



Audit of Water Utilities

Rolling Green Utilities, Inc. - Water

For the Year Ended December 31, 2017

Utility Audits Branch
April 10, 2020



MEMBERS OF THE TEAM

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**A digital copy of this report can be found at:
<http://www.cpuc.ca.gov/utilityaudits/>**

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EXECUTIVE SUMMARY

The Utility Audits Branch (UAB), formerly known as the Utility Audit, Finance and Compliance Branch (UAFCB)¹, is in the Utility Audits, Risk and Compliance Division (UARCD), which reports directly to the Executive Director of the California Public Utilities Commission (CPUC). Pursuant to PU Code, Sections 314.5, 314.6, 581, 582, and 584, the CPUC has statutory authority to inspect and audit the books and records of the utilities to ensure that ratepayers' money is well spent. PU Code Section 314.5 specifies that the CPUC shall inspect and audit the books and records for regulatory and tax purposes at least once every three years for utilities serving over 10,000 customers and at least once every five years for utilities serving 10,000 or fewer customers. PU Code Section 314.6(a) states that *"The commission may conduct financial and performance audits of any entity or program created by any order, decision, motion, settlement, or other action of the commission."*

Rolling Green Utilities, Inc. (RGU), which is comprised of Water and Sewer operations, was incorporated in California on March 29, 1965. RGU is a Class D water utility with 285 active service connections. RGU serves approximately 285 metered customers in the Rolling Green Terrace Subdivision near Big Pine, Inyo County, California. As a regulated water utility, RGU is required to prepare its financial statements on an accrual basis of accounting set forth in the Uniform System of Accounts (USOA) for Water Utilities adopted in Decision 85-04-076 that was subsequently updated in Decision 16-11-006 by the CPUC on November 16, 2016, which is a comprehensive basis of accounting other than the generally accepted accounting principles in the United States of America.

UAB conducted the audit of RGU's 2017 Annual Report filed with the CPUC in accordance with applicable PU Code, regulations, and CPUC's directives. The primary objectives of this audit are to ensure the fair presentation of the financial information in RGU's 2017 Annual Report and to determine whether RGU complied with the applicable regulations and CPUC's directives. The scope of our audit was limited to the financial information presented in RGU's 2017 Annual Report filed with the CPUC. In addition, UAB evaluated RGU's effectiveness of internal control over its accounting and reporting functions as it relates to the audit objectives.

Based on our examination, the following findings were identified:

- Finding 1: RGU lacks formal written policies and procedures for several operating processes.
- Finding 2: RGU does not have segregation of duties relating to the accounting functions; the same employees could perform multiple accounting functions.
- Finding 3: RGU does not have an asset management system in place. RGU did not maintain a detail list of assets, including a description of the utility plant, plant original acquisition costs, funding source, deletion or retirement, useful life for each item, et cetera.
- Finding 4: RGU did not provide its asset depreciation schedule to UAB for review. UAB found that RGU did not follow the CPUC's Standard Practice U-4-SM to calculate the annual depreciation accrual, nor did it follow the USOA's requirements to report its depreciation.

¹ Effective January 2020, Utility Audit, Finance and Compliance (UAFCB) was renamed to Utility Audits Branch (UAB).

- Finding 5: RGU used cash basis of accounting methodology to record its transactions. The CPUC's USOA mandates Utilities' books be kept on accrual basis. Cash basis method recognizes certain expenses when paid rather than when they were incurred.
- Finding 6: UAB noted multiple misclassifications of expenses during the audit period.
- Finding 7: RGU did not provide sufficient, appropriate evidence to support the transactions recorded in its (General Ledger) G/L.
- Finding 8: Material variances were noted between RGU's G/L, accounting records, and the Annual Report for numerous accounts.

RESTRICTED USE OF THIS AUDIT REPORT

This audit report is intended solely for the information and use by the CPUC and the management of RGU. It is not intended to be used and should not be used by anyone other than the specified parties. However, this report is a matter of public record and its distribution is not limited.

AUDIT REPORT

BACKGROUND

The California Public Utilities Commission (CPUC) was established by Constitutional Amendment as the Railroad Commission in 1911. The Legislature passed the Public Utilities Act in 1912 to expand the CPUC's regulatory authority over natural gas, electric, telephone, and water companies as well as railroads and marine transportation companies. In 1946, the Railroad Commission was renamed the California Public Utilities Commission.² The California Public Utilities (PU) Code granted CPUC's regulatory authority over Investor-Owned Utilities (IOU) in California. The Utility Audits Branch (UAB), formerly known as the Utility Audit, Finance and Compliance Branch (UAFCB)³, is in the Utility Audits, Risk and Compliance Division (UARCD), which reports directly to the Executive Director of the CPUC. The UAB provides auditing, accounting, financial, and advisory services on regulated utilities and monitors compliance with laws and CPUC directives.

PU Code, Section 314.5 states, in part, that:

The commission shall inspect and audit the books and records for regulatory and tax purposes... (2) at least once every five years in the case of every electrical, gas, heat, telegraph, telephone, and water corporation serving 10,000 or fewer customers....

In addition, PU Code, Section 314.6(a) states that, *"The commission may conduct financial and performance audits of any entity or program created by any order, decision, motion, settlement, or other action of the commission."* Regulated utilities are required to comply with PU Code Sections 581, 582 and 584 by timely submitting to the CPUC the requested documents in the form and detail prescribed by the CPUC.

