

- Internal Audit Report for November 2005

Summary

Six Audit Reports were issued during the month as follows, with opinions

- **Purchasing Process Audit Report** - Less Than Satisfactory
 - **Sacramento Valley Water Transfer Program Audit Report** - Generally Satisfactory
 - **401k Savings Plans and 457 Deferred Compensation Plan Process and Controls Audit Report** - Generally Satisfactory
 - **Oxidation Retrofit Program--Jensen Treatment Plant Audit Report** - Generally Satisfactory
 - **Oracle Database Management Systems Audit Report** - Generally Satisfactory
 - **PinnacleOne Agreement Audit Report** - Satisfactory
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Discussion Section

This report highlights the significant activities of the Internal Audit Department during November 2005. In addition to presenting background information and the opinion expressed in the audit reports, a discussion of findings noted during the examinations is presented.

Purchasing Process Audit Report

Background

The Procurement Team (Purchasing) of the Business Service Section is responsible for purchasing Metropolitan's materials, supplies, and nonprofessional services. Metropolitan utilizes several purchasing methods including purchase orders, blanket orders, and master contracts. The procurement process involves initiating a purchase requisition; obtaining proper approvals for the requisition; acquiring competitive bids; and creating and administering the purchase contract in accordance with Metropolitan policies and procedures and the Uniform Commercial Code. Procurement activities are processed and tracked through the Oracle purchasing application. During the fifteen months ending March 31, 2005, Purchasing processed 5,440 materials, supplies, and nonprofessional services contracts with a total requisition value of approximately \$84 million.

Opinion

In our opinion, the accounting and administrative procedures over the purchasing process provide for a less than satisfactory internal control structure. This opinion is the result of inadequate segregation of duties between personnel who prepare, process and approve purchase requisitions. It should be noted that Management has initiated remedial actions in response to our concerns.

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We intend to assist Management in evaluating permanent solutions to these internal control structure concerns while meeting operational needs.

Comments and Recommendations

As noted in the opinion, our audit revealed inadequate segregation of duties between personnel within the purchase requisition process. Specific concerns in this area are presented in detail, while additional comments on the purchasing process are summarized.

SEGREGATION OF DUTIES – PURCHASE REQUISITION PROCESS

Segregation of duties is intended to mitigate the risk of unauthorized or incorrect transactions. In addition, these controls assist in identifying processing problems and ensure that corrective action is taken. Within the District, Management established the “Authority Approval” list to identify staff authorized to approve purchase requisitions along with their authorized limits. Additionally, Management also established the “Delegated Authority” list, which identified the Water System Operations (WSO) staff authorized to approve purchase requisitions along with their authorized limits.

During our review of the purchase requisition process, we noted that 35 individuals were able to initiate and approve requisitions without the intervention of a second individual. Specifically, we noted that 13 of the 35 individuals were included on either the “Authority Approval” list or the “Delegated Authority” list. However, this authority inadvertently allows these individuals to initiate and approve requisitions without the intervention of a second person.

We also noted that 22 individuals were not included on either list, but were able to initiate and approve requisitions. Further review revealed that 11 of these 22 individuals were storekeepers stationed at Metropolitan warehouses who prepare purchase requisitions for Inventory Replenishment Contract (IRC) items. However, we noted that the Oracle purchasing system automatically approves requisitions initiated by these individuals. Although we understand the operational need to process IRC items on a timely basis, we question whether automatic approval without secondary review is the best practice for purchasing these items. The remaining 11 individuals were administrative staff located at Metropolitan’s headquarters or other facilities and should not be authorized to prepare and approve requisitions without a secondary review and approval. Purchasing management has been provided a list of these individuals and they have initiated corrective actions in response to our concerns.

We recommended that Purchasing management, in collaboration with operations management, review the existing purchasing requisition process and modify the Oracle application rules to ensure adequate segregation of duties. We also recommended that WSO management review the current “Authority Approval” and “Delegated Authority” lists and update them, as necessary.

COMPLIANCE WITH ESTABLISHED PROCEDURES

Metropolitan’s Purchasing Manual provides guidelines and procedures for the administration of purchase contracts.

