

- **Internal Audit Report for January 2008**

Summary

Four reports were issued during the month:

- **Fluoridation Program California Dental Association Foundation Funding Agreement Audit Report – Less Than Satisfactory**
 - **Tectonics & Tetra Design, Incorporated Agreements Audit Report – Less Than Satisfactory**
 - **High Efficiency Clothes Washers Audit Report – Generally Satisfactory**
 - **Security Practices at Union Station and Other Metropolitan Facilities Follow-up Audit Report**
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Discussion Section

This report highlights the significant activities of the Internal Audit Department during January 2008. In addition to presenting background information and the opinion expressed in the audit report, a discussion of findings noted during the examination is also provided.

Fluoridation Program California Dental Association Foundation Funding Agreement Audit Report

Background

In February 2003, Metropolitan adopted a policy to implement a fluoridation program at its five water treatment plants. In December 2003, Metropolitan entered into a Fluoridation Funding Agreement not to exceed \$5.5 million with the California Dental Association Foundation (CDAF), a nonprofit public benefit corporation, to assist Metropolitan in implementing fluoridated community water. Under the terms of the agreement, Metropolitan is reimbursed for eligible program costs related to the design, construction, fabrication, and installation of equipment necessary to provide water fluoridation at Metropolitan's water treatment facilities. The fluoridation facilities include fluorosilicic acid storage tanks; tank foundations; chemical feed facilities; spill containment capabilities; piping; and fluoride analyzers. Fluorosilicic acid was selected as the most cost-effective bulk chemical for use in the fluoridation process.

The funding agreement included two program phases. Phase I included all work necessary to provide fluoridation capacity in Metropolitan's treatment facilities, while Phase II included operating and maintaining the project for twelve months, following the completion date of Phase I. At the request of Metropolitan, Phase I was extended twice from its original completion date of December 2006 to October 2007.

Opinion

In our opinion, the accounting and administrative procedures over the Fluoridation Funding Agreement provide for a less than satisfactory internal control structure. This opinion is the result of cost overruns incurred for the fluoridation project and failure to report such cost overruns to

Senior Management in a timely manner. It should be noted that Project Management immediately initiated remedial actions in response to these concerns.

Comments and Recommendations

TIMELY SUBMISSION OF INVOICES

Invoices requesting reimbursement of expenditures related to grants should be submitted to grantor organizations in a timely manner to ensure prompt collection of funds and accurate grant revenue reporting. Specifically, the CDAF Agreement (Section 7(a) – “Reimbursements by Foundation”) permits submission of quarterly invoices for eligible program costs. During our review of agreement invoices totaling \$2.4 million, we noted that program expenditures were often not submitted in a timely manner to the Controller’s Office for subsequent invoicing to CDAF. Specifically, we noted:

1. Expenditures totaling \$1.3 million incurred from January 2004 through March 2005 (five quarters) were not invoiced until May 13, 2005.
2. Expenditures totaling \$343,000 incurred from April 2005 through September 2005 (two quarters) were not invoiced until November 19, 2005.
3. Expenditures totaling \$779,000 incurred from October 2005 through December 2006 (five quarters) were not invoiced until March 9, 2007.

We recommend that the Agreement Administrators and the Water System Operations Business Management Team review currently available agreement expenditure reports and ensure prompt invoicing, in accordance with agreement terms.

COMPLIANCE WITH TERMS AND CONDITIONS OF THE AGREEMENT

Compliance with contractual requirements is necessary to ensure accurate accounting records, proper supporting detail, and adequate control over the administration of the agreement. Compliance with the contractual terms and conditions of the agreement also ensures that parties fully discharge their duties and obligations and exercise their legal rights associated with the agreement. Our review of program cost accumulations, reimbursement checks, and contractual requirements revealed:

1. Ineligible program costs totaling \$336,000 were erroneously billed to CDAF. Specifically, we noted that costs related to the Skinner Chemical System Modifications (new chemical tank farms and feed systems for ferric chloride, ammonia, and sodium hydroxide) were accumulated on a task number, which was subsequently included in the Fluoridation Funding Agreement expenditure report. It should be noted that CDAF Agreement (Section 2 – “Purpose of Funding”) allows reimbursement of costs associated with the design, fabrication, installation, and construction of the fluoridation project in Metropolitan’s treatment facilities related only to water fluoridation capacity.
2. The second extension to Phase I’s completion date was not approved in writing by the CDAF. However, the Agreement (Section 9 - “Final Inspection”) required written approval from CDAF for any extension of the Phase I completion date. It should be noted that the first extension was properly approved by CDAF.

3. Funds received from CDAF were deposited directly to Metropolitan's commercial bank account rather than into a separate bank account, as required by the CDAF Agreement (Section 6 – "Separate Account").

We recommend that the Agreement Administrators: (1) Provide credit of \$336,000 to CDAF for ineligible program costs noted above; (2) Obtain written approval from CDAF for the second extension and for all future extensions that may be necessary to complete the fluoridation project; and (3) Work with CDAF to amend the agreement, specifically deleting Section 6 ("Separate Account" section) and revising Section 12(a) ("Separate Accounting of Grant Disbursements").