On April 17, 1985 CPUC approved Decision 85-04-076 the Uniform System of Accounts (USOA), which is a basis of accounting other than the generally accepted accounting principles in the United States, for the regulated water and sewer IOUs in California. All regulated water utilities are required to comply with the accounting requirements specified in the USOA. Among other requirements, the USOA requires that *"The books of account of all water utilities shall be kept by the double entry method, on an accrual basis. Each utility shall post its accounts monthly and shall close its books at the end of each calendar year."*⁴

For the purpose of applying systems of accounts prescribed by the CPUC, regulated water utilities are divided into four classes based on the number of service connections as follows:

- Class A Utilities—having more than 10,000 service connections.
- Class B Utilities—having between 2,001 service connections and 10,000 service connections.
- Class C Utilities—having between 501 service connections and 2,000 service connections.
- Class D Utilities—having 500 service connections or less.

Classes B, C and D water utilities are commonly referred to as "Small Water Utilities."

² <https://www.cpuc.ca.gov/history/>

³ Effective January 2020, Utility Audit, Finance and Compliance (UAFCB) was renamed to Utility Audits Branch (UAB).

⁴ D.85-04-076, Page 10.

Rolling Green Utilities, Inc. (RGU), which is comprised of the Water and Sewer operations, was incorporated in California on March 29, 1965. RGU is a Class D water utility with 285 active service connections. RGU serves approximately 285 metered customers in the Rolling Green Terrace Subdivision near Big Pine, Inyo County, California. RGU also provides sewer services to the Rolling Green Terrace Subdivision near Big Pine, Inyo County, California. RGU tracks and records each operation's costs separately in its general ledger (G/L).

OBJECTIVE AND SCOPE

The UAB conducted the audit of RGU's 2017 Annual Report filed with the CPUC in accordance with applicable PU Codes, regulations, and CPUC's directives. The primary objectives of this audit are to ensure the fair presentation of the financial information in RGU's 2017 Annual Report and to determine whether RGU complied with the applicable regulations and CPUC's directives. The scope of our audit was the financial information presented in RGU's 2017 Annual Report filed with the CPUC. In addition, UAB evaluated RGU's effectiveness of internal control over its accounting and reporting functions as it relates to the audit objectives.

METHODOLOGY

To determine RGU's compliance with the applicable regulations and CPUC directives in reporting the financial information in its 2017 Annual Report and to assess RGU's internal controls over its accounting and reporting, UAB obtained sufficient and appropriate evidence to achieve the audit objectives. The specific procedures performed during this audit included, but were not limited to, the following:

1. Obtained an understanding of the company's business operation and its accounting system.
2. Performed analytical procedures on the reported financial data to identify year-to-year trending and significant fluctuations of individual accounts over the past three-year period.
3. Assessed the company's internal controls through observation, inquiry, and documentation. Specific procedures included, but were not limited to:
 - Reviewed RGU's policies and procedures, and their implementation pertaining to accounting, recording, reporting, and record retention.
 - Discussed with key company personnel to obtain an understanding of RGU's internal control structure and operating environment.
 - Reviewed RGU's organization chart to evaluate segregation of duties, authorization and approval processes, performance monitoring and controls, and compliance with regulatory requirements and CPUC's directives.
4. Performed risk assessment and determined materiality level based on the auditor's understanding of the company's operations, the evaluation of its internal control, and UAB's financial analysis.
5. Determined the company's compliance with applicable regulations and CPUC's directives regarding timeliness of filing Annual Report; compliance with USOA accounting requirements; treatments of

public grants, loans, utility plant, Facilities Fees and Users Fee; disclosure and accounting treatment of affiliated transactions, etc.

6. Reviewed the list of water plant assets, related invoices, purchase orders, work orders, and depreciation schedule to determine the existence, completeness, rights and valuation of utility plant.
7. Reconciled Water Plant in Service, and depreciation expense balances shown in the Annual Reports to the G/L and depreciation schedules.
8. Determined that amounts recorded as Water Plant Construction Work in Progress are for on-going and uncompleted construction-related projects.
9. Reviewed the loan agreements and bank statements to determine the obligation, completeness, classification, and valuation of reported liabilities.
10. Determined the occurrence, completeness, accuracy, classification, and cutoff of the recorded expenditures by reviewing relevant supporting documents, such as purchase requisitions, cancelled checks, bank statements, invoices, contracts or agreements, and insurance policies, etc. Performed sample-testing as appropriate.
11. Determined the completeness, accuracy, and cutoff of the recorded revenues by reviewing the billing records and money received from ratepayers; and performed reasonableness tests of reported revenues based on the CPUC approved tariffs for the audit period.
12. Reconciled the amounts reported in the Annual Report to the underlying accounting records presented on the G/L and trial balance for the year ended December 31, 2017.
13. Determined that cash existed and was supported by bank statements and bank reconciliations. Determined that cash balance was properly classified (facilities fees, customers' deposits, contributions) in the financial statements and any restrictions on the use of the funds were properly disclosed.
14. Analyzed Common Stock and Other Paid-in Capital account by reviewing common stock certificate, par value, shares outstanding, recalculate average share price.
15. Determined and disclosed any related/affiliated party transactions per D.06-12-029.

AUDIT FINDINGS AND RECOMMENDATIONS

The results of our audit of RGU's 2017 Annual Report are described below. The audited financial statements and UAB's Audit Adjustments are presented in the next section, titled "Audited Financial Statements."

Finding 1: RGU lacks formal written policies and procedures for several operating processes.

Condition:

There were material weaknesses in the RGU's system of internal control over several of its operating processes which present a reasonable possibility that material misstatements in RGU's Annual Report will not be prevented or detected on a timely basis. RGU does not have formal written policies and procedures for the following:

- A. Record retention.
- B. Revenue recording and reporting, including recording and remittance procedures for surcharges collected.
- C. Recording and reporting cash disbursements.
- D. Payroll process.
- E. Inventory, recording, and reporting of material and supplies.
- F. Acquisition or retirement of capital assets.
- G. Preparation, filing, and maintenance of annual reports filed or to be filed with the CPUC.

