



MWD

METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

AUG 20 1996

Dave Blair
for EXECUTIVE SECRETARY June 28, 1996

(Special Audit Committee--Action)
To: Board of Directors (Finance & Insurance Committee--Action)
From: Auditor *Nicholas W. Homberg*
Subject: Renewal of Agreement for External Audit Services

RECOMMENDATION

It is recommended that the Board of Directors authorize the Chairman of the Board to execute, on Metropolitan's behalf, a new five-year agreement for external audit services commencing with fiscal year 1996-97 with the public accounting firm of KPMG Peat Marwick LLP in accordance with that firm's June 18, 1996, proposal for such services, as summarized in this letter, and in form approved by the General Counsel.

EXECUTIVE SUMMARY

Metropolitan's existing contract for external audit services with KPMG Peat Marwick LLP will expire in late 1996 and a new audit services agreement must be established for services related to fiscal 1996-97 and later years. It is recommended that the firm of KPMG Peat Marwick be retained as Metropolitan's external auditor for an additional five-year period under substantially similar terms and conditions to those provided in the current audit services contract, with the primary differences being revised hourly billing rates and annual maximum fee amounts. The hourly billing rates and maximum annual fee amounts proposed for the five-year renewal period are shown in Attachment A to this letter.

DETAILED REPORT

Metropolitan's current external audit services agreement with the public accounting firm of KPMG Peat Marwick LLP (Peat Marwick) will expire in late 1996 upon completion of the required audits of Metropolitan's accrual basis and cash basis financial statements for the fiscal year ended June 30, 1996. The Auditor serves as Agreement Administrator of this contract on the Board's behalf. Peat Marwick has performed such audit services for the District in a satisfactory manner for the last five years. The expiration of the current external audit services agreement necessitates that a new agreement be established with either Peat Marwick or a replacement firm commencing with fiscal 1996-97.

In April, I requested that Peat Marwick's service partner for the Metropolitan engagement, Mr. Tom Snow, provide me with a summary of his views on renewal of the audit

services agreement. Mr. Snow submitted a draft proposal to me in May which expressed the firm's strong desire to continue its business relationship with Metropolitan for at least five additional years. The draft proposal also included preliminary hourly billing rates and maximum annual fee amounts to provide Metropolitan's required audit services for the next five-year period. With the exception of revised hourly rates and maximum annual fee limits, the overall scope of services would remain substantially unchanged from services currently provided. A summary of the key terms in Peat Marwick's preliminary proposal was provided as a handout to the Special Audit Committee at its meeting on May 28 and is included as Attachment B to this letter.

The subject of external audit services contract renewal was discussed at length with the Special Audit Committee at its May 28 meeting. At that time, committee members and other directors in attendance generally supported retaining the District's external audit firm for another five-year period for a variety of reasons. Several directors acknowledged the benefits of avoiding disruptions and additional staff efforts which often result from a change in auditors. Other directors expressed concerns about making a change in external audit firms during a time when expenditures and debt financings related to the District's Capital Improvement Program are expected to increase substantially. On the other hand, Chair Frahm expressed concern over the potential impact on Peat Marwick's independence and objectivity as a result of that firm's recent engagement to assist management in a review of Metropolitan which parallels that being conducted by a consultant for the City of Burbank. She subsequently requested that Mr. Snow address this concern in writing prior to the committee's next meeting.

In response to directors' questions, I discussed past District external audit services agreements and my views on Peat Marwick's services during the last five years, including my opinion that Peat Marwick has been serving the District in a satisfactory manner. After committee discussion of the financial terms in KPMG's draft proposal, Mr. Snow reiterated that such terms were preliminary and subject to further negotiation. Chief Financial Officer Becker indicated that he wanted to meet with the Auditor and Mr. Snow to further discuss contract renewal and financial terms. The Special Audit Committee then tabled discussion and directed the Auditor to submit a written report on the matter at its next meeting in July.

On June 12, Chief Financial Officer Becker, Mr. Snow, and I met to discuss renewal of the District's external contract with KPMG. Staffing and service responsiveness were the key issues discussed with Mr. Snow, in addition to the proposed rate and maximum annual fee levels. In addition to responding to staffing and service level matters, Mr. Snow committed to submitting a formal proposal to me which would reflect reductions in the preliminary hourly billing rates and maximum annual fee amounts. Mr. Becker indicated that, with such reductions, he was prepared to support the renewal of KPMG's services agreement with the District for an additional five-year term.

