

**BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION
COMMISSION**

**WASHINGTON UTILITIES AND TRANSPORTATION
COMMISSION,**

COMPLAINANT,

VS.

RAINIER VIEW WATER COMPANY, INC.,

RESPONDENT.

**REBUTTAL TESTIMONY
OF FRANK AULT, CPA, CVA
ON BEHALF OF RAINIER VIEW WATER COMPANY, INC.**

January 18, 2002

Q. Please state your name and provide your business address.

A. Frank Ault. My address is 1145 Broadway Plaza, Suite 900,
Tacoma, WA 98402.

Q. By whom are you employed?

A. RSM McGladrey, Inc. RSM McGladrey, Inc. and affiliates are an accounting and consulting firm with offices nationwide. In Washington State the firm has four offices with a total staff of approximately 160 people in Seattle, Tacoma, Renton and Olympia. The firm provides a wide array accounting, tax and consulting services, including consulting for general business, valuation and litigation services.

I have been employed by RSM McGladrey and its predecessor, Knight Vale and Gregory PLLC since 1978.

Q. What are your education and experience qualifications?

A. I graduated from California State University at Fullerton in Fullerton, California in 1966. I am a Certified Public Accountant (CPA) in California and Washington and a Certified Valuation Analyst (CVA). I taught accounting at Fullerton Junior College. I served for five years as a VP of Finance for a manufacturing company. I have been in public accounting for approximately 30 years. I routinely value businesses and professional practices for divorce and shareholder disputes

Valuation matters often include issues of reasonable compensation, issues of tax effect on S Corporations, as well as other accounting matters.

I attended Golden Gate University in Seattle dealing with courses in Federal Income Tax. I have instructed courses on Financial Accounting Standards Board (FASB) pronouncement #109 – “Accounting for Income Taxes” for the American Institute of Certified Public Accountants (AICPA), Washington Society of Certified Public Accountants (WSCP), as well as Tacoma Community College and internally for our firm. I routinely deal with clients and value companies that are S-Corporations. I routinely assist accounting professionals in our firm in the computation of Federal Income Tax in accordance with FASB #109. Exhibit ____ (FA-2) sets out in more detail my professional and educational background.

Q. What is your role with Rainier View?

A. RSM McGladrey, Inc. and affiliates provide accounting and tax services to Rainier View Water Company, Inc. (Rainier). We have been hired in this case to assist in providing expert accounting testimony in the matter before the Commission.

Q. Please describe the purpose of your testimony.

A. My testimony will be related to the issues of reasonable compensation of Neil Richardson and the consideration and inclusion of a factor for income taxes in the

calculation of expenses for establishing water rates. I will also be discussing certain accounting issues that have been raised by Mr. Kermode in his direct testimony. Neither myself nor my firm, RSM McGladrey, Inc., have any current or future financial interest in Rainier or its affiliates.

Q. Please summarize your testimony.

A. That compensation paid to Mr. Richardson is reasonable considering his involvement in the Company and time devoted to the company. That the compensation paid to Mr. Richardson is reasonable based on salary surveys of non-public companies in the Northwest and the Puget Sound Region. That the inclusion of income tax based on the earnings of Rainier is appropriate for the purpose of establishing water rates and that S Corporations are not forms of tax-free organizations. Also, that depreciation should be considered on “Book” accounting method and not an income tax accounting method for proper recognition of tax costs. I will also be addressing issues of bad debt expense, amortization and depreciation issues raised by Danny P. Kermode, CPA in his direct testimony.

Q. Please describe your testimony relative to the issue of reasonable compensation to Mr. Richardson.

A. Mr. Richardson is the Chief Executive Officer (CEO) and President of Rainier

View Water Company, Inc. and received a salary from Rainier in the amount of \$92,489 in the year 2000 (per Federal Income Tax return). Mr. Richardson devotes 60% to 65% of his time to the activities of Rainier.