Criteria:

Good internal controls and prudent business practices require companies to establish proper written policies and procedures to carry out complex and routine operations.

Cause:

RGU has not developed written policies and procedures to govern its operating processes.

Effect:

The absence of formal written policies and procedures to govern RGU's business operations could result in inaccurate accounting records and mismanagement of financial statements.

Recommendations:

RGU should establish written policies and procedures for the aforementioned areas to govern its business operations. In addition, RGU should provide a copy of its written policies and procedures to the UAB along with its corrective action plan.

Finding 2: RGU does not have segregation of duties relating to the accounting functions.

Condition:

RGU does not have adequate segregation of duties over key functions that should have been separated, such as opening mail, receiving and depositing cash, recording cash payments in the G/L, processing disbursements, and preparing bank reconciliations.

Criteria:

Good internal control practices dictate that key accounting functions should be properly segregated to prevent errors and fraud.

Cause:

RGU has not established an adequate system of internal controls over its accounting operations.

Effect:

A poor system of internal controls could result in inaccurate accounting records and misstatement of the financial statements.

Recommendations:

When possible, RGU should segregate the accounting functions performed by its employees to ensure checks and balances are in place and implemented to minimize errors or fraud. The same employee should not perform more than one of the following functions: 1) receiving and depositing remittances, 2) preparing checks, 3) authorizing disbursements, 4) signing checks, 5) reconciling bank accounts and posting to G/Ls, and 6) initiating or preparing invoices, etc.

RGU should include in its corrective action plan to the UAB regarding its plan to establish and implement an adequate system of internal controls over its accounting and reporting functions.

Finding 3: RGU does not have an asset management system in place.**Condition:**

RGU does not have a system in place to identify assets owned, their depletion and useful lives. RGU did not maintain a detail list of assets, including a description of the plant, plant original acquisition data, funding source, deletion or retirement, useful life for each item, et cetera.

Criteria:

General Instructions 3.A of the USOA states, in part, that:

A. All water plants shall be recorded at original cost

General Instructions 4.A of the USOA states, in part, that:

The rates shall be reviewed periodically and adjusted as required, so that the depreciation accrual will bear a reasonable relationship to the remaining life....

Cause:

RGU has not established an adequate system of internal control over its assets.

Effect:

A poor system of internal control could result in the loss of assets undetected or inaccurate assets being reported.

Recommendations:

RGU should maintain adequate documentation to support its Water Plant in Service including depreciation and amortization schedules and the related accounting records. RGU should also provide a detail list of its assets to UAB along with its corrective action plan.

Finding 4: RGU did not provide its asset depreciation schedule to UAB for review.**Condition:**

RGU's depreciation calculation methodology did not comply with the USOA and CPUC's Standard Practice U-4-SM. Based on our review of Schedule A-2, Depreciation and Amortization Reserves of RGU's 2017 Annual Report, UAB noted that RGU used a single composite depreciation rate of 2.4

percent to calculate its annual depreciation expense. The USOA and CPUC's Standard Practice U-4-SM do not allow water utilities with annual revenue over \$100,000 to use the single composite rate methodology to calculate depreciation expense. In addition, RGU did not provide its asset depreciation schedule to support the accumulated depreciation reported in the Annual Report. As a result, UAB was unable to verify the accuracy of the reported depreciation expense of \$5,346 in Account 403 and the accumulated depreciation of water plants of \$162,788 in Account 108.

Criteria:

The General Instructions 2.B of the USOA states that:

All books of account, together with records and memoranda supporting the entries therein, shall be kept in such a manner as to support fully the facts pertaining to such entries. The books and records referred to herein include not only the accounting records in a limited technical sense, but also all other records, reports, correspondence, memoranda and information useful in determining the facts regarding a transaction.

Under Account 403, Depreciation Expense, on Page B39, the USOA specifies, in part, that:

...Use of a single composite depreciation rate applied to all depreciable plant is permissible for water utilities with annual revenues of \$100,000 or less....

Cause:

RGU did not follow the USOA requirements to properly record and report its asset depreciation and did not maintain documentation to support Accumulated Depreciation reported in the Annual Report.

Effect:

Failure to follow the requirements of the USOA and CPUC's directives can result in reporting inaccurate financial information in the Annual Report, which may be used during RGU's General Rate Case (GRC) application review process and could potentially impact the water rates for RGU's ratepayers.

Recommendations:

RGU should follow the USOA requirements in recording and reporting its Depreciation Expense and Accumulated Depreciation of Water Plant. In addition, RGU should provide a copy of its depreciation schedule to UAB along with its corrective action plan.

Finding 5: RGU did not record expenses using accrual basis of accounting.

Condition:

Transactions in Account 684 – Insurance, Account 689 – General Expense, and Account 664 – Other Plant Maintenance Expense were incorrectly recorded when paid, instead of when the expenses were incurred. The USOA mandates the utilities' books must be kept using accrual basis of accounting. The cash basis method recognizes certain expenses when paid rather than when they were incurred. As a result, Insurance expenses were understated by \$5,957, General Expenses were overstated by \$855, and Other Plant Maintenance Expenses were overstated by \$6,707.

Criteria:

The General Instructions 2.A of the USOA states that:

A. The books of account of all water utilities shall be kept by the double entry method, on an accrual basis. Each utility shall post its accounts monthly and shall close its books at the end of each calendar year.

Cause:

RGU did not use accrual basis of accounting to record its financial data.

Effect:

Because RGU did not use accrual basis of accounting, some accounts in the 2017 Annual Report were not accurately reported. In addition, misstated expenses in the Annual Report, which may be used during the RGU's GRC application review process, could potentially impact the water rates for RGU's ratepayers.