During our review, we noted that the Purchasing Manual guidelines were not always followed. Specifically, we noted that 35 standard Office Depot purchase orders were created as one-time purchases and were not linked to an existing master contract. In addition, we noted that releases for blanket orders and purchase orders were created after the blanket orders and master contracts, respectively, had expired. Furthermore, we noted that contract effective dates preceded the contract initiation dates for 35% of blanket orders and 57% of master contracts examined.

We recommended that Purchasing management remind personnel of the importance of complying with established procedures and conduct periodic reviews to ensure compliance.

REVIEW AND APPROVAL

For purchase requisitions and contracts, authorized personnel review detail for compliance with policies and procedures, check attached documentation for completeness, and examine the purchase for propriety.

We noted that seven of the fifteen purchase contracts selected for testing remained opened after goods or services had already been received and payments issued. It should be noted that Purchasing management is currently implementing review procedures to ensure that contracts are closed in a timely manner. We also noted that two terminated employees had not been removed from the current "Approved Authority" list.

We recommended that Purchasing management periodically review the status of purchasing contracts and ensure that they are closed on a timely basis. We also encouraged group management, especially Human Resources management, to inform Purchasing management of employee separation or position change and ensure that an updated approver list is maintained. Finally, we recommended that Purchasing management remind staff of the importance of maintaining accurate contract information in the Oracle system.

Sacramento Valley Water Transfer Program Audit Report

Background

The Sacramento Valley Transfer Program (Program) was developed to provide water supply reliability through water transfer option agreements with water districts in the Sacramento Valley. The Program has been implemented on an as-needed basis to hedge against dry-year risks and water supply shortfall.

During 2003, Metropolitan executed one-year water transfer options agreements with eleven Sacramento Valley Water Districts. Metropolitan also entered into two agreements with the United States Bureau of Reclamation (USBR): first, to reimburse USBR for costs incurred up to \$70,000 during the agreement review process; and, second, to exchange up to 50,000 acre-feet (AF) of the 2003 transfer supply to be returned to Metropolitan by December 31, 2008. During 2003, Metropolitan exercised ten water transfer options and purchased 124,445 AF for

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approximately \$13 million. However, due to the precipitation in April, the State Water Project allocation increased from 45 to 90 percent, which resulted in less capacity at the Banks Pumping Plant to convey the transferred water. Furthermore, the water stored in Lake Oroville had to be released to meet flood control requirements. As a result, Metropolitan was able to secure only 45,671 AF, or \$4.8 million, through its exchange agreement with USBR with the remaining 78,774 AF, or \$8.2 million, spilled or lost due to improved water supply conditions.

In February 2005, Metropolitan and three other State Water Project Contractor members (Dudley Ridge Water District, Kern County Water Agency, and Palmdale Water District –“buyers”) executed one-year water transfer option agreements with three Sacramento Valley water districts (Glenn-Colusa Irrigation District, Richvale Irrigation District, and Western Canal Water District –“sellers”) to purchase up to 127,275 AF of water to ensure water reliability for their respective service areas. The four buyers had also executed an agreement with the State Water Project Contractors Authority (SWPCA) in October 2004 to facilitate and administer the 2005 water transfer option agreements. Pursuant to the October 2004 SWPCA agreement, Metropolitan made an advance payment of 17.0 million, including \$15.2 million to the sellers for 112,495 AF of water available for transfer (\$135/AF). However, Metropolitan decided not to exercise its 2005 options due to the improved water supply conditions and substantially lower than anticipated demands. Consequently, advance payments totaling \$15.8 million were refunded to Metropolitan, excluding \$1.1 million in nonrefundable option fees. As of June 30, 2005, a \$127,000 balance remained in the account, pending a final accounting of costs.

Opinion

In our opinion, the accounting and administrative procedures over the Sacramento Valley Transfer Program include those practices usually necessary to provide for a generally satisfactory internal control structure. The degree of compliance with such procedures provided effective control for the period January 1, 2003 through June 30, 2005.