PROJECT COST OVERRUNS

Management reports are designed to provide meaningful information to Managers to support them in their assessment of day-to-day activities and in developing effective strategic plans. These reports can take the form of text, graphs, and tables and can be informative (e.g., raw financial data) and/or analytical (e.g., number/dollar of extra work orders approved, percentage of project completed versus budget expended). Management's review of these reports is necessary to ensure that the desired outcome and the District strategies are being met and to secure Senior Management's involvement, as warranted.

During our audit, we noted that Fluoridation final costs exceeded the project budget. These cost overages were the result of unanticipated health and safety upgrades; redesign expenses and the fact that the project budget did not include a cost contingency factor. Furthermore, we noted that the Board appropriation was closed in July 2007, and that Project Management did not report these cost overruns to Senior Management in a timely manner.

At the January 7, 2008 Engineering and Capital Programs Committee Meeting, Project Management requested that the Board authorize the reopening of Appropriation No. 15414 for the completion of the Fluoridation Program. Further, Management also presented a list of Lessons Learned with associated recommendation for corrective action. We support these recommendations and will work with Management to evaluate these solutions.

SAFEKEEPING AND TIMELY DEPOSIT OF REMITTANCES

Prudent business practices dictate that all monies received be promptly deposited in a Metropolitan bank account. Furthermore, strict physical control should be maintained when handling these items in order to establish accountability and to safeguard assets. These physical controls should include assurance that items not deposited or processed at the end of the day should be placed in a safe or locked file cabinet and operating controls established to ensure that these items are processed the next business day. Once processing is complete, reconciliations and supervisory reviews over the cash receipts process should be performed to ensure timely and accurate recordation. For Metropolitan, Operating Policy C-09 outlines the procedures for handling remittances and the responsibilities of receiving agents (e.g., mail services, treasurer, business services). These policies require that all remittances received at Union Station Headquarters and field offices be sent to the Treasurer for deposit, along with a completed collection report.

During our review, we noted that a check for \$131,749 received from the California Dental Association Foundation (CDAF) was not deposited on a timely basis. Specifically, we noted that this item was deposited on September 28, 2007; fourteen days after Mail Services received it.

Further review revealed that this item was a replacement check requested from the CDAF for an item that was reported lost by Metropolitan. That is, our review revealed that Mail Services received the original check on July 6, 2007; however, this item was lost and staff requested that CDAF void the original check and issue a replacement. CDAF complied with this request and issued a replacement check on August 22, 2007. However, this item, which was received on September 14, was not deposited until September 28, 2007.

We recommend that the Treasurer deposit all cash receipts on a prompt basis. We also recommend that Group Management remind the receiving agents of the need to comply with the remittances handling/processing policy and conduct periodic reviews to ensure compliance.

Tectonics & Tetra Design, Incorporated Agreements Audit Report

Background

Metropolitan implemented the Oxidation Retrofit Program (ORP) to provide Treatment Plants an alternative disinfectant process (i.e., ozone) that would remove blend restrictions and substantially lower disinfection by-product levels for compliance with the United States Environmental Protection Agency's Disinfectant/Disinfection By-Products Rule. Accordingly, in October 2002, Metropolitan contracted with Tectonics in an amount not to exceed \$500,000 to provide architectural services to the Skinner Treatment Plant ORP. Furthermore, in January 2003, Metropolitan contracted with Tetra Design, Inc. in an amount not to exceed \$500,000 to provide architectural services to the Weymouth Treatment Plant ORP. These agreements were critical to the implementation of the ORP for the Skinner and Weymouth Treatment Plants.

Since inception, these contracts were amended several times to provide for additional services, revise the scope of work and fee schedules, and to increase the contract amount. Currently, the Tectonics contract is for \$1.5 million and it expired in October 2007; whereas the Tetra contract is set at \$2.2 million and it will expire in December 2008. Through July 2007, Metropolitan has paid Tectonics \$1.2 million and Tetra \$1.8 million under their respective agreements.

Opinion

In our opinion, the accounting and administrative procedures over the agreements include those practices usually necessary to provide for a less than satisfactory internal control structure. This opinion is the result of overbilling errors on consultant and sub-consultant labor charges billed on Tetra Design Inc.'s invoices. It should be noted that project management immediately initiated remedial actions in response to these concerns.

Comments and Recommendations

REVIEW OF CONSULTANT AND SUB-CONSULTANT CHARGES

Review and approval controls are designed to verify the accuracy of billings, provide assurance as to the propriety of transactions, and ensure that follow-up procedures for exceptions exist. For the Tectonics and Tetra agreements, consultants and sub-consultant labor charges should be verified against payroll records and appropriate fee schedules. Our review of timesheets for three of twenty-four selected consultant and sub-consultant employees revealed overbilling errors totaling \$10,876, as follows:

Employee	Consultant/ Sub- Consultant*	Invoice No.	Invoice Date	Period Covered From-To	Billed Hours	Actual Hours	Overbilled Hours	Rate	Overbilled Amount
1. M. Daley	Ahbe*	1,3 & 4	3/7/06	1/1/06-2/28/06	221	162	59.0	134	\$ 7,906
2. A. Herrera	Tetra	8	8/11/05	5/1/04-8/31/04	19	1	18.0	98	1,764
3. M. Buckland	Tetra	8	8/11/05	5/1/04-8/31/04	18	0	18.0	67	1,206
Total									\$10,876

We recommend that the Agreement Administrator seek reimbursement from the consultant for the \$10,876 overbilling noted above. We also recommend that the Agreement Administrator review Ahbe's other paid invoices to ensure accuracy of sub-consultant charges. Further, we recommend that the Agreement Administrator conduct periodic review of timesheets to ensure accuracy of billed labor hours.