I recently received KPMG's formal proposal, dated June 18, 1996. As expected, the firm reduced its preliminary maximum annual fee amounts for fiscal 1997-98 and thereafter (by a total of \$25,400), as well as the hourly billing rates for all classifications. In my opinion, the

proposal outlines the extension of required external audit services for an additional five-year term at favorable financial arrangements and Chief Financial Officer Becker concurs.

A copy of Mr. Snow's July 1, 1996, letter to Special Audit Committee Chair Frahm responding to her concerns about external auditor independence and objectivity is included (without its extensive attachments) as Attachment C to this letter. Copies of the referenced attachments in Mr. Snow's letter are available to interested directors from my office upon request.

Upon approval by your Board of the recommendation in this letter to engage Peat Marwick's services, a new contract, in form approved by the General Counsel, will be prepared by my office for execution by the parties.

Peat Marwick is an equal opportunity employer and has a detailed affirmative action plan, both nationally and at the local office level.

This action is exempt from the provisions of the California Environmental Quality Act because there is no possibility that the proposed agreement will have a significant effect on the environment.

Attachments

LETTER OF AUDITOR, DATED JUNE 28, 1996

ATTACHMENT A

SUMMARY OF KPMG PEAT MARWICK PROPOSAL TO
RENEW AUDIT SERVICES CONTRACT WITH MWD

Contract would be for an additional 5-year term.

Contract can be terminated by either party with one month's advance notice.

Scope of services would remain substantially unchanged, although all work related to new MWD Asset Financing Corporation would be included in overall scope.

MWD's Audit Department would continue to provide a minimum of 500 hours of time per year to assist in annual and quarterly audits.

Discounted hourly rates would remain the same for Fiscal Year 1996-97 as current year 1995-96. Hourly rates would be increased twice (every other year) starting in 1997-98 as shown below:

<u>Staff Classification</u>	<u>Current Standard Hourly Rates</u>	<u>Discounted Hourly Rates</u>				
		<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>
Partner	\$345	160	168	168	176	176
Senior Manager	210	133	140	140	147	147
In-charge Accountant	105	80	84	84	88	88
Staff Accountants	90	67	70	70	74	74

Maximum annual fee limit would remain the same for Fiscal Year 1996-97 as 1995-96. The limit would be increased twice (every other year) starting in 1997-98 as shown below:

<u>Current Year (1995-96)</u>	<u>Proposed Maximum Annual Fee Limits</u>				
	<u>1996-97</u>	<u>1997-98</u>	<u>1998-99</u>	<u>1999-2000</u>	<u>2000-01</u>
\$81,500	\$81,500	\$85,600	\$85,600	\$89,900	\$89,900

ATTACHMENT B

HANDOUT AT SPECIAL AUDIT COMMITTEE MEETING OF MAY 28, 1996

AGENDA ITEM 9.

DRAFT
 SUMMARY OF KPMG PEAT MARWICK/PROPOSAL TO
 RENEW AUDIT SERVICES CONTRACT WITH MWD

Contract extension would be for an additional 5-year term.

Contract can be terminated by either party with one month's advance notice.

Scope of services would remain substantially unchanged, although all work related to new MWD Asset Financing Corporation would be included in overall scope.

Discounted hourly rates would remain the same for Fiscal Year 1996-97 as current year 1995-96. Hourly rates would be increased every other year beginning in 1997-98 (thus, 2 rate increases in 5-year period).

Annual maximum fees would likewise stay the same in 1996-97 as 1995-96; be increased twice (every other year) starting in 1997-98 as shown below:

Current Year	Proposed Annual Maximum Fees				
<u>(1995-96)</u>	<u>1996-97</u>	<u>1997-98</u>	<u>1998-99</u>	<u>1999-2000</u>	<u>2000-01</u>
\$81,500	\$81,500	\$89,600	\$89,600	\$98,600	\$98,600

Over the proposed 5-year contract extension period, the gross maximum fees would be increased \$17,100 (an average of \$3400, or about 4%, over the current fee amount per year).



