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METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

[Signature]
EXECUTIVE SECRETARY

9-12

August 23, 1994

To: Board of Directors (Special Audit Committee--Information)
Board of Directors (Legal & Claims Committee--Information)

From: General Counsel

Subject: Status of Peat Marwick as External Auditor

Report

At its meeting on July 26, 1994, the Special Audit Committee considered a report of the Auditor, dated June 29, 1994, regarding Review of Imperial Irrigation District (IID)/ Metropolitan Water Conservation Program for the year ended June 30, 1993. After discussion, the Committee requested a report from the General Counsel as to whether a conflict of interest resulted from the fact that Metropolitan's external auditor, KPMG Peat Marwick (hereinafter "Peat Marwick"), is also the external auditor for IID. The Committee requested that this question be referred to the Legal and Claims Committee for staff follow-up.

A review of this matter indicates that no conflict of interest results from this situation.

After interviewing representatives from several CPA firms, Metropolitan's Audit Subcommittee recommended that Peat Marwick be hired as Metropolitan's external auditor at its meeting on July 2, 1991. During Peat Marwick's presentation, the Audit Subcommittee was informed of the nature of the firm's relationship with IID. At that meeting, Mr. Tom Snow, the Peat Marwick partner who handles Metropolitan's work, reported that he was the engagement partner on the IID audit. Mr. Snow was specifically asked about a possible conflict of interest due to Peat Marwick's relationship with IID. He and his associates informed the Committee that, based on the circumstances of the Metropolitan-IID relationship, serving as auditor to both IID and Metropolitan did not result in a conflict under professional auditing standards applicable to certified public accountants. This conclusion was based on the disclosure to Metropolitan and the fact that Metropolitan would not use Peat Marwick to audit the Metropolitan/IID contract.

Mr. Snow explained that the contract with IID is not material to Metropolitan's overall financial position. Due to

Peat Marwick's relationship with IID, Metropolitan's Internal Auditor would and has assumed the responsibility for periodic audits of the contractual activities between Metropolitan and IID since the inception of Metropolitan's contract with IID. Under these circumstances a conflict situation does not arise.

The information provided by Peat Marwick representatives at the July 2, 1991 meeting is in accord with the Ethical Rules of the American Institute of Certified Public Accountants (hereinafter "AICPA"), which permit a client to hire a public accountant after being informed of the nature of the accountant's relationship with another entity which might be viewed as impairing the accountant's objectivity. AICPA Ethical Rule 102 requires that:

"In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others."

The AICPA interpretation of Rule 102 further states that:

"A conflict of interest may occur if a member performs a professional service for a client, or employer and the member or his or her firm has a significant relationship with other person, entity, product, or service that could be viewed as impairing the member's objectivity. If this significant relationship is disclosed to and consent is obtained from such client, employer, or other appropriate parties, the rule shall not operate to prohibit the performance of the professional service. When making the disclosure, the member should consider Rule 301, 'Confidential Client Information.'" (Emphasis added.)

Rule 301 provides that a member "shall not disclose any confidential client information without the specific consent of the client."

In addition, at the July 2, 1991 meeting Peat Marwick pointed out that it had no "independence" problems with regard to its relationship with IID as its relationship with IID was limited to its role as outside auditor. Under the AICPA Rules, independence means that an accountant is not related in a

personal, external or organizational manner to a client, so that the accountant can perform its work in a objective manner. The AICPA Professional Standards provide that:

"To be independent, the auditor must be intellectually honest, to be recognized as independent, he must be free from any obligation to or interest in the client, its management, or its owners." (AICPA Professional Standards, AU Section 220.03.)

Therefore, based on the disclosures made by Peat Marwick to the Audit Subcommittee prior to being retained by Metropolitan as its external auditor, the firm's obligations under the professional auditing standards governing certified public accountants to maintain the confidential information of its clients, and the fact that Metropolitan's Internal Auditor performs the audits of the IID/Metropolitan Water Conservation Program, Peat Marwick's position as external auditor to both Metropolitan and IID does not result in a conflict of interest.

Recommendation

For information only.


N. Gregory Taylor