-12 "Accounting for OPEB Costs by Rate-Regulated Enterprises"
- EITF 93-4 "Accounting for Regulatory Assets"
- Specific guidance for rate regulated enterprises included in various other standards

Utility subsidiaries must be careful to comply with individual state requirements to defer costs, such as the need to request advance permission for deferrals.

All regulatory assets are to be supported by a Regulatory Asset Authorization form (copy attached). This form is to be prepared by the Vice President of Finance and then forwarded to the Service Company Vice President and Comptroller for review, and then it will be forwarded to shared services as authorization to establish a regulatory asset. As there is updated information, it is to be added to the bottom of the form. Shared services will require these forms immediately to establish a new regulatory asset.

Information regarding specific regulatory assets that are common among the utility subsidiaries is as follows:

VACATION PAY:

For rate-making purposes vacation pay is generally included in allowable costs when compensation is paid by including the accrued costs on an as-paid basis, the regulator provides reasonable assurance of the existence of an asset.

INCOME TAXES RECOVERABLE THROUGH RATES:

The utility subsidiaries record a regulatory asset for the additional revenues expected to be realized as the tax effects of temporary differences previously flowed through to customers reverse. These temporary differences are primarily related to the difference between book and tax depreciation on property placed in service before the adoption by the regulatory authorities of full normalization for rate making purposes.

The regulatory asset for income taxes recoverable through rates is net of the reduction expected in future revenues as deferred taxes previously provided, attributable to the difference between the state and federal income tax rates under prior law and the current statutory rates, reverse over the average remaining service lives of the related assets.

As rate cases are prepared care must be taken to make sure that income tax expense properly reflects the recovery of these benefits that were previously flowed through to the rate-payers.

DEBT AND PREFERRED STOCK EXPENSE:

Debt expense is amortized over the lives of the respective issues. Call premiums on the redemption of long-term debt, as well as unamortized debt expense, are deferred and amortized to the extent they will be recovered through future service rates. Expenses of preferred stock issues without sinking fund provisions are amortized over 30 years from date of issue; expenses of issues with sinking fund provisions are charged to operations as shares are retired.

PENSION EXPENSE:

Most state public utility commissions recognize pension cost as actual tax deductible contributions are made to the pension plan, although some states base rate recovery on SFAS 87 and other states utilize what appear to be arbitrary methods that vary from one rate case to

the next. In states that recognize pension cost as actual contributions are made to the plan the regulated utility subsidiaries have recorded regulatory assets for the cumulative difference between SFAS 87 cost and cash contributions. In 1992 the Company sought formal authorization from the various public utility commissions to record such regulatory assets. These deferred costs will be recovered in future service rates as contributions are made to the pension plan. All other regulated subsidiaries recognize the SFAS 87 cost currently each year.

POSTRETIREMENT BENEFIT EXPENSE:

Postretirement benefit expense in excess of the amount recovered in rates through 1997 has been deferred by certain subsidiaries. These costs are now recognized in the rates charged for water service and will be fully recovered over a 20-year period ending in 2012 as authorized by the regulatory authorities.

TREATMENT PLANT COSTS:

Deferred treatment plant costs consist of operating expenses, including depreciation and property taxes, and the carrying charges associated with several water treatment plants and related facilities from the time the assets were placed in service until recovery of such costs is allowed in future service rates. These costs have been recognized in the rates charged for water service and are being amortized over a 10-year period as authorized by the regulatory authorities.

BUSINESS SERVICES PROJECT EXPENSES:

Deferred business services project expenses consist of reengineering and start-up activities for consolidated customer and shared administrative service centers that began operations in 2001. These costs are being deferred as it is expected that these costs will be recovered in the rates charged for utility service in the future.

SECURITY COSTS:

The Company has deferred the cost of additional security measures that were implemented to protect facilities after the terrorist attacks on September 11, 2001. These costs are being deferred as it is expected that these costs will be recovered in the rates charged for utility service in the future.

TANK PAINTING COSTS:

Tank painting costs are generally deferred and amortized to current operations on a straight-line basis over periods ranging from 4 to 20 years, as authorized by the regulatory authorities in their determination of rates charged for service.

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08/22/2003 12:04 PM

Subject: 2.26 Regulatory Asset Authorization Form
Category: 2. Assets

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

REGULATORY ASSET AUTHORIZATION

(Company)

(Expense to be deferred)

Description of expense to be deferred:

Plan to address recovery in rates:

Submitted By:

(VP of Finance and Comptroller)

(Date)

Reviewed By:

(Service Company VP and Comptroller)

(Date)

Updated Information:

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08/22/2003 12:04 PM

Subject: 2.27 Goodwill
Category: 2. Assets

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

GOODWILL

Any remaining acquisition premium after recording tangible assets at fair value and recording intangible assets as goodwill that will not be amortized, but will be subject to mandatory annual impairment testing. The impairment test has two steps. Step one compares the fair value of the reporting unit to its book value. If the fair value is less than the book value, you must determine the fair value of the tangible and intangible net assets. The fair value of the reporting unit less the fair value of the tangible and intangible net assets is the implied fair value of the goodwill. Any goodwill on the books in excess of the implied fair value of the goodwill must be written off as an impairment charge.