ATTACHMENT C

Peat Marwick LLP

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Los Angeles, CA 90017

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Telex 6831572 PMMLA
Cable Address VERITATEM

Telefax 213 622 1217

July 1, 1996

RECEIVED

Ms. Christine Frahm
Chairperson Special Audit Committee
Metropolitan Water District of Southern California
406 Maple Street
San Diego, California 92103

JUL 03 1996

Auditor's Office
The Metropolitan Water District
of Southern California

Dear Ms. Frahm:

This letter is being written in response to your request for clarification as to why the project to perform a "Diagnostic Review of Financial Policy Implementation and Rate Setting Practices" which our Firm has recently been contracted to perform is not in conflict with our retention as auditors for the Metropolitan Water District of Southern California (Metropolitan). I shall be happy to discuss its contents with you at your convenience.

This letter is rather long. I have taken the liberty of dividing it into more manageable sections, as follows:

- Our Present Professional Relationship
- Professional Auditing Standards Governing Auditors' Independence
- Study of Metropolitan by Burbank
- Our Diagnostic Review of Metropolitan's Policy
- Discussion of Independence and Objectivity Issues

OUR PRESENT PROFESSIONAL RELATIONSHIP

As you are aware, we have served as Metropolitan's auditors for the last five years. As Metropolitan's auditors, our task has been to perform the annual financial statement attestation work in the following areas:

- *For Metropolitan as a Whole:*
 - Annual Financial Statements – Our auditors' report is directed at Metropolitan's accrual basis financial statements. These General Purpose



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Financial Statements are ultimately included in Metropolitan's Annual Financial Report and Comprehensive Annual Financial Report. Our audit is conducted in accordance with generally accepted auditing standards and Government Auditing Standards, promulgated by the Comptroller General of the United States.

- **Single Audit** – We also perform a separate “Single Audit” of Metropolitan’s Federal financial assistance programs in accordance with generally accepted auditing standards; Government Auditing Standards, promulgated by the Comptroller General of the United States; and Office and Management and Budget (OMB) Circular A-128, concerning Audits of State and Local Governments. A number of reports are included under the “banner” of the Single Audit. These reports deal with internal control and compliance with applicable Federal laws and regulations over the receipt and expenditure of Federal funds.
- **Statements of Cash and Investments and Cash Receipts and Disbursements, by Fund Category and in Total** – On a separate basis, we undertake an audit of certain supplemental cash basis financial statements. Our auditors’ reports are directed at Metropolitan’s cash basis financial statements for the periods ending September 30, December 31, March 31, and June 30 of each fiscal year. Our audits are conducted in accordance with generally accepted auditing standards upon which we render our accountants’ report differs from our annual audit in that these financial statements are accounted for using the cash basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles (GAAP). In addition to auditing procedures necessary to render our opinions on the aforementioned cash basis financial statements, we generally simultaneously conduct interim auditing procedures related to the annual audit of Metropolitan’s accrual basis general purpose financial statements.

In the past, our audit work has also encompassed Metropolitan’s Trustee entities. Metropolitan acts as trustee and depository for three agencies: the Six Agency Committee, the Colorado River Association and the California Utilities Emergency

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Association (formerly known as the Utility Policy Committee). Our audits in this regard are conducted in accordance with generally accepted auditing standards. These financial statements are also accounted for using the cash basis of accounting, which is a comprehensive basis of accounting other than GAAP. In the future, we expect to also audit Metropolitan's Asset Financing Corp. Metropolitan has established a separate asset financing corporation to serve as a vehicle for seeking additional financial support. Our proposed audit scope will encompass this new organization.

We have always also issued management letters which address our observations concerning Metropolitan's internal control structure and other areas coming to our attention. Naturally, we have also been at attendance at as many Board and Committee meetings as you have requested that we be in attendance.

The scope of our work for Metropolitan over our years of service has been to provide external auditing services dealing with accounting and financial operating matters. Such services *have not* been directed towards determining Board policy — and, especially, *not* in the implementation thereof.

PROFESSIONAL AUDITING STANDARDS GOVERNING AUDITORS' INDEPENDENCE

Two distinct sets of professional standards are both brought into play at Metropolitan. In performing the aforementioned audits, we made reference to generally accepted auditing standards and to government auditing standards. While not interchangeable, both sets of standards are closely related and are formally codified. Under both sets of standards, an auditors' independence is one of the most basic general standards of professional behavior. Allow me to quote from Statement on Auditing Standards Number 1, published by the American Institute of CPAs:

“ 0.1 The second general standard is:

In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.