The first source we considered was 1999/2000 Northwest “Executive Compensation Survey” as compiled and published by Milliman & Robertson, Inc., with a publication date of January 2000. That publication reflects total compensation for CEO’s of privately traded companies with revenues up to \$24.9 million, based on a survey of Northwest companies at an average amount (mean) of \$134,581 and a median level of \$135,928. The salary information quoted is all based on 1999 information. A one year pay increase would need to be considered to maintain comparability. The 1999/2000 Northwest “Executive Compensation Survey” states that average base salary for CEO’s of privately traded companies in the Northwest increased by 7.4% from 1998 to 1999, if that same increase from 1999 to year 2000, year 2000 would be adjusted as follows:

		Adjusted 7.4% to 2000	<u>60%</u>	<u>65%</u>
Average (mean)	\$134,581	\$144,540	\$86,724	\$93,951
Median	\$135,928	\$145,987	\$87,592	\$94,892

A second source of pay increases would be Washington State Household Income from U.S. Census of Population and Housing that reflects that median household

incomes for the State of Washington increased by 4.61% from 1998 to 1999 and that the five year average for 1994 through 1999 represented a 5.03% increase. It should be noted that Washington State household income for the years 1993 through 1999 increased by 31.5% based on the median household income by Washington counties as printed by the U.S. Census as listed at www.wa.gov.

We also reviewed a source on-line at “Career Journal” from The Wall Street Journal, which showed executive compensation for 1999 as follows:

Senior Executives – Startup Companies – Median salaries

Company annual revenues up to \$10 million - \$162,000

60% = \$97,200

65% = \$105,300

Senior Executives – Private Companies – Median salaries

Company annual revenues up to \$25.8 million - \$166,000

60% = \$99,600

65% = \$107,900

Again, salary information quoted above is all based on 1999 information.

A one year pay increases would need to be considered to maintain comparability. However, the salary numbers per the Wall Street Journal for 1999 already exceed the compensation paid to Mr. Richardson for his 60% to 65% time involvement.

In 1993 when Mr. Richardson for rate purposes was permitted a salary of \$44,721 for his 60% to 65% time commitment at Rainier, Rainier was generating revenue of \$1.1 million and had 4,700 customers. Currently, the revenue of Rainier is in excess of \$3 million per year and serves almost 12,000 customers. Thus, revenue has increased 2.9 times and customer numbers have increased 2.6 times. If thus multiples were applied to Mr. Richardson's 1993 compensation of \$44,721, the results would be as follows:

<u>1993 Compensation</u>	<u>Times</u>	<u>2000 Compensation</u>
\$44,721	2.9	\$129,691
\$44,721	2.6	\$116,275

In conclusion, it is my opinion that the compensation paid to Mr. Richardson by Rainier View Water Company, Inc. in the amount of \$92,489 for year 2000 is reasonable.

This is based on his duties, the time spent and gives consideration to the growth and expansion of Rainier in revenues and customer base.

These conclusions are based on the salary survey information cited above, the growth at Rainier and my experience in determining reasonable compensation for purposes of computing valuations of privately held companies and professional service practices.

Q. Please describe your testimony relative to the issue of the inclusion of income tax in the calculation of water rates for sub chapter S Corporations.

A. C Corporations are provided an adjustment for income taxes in the computation of operating expenses for purposes of calculating water rates. The suggestion by Mr. Kermodé's testimony is that S Corporation income escapes Federal Income Tax and is therefore not a factor in establishing operating expenses for purposes of establishing water rates.

Mr. Kermodé suggests that an S Corporation is a tax-free enterprise and passes income tax free to its shareholders. If this conclusion were in fact correct, why wouldn't all companies that could pass the test of having 75 or less shareholders be an S Corporation?

