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METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

APR - 9 1996

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Dawn Chi
for EXECUTIVE SECRETARY

March 19, 1996

To: Board of Directors (Finance & Insurance Committee--Action)
From: Auditor *Michael W. Handberg*
Subject: Authorize Payment of Supplemental Billing from KPMG Peat Marwick

RECOMMENDATION

It is recommended that the Board of Directors authorize the payment of a supplemental billing of \$29,018 from KPMG Peat Marwick, LLP, for extraordinary work performed by the firm in order to complete the audit of the District's accrual basis financial statements for the fiscal year ended June 30, 1995.

DETAILED REPORT

As a result of extraordinary work performed by the District's external auditor, KPMG Peat Marwick, LLP, (Peat Marwick) to complete the audit of the District's accrual basis financial statements for the fiscal year ended June 30, 1995, authorization from your Board is requested to pay a supplemental invoice from the firm totaling \$29,018. This invoice is in addition to the \$74,100 already paid to the firm for fiscal 1994-95 external audit services which were subject to an annual maximum fee limitation of that amount. A detailed explanation of this matter follows.

Peat Marwick is under contract with the District to perform specific audit services each year. The contract in effect is a five-year contract which will expire in early calendar 1997, once all required audit services for current fiscal year 1995-96 have been completed by the firm. The multi-year agreement specifies an annual maximum fee limit for the services to be rendered by the firm on the District's behalf for each fiscal year to be audited. These annual fee limits were contractually established in 1992 based on estimates by Peat Marwick representatives of the fees necessary to perform the required audit services for such future years in normal circumstances.

Over the first three years of the contract, Peat Marwick performed all required audit services and was paid for such work at the hourly rates applicable for such contract years. For each audit year, the firm's billings for actual time spent conducting the audits exceeded the maximum fee limit for such periods as specified in the contract. Accordingly, all Peat Marwick charges and billings in excess of the respective annual fee limits were written off by the firm.

In early 1995, during the planning for the year-end audit for fiscal 1994-95, it was recognized that the then pending April 1995 conversion to new integrated core-business financial systems was likely to have a significant impact on the scope and timing of the year-end audit work. Concerns about the impacts of the mid-year implementation of the new financial systems on the year-end audit were expressed to management by myself and Peat Marwick representatives prior to implementation. Management elected to implement the systems in April, thus creating an audit environment involving both old and new financial systems within the same audit year. As a result, Peat Marwick representatives expected that additional audit time and effort would be required to perform the year-end audit, although the magnitude of such additional efforts could not be reasonably projected until work was actually commenced.

Ultimately, KPMG Peat Marwick personnel encountered significant problems completing the year-end audit field work sufficiently and timely. Difficulties were encountered by the firm's staff in many audit areas, most notably accounts payable, fixed assets, and internal control assessments. Since completion of the annual audit and timely issuance of the audited financial statements are essential to Metropolitan's financial stature, not to mention its ability to issue debt, I authorized Peat Marwick to proceed in conducting whatever work was necessary in the circumstances. I also advised Peat Marwick's assigned partner and manager that I wanted regular status reports on audit problems and issues encountered by their staff, and, furthermore, that I expected them to provide me with a detailed breakdown in their billings of any so-called "extraordinary" work which was necessary to complete the 1994-95 audit. These matters were subsequently discussed on at least two occasions with the Special Audit Committee, particularly at its September 19, 1995, meeting, shortly after the various audit problems began to materialize.

Audit status reports were provided regularly to me as requested, and the District's audited financial statements were issued by the firm in late October 1995. The remainder of the District's 1994-95 required audit services, primarily the annual Letter to Management and the District's Single Audit Reports, were completed by Peat Marwick in January and February 1996. A final detailed billing was then submitted to me in early March which recapped the time and charges for all services performed by the firm for the fiscal 1994-95 audits.

Peat Marwick's final billing detail was comprised of two elements. The first consisted of an invoice for \$2,656, representing the balance due for so-called "normal" required audit services billings subject to the fiscal 1994-95 audit year maximum fee limit of \$74,100. The second element was the aforementioned supplemental billing of \$29,018 for "extraordinary" year-end audit efforts resulting from the impacts of the April 1995 financial systems implementation.

Upon review of the final detailed billing information, as well as discussions with the assigned partner and manager, I believe that Peat Marwick is entitled to the additional compensation it has requested in the supplemental billing submitted. Both the reasons for the extra work, as well as the hours billed, appear consistent with the audit problems and difficulties encountered by the auditors during year-end field work last fall. Furthermore, the firm has continued to recognize adjustments for audit inefficiencies and other factors in its billing details consistent with its billing practices in prior years. In fact, Peat Marwick's billing adjustments

pertaining to the so-called "normal" 1994-95 audit services totaled \$32,876, which is substantially higher than previous annual write-offs.

Attached to this letter is a table which summarizes the history of billings from Peat Marwick relative to the annual contractual fee limits for the first four years of the audit contract.

It is recommended that Peat Marwick's supplemental billing for fiscal 1994-95 audit services be authorized for payment. A supplemental billing of this nature is not anticipated for fiscal 1995-96 audit services since the special circumstances which gave rise to this situation in 1995 are not expected to recur. The maximum fee limit for the final year of the audit services contract is \$81,500.

Attachment

ATTACHMENT TO LETTER OF AUDITOR, DATED MARCH 19, 1996

SUMMARY OF EXTERNAL AUDIT CONTRACT FEE LIMITS
AND CHARGES FOR FISCAL YEARS 1991-92 THROUGH 1994-95

	<u>FISCAL YEAR</u>			
	<u>1991-92</u>	<u>1992-93</u>	<u>1993-94</u>	<u>1994-95</u>
Maximum Annual Audit Fee Limit (1)	\$61,500	\$61,500	\$67,400	\$74,100
Total Charges For All Required Audit Services	<u>74,140</u>	<u>79,520</u>	<u>77,547</u>	<u>106,976</u> (2)
Service Charges Absorbed by KPMG Peat Marwick (Write-offs)	<u>\$12,640</u>	<u>\$18,020</u>	<u>\$10,147</u>	<u>\$32,876</u>
Write-offs as % of Annual Maximum Fee	21%	29%	15%	44%

- (1) Annual required services include: quarterly audits of cash basis financial statements, the year-end accrual basis financial statement audit, including issuance of an annual Letter to Management, and preparation of other reports such as the Single Audit Reports in years when required.
- (2) Excludes charges totaling \$29,018 for "extraordinary" work required due to audit problems relating to mid-year implementation of the District's new integrated financial systems.