0.2 This standard required that the auditor be independent; aside from being in public practice (as distinct from being in private practice), he must be without bias with respect to the client since otherwise he would lack that

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impartiality necessary for the dependability of his findings, however excellent his technical proficiency may be. However, independence does not imply the attitude of a prosecutor but rather a judicial impartiality that recognizes an obligation for fairness not only to management and owners of a business but also to creditors and those who may otherwise rely (in part, at least) upon the independent auditor's report, as in the case of prospective owners or creditors.

0.3 It is of utmost importance to the profession that the general public maintain confidence in the independence of independent auditors. Public confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence. 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. For example, an independent auditor auditing a company of which he was also a director might be intellectually honest, but it is unlikely that the public would accept him as independent since he would be in effect auditing decisions which he had a part in making. Likewise, an auditor with a substantial financial interest in a company might be unbiased in expressing his opinion on the financial statements of the company, but the public would be reluctant to believe that he was unbiased. Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence.

0.4 The profession has established, through the AICPA's Code of Professional Conduct, precepts to guard against the *presumption* of loss of independence. "Presumption" is stressed because the possession of intrinsic independence is a matter of personal quality rather than of rules that formulate certain objective tests. Insofar as these precepts have been incorporated in the profession's code, they have the force of professional law for the independent auditor.

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0.5 The Securities and Exchange Commission has also adopted requirements for independence of auditors who report on financial statements files with it that differ from the AICPA requirements in certain respects. [As modified, November 1979, by the Auditing Standards Board.]

0.6 The independent auditor should administer his practice within the spirit of these precepts and rules if he is to achieve a proper degree of independence in the conduct of his work.....”

Frequently, auditors are engaged to assist their clients beyond the regular audit focus. In fact, auditors by their nature and familiarity with their clients' operations are natural persons to turn to for assistance. Studies such the “Diagnostic Review” we have been contracted to conduct by Metropolitan fit into this area. Such special services *are not precluded* under existing professional standards, so long as the auditor's independence is not compromised.

Because of increasing demand for these types of services by clients, formal guidance over independence has been modified from time to time. We have taken great care in our professional relationship with Metropolitan to adhere to this Second General Standard of Auditing. Despite formal guidance, issues of independence occasionally arise and our profession has risen to their responsibility by adopting a Code of Professional Conduct and various rules of conduct. Our profession's long established “*Rules 101 – Independence; and 102 – Integrity and Objectivity*”, also come into play. These rules are well known to our people and are paramount in our decisions to retain clients and accept work on behalf of our clients. Copies of the Rules have been attached as Appendix A to this letter. We believe that our audit *does not conflict* with the “Diagnostic Review” work that the District has asked us to perform.

STUDY OF METROPOLITAN BY BURBANK

Metropolitan is currently undergoing an “Assessment of Financial Policy and Rate Setting of the Metropolitan Water District for the City of Burbank City Council”. This work is being undertaken and underwritten at the request of a member agency to Metropolitan — the City of Burbank. The scope of the work to be undertaken is *not an*

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audit, as the term is defined, and is *very different* from the work that we have been doing. Specifically, the proposal that was developed by Burbank's designated consultant addressed the following areas of review:

- Financial Policy
- Financial Policy Implementation
- Rate Setting

This may be a confusing point, but again it is important to clarify that the work being conducted on behalf of the City of Burbank is *not an audit*. Reference to their proposal, which has been included as Appendix B, clearly illustrates this point. The twelve page proposal submitted by the consultant does not use the term "audit". Instead, the consultant refers to an independent review of Metropolitan's policy. The scope of their review is to point out areas where existing policies could be changed.

A financial audit does not ordinarily view "policy" as being within the scope of audit unless policy clearly negatively impacts financial results. Otherwise, a financial audit views compliance with established policy as being within the scope of audit. This aspect is clearly the case at Metropolitan.

OUR DIAGNOSTIC REVIEW

As you are aware, upon receipt of the Burbank Proposal, Metropolitan's Chairman and management became concerned over what they perceived as a lack of objectivity in the proposal's scope of work. We are informed that this concern was expressed to Burbank's City Council and that a counter-proposal was extended to Burbank wherein a jointly funded study be undertaken by a consultant to be jointly selected by both parties. This counter-proposal was rejected.