Recommendation:

RGU should comply with the accounting methodology prescribed by the USOA by using accrual basis of accounting to record its transactions.

Finding 6: Operating Expenses Reporting Deficiencies

Condition:

UAB reviewed RGU's operating expenses and noted the following deficiencies:

- Expenses for telephone services were incorrectly recorded as Office Services and Rentals expenses in Account 678 instead of Office Supplies and Expenses in Account 681.
- The prepaid auto insurance and workers' compensation insurance were incorrectly reported as expenses in Account 684, Insurance, instead of as a prepaid asset in Account 174, Other Current Assets.

As a result, Other Current Assets was understated by \$762; Insurance expense account was understated by \$762; Office Services and Rentals was overstated by \$2,955; and Office Supplies and Expense was understated by \$2,955.

Criteria:

The USOA defines the aforementioned accounts as follows:

Account 174—Other Current Assets:

A. This account shall include prepayment of rents, taxes, insurance and similar expenses for which payment has been made in advance of the period to which they apply. As the periods covered by such prepayments expire, this account shall be credited, and the proper operating expense or other accounts shall be charged with the amounts applicable to the current period.

B. This account shall include the book cost of all notes receivable and accounts receivable, other than from customers for water service, maturing or collectible within one year.

C. This account shall include all other current assets not provided for in other balance sheet accounts.

D. Separate subaccounts shall be maintained for each class of current asset included in this account."

Account 681-Office Supplies and Expense:

This account shall include the cost of office supplies and expenses, including printing, stationery, general accounting supplies, repair, maintenance and telephone, utilities, and other office expenses.

Account 684-Insurance:

This account shall include all insurance costs applicable to the accounting period, including workers' compensation, liability, vehicle, fire and theft or robbery insurance.

Account 689-General Expense:

This account shall include all expenses not includible in other operating expense accounts.

Cause:

RGU lacks adequate internal control over its accounting and reporting functions to ensure its expenses were recorded and reported accurately.

Effect:

Inaccurate reporting of prepaid assets in the Annual Report distorted RGU's Balance Sheet. Misstated expenses in the Annual Report, which may be used during the RGU's GRC application review process, could potentially impact the water rates for RGU's ratepayers

Recommendation:

RGU should establish proper internal controls to ensure its financial data are accurately recorded and reported.

Finding 7: RGU did not provide sufficient, appropriate evidence for several accounts to support the transactions recorded in its G/L.

Condition:

RGU did not provide adequate documentation such as invoices, receipts, contracts, asset listing, accounts receivable aging report, materials and supplies listing, stock certificates, and schedule of retained earnings to support the transactions recorded in the following accounts: Account 101 – Water Plant in Service, Account 141 – Accounts Receivable, Account 151 – Materials and Supplies, Account 211 – Other Paid-in Capital, Account 215 – Retained Earnings, and Account 231 – Accounts Payable.

As a result, UAB was unable to verify the reported balances for Account 101 –Water Plant in Service of \$231,366, Account 141 – Accounts Receivable of \$12,500, Account 151 – Materials and Supplies of \$1,000, Account 211 – Other Paid-in Capital of \$52,745, Account 215 – Retained Earnings of \$49,544, and Account 231 – Accounts Payable of \$33,442.

Criteria:

PU Code, Section 582 states, in part, that:

Whenever required by the commission, every public utility shall deliver to the commission copies of any or all maps, profiles, contracts, agreements, franchises, reports, books, accounts, papers, and records in its possession or in any way relating to its property or affecting its business, and also a complete inventory of all its property in such form as the commission may direct.

The USOA General Instructions 2.B states that:

All books of account, together with records and memoranda supporting the entries therein, shall be kept in such a manner as to support fully the facts pertaining to such entries. The books and records referred to herein include not only the accounting records in a limited technical sense, but also all other records, reports, correspondence, memoranda and information useful in determining the facts regarding a transaction.

Cause:

RGU did not comply with the USOA requirements to maintain sufficient supporting documents for its reported financial data in the 2017 Annual Report. RGU does not have control procedures in place to ensure documentation is retained to support transactions recorded in its books.

Effect:

Due to the lack of documentation to support account balances, UAB is unable to attest to the accuracy of assets, liabilities, and ownership equity reported on the RGU's Balance Sheet as of December 31, 2017.

Recommendations:

RGU Management should comply with all accounting requirements specified in the USOA. In addition, RGU should strengthen its internal controls to ensure all transactions booked in its G/L are adequately supported by proper documentation.

Finding 8: Material variances were noted between RGU's G/L, accounting records, and the Annual Report for numerous accounts.

Condition:

The UAB noted the following variances between the Annual Report and RGU's accounting records:

- Account 131 – Cash: RGU's 2017 Bank Statements showed an ending balance of \$81,701 as of December 31, 2017. However, RGU reported a different amount at \$80,804 in its 2017 Annual Report, resulting in an understatement of \$897 (\$81,701 - \$80,804).
- Account 141 – Accounts Receivable-Customers: UAB recalculated an ending balance of \$24,428 as of December 31, 2017. However, RGU reported \$12,500 in its 2017 Annual Report, resulting in an understatement of \$11,928 (\$24,428 - \$12,500).
- Account 201 – Common Stock: CPUC Decision No. 69724 showed RGU issued 5,430 shares of Common Stock with a par value of \$10. Advice Letter (AL) 31-W showed stocks purchased were allocated to Water Utility and Sewer Utility were 67 percent and 33 percent, respectively. Therefore, the value of outstanding Commons Stock allocated to the Water Utility is \$36,380 (5,430 * \$10 * 67%). However, RGU reported \$27,150 in its 2017 Annual Report, resulting in an understatement of \$9,230 (\$36,380 - \$27,150).
- Account 630 – Employee Labor: The 2017 Payroll Summary showed the Employee Labor expense for the year ended December 31, 2017 was \$14,306. However, RGU reported \$31,020 in its 2017 Annual Report, resulting in an overstatement of \$16,714 (\$14,306 - \$31,020).