Each state utility company will be a reporting unit. One important aspect of the rules is that unrecognized and/or appreciated assets provide a cushion that protects against possible impairment charges by causing the fair value of a reporting unit to exceed its book value – the "goodwill shield". For example, if a very large company made a small acquisition that turned out to have no fair value, it would presumably be shielded from an impairment charge since prior to the acquisition the fair value of the company was probably much higher than its book value. In the case of Arizona-American's purchase of the Citizens assets, there won't be much of a goodwill shield if the acquiring company was very small.

The fair value for the annual impairment test will be based on a discounted cash flow analysis (DCF). If the acquisition doesn't perform as expected, this would lower projected future performance and thus lower the value from the DCF. In addition, other assumptions used in the DCF such as the terminal value may change in the future and lower the fair value of the reporting unit.

**American Water
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08/22/2003 12:04 PM

Subject: 2.28 Intangible Assets
Category: 2. Assets

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

INTANGIBLE ASSETS

Acquired intangibles need to be separated into two groups – those with a finite useful life and those with an indefinite life. Intangibles with a finite useful life need to be amortized over their economic life. Intangibles originally thought to have an indefinite life will be amortized if it is subsequently determined that the asset has a finite life. All intangibles are subject to mandatory annual impairment testing.

Depending on the size and complexity of the transaction it may be advisable to engage an outside firm to identify and/or value acquired intangibles.

American Water
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08/22/2003 12:04 PM

Subject: 2.29 Other Investments
Category: 2. Assets

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

OTHER INVESTMENTS

Other investments include primarily equity securities of publicly and privately held companies. Investments in publicly traded securities are classified as available for sale and are recorded in the balance sheet at fair market value with the change in market value, net of the tax effect, recorded as part of other comprehensive income. The fair value of these investments is determined using quoted market prices. Investments in privately held companies are carried at cost.

**American Water
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08/22/2003 12:04 PM

Subject: 3.01 Accounts Payable
Category: 3. Liabilities

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

ACCOUNTS PAYABLE

All valid accounts payable transactions, and only those transactions will be accurately recorded as accounts payable. Employees independent of the ordering or receiving functions will record the recording of assets or expenses and the related liability. Approved documentation evidence of receipt or performance, invoices, and the related general ledger account distribution should be reviewed before recording. The amounts recorded are to be based on vendor invoices for the related goods or services.

It is the company's policy to pay all invoices, in a timely manner, taking advantage of any available discounts. In many instances invoices will be paid after they are matched with an approved purchase order. All non-purchase order invoices require approval before payment is made.

**American Water
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08/22/2003 12:04 PM

Subject: 3.02 Payables To Banks
Category: 3. Liabilities

Owner
Robert D
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PAYABLES TO BANKS

Other current liabilities are to include payables to banks, which represent checks issued but not presented to banks for payment, net of the related bank balance.

**American Water
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08/22/2003 12:04 PM

Subject: 3.03 Customer Guarantee Deposits
Category: 3. Liabilities

Owner

Robert D
Sievers/ADMIN/CORP/AWWSC

CUSTOMER GUARANTEE DEPOSITS

A pre-numbered receipt book is to be used and a receipt is to be issued with each incoming customer guarantee deposit. The unused receipt books are to be locked up when not in use. Customer guarantee deposit receipts are to be issued in numerical order with a unique certification number assigned to each incoming customer guarantee deposit.

Where applicable, interest is to be properly calculated

A refund to the customer is to be made, as the customer guarantee deposit is no longer required on the customer account. The customer may receive a refund or the amount of the refund may be applied to the customer's account.

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08/22/2003 12:04 PM

Subject: 3.04 Advances And Contributions In Aid Of Construction
Category: 3. Liabilities

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

ADVANCES AND CONTRIBUTIONS IN AID OF CONSTRUCTION

Utility subsidiaries may receive advances and contributions to fund construction necessary to extend service to new areas. As determined by the regulatory authorities, advances for construction are refundable for limited periods of time as new customers begin to receive service. Amounts which are no longer refundable are reclassified to contributions in aid of construction. Utility plant funded by advances and contributions is excluded from rate base and is generally not depreciated for rate-making purposes. Generally, advances and contributions received during the period January 1, 1987 through June 12, 1996 have been included in taxable income and the related property is depreciable for tax purposes. As a result of a tax law change, advances and contributions received subsequent to June 12, 1996 are excluded from taxable income and the related property is not depreciable for tax purposes.

On January 11, 2001 the Internal Revenue Service issued regulations that excluded lateral service lines from its definition of contributions in aid of construction that are not included in taxable income. These customer connection fees are defined as the cost of installing a connection or service line from the Company's main lines to the lines owned by the customer. The regulations were effective immediately, and the Company is now paying tax on money or property received for these connections.

**American Water
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08/22/2003 12:04 PM

Subject: 3.05 Deferred Taxes
Category: 3. Liabilities

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

DEFERRED TAXES

INCOME TAXES:

Certain income and expense items are accounted for in different time periods for financial reporting than for income tax reporting purposes. Deferred income taxes have been provided on the difference between the tax bases of assets and liabilities and the amounts at which they are carried in the financial statements. These deferred income taxes are based on the enacted tax rates to be in effect when such temporary differences are expected to reverse. The utility subsidiaries also recognize regulatory assets and liabilities for the effect on revenues expected to be realized as the tax effects of temporary differences previously flowed through to customer reverse.