The fact is that closely held corporations, whether S or C, generally do not pay dividends to their shareholders, but instead use the net of tax income to grow their business. They retain the net income after tax as additional equity. The normal situation with an S Corporation is to distribute enough cash to its shareholders in order for them to pay the income tax associated with the corporate income that passes to them as a result of the S Corporation status. This is in fact the case with Rainier. Rainier is not making substantial distributions to Mr. Richardson in

excess of the tax payments to the IRS and the earnings net of tax is being retained in the Company.

In addition, Rainier has, in fact, paid the Federal Income Tax expense related to its earnings directly to the Internal Revenue Service (IRS). The payments directly to the IRS are on behalf of Mr. Richardson; however, they indicate a tax comparable to that paid by a C Corporation and that the income does not escape tax just because of the S Corporation status of Rainier. We have reviewed and obtained copies of three checks in year 2000 and January 2001 that are direct payments from Rainier to the IRS on behalf of Neil Richardson in amounts totaling \$220,000. These payments follow the normal policy of distributing enough cash to shareholders in order to pay the tax associated with the corporate taxable income and retaining the remainder. Of the total amount of \$220,000 listed in the three checks, \$12,000 was for year 1999 tax (plus the amounts paid in the prior year) and \$208,000 represented estimated tax for year 2000. This is actually greater than the \$167,639 Federal Income Tax expense as proposed by Rainier.

Finally, Rainier has been an S Corporation since its formation in 1990 and has a history of reflecting income tax in computing its rate structure, to change now would force Rainier to consider the corporate status of its structure before the IRS due to the difference in permitting income tax as a part of determining the rate structure.

Q. How is this different from the normal approach followed by closely held C Corporations that pay the corporate income tax and then retain the remainder to fund growth and enlarge the equity of the business?

A. The majority of closely held C Corporations retain their after tax income to fund the expansion of the business. Therefore, the income tax relative to the second tax paid on a distribution is not paid until the corporation is liquidated and distributed to the shareholders, normally in a sale or liquidation of the business. That ultimate distribution in the form of a sale or liquidation of the business normally results in the ultimate taxable income to the shareholders in the form of capital gains. Attached is Exhibit _____ (FA-3) to show the normal comparison of tax differential experienced between an S Corporation and a C Corporation with an taxable income example of \$400,000. The total tax is greater for a C Corporation. However, after considering the time value of money related to the delay in tax related to the C Corporation distributions in a sale or liquidation 10 to 20 years later, the total tax results are comparable.

Q. Do you have any examples of cases in which the IRS was successful in pursuing an S Corporation for the tax liability of a shareholder?

A. Yes, the IRS is able to make tax assessments against a corporation if the corporate shareholder has not paid their tax. This is defined as “alter-ego” tax assessment when the IRS is able to attach corporate assets in order to pay personal income

taxes. I have attached Exhibit _____ (FA-4) to cite certain cases where the IRS has been able to assess tax of the shareholder directly against the assets of the corporation.

Q. Is it reasonable to assume that the taxable earnings of an S Corporation escape income tax?

A. No! The timing of tax related to S Corporation earnings is initially greater for S Corporation's taxable earnings than for a C Corporation. However, the later distributions and taxability of the C Corporation earnings ultimately evens the impact of taxation on the entities. Hopefully I have been able to display the comparison of the timing and time value impacts of S Corporation tax relative to C Corporation tax in Exhibit _____ (FA-3). It is certainly my belief that substantial minds at the Treasury Department anticipated the majority of these factors when they were designing the tax regulations. Rainier is paying the cash directly to the IRS in order to satisfy the Federal Income Tax. The Company should be entitled to a deduction for the expenditure.

Q. Mr. Kermode proposes that if the Commission decides to impute income taxes and allow Rainier to recover them in rates that tax-basis depreciation should be used instead of regulatory basis depreciation expense, do you agree?

A. No, there are significant differences between asset basis for tax and regulatory

methods. I assume that Mr. Kermode is not making this suggestion for all water company rates, only those that are S Corporations. This would place a new factor of determining the deferred income tax implications relative to the difference in income tax basis of the assets. Why would you impose this change on one form of enterprise and not on all forms of enterprises that appear before the Commission?

