MWD
METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

**Report**
April 30, 2006
Office of the General Auditor

- **Internal Audit Report for April 2006**

**Summary**

Three Audit Reports were issued during the month:

- **Water Rate Forecasting Audit Report - Generally Satisfactory**
- **Remote Site Activities Audit Report – Generally Satisfactory**
- **Palos Verde Forbearance and Fallowing Program Audit Report – Generally Satisfactory**

**Discussion Section**

This report highlights the significant activities of the Internal Audit Department during April 2006. In addition to presenting background information and the opinion expressed in the audit report, a discussion of findings noted during the examination is presented.

## Water Rate Forecasting Audit Report

**Background**

The Financial Planning Section of the Office of the Chief Financial Officer prepares the annual cost-of-service analysis and updates the ten-year long-range finance plan. The annual cost-of-service analysis provides the necessary support to seek board approval on Metropolitan's rate structure. The ten-year long-range finance plan is used for capital planning and decision-making purposes. The plan is updated every three years, with the most recent update published in July 2004. The Financial Planning Section utilizes water rate forecasting models in preparing the cost-of-service analysis and the ten-year long-range finance plan. Those models are used to determine water rates and capacity and readiness-to-serve charges for the current year and to estimate the same for the next ten years.

**Opinion**

In our opinion, the accounting and administrative procedures over the water rate forecasting process include those practices usually necessary to provide for a generally satisfactory internal control structure. The degree of compliance with such policies and procedures provided effective control for the period July 1, 2004 through December 31, 2005.

**Comments and Recommendations**

During our review, we noted a lack of succession planning. Specifically, we noted that the Financial Planning Section has two employees who are responsible for the water rate forecasting models. However, we noted that there is no backup or cross training to minimize disruption of workflow or knowledge gap during an employee's absence. In addition, we noted some potential areas of improvement in the procedures manual.

We recommend that the Financial Planning Section management identify core competencies for the positions and develop a plan for succession management. In addition, we recommend that

Financial Planning Section management establish a target date for updating the procedures manual to include sample exhibits of each model's key spreadsheets. Management concurs with these comments and will work to develop backup strategies.

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## Remote Site Activities Audit Report

**Background**

The Conveyance and Distribution Section consists of three regions: Eastern, Western, and Desert. The Eastern region includes Orange County, Riverside, Lake Skinner, and the Diamond Valley Lake Teams. The Western region includes Los Angeles, La Verne, and Valley Teams. The Desert region consists of Gene, Intake, Iron Mountain, Eagle Mountain and Hinds Teams. Our review evaluated the training, timekeeping, and reservation desk activities for the Orange County, Riverside, Lake Skinner, Los Angeles, La Verne, Gene, Intake, Iron Mountain, Eagle Mountain and Hinds Teams.

Operating Policy Section J-05 describes policies and procedures for the administration of training. Although the Human Resources Section's Training and Organizational Effectiveness Unit has overall responsibility for Metropolitan's training programs, line managers are responsible for identifying training needs and for ensuring that employees complete job related or mandated training. Operating Policy Section C-07 and Time Entry Business Rules manual provides policies and procedures to assist employees, timekeepers, and approvers in entering, monitoring, and approving time for accounting and payroll purposes. The Gene Facility Guest Services manual describes Metropolitan's policies and procedures concerning the Reservation Desk, lodging, and meals, which are provided to directors, employees, and their guests during an inspection trip.

**Opinion**

In our opinion, the operating and administrative procedures over remote site activities include those practices usually necessary to provide for a generally satisfactory internal control structure. The degree of compliance with such policies and procedures provided effective control for the period January 1, 2004 through October 31, 2005.

**Comments and Recommendations**

During our review, we noted instances of non-compliance with existing time-recording policies. Specifically, we noted that overtime and/or leave slips could not be located for many of the leave requests tested. Further review revealed that overtime and/or leave requests might have been communicated verbally or via emails rather than through leave or overtime slips.

We recommend that management review current policies and make revisions to ensure consistent guidance is provided to employees. In addition, we recommend that management emphasize the importance of complying with established policies and conduct periodic tests to ensure compliance with these policies and procedures.