INVESTMENT TAX CREDITS:

Investment tax credits have been deferred by the utility subsidiaries and are being amortized to income over the average estimated service lives of the related assets.

**American Water
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08/22/2003 12:04 PM

Subject: 3.06 Accrued Benefit Plan Expense
Category: 3. Liabilities

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

ACCRUED BENEFIT PLAN EXPENSE

PENSION:

The Company maintains noncontributory defined benefit pension plans covering substantially all associates employed in its regulated utility and shared services operations. Benefits under the plans are based on the associate's years of service and compensation. The Company's funding policy is to contribute at least the minimum amount required by the Employee Retirement Income Security Act of 1974.

The Company also has several unfunded noncontributory supplemental non-qualified pension plans that provide additional retirement benefits to certain associates of the Company and its subsidiaries.

POSTRETIREMENT BENEFITS:

The Company maintains postretirement benefit plans providing varying levels of medical and life insurance to eligible retirees. The Company's policy is to fund postretirement benefit costs accrued.

DISCOUNT RATE ASSUMPTION:

FASB and SEC guidance directs plan sponsors to focus on the yield on high quality bonds as of the December 31 measurement date. The Company's discount rate is closely tied to Moody's Aa bonds, which are the minimum "high quality" bonds for this purpose.

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Subject: 4.01 Recognition Of Revenues
Category: 4. Revenues

Owner
Robert D
Sievers/ADMINICORPIAWWSC

RECOGNITION OF REVENUES

Revenues of the regulated utility subsidiaries include amounts billed to customers on a cycle basis and unbilled amounts based on estimated usage from the date of the latest meter reading to the end of the accounting period.

Revenue from American Water Services' residuals management, underground infrastructure development, engineering and large multi-year operations and maintenance contracts are recognized over the contract term based on the estimated percentage of services provided during the period compared to the total estimated services to be provided over the entire contract. Losses on contracts are recognized during the period in which the loss first becomes known. Revenue recognized in excess of billings on service contracts are recorded as unbilled revenue. Billings in excess of revenues recognized on service contracts are recorded as a liability on the Company's balance sheet until the above revenue recognition criteria are met. Changes in contract performance and related estimated contract profitability may result in revisions to costs and revenues and are recognized in the period in which revisions are determined. For other water and wastewater treatment contracts and for time and material contracts, revenue is recognized as services are provided.

**American Water
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08/22/2003 12:04 PM

Subject: 4.02 Billing Records - Company-Owned Facilities Water Service
Category: 4. Revenues

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

BILLING RECORDS - COMPANY-OWNED FACILITIES WATER SERVICE

Each facility should have a metered service which will be read as part of the regular route reading process.

The service should be coded as an inactive account, so a bill will not be generated.

The account will appear on the billing edit reports as an inactive account with consumption

This procedure will assure that the meters are included in your testing and replacement programs. It will also assist in supporting company-owned facility consumption which might be necessary for sewer reporting purposes.

**American Water
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08/22/2003 12:04 PM

Subject: 5.01 Accruals - Other
Category: 5. Expenses

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

ACCRUALS - OTHER

Vacation – accrual adjusted quarterly to reflect the liability for vacation at the end of the quarter. The vacation accrual must be recorded as a liability on the balance sheet for financial presentation purposes. Vacation expense is recognized by the utility subsidiaries as associates use their vacation.

Purchased Water – is to be accrued for on the basis of meter readings of the actual amounts received into the system.

Sludge – is to be accrued monthly based on the last payment and the anticipated next payment.

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08/22/2003 12:04 PM

Subject: 5.02 Power Accruals
Category: 5. Expenses

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

POWER ACCRUALS

In order to ensure the accurate and timely recording of the total monthly expense for fuel and power costs of the utility subsidiaries, the shared services center general accounting group will prepare, record and post a monthly reversing journal entry accruing for the difference between the estimated total power expense and invoices recorded through accounts payable in the month. This journal entry will be based on actual system deliver.

System delivery is made up of three distinct components:

Water sales – the water meter readings of all water customers.

Unaccounted for water – water lost through leaks, bad metering, etc

Non-revenue usage – water used in the process of delivering water (such as back washing filter).

Cost per million gallon is the monthly rate calculated as part of the approved plan for each district.

System delivery reports are prepared at month-end by each utility subsidiary. These reports will be used by the shared services center to calculate the monthly power accrual amount and subsequently record and post this amount via a monthly reversing journal entry.

Actual system delivery amount multiplied by the budgeted cost per million gallon rate is used to calculate the estimated power expense for the given month.

Estimated power expense is then compared to the invoices recorded through accounts payable in JD Edwards for the given month.

An accrual is only prepared if the estimated power expense is higher than the invoices recorded through accounts payable in JD Edwards.

The planned cost per million gallon rate is reviewed on a quarterly basis to determine if an adjustment to the plan should be made. If an adjustment is required, the actual cost per million gallon rate will be calculated for the quarter and used for the following quarter's accrual calculation.