- Account 671 – Management Salaries: The 2017 Payroll Summary showed that Management Salary expense for the period ended December 31, 2017 was \$21,672. However, RGU reported \$28,879 in its 2017 Annual Report, resulting in an overstatement of \$7,207 (\$21,672 - \$28,879).
- Account 410 – Federal Corporate Income Tax Expense: RGU reported \$4,030 of federal income tax on its Annual Report. However, UAB determined that RGU's federal income taxes were \$2,597 by multiplying RGU's tax rate of 15 percent and net income of \$17,314. As a result, federal income taxes were overstated by \$1,433 (\$2,597 - \$4,030).

Criteria:

PU Code, Section 581 states that:

Every public utility shall furnish to the commission in such form and detail as the commission prescribes all tabulations, computations, and all other information required by it to carry into effect any of the provisions of this part, and shall make specific answers to all questions submitted by the commission.

Every public utility receiving from the commission any blanks with directions to fill them shall answer fully and correctly each question propounded therein, and if it is unable to answer any question, it shall give a good and sufficient reason for such failure.

PU Code, Section 582 states that:

Whenever required by the commission, every public utility shall deliver to the commission copies of any or all maps, profiles, contracts, agreements, franchises, reports, books, accounts, papers, and records in its possession or in any way relating to its property or affecting its business, and also a complete inventory of all its property in such form as the commission may direct.

Cause:

RGU does not conduct periodic reconciliations of its underlying accounting records relating to Cash, Accounts Receivable-Customers, Common Stock, Employee Labor, Management Salaries, and Federal Corporate Income Tax on Financial Statements to the Annual Report to ensure the information reported was accurate.

Effect:

Inaccurate reporting of Cash (Account 131) and Common Stock (Account 201) in the Annual Report distorted RGU's financial position as of December 31, 2017. Misstated expenses for Management Salaries (Account 671) and Employee Labor (Account 630) in the Annual Report, which may be used during the RGU's GRC application review process, could potentially impact the water rates for RGU's ratepayers.

Recommendation:

RGU should conduct periodic reconciliations of its books' financial data to the Annual Reports to ensure the information reported is accurate.

CONCLUSION

In conducting this audit, we obtained an understanding of RGU's internal controls, including any information system's controls that we considered significant within the context of our audit objective. We assessed whether those controls were properly designed, implemented, and operating effectively. Any deficiencies in internal control that were identified during this audit and determined to be significant within the context of our audit objective are included in this report.

RGU's management is responsible for the preparation and fair presentation of its 2017 Annual Report filed with the CPUC. The CPUC requires that the statements be in accordance with the accounting requirements as set forth in USOA. RGU's management is also responsible for the design, implementation, and maintenance of internal controls relevant to the preparation and fair presentation of its 2017 Annual Report that are free from material misstatements, whether due to fraud or error. In addition, RGU's management is responsible for the development of its policies and procedures to ensure full compliance with applicable regulations and CPUC's directives.

We conducted our audit in accordance with the applicable PU Code, regulations, and CPUC's directives. We planned and performed the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings, audit adjustments and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings, audit adjustments, and recommendations presented in this report.

RGU's Management should submit an electronic copy of its corrective action plan to the UAB at UtilityAudits@cpuc.ca.gov, with a copy to Lucian Filler, Deputy Executive Director of CPUC, at Lucian.Filler@cpuc.ca.gov, and Bruce DeBerry, Program Manager of Water Division, at Bruce.DeBerry@cpuc.ca.gov no later than May 25, 2020. The corrective action plan should address how RGU will implement the recommendations and provide the timing of incorporating UAB's audit adjustments to RGU's books and records. If RGU is unable to implement UAB's recommendations, the corrective action plan should state the reason(s) for not being able to implement any of the recommendations. RGU should use the audited amounts in UAB's audit report as the basis to file its 2019 Annual Report with the CPUC.

VIEWS OF RESPONSIBLE OFFICIAL

On November 13, 2019, UAB provided a draft audit report to RGU and requested a written response for the findings. UAB made multiple requests for a written response to findings on January 15, 2020, February 18, 2020, and March 6, 2020. However, RGU's management did not provide a written response to the draft audit report as of the date of this report. RGU's management did not dispute the audit findings and recommendation during our exit meeting on November 25, 2019. The audit findings and recommendations presented in this report represent our final determination of this audit.

Angie Williams

Angie Williams, Director
Utility Audits, Risk and Compliance Division

cc: Alice Stebbins, Executive Director, CPUC
Lucian Filler, Deputy Executive Director, CPUC
Bruce DeBerry, Program Manager, Water Division
Raymond Yin, Program and Project Supervisor, UAB
Khusbindar Kaur, Senior Management Auditor, UAB
Sharmin Wellington, Public Utilities Regulatory Analyst V, UAB