We also noted instances of non-compliance with the Gene Facility Guest Services manual. Specifically, we noted incomplete reservation forms, a lack of manager approval on those forms, and late payment from employees for services received.

We recommend that management emphasize the importance of complying with established procedures and conduct periodic tests to ensure compliance with these procedures. In addition, we recommend that management review the current reservation form and make changes (e.g., manager's approval) to ensure reservation desk objectives can be realized. We further recommend that management encourage employees to reimburse Metropolitan immediately for the above expenses.

Finally, we noted issues with the meals and lodging monthly reports. Specifically, we noted reimbursements for lodging and meals totaling $2,000 was not forwarded for deposit on a timely basis. Also, we noted minor discrepancies between the quantity and value of meals reported on the monthly activity reports, and monthly reports were submitted between 47 and 139 days after month end.

We recommend that management emphasize the importance of preparing and submitting monthly reports accurately and timely. Management concurs with these findings.

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## Palos Verde Irrigation District (PVID) Forbearance and Fallowing Program Audit Report

**Background**

In August 2004, Metropolitan entered into a thirty-five year Forbearance and Fallowing Program Agreement with Palos Verde Irrigation District (PVID) to develop a flexible water supply up to 111,000 acre-feet per year through non-irrigation of Program qualified land and to provide assistance in stabilizing the farm economy within the PVID Valley. Participation in the program requires that qualified landowners execute landowner agreements with maximum term ending July 31, 2040 with PVID and Metropolitan. It also requires easement of proposed encumbered land described under the landowner agreements for execution and delivery into escrow, which Metropolitan established to receive funds and documents specified in the joint escrow instructions. Under this program and at Metropolitan's request, participating landowners would not irrigate their qualified land and PVID would authorize the diversion of saved Colorado River water to Metropolitan. Metropolitan is then required to make payments to participating landowners for encumbering and fallowing their land and to compensate PVID for related administration costs. Payments to each participating landowner include a one time sign-up payment of $3,170 per encumbered acre and an annual payment of $602 per fallowed acre for the first contract year, adjusted by 2.5% per year for the first ten years and then adjusted yearly by the CPI with a minimum of 2.5% and a maximum of 5% for the remaining years of the landowner agreement. An annual advance payment is also made to PVID to cover administrative costs during each contract year. In addition to the above one time sign-up payments estimated at $86.8 million and estimated annual payments of up to $16 million, Metropolitan is also required to pay $2.9 million for program setup costs and consulting fees and $6 million for community improvement programs.

Landowners initially executed seven-month interim agreements effective from January 2005 through July 2005 with Metropolitan so that they can fallow land while waiting to close escrow. Several of these interim agreements were extended to July 2006. As of October 2005, there were

78 executed landowner agreements, of which 43 had closed escrow and 35 in escrow. In addition, there were 16 landowner agreements at early contract documentation stage. Landowner payments totaled $46.9 million, of which $26.7 million were for one time sign-up payments to landowners who had closed escrow and $20.2 million were for annual payments to landowners for fallowing qualified land.

In July 2002, Metropolitan also contracted with EcoPlan to provide scientific and technical support services in the planning and implementation of the Program. This contract was amended in July and September 2005 to allow EcoPlan to act as a liaison between PVID and participating landowners in the Palo Verde Valley, to evaluate and process landowner applications, and to verify fallowed fields and acreages. The 4 ½-year agreement with EcoPlan is capped at $450,000 and terminates on December 31, 2006. As of October 2005, $283,000 has been paid to EcoPlan for their consulting services.

**Opinion**

In our opinion, the accounting and administrative procedures over the 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 August 1, 2004 through October 31, 2005. Although this report expresses an acceptable opinion, we note some concerns over the management of the project. Our audit revealed that project timetables were often imposed upon Water Resources Management staff, project particulars were modified without formal notice, and project expectations (deliverables) did not always reflect the nature of the work performed or the challenges encountered. We recommend a closer collaboration between executive and line management for future projects of this complexity and sensitivity.

**Comments and Recommendations**

As noted in the opinion, our audit revealed some concerns over the management of the project. Specific concerns in this area are presented in detail, while additional comments on the Program are summarized.