**American Water
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08/22/2003 12:04 PM

Subject: 5.03 Insurance Other Than Group
Category: 5. Expenses

Owner
Robert D
Sievers/ADMINICORPIAWWSC

INSURANCE OTHER THAN GROUP

The American Water System has a prepaid deductible insurance program for its general liability, workers compensation and automobile liability coverage. During each policy year we are billed on a quarterly basis for the estimated premiums for this coverage. These premiums are allocated to the various companies on the basis of insurable values. The premiums for this coverage are based on an estimate of losses, the charges of the carrier to administer the program, and the cost to insure against individual and total claims above certain limits.

The carrier holds the funds until claims are paid, and in the interim we are credited with interest on that money. As losses develop claims are paid out of these funds. In addition, estimates are made of losses for claims that have been made but not settled and for incurred but not reported claims based on past experience. We are for all practical purposes self-insured.

After five years an annual process of trueing up the cash reserve for the policy year begins. This waiting period provides time for claims to be filed and settled, which in turn prevents a premature refund of money to the Company and subsequent additional billings as losses develop. Refunds or additional billings are allocated to the companies on the same basis used for the premiums paid during the policy year. Individual policy years never close, so we remain responsible for any claims that might come up, subject to the individual and total loss limits for any given policy year.

The utility subsidiaries have always accounted for insurance other than group in a cash basis. Recovery of insurance other than group expense in rates has always closely followed our cash basis of accounting. Our success in rates reflects the fact that our expense is based on actual cash payments and the relative lack of volatility resulting from waiting five years before the first retrospective premium adjustment takes place.

In those cases where adverse experience has created a deficit funding position supplemental *billings* will be issued. These *supplemental billings* would result in sufficient cash reserves being available for each policy year as those *policy* years reach their fifth anniversary at which time the initial retrospective premium adjustment will take place, and will allow us to maintain the consistency between cash payments and rate recovery that has benefited us in the past.

**American Water
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08/22/2003 12:04 PM

Subject: 6.01 Income Tax Provision
Category: 6. Taxes

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

INCOME TAX PROVISION

A monthly income tax provision will be prepared based on an effective tax rate (ETR). A discrete income tax provision will be calculated on a quarterly basis from Insource. Some of the information into Insource will be provided from tax memo accounts. State taxes will be calculated within Insource and entered as an adjustment within Insource. Federal tax provision will be calculated. The result will be a journal entry for current and deferred taxes. The calculation will be reviewed and adjustments made as determined.

The Insource system will be locked by Corporate Tax.

**American Water
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08/22/2003 12:04 PM

Subject: 6.02 Tax Accounting Treatment Of Regenerated Carbon
Category: 6. Taxes

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

TAX ACCOUNTING TREATMENT OF REGENERATED CARBON

From a tax accounting perspective purchased carbon should be treated in the following manner:

At the time of purchase the acquisition cost is capitalized to a depreciable property account. While the carbon is in use it is depreciated over the 20-year life assigned to water property, using the 150 percent declining balance method.

When the carbon is removed from service for regeneration, it is written down to zero for tax purposes.

Regeneration costs are capitalized and a new asset is recorded.

When the carbon is placed in service, the cycle reverts to Step 2 above.

The methodology described above will be used consistently throughout the American system.

**American Water
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08/22/2003 12:04 PM

Subject: 6.03 Other Taxes
Category: 6. Taxes

Owner

Robert D
Sievers/ADMIN/CORP/AWWSC

OTHER TAXES

Taxes are due to various municipalities on various schedules. The taxes can be based upon revenues, purchases or property. Tax bills can be received or can be automatically due after a month-end. Tax bills need to be verified for accuracy and processed. For the taxes that are automatically due, a tax calendar will need to be consulted, and a report run to determine the amount. A check will be requested and accompanied with the appropriate letter/tax form. The letter will be signed and sent to the appropriate taxing authority.

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08/22/2003 12:04 PM

Subject: 7.01 Environmental Costs
Category: 7. Miscellaneous

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

ENVIRONMENTAL COSTS

Environmental expenditures that relate to current operations or provide a future benefit are expensed or capitalized as appropriate. Remediation costs that relate to an existing condition caused by past operations are accrued when it is probable that these costs will be incurred and can be reasonably estimated.

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08/22/2003 12:04 PM

Subject: 7.02 Comprehensive Income
Category: 7. Miscellaneous

Owner

Robert D
Sievers/ADMIN/CORP/AWWSC

COMPREHENSIVE INCOME

Statement of Financial Standards No. 130 "Reporting Comprehensive Income" established standards for reporting and display of comprehensive income and its components (revenues, expenses, gains, and losses) in a full set of general-purpose financial statements. This Statement requires that all items that are required to be recognized under accounting standards as components of comprehensive income be reported in a financial statement that is displayed with the same prominence as other financial statements. This Statement requires that an enterprise display an amount representing total comprehensive income for the period in that financial statement.

This Statement requires that an enterprise (a) classify items of other comprehensive income by their nature in a financial statement and (b) display the accumulated balance of other comprehensive income separately from retained earnings and additional paid-in capital in the equity section of a statement of financial position.