Comments and Recommendations

Comments were noted in the areas of misclassifications of program costs in Metropolitan’s accounting records; improvements in management reporting of water losses; and minor contract administration issues. Specifically, we noted that water losses and related administration and legal fees totaling approximately \$1 million were not reclassified to the appropriate accounts in Metropolitan’s accounting records. Further, we noted that management’s reporting of the final disposition of water losses in June 2003 was incomplete.

We recommended that the Controller’s Office prepare adjusting journal entries to correct misclassified costs and enhance administrative procedures to ensure accurate and timely accounting and reporting of financial transactions. In addition, we recommended that Water Resources Management staff promptly provide the Controller’s Office with documentation of executed water transfer agreements to prepare the necessary accounting entries in the Oracle financial system. Finally, we recommended that program management maintain an effective reporting process and keep on file periodic reports that communicate the activities and status of

the program to ensure that program objectives are realized. Controller's Office management concurred with our recommendations.

401k Savings Plans and 457 Deferred Compensation Process and Controls Audit Report

Background

Metropolitan established its 401k Savings Plans and 457 Plan (Plans) in 1985 and 1977, respectively. The 401k Savings Plans are defined contribution retirement plans that allow Metropolitan employees and District temporary employees to invest pre-tax earnings matched by Metropolitan on a dollar-to-dollar basis up to 4.5% of an employee's annual salary. The 457 Deferred Compensation Plan enables employees to defer portions of their gross earnings into an account not matched by Metropolitan. Through these Plans, employees authorize Metropolitan to deduct a specified amount from their payroll and instruct the third-party service provider to allocate that money among various investment options offered by the Plans. Plan contributions and related earnings on investment are not subject to taxes until they are withdrawn from the Plans. In August 2003, Metropolitan contracted with Great-West Life & Annuity Insurance Company (Great-West) to provide recordkeeping and plan management services for the Plans.

As of April 30, 2005, the 401k and 457 Plans included 1,908 and 1,280 participants with total assets of \$118.6 million and \$44.7 million, respectively. Further, 1,663 and 935 employees contributed \$4.4 million and \$1.8 million to the respective Plans from January through April 2005, with a \$1.9 million match from Metropolitan.

Opinion

In our opinion, the accounting and administrative procedures over the Plans' processes provide for a generally satisfactory internal control structure. The degree of compliance with such procedures provided effective control for the period January 1, 2004 through April 30, 2005.

Comments and Recommendations

Comments were noted to improve plan monitoring; to obtain updated IRS determination letters; and to complete written procedures. Specifically, we noted that Plan distributions due to retirement, severance, hardship, or death are not verified against the Great-West Disbursements Reports. Furthermore, we noted a difference between Metropolitan's records and those maintained by Great West in the number of active employees contributing to the Plans. We recommended that Benefits Management establish procedures to ensure that Plan distributions are verified against Great-West Disbursements Reports and prepare quarterly reconciliations between the Peoplesoft and Great-West reports related to Plan participants.

Finally, we recommended that Benefits Management and the Controller Section Management establish a target date for the development and completion of the Policies and Procedures manual

for benefits administration and payroll accounting. Benefits Management concurred with our recommendations.

Oxidation Retrofit Program—Jensen Plant Audit Report

Background

Metropolitan's Oxidation Retrofit Program consists of retrofitting its five water treatment plants with an ozonation process to replace chlorine as the primary disinfectant to meet US Environmental Protection Agency disinfectant/disinfection by-product standards. Total estimated program cost for the ORP Program is \$829.4 million and the program is scheduled to be on-line by 2012. The Mills and Jensen treatment plants were the first two facilities within Metropolitan's system to be retrofitted and were placed into service in October 2003 and July 2005, respectively. Although the ORP Program for the Mills and Jensen treatment plants were managed as two separate projects, costs incurred on these projects were tracked under one appropriation. Total estimated program cost for the Mills and Jensen portion of the ORP Program is \$234 million, of which \$225.1 million has been expended as of May 31, 2005. An audit report on the Mills ORP Construction and Oxidation/Ozone Equipment Projects was issued in April 2003.