AUDITED FINANCIAL STATEMENTS

RGU Water Company **BALANCE SHEET (AS AUDITED)** As of December 31, 2017

ASSETS	
UTILITY PLANT	
Water Plant in Service	\$231,366
Accumulated Depreciation of Water Plant	<u>(162,788)</u>
Net Utility Plant	68,578
 CURRENT AND ACCRUED ASSETS	
Cash	81,701
Accounts Receivable	24,428
Materials and Supplies	1,000
Other Current Assets	<u>762</u>
Total Current and Accrued Assets	107,891
Total Assets	<u><u>\$176,469</u></u>
 CAPITALIZATION AND LIABILITIES	
CORPORATE CAPITAL AND SURPLUS	
Common Stock	\$36,380
Other Paid-in Capital	52,745
Retained Earnings	<u>53,902</u>
Total Capitalization	143,027
 CURRENT AND ACCRUED LIABILITIES	
Accounts Payable	<u>33,442</u>
Total Current and Accrued Liabilities	33,442
 Total Equity and Liabilities	 <u><u>\$176,469</u></u>

(The accompanying Notes to Financial Statements are an integral part of these Financial Statements)

RGU Water Company
INCOME STATEMENT (AS AUDITED)
For Year Ended December 31, 2017

OPERATING REVENUES	
Metered Water Revenue	\$157,724
Other Water Revenue	2,739
Total Operating Revenue	160,463
OPERATING EXPENSES	
Plant Operation and Maintenance Expenses	
Power	7,146
Employee Labor	14,306
Materials	9,633
Contract Work	2,752
Transportation Expenses	5,779
Other Plant Maintenance Expenses	1,721
Total Plant Operation and Maintenance Expenses	41,337
Administrative and General Expenses	
Office Salaries	7,035
Management Salaries	21,672
Employee Pensions and Benefits	6,171
Uncollectible Accounts Expense	196
Office Services and Rentals	1,800
Office Supplies and Expenses	4,327
Professional Services	1,952
Insurance	16,132
Regulatory Commission Expense	2,739
General Expenses	1,763
Net Administrative and General Expenses	63,787
Total Operating Expenses	105,124
Depreciation Expense	5,346
Taxes Other Than Income Taxes	5,779
State Corporate Income Tax Expense	1,533
Federal Corporate Income Tax Expense	2,597
Total Operating Revenue Deductions	120,379
Total Utility Operating Income / (Loss)	40,084
OTHER INCOME AND DEDUCTIONS	
Interest Expense	(284)
Total Other Income and Deductions	(284)
Net Income / (Loss)	\$39,800

(The accompanying Notes to Financial Statements are an integral part of these Financial Statements)

RGU Water Company
STATEMENT OF RETAINED EARNINGS (AS COMPILED ⁵)
 For Year Ended December 31, 2017

Retained Earnings, Beginning of Year	\$38,076
CREDITS:	
Net Income	39,800
UAB Adjustment to Cash	897
UAB Adjustment to Accounts Receivable-Customers	11,928
UAB Adjustment to Insurance	6,719
Total Credits	59,344
DEBITS:	
UAB Adjustment to Common Stock	(9,230)
UAB Adjustment to Employee Labor	(16,714)
UAB Adjustment to Other Plant Maintenance Expenses	(6,707)
UAB Adjustment to Management Salaries	(7,207)
UAB Adjustment to Office Services and Rentals	(1,372)
UAB Adjustment to General Expense	(855)
UAB Adjustment to Federal Corporate Income Tax Expense	(1,433)
Total Debits	(43,518)
Retained Earnings, End of Year	\$53,902

(The accompanying Notes to Financial Statements are an integral part of these Financial Statements)

⁵ UAB compiled the Statement of Retained Earnings based on the audited Balance Sheet and Income Statement, and other relevant financial data.

RGU WATER COMPANY

NOTES TO FINANCIAL STATEMENTS

Regulated water utilities are required to prepare their financial statements on accrual basis of accounting set forth in the Uniform System of Accounts (USOA) adopted in Decision (D.) 85-04-076 by the CPUC on April 17, 1985, which is a comprehensive basis of accounting other than the generally accepted accounting principles (GAAP) in the United States of America. The followings describe certain differences in accounting treatments between GAAP and USOA, RGU's current accounting practices, and its compliance with applicable regulation and CPUC's directives.

1. Purpose of Financial Information and Targeted Audience

The objective of preparing financial statements in accordance with GAAP is to provide information that is useful in making decisions about providing resources to the entity. Users of the financial information include existing and potential investors, lenders, and other creditors.

The purpose of using USOA to prepare financial statements is to have the utilities provide financial transparency of their water operations on a consistent basis. The primary user of the financial information is the CPUC for ratemaking and other compliance purposes.

2. Property, Plant, and Equipment

The USOA distinguishes the plant assets for water operations (i.e., Account 101, Water Plant in Service) from those for non-water operations (i.e., Account 121, Non-Water Utility Property and Other Assets), for ratemaking purposes.

(1) Depreciation Methodology

GAAP allows entities to elect a depreciation methodology of their choices, such as straight-line, double-declining balance, or sum-of-the-years digits depreciation method.

USOA requires utilities to the use "Straight-line remaining life method." "Remaining life" implies that estimates of future life and salvage value will be re-evaluated periodically and that depreciation rates will be adjusted to reflect any changes in estimates. Water utilities are required to comply with the CPUC's Standard Practice (SP) U-4-SM and SP U-4-M when determining depreciation accruals. Specifically, for the water plant with over \$100,000, the utility must maintain separate depreciation reserve by different plant accounts in accordance with Appendix B1 of SP U-4-SM; for the water plant under \$100,000, if the utility elects not to separate or maintain the depreciation reserve by accounts, it is appropriate to develop a composite value for remaining life for the entire plant in accordance with Appendix B2 or B3 of SP U-4-SM. The USOA suggested that all utilities maintain a separate accumulated depreciation subaccount for each depreciable plant account; and, it is mandatory for water utilities having more than 500 customers.⁶ The utility must obtain prior written approval from the CPUC for any practice deviates from the aforementioned SPs.