At that point, Metropolitan's management approached KPMG Peat Marwick LLP (Peat Marwick) for assistance in performing a second, independent review on an urgent basis which could be conducted simultaneously with the Burbank review. Our reply (Proposal) to their request, which is attached as Appendix C to this letter, makes mention of the concerns of other member agencies and addresses the same three areas of the other consultant, namely:

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- Financial Policy
- Financial Policy Implementation
- Rate Setting

The respective scopes of work of the proposed reviews are not mirror images of one another. Instead, they are slightly different. Most noticeably, the review proposed by Metropolitan also addresses Metropolitan's capital program which has been an integral part of Metropolitan's rate setting strategy. This area is expressly excluded from the Burbank study. As you read the appended proposals, other differences between the studies emerge.

DISCUSSION OF INDEPENDENCE AND OBJECTIVITY ISSUES

At the outset of this engagement, we were asked by Metropolitan's management to submit a proposal that outlined our work program. This work plan was discussed thoroughly with management, as was our understanding that we would be given complete autonomy. We understand that our workplan and management's intention to engage our services was approved by Metropolitan's Executive Board.

Prior to submitting even a draft proposal, our ability to perform the work was also discussed with Metropolitan management, as well as internally within Peat Marwick. Our proposal, which Metropolitan's management has agreed to, was to utilize *other* KPMG Peat Marwick LLP professionals who were not associated with the Metropolitan's normal process, and whose expertise was in areas more geared to the scope of study than auditing to perform the work in question. This step was done for two reasons:

- To engage professionals whose backgrounds were similar to those of the Burbank Study team
- To separate Peat Marwick's team of auditors, to the maximum extent possible, from the consultancy nature of this engagement. We simply did not want to be in the position of even suggesting that we would be auditing our own work — even at the loss of project efficiency.

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This last point was from the self-motivated point of view of providing a “fresh pair of eyes”, even though the annual audit process and this review are not connected. It should be pointed out that our proposal does make mention of two auditors being on the review project’s engagement team — myself and the audit engagement team manager. Both individuals are on the team in a liaison/facilitator capacity. Our presence is to provide background information and to facilitate the flow of requested information. To date, this has not involved any significant expenditure of professional time, nor is it expected to through the completion of the project.

In short, we have taken the extraordinary step of using two distinct engagement teams to perform the Metropolitan work. Both teams operate independently of one another as well as Metropolitan. It should be emphasized that the scope of, and the results of our study, is not bound by Metropolitan’s management but by the established professional standards to which I referred previously. We hold our objectivity in utmost esteem — it is the cornerstone of our business. We would not undertake an engagement if we believed that our objectivity was to be compromised.

As can be seen from both proposals attached, the areas of study do not deal with information that we subject to audit. They deal with policy issues. Accordingly, there is no conflict with the consulting work we have been engaged to perform.

Suggestions arising from our work will be discussed and finalized with Metropolitan’s management and duly reported to the Board. We will not participate in the implementation of any recommendations that we make, as that could be construed as compromising our independence and objectivity.

In response to those who might feel that Peat Marwick’s work and professional conclusions would be unduly influenced by Metropolitan’s management, I will state in the strongest possible manner, that our own standards and integrity do not allow for such influences. In short, “our report is our report”. While reports generally go through several edits, our Firmwide policy is now, and always has been, that our reports stand on their own, reflecting our independent views and not the views of others who would try to influence the comments we make. Should the Special Audit Committee wish, I will

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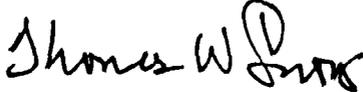
personally walk the Committee through each report iteration to demonstrate the Firmwide integrity to which I allude.

* * * * *

The Metropolitan Water District of Southern California is a valued client of KPMG Peat Marwick LLP. As mentioned previously, we take great pride in having served Metropolitan and having served it well. We have taken extraordinary professional steps to separate engagement teams and create an even greater independence of thought than professional standards require. We hope that you will look favorably upon our efforts. I also hope that the foregoing comments clarify your questions; if there is anything further I can add, please do not hesitate to contact me.

Very truly yours,

KPMG Peat Marwick LLP



Thomas W. Snow
Partner

TWS:lyh

cc: M. W. Hondorp
L. H. Becker
S. R. Smith