In February 1999, Metropolitan contracted with Ozonia North America (Ozonia) for \$24.4 million to manufacture and perform startup services of the oxygen/ozone equipment for the Jensen and Mills treatment plants. In January 2002, Metropolitan awarded a \$2.03 million contract to Steve Bubalo Construction Co. (Bubalo) for the existing Jensen service center demolition and reclaimed washwater line installation. In January 2003, the contract with Bubalo was completed and a final payment was issued. As of May 31, 2005, \$13.3 million and \$2.03 million have been paid to Ozonia and Bubalo, respectively.

In September 2002, a lump sum construction contract of \$69.7 million was awarded to Kiewit Pacific Co. (Kiewit) for the Jensen ozone facilities, initially designed for 500 million gallons per day (MGD) in treatment capacity. However, the contract was subsequently revised in July 2003 to \$86.5 million due to \$16.8 million of extra work orders, including \$15.9 million for increased ozone treatment capacity up to 750 MGD. As of May 31, 2005, Metropolitan has paid approximately \$85.7 million on the Kiewit construction contract.

Opinion

In our opinion, the accounting and administrative procedures over the Oxidation Retrofit Program (ORP) - Jensen Plant include those practices usually necessary to provide for a generally satisfactory internal control structure. The degree of compliance with such procedures provided effective control during the period from inception of the agreements through May 31, 2005.

Comments and Recommendations

Comments were noted in the areas of contract retention and release and contract tracking administrative procedures. Specifically, we recommended that Controller Section management

enhance administrative procedures to ensure that holdbacks are adequately retained from progress payments and are transferred to escrow bank accounts in the month of retention. We also recommend that Construction Administration management implement monitoring controls for the progress payment process. We further recommend that Controller Section management remind personnel of the importance of entering payment data including holdbacks accurately into the Oracle Financial System and the "Contract Register." Finally, we recommend that Controller Section management evaluate whether the "Contract Register" spreadsheet should be revised to better track construction contracts. The Controller's Office and Construction Administration management concurred with our recommendations.

Oracle Database Management Systems Audit Report

Background

The Information Technology Section (IT) of Corporate Resources Group is responsible for managing information and technology infrastructures including the Oracle Data Base Management System (DBMS). The Oracle DBMS is used to host more than 36 Metropolitan's business application systems, including Oracle Financial, Peoplesoft Human Resources, Payroll, Project Accounting, and the Purchase Card System. These applications process Metropolitan's information/data to meet the business operation and management reporting purposes.

Opinion

In our opinion, the security and backup procedures over Oracle DBMS include those practices usually necessary to provide for a generally satisfactory internal control structure. The degree of compliance with such procedures provided effective control as of August 31, 2005.

Comments and Recommendations

Comments were noted in the areas of enforcing password policies; database security controls and parameter settings; and terminated user accounts. Specifically, we recommended that the Database and IT Operations Services Team set password parameters in accordance with the established password management policies; test and set "execute" privilege only to the users/systems that run specific applications; and disable terminated user accounts in accordance with Metropolitan's policies. In addition, we recommended that the Database and IT Operations Services Team update operational database backup and restore procedures to meet business needs and technical changes. IT management concurred with our recommendations.

PinnacleOne Agreement Audit Report

Background

The Diamond Valley Lake Recreation (DVLR) programs consist of the East Recreation Area, the Trails, and the East Marina programs. The staffing strategy for the DVLR program is a mix of Metropolitan staff and consultants. Use of consultants are an effective option for staffing the project management support services for the DVLR programs due to limited availability of Metropolitan staff. PinnacleOne was awarded a time and material agreement in May 2003, limited to \$1.2 million. Support services provided by PinnacleOne include preparation of Capital Investment Projects updates and reports; master schedules and project-specific schedules; monthly program status reports, including labor reports; and document management. As of July 2005, \$979,000 has been paid to PinnacleOne on twenty-six billings.

Opinion

In our opinion, the accounting and administrative procedures over the PinnacleOne agreement include those practices usually necessary to provide for a satisfactory internal control structure. The degree of compliance with such policies and procedures provided effective control for the period May 26, 2003 through July 31, 2005.

Comments and Recommendations

Minor contract administrative findings were noted. We recommended that the Agreement Administrator conduct periodic reviews of PinnacleOne's activities to ensure compliance with the terms and conditions of the agreement. DVL management concurred with our recommendation.