The depreciation expense was computed at a composite rate of 2.61 percent in order to depreciate all plant assets for ratemaking purposes and for reporting all the depreciation expense in RGU's

⁶ D.16.11-006 dated November 10, 2016, General Accounting Instructions 4 on Page B14.

Annual Reports filed with the CPUC. RGU could not provide supporting documents for the 2.61 percent composite rate it used to depreciate its plant assets.

(2) Asset Retirement

USOA requires that water plant be recorded at original cost. In USOA's depreciation schedule, the difference between the estimated cost of removal and the salvage value is included into the depreciable base to obtain the annual depreciation expense. When retiring an asset, the cost of removal will reduce the balance of Account 108, Accumulated Depreciation of Water Plant, while the cash received from the salvage value or sale price will increase the balance of Account 108, Accumulated Depreciation of Water Plant. The gain or loss from the asset retirement that is recognized under GAAP is accumulated in Account 108, Accumulated Depreciation of Water Plant under the USOA.

Utility plant is recorded at original cost when first constructed or purchased. Retired utility plant assets are removed from utility plant accounts based on estimated cost and charged against accumulated depreciation. RGU did not maintain a detail list of water plant assets. Even though UAB repeatedly requested the supporting documents for the water plant assets, RGU was unable to provide UAB with a detail list supporting the value of its water plant assets. UAB was unable to satisfy itself by other auditing procedures concerning the reported account balance of \$231,366 as of December 31, 2017. Therefore, UAB was unable to verify the accuracy of this account.

3. Inventory

GAAP allows entities to use different methodologies, such as average cost, first-in-first-out, and last-in-first-out, for the valuation of inventory, which includes cost components of raw materials, work-in-process, and finished goods, etc.

Under USOA, the inventory includes meters, materials and supplies. If identifiable, the inventory should be recorded at original cost, which includes transportation charges, sales and use taxes and other directly assignable costs. Items of small value whose original cost cannot be readily determined shall be recorded at current prices. Scrap materials shall be carried in inventory at estimated scrap value.

RGU could not provide sufficient, appropriate evidence to support the transactions recorded in Account 151-Material and Supplies. Due to the lack of sufficient supporting documents, UAB was unable to verify the reported account balance of \$1,000 as of December 31, 2017.

4. Water Utility Users Fee

PU Code, Sections 401 through 410 authorized the CPUC to set a fee annually to water utilities to cover the costs incurred by the CPUC in regulating them. USOA requires water utilities to credit regular operating revenue accounts with amounts of Users Fee billed to customers and charge Account 688-Regulatory Commission Expense, with fees paid to the CPUC.⁷

RGU included Water Utility Users Fee into the water services billings charged to its customers and recorded the total billed amounts as its operating revenue. Payments of Water Utility Users Fee to the CPUC should be recorded into the Regulatory Commission Expense account when payments are due.

⁷ D.85-04-076 dated April 17, 1985, General Accounting Instructions 9 on Page 16.

RGU should have credited Account 480 – Other Water Revenue with \$2,739 of Users Fee billed to its customers and charged Account 688-Regulatory Commission Expense, with fees paid to the CPUC.

5. Form of Financial Statements ⁸

(1) Balance Sheet

Unlike the financial statements of other industries, the financial statements of regulated water utilities present the water plant as the first major caption on the asset side of the balance sheet, and capitalization is first on the liability side. Current assets and current liabilities are relegated to a comparatively unimportant position in the center of the balance sheet, rather than being placed prominently as in statements for non-regulated industries.

(2) Income Statement

The form of Income Statement reflects the classification of revenues and expenses in ratemaking. Operating revenues and expenses are referred to as “above the line” because they are allowable in ratemaking, and the result of deducting total operating expenses from total operating revenues is the operating income. Other Income and Deductions are referred to as “below the line” because they are applied after operating income and are not allowable in ratemaking. The “below the line” items include interest revenue, dividend income, other revenues that are from non-water utility operations and/or non-water utility properties, expenses that are unrelated to water utility operations, and interest expense (the interest expense is recovered through the authorized rate of return). The concept of “above the line” revenues and expenses being allowable in ratemaking affects the form of income statement, the classification of revenues and expenses, and decisions of management in incurring expenses.

RGU has complied with these requirements and presentation of the financial statements, which are comprised of the balance sheet as of December 31, 2017, and the related statements of income.

6. Exclusion of Statement of Cash Flows

Financial Accounting Standards Board specifies in its Statement of Financial Accounting Standards No. 95 that a Statement of Cash Flows is part of a complete set of financial statements under GAAP. However, Codification of Statements on Auditing Standards AU-C Section 800.A35 states, in part, that, “*Special purpose financial statements may not include a statement of cash flows....*” Since the USOA is an accounting framework other than GAAP for regulatory purpose, the Statement of Cash Flows is not required and therefore excluded from this audit report.

7. Compliance filing of 2017 Annual Report with the CPUC

PU Code, Sections 581, 582, and 584, and CPUC’s directive (i.e., Water Division’s annual memorandum to water and sewer utilities) require all regulated water and sewer IOUs to file an Annual Report with the CPUC every year. For the year being audited, RGU has complied with these requirements.

⁸ Regulated Utilities Manual-A Service for Regulated Utilities by Deloitte & Touché USA LLP, pages 36-37.