MONITORING, TRACKING AND RECORDING OF CASH ADVANCES AND EXPENSES

The Program agreement requires Metropolitan to provide an annual cash advance ($599,000 in the initial contract year 2004-05) to PVID to cover Program administration costs incurred during the contract year. In addition, Metropolitan's community improvement agreement with PVID also requires advance cash payment of $100,000 to fund the setting-up of non-profit benefit corporation Palo Verde Valley Community Improvement Fund (PVVCIF).

During our review of PVID cash advances totaling approximately $699,000, we noted:

- Initial Contract Year Cash Advance of $599,000 (Reimbursable Fund)

(1) The Accounting Operations Team expensed the entire $599,000 although only $429,000 was withdrawn from the bank during the initial program year (July 2005) to pay for program expenses and PVID's administrative costs. As a result, the Reimbursable Fund had a remaining balance of $170,000, including $5,000 interest earned on the account.

This resulted in an overstatement of expenses and an understatement of assets by $170,000 for the initial contract year ending July 2005.

(2) Metropolitan was required to advance $480,000 to PVID to cover program expenses for the second contract year. As stated above, there was a $170,000 balance remaining in the Reimbursable Fund that Program Management could have used to reduce the $480,000 obligation. However, at the time the second contract year budget was being prepared, Program Management and PVID estimated the remaining balance to be $100,000, as PVID was not able to provide the true-up report in time. As such, Program Management advanced an additional $380,000. When the final accounting was completed and it was determined that the remaining balance was $170,000, the excess cash advance of $70,000 should have been returned to Metropolitan. Management has subsequently received a refund of the $70,000.

(3) We could not locate PVID's supporting documentation to verify the basis for charging the program a 95.35% overhead rate and a 15% markup rate on consultant labor charges and other reimbursable costs. The Program Manager has indicated that PVID is currently compiling the required supporting documentation.

- Cash Advance of $100,000 (Community Improvement Fund). Metropolitan's Community Improvement agreement with PVID required an advance cash payment of $100,000 paid by Metropolitan in December 2004 to cover initial costs for establishing the PVVCIF, a non-profit benefit corporation that will oversee $6 million mitigation funds established by the Program agreement in support of the economic growth in the Palo Verde Valley. Under this agreement, PVID is required to return any excess cash advance to Metropolitan by December 2007. As of October 2005, approximately $23,000 was paid to expert business development consultants, who assisted in the evaluation of PVVCIF board structure, finalization of bylaws, and compilation of business plans. We noted that the remaining excess cash balance amounted to $78,000, including $1,000 interest earned on the account. However, Metropolitan has not been provided copies of the program's monthly bank statements or summaries of program expenses. PVID Program Manager indicated that a request has been made to PVID to provide copies of monthly bank statements to Metropolitan on a go-forward basis. In addition, since the $100,000 cash advance was capitalized to program set-up costs, we noted that the amortization expenses were overstated by $2,000 as of October 2005.

We recommend that Accounting Operations Team and Program Management develop procedures to ensure proper monitoring, tracking, and accounting of PVID cash advances, including balances remained in the Reimbursable Fund and Community Improvement Fund. We also recommend that the Accounting Operations Team prepare adjusting journal entries to correct the above errors to ensure accurate reporting of program expenses. We further recommend that Program Management obtain supporting documentation from PVID for the calculation of standard and overhead rates and for costs incurred under the Community Improvement agreement, including bank statements.

RECONCILIATION OF LANDOWNER SIGN-UP FEES

For the Program, Program Management tracks all one time sign-up and annual payments made to landowners on an Excel spreadsheet, and the Accounting Operations Team records these fees and payments and related amortization to the appropriate general ledger accounts.

During our review of Program costs, we noted that the sign-up fees recorded in the general ledger are not periodically reconciled to the landowner agreement tracking spreadsheets prepared and maintained by Program Management.

We recommend that Accounting Operations Team perform periodic reconciliation of the "PVID Participation Rights" general ledger account and prepare adjusting journal entries to properly record sign-up fees and corresponding amortization. We also recommend that Program Management promptly provide the sign-up and annual payment tracking spreadsheets to the Accounting Operations Team so that they can perform the reconciliation noted above.