Q. Do you agree with Mr. Kermode's conclusion that allowing imputed income tax to an S Corporation provides a windfall to the shareholders of the Corporation?

A. No! Again Mr. Kermode follows the assumption that an S Corporation earnings somehow escape tax and S Corporations are somehow tax free entities. The clear result from the cash disbursement records of Rainier is that more tax is actually being disbursed from Rainier in year 2000 because of its election of S Corporation tax status. The election of S Corporation status is more than just electing a tax status for rate paying. The shareholder is making this election recognizing that the tax will actually be greater with the initial filing of the year-end tax return, but there are other Federal Income Tax issues to be considered, such as built-in gains tax and certain tax deductions that are not available to an S Corporation. This is being proposed as a very simple issue, however the contrary is actually true. The election of S Corporation status actually causes Rainier to pay more tax for the year in question not less, as is indicated

by the cash payments made by Rainier to the IRS in the year 2000. Rainier is not making a request for this additional tax, only the imputed tax similar to a C Corporation.

Q. Mr. Kermode suggests that the UTC has not previously approved income tax in the rates of Rainier, do you agree?

A. No. As Mr. Fisher points out, the Commission previously approved the Kennedy Extension in April 1991, that contract contained the following language “the customer will pay to the company 39% of the customer’s cost of constructing the line extension to cover the tax on contributions in aid of construction which will be incurred by the company.” The Company has recovered income tax expense from its contracts since 1991. More importantly, the Commission approved a tax surcharge in 1990 in the Company’s tariff in order for the Company to recover the effect of income taxes paid on contribution in aid of construction, after the changes in the 1986 Tax Reform Act. A copy of the tariff is attached as Exhibit _____ (FA-5).

Q. Do you agree with Mr. Kermode’s pro forma adjustment #8 to restate bad debt expense and spread the expense over three years, for an expense of \$18,526 in 2000?

A. No. Mr. Fisher points out why the expense was not booked in 2000 and the actual expense. As an alternative, and only as an alternative if the Commission is not

willing to accept Mr. Fisher's explanation, then, at the very least, the average expense over time is appropriate. That average should consider a reasonable period of time. I suggest that the write-offs of 1997 through 2001 being considered and an average year amount be used. The Company recorded the following bad debt expenses in 1997 - \$33,222, 1998 - \$29,555, 1999 - \$47,431, 2000 - (\$627) and 2001 - \$58,198. This represents \$167,779 in five years or an annual amount of \$33,556. I suggest that the adjustment reflect a resulting amount of \$33,556, the five year average. Therefore, the alternative for pro forma adjustment #8 is to adjust the negative expense of (627) to a five year average amount of \$33,556.

Q. Please discuss restating adjustment #9 for depreciation as proposed by Mr. Kermode?

A. The restating adjustment #9 represents a proposed adjustment to retained earnings of \$119,040 and \$5,443 to CIAC for a net amount of \$113,597. This represents a catch-up adjustment relative to an analysis that was done in 2000 to examine the useful lives of the assets and properly state the total accumulated depreciation at that date. I agree that the entire adjustment effect should not be reflected in a single year for rate adjustment purposes. However, this process is done periodically and adjusted accordingly. I suggest that the adjustment be reduced from a net amount of \$113,597 to \$75,731. This would spread the effect of the adjustment made in year 2000 over a period of three years for rate adjustment purposes. This would

adjust two-thirds of the catch-up adjustment out of year 2001.

Q. Please discuss restating adjustment #10 restating amortization to CIAC?

A. The proposed adjustment adjusts amortization expense. However, the total amortization is actually correct when line 32 amortization is combined with line 33 amortization of CIAC. Therefore the proposed adjustment is not needed and amortization of CIAC is actually properly stated when line 32 and 33 is combined.

Q. Does that conclude your written testimony?

A. Yes, at this time.