Components of comprehensive income currently applicable to the company are:

Foreign currency translation adjustments

Unrealized gains on securities

Reclassification adjustment for gains on securities included in net income

Minimum pension liability adjustments

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08/22/2003 12:04 PM

Subject: 7.03 Intercompany Profit
Category: 7. Miscellaneous

Owner

Robert D
Sievers/ADMIN/CORP/AWWSC

INTERCOMPANY PROFIT

Profit on sales to regulated affiliates is not eliminated in the consolidated financial statements if it is probable that, through the rate-making process, future revenue approximately equal to the sales price will result from the regulated affiliate's use of the products.

Revenues from intercompany sales are netted against expense in consolidation.

**American Water
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08/22/2003 12:04 PM

Subject: 7.04 Use Of Estimates
Category: 7. Miscellaneous

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

USE OF ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period.

**American Water
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08/22/2003 12:04 PM

Subject: 7.05 Asset Impairment
Category: 7. Miscellaneous

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

ASSET IMPAIRMENT

Long-lived assets held and used by the Company are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets, on a separate entity basis, may not be recoverable. If the sum of the future cash flows expected to result from the use of the assets and their eventual disposition is less than the carrying amount of the assets, an impairment loss is recognized. Measurement of an impairment loss is based on the fair value of the assets. A regulatory asset is charged to earnings if and when future recovery in rates of that asset is no longer probable.

**American Water
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08/22/2003 12:04 PM

Subject: 7.06 Segment Information
Category: 7. Miscellaneous

Owner

Robert D
Sievers/ADMIN/CORP/AWWSC

SEGMENT INFORMATION

The Company has identified Regulated Utility Services and Unregulated Services as its two reportable segments. The Company has organized its business based upon the products and services provided and based upon similar environments. The results of operations reported by segment include costs allocated by American Water Works Service Company. The "other items" include corporate costs of American Water Works Company and intersegment eliminations.

The **Regulated** Utility Services segment includes subsidiaries that provide water and wastewater to customers. All of these companies are subject to both federal and state regulation regarding the quality of water distributed and the discharge of waste residuals. With the exception of one small company, the utility subsidiaries also function under economic regulations prescribed by state regulatory commissions.

The **Unregulated Services** segment includes American Water Services and its subsidiaries and American Water Resources. American Water Services provides a broad range of water and wastewater services including operations and maintenance, residuals management, underground infrastructure development and engineering throughout the U.S. and Canada. American Water Resources currently offers a consumer protection program for residential water service lines and a service to regenerate granular activated carbon that is used by water utilities in the filtration process. Intersegment revenues include carbon regeneration services and leased equipment and office space.

**American Water
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08/22/2003 12:04 PM

Subject: 7.07 Service Company Billing
Category: 7. Miscellaneous

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

SERVICE COMPANY BILLING

The American Water Works Service Company is to be a no-cost business unit. The Service Company Agreement calls for all time charges and other costs of the Service Company which can be identified and related exclusively to a specific company to be charged directly to that company. All costs incurred in rendering services to a group of regulated companies, which cannot be identified and related exclusively to services rendered to a particular company, should be distributed using the appropriate formula.

While most of the work done by Service Company associates in the Corporate office supports the regulated companies, there is a limited amount of time spent on supporting non-regulated companies. Particular care must be taken to make sure that no time or costs related to non-regulated activities are charged to the regulated companies. For example, time and expenses related to our management services subsidiary, American Water Services, should be charged directly to company number 917. Time and expenses related to American Water Resources, which is developing complementary water resource management product and service capabilities, should be charged directly to company number 585.

**American Water
Accounting
Policies**

08/22/2003 12:04 PM

Subject: 7.08 Derivative Instruments And Hedging Activities
Category: 7. Miscellaneous

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

Statement of Financial Standards No. 133 "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133) established accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, (collectively referred to as derivatives) and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as (a) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (b) a hedge of the exposure to variable cash flows of a forecasted transaction, or (c) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction.

The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation.

For a derivative designated as hedging the exposure to changes in the fair value of a recognized asset or liability or a firm commitment (referred to as a fair value hedge), the gain or loss is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributable to the risk being hedged. The effect of that accounting is to reflect in earnings the extent to which the hedge is not effective in achieving offsetting changes in fair value.

For a derivative designated as hedging the exposure to variable cash flows of a forecasted transaction (referred to as a cash flow hedge), the effective portion of the derivative's gain or loss is initially reported as a component of other comprehensive income (outside earnings) and subsequently reclassified into earnings when the forecasted transaction affects earnings. The ineffective portion of the gain or loss is reported in earnings immediately.

For a derivative designated as hedging the foreign currency exposure of a net investment in a foreign operation, the gain or loss is reported in other comprehensive income (outside earnings) as part of the cumulative translation adjustment. The accounting for a fair value hedge described above applies to a derivative designated as a hedge of the foreign currency exposure of an unrecognized firm commitment or an available-for-sale security. Similarly, the accounting for a cash flow hedge described above applies to a derivative designated as a hedge of the foreign currency exposure of a foreign-currency-denominated forecasted transaction.