UAB'S AUDIT ADJUSTMENTS

FOR THE YEAR ENDED DECEMBER 31, 2017

Audit Adj. No.	Annual Report				Description	Debit	Credit
	Sch.	Line	Col.	Acct No.			
1	A	30	c	131	Cash	\$897	
	A	6	c	215	Retained Earnings <i>To adjust Cash to agree with the audited amount.</i>		\$897
2	A	32	c	141	Accounts Receivable-Customers	\$11,928	
	A	6	c	215	Retained Earnings <i>To adjust Accounts Receivable to agree with the audited amount.</i>		\$11,928
3	A	6	c	215	Retained Earnings	\$9,230	
	A	2	c	201	Common Stock <i>To adjust Common Stock to agree with the audited amount.</i>		\$9,230
4	A	6	c	215	Retained Earnings	\$16,714	
	B-2	9	b	630	Employee Labor <i>To adjust Employee Labor to agree with the audited amount.</i>		\$16,714
5	A	6	c	215	Retained Earnings	\$6,707	
	B-2	13	b	664	Other Plant Maintenance Expenses <i>To adjust Other Plant Maintenance Expenses to agree with the audited amount.</i>		\$6,707
6	A	6	c	215	Retained Earnings	\$7,207	
	B-2	19	b	671	Management Salaries <i>To adjust Management Salaries to agree with the audited amount.</i>		\$7,207

UAB'S AUDIT ADJUSTMENTS FOR THE YEAR ENDED DECEMBER 31, 2017

Audit Adj. No.	Annual Report				Description	Debit	Credit
	Sch.	Line	Col.	Acct No.			
7	A	6	c	215	Retained Earnings	\$1,372	
	B-2	23	b	681	Office Supplies and Expenses	2,955	
	B-2	22	b	678	Office Services and Rentals		\$4,327
					<i>To adjust Office Services and Rentals to agree with the audited amount and to reclassify telephone expenses to Office Supplies and Expenses.</i>		
8	B-2	25	b	684	Insurance	\$5,957	
	A	36	c	174	Other Current Assets	762	
	A	6	c	215	Retained Earnings		\$6,719
					<i>To adjust Insurance to agree with the audited amount and reclassify prepaid Auto Insurance to Other Current Assets.</i>		
9	A	6	c	215	Retained Earnings	\$855	
	B-2	27	b	689	General Expense		\$855
					<i>To adjust General Expense to agree with the audited amount and reclassify prepaid expense to Other Current Assets.</i>		
10	A	6	c	215	Retained Earnings	\$1,433	
	B	10	c	410	Federal Corporate Income Tax Expense		\$1,433
					<i>To adjust the reported Federal Corporate Income Tax Expense to agree with the audited amount.</i>		

APPENDICES

APPENDIX A—BALANCE SHEETS (AS REPORTED) ⁹

	As of	
	12/31/2017	12/31/2016
ASSETS		
UTILITY PLANT		
Water Plant in Service	\$231,366	\$209,544
Accumulated Depreciation of Water Plant	(162,788)	(163,117)
Net Utility Plant	<u>68,578</u>	<u>46,427</u>
CURRENT AND ACCRUED ASSETS		
Cash	80,804	58,391
Accounts Receivable	12,500	13,882
Materials and Supplies	1,000	1,000
Total Current and Accrued Assets	<u>94,304</u>	<u>73,273</u>
Total Assets	<u>\$162,881</u>	<u>\$119,699</u>
CAPITALIZATION AND LIABILITIES		
CORPORATE CAPITAL AND SURPLUS		
Common Stock	\$27,150	\$27,150
Other Paid-in Capital	52,745	43,376
Retained Earnings	49,544	38,076
Total Capitalization	<u>129,439</u>	<u>108,602</u>
CURRENT AND ACCRUED LIABILITIES		
Accounts Payable	<u>33,442</u>	<u>11,098</u>
Total Current and Accrued Liabilities	<u>33,442</u>	<u>11,098</u>
Total Equity and Liabilities	<u>\$162,881</u>	<u>\$119,699</u>

⁹ The reported amounts were derived directly from RGU's 2016 and 2017 Annual Reports without modification. They contain rounding variances and do not represent the audited amounts. They are included here for disclosure purposes only.

APPENDIX B—INCOME STATEMENTS (AS REPORTED) ¹⁰

	For the Year of	
	2017	2016
OPERATING REVENUES		
Metered Water Revenue	\$157,724	\$147,340
Other Water Revenue	2,739	1,744
Total Operating Revenue	160,463	149,084
OPERATING EXPENSES		
Plant Operation and Maintenance Expenses		
Power	\$7,146	\$9,201
Employee Labor	31,020	14,570
Materials	9,633	7,233
Contract Work	2,752	2,855
Transportation Expenses	5,779	3,970
Other Plant Maintenance Expenses	8,428	3,453
Total Plant Operation and Maintenance Expenses	64,758	41,282
Administrative and General Expenses		
Office Salaries	7,035	8,971
Management Salaries	28,879	27,727
Employee Pensions and Benefits	6,171	5,453
Uncollectible Accounts Expense	196	1,564
Office Services and Rentals	6,127	3,698
Office Supplies and Expenses	1,372	1,266
Professional Services	1,952	1,792
Insurance	10,175	3,497
Regulatory Commission Expense	2,739	0
General Expenses	2,618	1,634
Net Administrative and General Expenses	67,265	55,602
Total Operating Expenses	132,024	96,884
Depreciation Expense	5,346	4,817
Taxes Other Than Income Taxes	5,779	11,720
State Corporate Income Tax Expense	1,533	2,942
Federal Corporate Income Tax Expense	4,030	4,551
Total Operating Revenue Deductions	148,711	120,914
Total Utility Operating Income / (Loss)	11,752	28,171
OTHER INCOME AND DEDUCTIONS		
Non-Utility Income	0	(1,744)
Interest Expense	(284)	(635)
Total Other Income and Deductions	(284)	(2,379)
Net Income / (Loss)	\$11,468	\$25,792

¹⁰ The reported amounts were derived directly from RGU's 2016 and 2017 Annual Reports without modification. They contain rounding variances and do not represent the audited amounts. They are included here for disclosure purposes only.