VERIFICATION OF ENCUMBERED AND FALLOWED LAND

Under the Program agreement, PVID's responsibility includes verifying compliance of participating landowner's land with the Program's qualification requirements such as land irrigated for two years within a five-year period. PVID is also responsible for verifying the correctness of qualified and encumbered acreages specified in the land participation offers against PVID's records.

During our review of ten landowner agreements, we noted that the reported encumbered and fallowed acreages under Agreement No. 63900 were overstated by 20 acres when verified against the recorded acreages in the PVID Annual Crop Reports. This overstatement resulted in approximately $64,000 overpayment in sign-up and annual payments to the landowner.

We recommend that Program Management work with PVID and the landowner to amend Agreement No. 63900 to reflect the actual acres of encumbered and fallowed land. We also recommend that Program Management encourage PVID and EcoPlan to conduct timely verification of encumbered and fallowed acreages. Furthermore, we recommend that Program Management perform periodic testing to ensure contractual acreage is realized.

REVIEW OF ESCROW AND TITLE FEES AND SELECTION OF ESCROW COMPANY

Metropolitan selected escrow company Orange Coast Title Company (OCTC) to handle funds for delivery to the landowner and to deliver documents to PVID and Metropolitan upon performance of all conditions of the Landowner agreement. To ensure reasonableness and proprietary of escrow charges, Program Management and\or Real Estate team should verify invoice charges against the escrow company's fee schedule before approving for payment.

During our review of sixteen OCTC escrow invoices, we noted:

a) We could not verify the billed escrow fees against OCTC's fee schedule for all sixteen invoices selected for testing. Metropolitan's Real Estate Team indicated that OCTC uses a tiered pricing schedule based on the range to which a transaction value falls to determine its escrow fees. Although we understand that escrow fees vary from company to company, we compared escrow fees charged by different companies and noted that their fees can be calculated based on transaction values and predetermined formulas and therefore, can be verified for validity of charges.

b) We noted that title fees for nine of sixteen invoices reviewed were billed at rates other than basic rates. Specifically, we noted that three items were billed above basic rates and six at below basic rates. However, this billing inconsistency did not result in a material over/underpayment.

In addition, we could not locate documentation for the selection of OCTC as the escrow company. We noted, however, that OCTC was approved by Program Management to act as the Program's escrow company.

We recommend that Real Estate Team consider negotiating escrow fees, which can be verified against the level and type of services performed, for all future escrow agreements. In addition, we recommend that Real Estate Team and Program Management work with OCTC to ensure that title fees are billed at the appropriate rates. Furthermore, we recommend that the Real Estate Team, in conjunction with the PVID Management, consider comparing escrow companies to ensure quality service and competitive pricing and documenting the result of its review process.

PROCESSING OF LANDOWNER AGREEMENTS AND CLOSING OF ESCROW

Efficient processing of landowner and escrow agreements is necessary to ensure that program goals and objectives can be achieved.

During our review, we noted that it took approximately four to ten months to close escrow. The Program Manager indicated that the delay in processing landowner agreements and closing escrow was caused by staffing shortage at OCTC during early program implementation stage; landowner's inability to provide required documentation timely; lender's reluctance to work with subordination agreements; and multiple revisions of agreements due to joint ownership of farmland.

We recommend that Program Management continue to work with PVID Management to coordinate efforts; follow-up with landowners for required documents; and encourage the escrow company to expedite its processing of agreements and closing of escrow.

PROGRAM ADMINISTRATION PROCEDURES

During our review, we noted that Program Management is in the process of completing the Program's procedures manual. We noted, however, that the draft manual does not address roles and responsibilities for the administration of the program by Metropolitan staff (Program Management, Right-of-Way Team, Real Estate Team), PVID Management, and program contractors (EcoPlan, OCTC).

We recommend that Program Management establish a target date for the completion of the Policies and Procedures manual for the Program.

We conducted detailed discussions with Water Resources Management and they are in concurrence with the comments and recommendations. Further, they are preparing an action plan to address the control concerns.