For a derivative not designated as a hedging instrument, the gain or loss is recognized in

earnings in the period of change.

Under SFAS 133, an entity that elects to apply hedge accounting is required to establish at the inception of the hedge the method it will use for assessing the effectiveness of the hedging derivative and the measurement approach for determining the ineffective aspect of the hedge. Those methods must be consistent with the entity's approach to managing risk.

American Water Works Company, Inc. and its subsidiaries do not have any derivative instruments or hedging activities. Any questions regarding whether a proposed transaction would constitute a derivative instrument should be directed to the Comptroller of American Water Works Company, Inc. No derivatives or hedging activities may be entered into without the prior approval of the Chief Financial Officer of American Water Works Company, Inc.

**American Water
Accounting
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08/22/2003 12:04 PM

Subject: 7.09 Internal Controls
Category: 7. Miscellaneous

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

INTERNAL CONTROLS

The company will maintain an effective system of internal control in order to monitor compliance with policies and procedures established by management. Internal controls are divided into two areas: accounting controls and administrative controls. Accounting controls are to be designed to achieve four basic objectives: validation, accuracy, completeness, and physical security.

The application of control includes forms of organization, policies, systems, procedures, instructions, plans, reports, records, internal auditing and other considerations in the operation of a company's business.

**American Water
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Policies**

08/22/2003 12:04 PM

Subject: 7.10 Chart Of Accounts
Category: 7. Miscellaneous

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

CHART OF ACCOUNTS

NARUC UNIFORM SYSTEM OF ACCOUNTS:

The individual state public utility commissions generally require the companies they regulated to comply with the Uniform System of Accounts (USOA) for Class A Water Utilities that is maintained by the National Association of Regulatory Utility Commissioners. The USOA contains a chart of accounts along with detailed accounting instructions.

CHANGES:

Approval must be obtained for all additions and or changes to the Chart of Accounts. The addition of new accounts to the Chart of Accounts may be made only upon the approval of Corporate Accounting. All additions of new sub-ledgers are to be approved at the department level.

All additions and or modifications to the Chart of Accounts are to be entered into the Master Chart of Accounts first, before it can be copied to necessary locations.

**American Water
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Policies**

08/22/2003 12:04 PM

Subject: 7.11 Financial Systems Access
Category: 7. Miscellaneous

Owner

Robert D
Sievers/ADMIN/CORP/AWWSC

FINANCIAL SYSTEMS ACCESS

Access to the financial computer system will be limited to the user groups as defined by the Shared Service Center management.

**American Water
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Policies**

08/22/2003 12:04 PM

Subject: 7.12 General Ledger: Maintenance And Activity
Category: 7. Miscellaneous

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

GENERAL LEDGER: MAINTENENCE AND ACTIVITY

The company will adequately maintain its software systems to ensure an effective accounting system, which captures the data regarding the economic activity of the company. All valid ledger entries, and only those entries, should be accurately recorded in the general ledger.

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Policies**

08/22/2003 12:04 PM

Subject: 7.13 Susidiary Ledgers
Category: 7. Miscellaneous

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

SUBSIDIARY LEDGERS

Subsidiary ledgers are to be maintained on the JD Edwards system when possible and reviewed for accuracy on, at least, a quarterly basis.

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08/22/2003 12:04 PM

Subject: 7.14 Code Of Ethics
Category: 7. Miscellaneous

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

CODE OF ETHICS

ANNUAL CERTIFICATION LETTERS:

All associates hired before December 1st are required to sign and return the annual Code of Ethics certification letters. All associates joining the company after December 1st will receive and review the company's Code of Ethics material during their initial hiring orientation by Human Resources.

HOTLINE:

The American Water system has established an Ethics Hotline at 1-877-207-4888. Associates can use this hotline to report, in good faith, suspected violations of this Code. All calls will be held in confidence if requested and to the extent permitted by law. Calls to the hotline will be monitored by the Service Company's Director of Internal Audit. The Hotline provides an additional reporting channel associates can use to expedite action on suspected violations of this Code or in situations in which they are not comfortable using available reporting channels within their company.

**American Water
Accounting
Policies**

08/22/2003 12:04 PM

Subject: 8.01 Payroll
Category: 8. Payroll

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

PAYROLL

PAYROLL DEDUCTIONS:

Payroll deductions must be correctly recorded and paid to the appropriate third parties on a timely basis. Also, related payroll reports to third parties should be submitted on a timely basis.

SEGREGATION OF DUTIES:

All pay rates are to be authorized by the business unit president. All pay rates are to be inputted into the computer by a Human Resource employee.

Associates who participate in processing payrolls should not have custody of payroll checks after they are signed.

TIME ENTRY:

Payment for wages and salaries are to be made in accordance with records of work performed, to ensure that disbursements of company funds are for valid services performed.

WAGES AND SALARIES:

Payment for wages and salaries will be made only to company associates at rates of pay, reflecting complete and authorized standing data.

**American Water
Accounting
Policies**

08/22/2003 12:04 PM

Subject: 8.02 Meals Allowance And Reimbursements
Category: 8. Payroll

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

MEALS ALLOWANCES AND REIMBURSEMENTS

Each System Company must track all of the meal allowance and reimbursement payments made during the year and report those amounts on Form W-2 at year-end. These payments are subject to income, FICA and unemployment taxes. When meal allowances are earned in late December that cannot be practically included in that year's payroll reporting, payment and tax reporting should both be delayed until the following year.

The entire cost of any taxable overtime meals on expense statements should be charged to Meals and Entertainment Expense-Taxable. The cost of this type of meal is fully deductible since it is included in the employee's taxable income.

**American Water
Accounting
Policies**

08/22/2003 12:04 PM

Subject: 8.03 Non-Deductible Dues And Memberships
Category: 8. Payroll

Owner

Robert D
Sievers/ADMIN/CORP/AWWSC

NON-DEDUCTIBLE DUES AND MEMBERSHIPS

Organizations that incur lobbying expense are required to provide an estimate of the portion of dues that do not longer qualify as deductible business expenses. The non-deductible portion of dues should be charged to A/C 575300.16 Dues for Club-nondeductible, and the deductible portion should be charged to A/C 575280.16 Dues for Club-Deductible.

Clubs are organized for business, pleasure, recreation, or other social purposes if their principal purpose is to conduct entertainment activities for members or their guests or to provide these individuals with entertainment facilities. Examples of clubs for which dues are not deductible include country clubs, airline and hotel clubs, and meal clubs operated in a manner conducive to business discussion.

Dues of business leagues, trade associations, chambers of commerce, boards of trade, real estate boards, professional organizations (such as bar associations) and civic or public service organizations (such as Kiwanis, Lions, Rotary, or Civitan) are tax deductible.

**American Water
Accounting
Policies**

08/22/2003 12:04 PM

Subject: 8.04 Taxability Of Savings Bonds As Safety Awards
Category: 8. Payroll

Owner:
Robert D
Sievers/ADMIN/CORP/AWWSC

TAXABILITY OF SAVINGS BONDS AS SAFETY AWARDS

Cash awards (U.S. Savings Bonds are the equivalent of cash) are taxable and are included in gross income. Furthermore, the awards are not excludable from gross income as de minimis fringe benefits.

**American Water
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Policies**

08/22/2003 12:04 PM

Subject: 8.05 Taxability Of Physical Examinations
Category: 8. Payroll

Owner

Robert D
Sievers/ADMIN/CORP/AWWSC

TAXABILITY OF PHYSICAL EXAMINATIONS

The cost of providing physical examinations is not excludable as a working condition fringe benefit, regardless as to whether the program is voluntary or mandatory. Therefore, the cost of these examinations is taxable to the employee. Furthermore, since our group medical insurance plan does not cover the cost of physical examinations payments are not excludable under IRC section 105 either.

**American Water
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Policies**

08/22/2003 12:04 PM

Subject: 8.06 Taxable Cost Of Group-Term Life Insurance

Category: 8. Payroll

Owner

Robert D
Sievers/ADMIN/CORP/AWWSC

TAXABLE COST OF GROUP-TERM LIFE INSURANCE

Active associates and retirees (unless disabled) must include in income the cost of group-term life insurance provided by the company to the extent such cost exceeds the cost of \$50,000 of such insurance. Cost is based on the IRS uniform premium table, and any amount paid by the retiree toward the purchase of group-term life insurance coverage on his life during the year reduces the amount includable in his gross income.

However, the \$50,000 cost limit does not apply to any retiree if he retired on or before January 1, 1984 or was born on or before January 1, 1929 and was hired on or before December 1, 1983.

The taxable cost of group-term life insurance provided to associates and retirees must be reported on IRS Form W-2 at year-end.

The taxable cost of this coverage is subject to the employer and employee portions of social security and Medicare taxes, and includable in income in all states except Pennsylvania. The taxable cost of this coverage is excludable for unemployment tax purposes. Taxes are not withheld and collected by the company for retirees, but the Form W-2 must indicate the amount of social security and Medicare tax payable by the retiree.

**American Water
Accounting
Policies**

08/22/2003 12:04 PM

Subject: 9.01 Procurement
Category: 9. Procurement

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

PROCUREMENT

QUALIFYING NEW SUPPLIERS:

New suppliers of items required by the Company will be selected after analysis of the potential suppliers by the Procurement Department. Only authorized Procurement Department associates will add new suppliers to the JD Edwards Address Book.

PLACEMENT OF ORDERS:

Proper approval will be obtained prior to the establishment of a firm offer or contract to purchase. Administrative control will be established over orders placed.

RECEIPT AND ACCEPTANCE:

Control is to be established over goods and services received as a basis for determining and recording the liability for goods and services received. The physical receipt of all purchased goods will be the responsibility of a designated individual who should inspect the goods for conformity with specifications on purchase orders. Quantities will be verified by counting, weighing, or measuring. Receipt and acceptance of a shipment is to be documented with copies being routed to the purchasing and accounting departments.

RETURN OF GOODS TO SUPPLIERS:

Returns of goods to suppliers will be adequately controlled, documented, and recorded

**American Water
Accounting
Policies**

08/22/2003 12:04 PM

Subject: 9.02 JD Edwards Purchasing Security
Category: 9. Procurement

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

JD EDWARDS PURCHASING SECURITY

There are 6 security access levels for purchasing and inventory in the operating companies, each being mutually exclusive of the others. These security access levels are:

Inquiry – Ability to check PO status, use JD Edwards e-mail, run reports, and inquire on inventory.

Requisitioner – Ability to create stock and non-stock POs and inquire on inventory and POs.

Approver – Ability to approve POs, use JD Edwards e-mail, and inquire on inventory and POs.

Receiver – Ability to complete non-stock receipts and inquire on inventory and POs.

Issuer & Receiver – Ability to issue and transfer inventory, complete inventory receipts, run cycle counts and inquire on inventory and POs.

Requisitioner, Issuer & Receiver – All the abilities noted above. However, this security access level is only to be available at districts where only two associates have access to the computer. Thus, at a two-person district you would have an Approver and a Requisitioner, Issuer & Receiver.

Any request for the Requisitioner, Issuer & Receiver security access level at a two salaried associate district should be directed to the Director of Internal Auditing at the Corporate Office by someone at the Vice President level of the Utility Subsidiary. The request should include the following information:

Full Name of the Associate

Position/Title of Associate

Physical location of the Associate requesting the 'special' JD Edwards Security Access Level

Number of Associates at that physical location

Manager/Supervisor for that Associate

Approver for that Associate

In the absence of one of the two associates at a two associate district, their function should be performed by an associate with the proper authority at the District/State/Region office that is responsible for that two associate district. There are also the purchasing cards that could be used in case of someone's absence.

The controls in the purchasing/payables system are all upfront. When the invoice finally arrives it is automatically processed and paid by associates at a location (Shared Services) that is not near the initiating location and who are not familiar with the day-to-day operations. Because segregation of duties is an integral part of this control and there are so many security access level options, it is expected that exceptions to this policy should not be necessary.

Any requests for exceptions to the above policy should be submitted to the Director of Internal

Auditing at the Corporate Office by someone at the Utility Subsidiary Vice President level with an explanation of why their districts cannot comply.

**American Water
Accounting
Policies**

08/22/2003 12:04 PM

Subject: 9.03 Purchase Cards
Category: 9. Procurement

Owner
Robert D
Sievers/ADMIN/CORP/AWWSC

PURCHASE CARDS

The Purchasing Card Program uses a Master Card product to provide associates with a more efficient and effective way to make small-dollar purchases, one-time infrequent purchases, or small-dollar routine purchases. The objectives of the program are: 1) Reduce the administrative work of supervisors related to small purchases by eliminating the need for purchase orders, assigning of the proper account distribution to the purchase through the card default and Merchant Category Codes decreasing the time spent in reviewing and approving purchases, and eliminating individual invoices for each purchase. 2) Provide a means to make purchases at more locations, potentially resulting in purchasing at lower prices and spending less time going to a location to make a purchase. 3) Reduce accounting costs by eliminating invoice entry into accounts payable, check processing, and bank reconciling. 4) Improve purchase controls.

Cards will be issued to associates that have been authorized to make purchases for the Company. Prime candidates to receive cards are associates whom requisition or purchase goods or services and associates who occasionally travel out of town on company business.

Cards are given to individual associates with their name listed on the card. These cards are to be used only by the listed cardholder. The purchasing card may be used to make small-dollar purchases of goods or services (generally less than \$500) in conjunction with business travel, subscription purchases, purchases from one-time vendors, and any other low dollar authorized purchases. Cards are not to be used for personal or non-job related purchases. However, there may be situations where personal charges cannot be separated from business charges (e.g. items of a personal nature automatically charged to a room bill that cannot be paid separately at checkout). In these circumstances, a reimbursement check is to be sent to Accounting promptly at the conclusion of the trip, with a copy of the statement (e.g. hotel bill). Questions on whether the card can be used for a purchase are to be directed to the Program Administrator.

The itemized copy of the receipts, copies of the charge slips, packing slips, and other associated documentation are to be accumulated throughout the month.

A preferred vendor listing will be created representing those vendors who will accept the purchasing card, and in some instances will give the Company a discount off purchases.

If a purchasing card is lost or stolen, it is to be reported immediately to both the National City/ProCard Customer Service Department of Total Systems Customer Service Center (24 hours a day) and the Company Program administrator.

If an associate is transferring to another location within the company the supervisor is to report the transfer to the Program Administrator via email. Appropriate changes will be made to the

card and report distribution. Any changes or updates to a cardholder's name, location, spending limits, or account distribution should be directed to the Program Administrator via email.

Cardholders who leave the employment of the Company, either by resignation or termination must turn in their purchasing card prior to exiting the department. It is the responsibility of the cardholder's supervisor to get the card and to request the Program administrator to cancel the card via email.

Associates have a responsibility to report instances where the Company's policies and procedures are not being followed. These instances are to be reported immediately to a supervisor, the Program Administrator, or the Comptroller.

To ensure the continued success of the Purchasing Card Program and meet internal audit requirements, periodic review of receipts and documentation, purchases, vendors, and sales tax will be conducted. The primary purpose of these reviews is to ensure that the correct information is being maintained and that the Purchasing Card Program procedures are being adhered to.