COMPLIANCE TO BILLING AND PAYMENT REQUIREMENTS

Compliance with contractual requirements is necessary to ensure accurate accounting records, proper supporting detail, and adequate control over the administration of the agreement. Compliance with the contractual terms and conditions also ensures that parties fully discharge their duties and obligations and exercise their legal rights associated with the agreement. Our review of 10 selected consultant invoices (5 for Tectonics and 5 for Tetra) totaling \$1.4 million revealed:

1. All 5 (100%) Tetra invoices and 1 of 5 (20%) Tectonic invoices were not submitted on a monthly basis. Furthermore, charges included on invoices covered periods ranging from two to seven months. This was in contrast to the Billings and Payments Section of the agreements that required monthly invoicing.
2. Invoices were paid late on 3 of 5 (60%) Tetra invoices and 4 of 5 (80%) Tectonics invoices. Specifically, we noted that these invoices were paid between 5 to 40 days after the payment due date. This was in contrast to the Billings and Payments Section of the agreements that required payment within 30 days after receipt of the invoice.

We recommend that the Agreement Administrators resolve the noted discrepancies. Further, we recommend that the Agreement Administrators remind the consultants of the need to comply with terms and conditions of the agreements and conduct periodic reviews to ensure compliance.

High Efficiency Clothes Washers Audit Report

Background

From 1995 through 2002, Metropolitan entered into separate agreements with Member Agencies to provide financial incentives to residents who installed residential High Efficiency Clothes Washers (HECWs). These financial incentives were provided in the form of credits on Metropolitan's water invoices to Member Agencies, based on the number of HECWs installed.

These credits were then passed to the residential customer in the form of a cash rebate. From July 2003 through July 2004, Metropolitan entered into three-year Master Funding Agreements with Member Agencies to expand the program to provide financial incentives for installing HECWs, high-efficiency toilets, irrigation controllers, and other water saving devices. Finally, from July 2006 through July 2007, Metropolitan entered into ten-year Master Funding Agreements with Member Agencies to extend these programs. These programs differed not only in the length of each successive contract or by expanding the qualifying water saving devices, but by modifying the amount of the financial incentive and by establishing alternate funding sources.

As a background, before 1999 Metropolitan offered high rebates (\$200 - \$300 per unit) to generate interest in the HECWs' Rebate Program. However, in January 1999, this strategy was changed as rebates were reduced to \$35 per unit. Accordingly, Metropolitan pursued grants and other outside funding to provide additional incentives for consumers to implement HECWs. To this end, Metropolitan collaborated with Southern California Edison for additional rebates, obtained a CALFED grant, and received Proposition 13 and Proposition 50 funding through the Department of Water Resources. These programs have been instrumental in the success of the HECW Program. To wit, during the audit period, Metropolitan has credited Member Agencies \$11.3 million for their participation in these Master Funding Agreements. Furthermore, during this period, 103,300 HECW units were installed within Metropolitan's service area, which has resulted in lifetime water savings of approximately 60,400 acre-feet.

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 policies and procedures provided effective control for the period July 2004 through July 2007.

Comments and Recommendations

COMPLIANCE WITH TERMS AND CONDITIONS OF THE AGREEMENTS AND REBATE PROGRAM GUIDELINES

Compliance with contractual requirements and Rebate Program guidelines is necessary to ensure accurate accounting records, proper supporting detail, and adequate control over the administration of the Agreement and the Rebate Program. Our review of Member Agencies' compliance with the requirements of the Master Funding Agreements and the Rebate Program guidelines revealed:

1. Review of 2,946 rebates (\$324,060) processed by Long Beach Water Department disclosed rebates (\$110) were issued twice to the same address in four instances. This was in contrast to the Member Agencies' Program guidelines that allowed only one rebate per residential customer address. Further, we noted that Water Resources' Conservation team did not conduct periodic analysis of the Member Agency's rebate database to detect duplicate rebates, as is required in the "Other Terms" section of the Master Funding Agreements.
2. Review of five selected rebates (\$550) issued by the San Diego County Water Authority disclosed applicable supporting documentation, including rebate application, purchase receipt and water bill, could not be located for three rebates. Member Agencies' Program guidelines required that rebates be supported by rebate application, purchase receipt, and water bill.

Further, we noted that the current Master Funding Agreements lacked provisions that allowed Metropolitan to conduct periodic reviews of rebates to ensure program compliance.

3. Although the Master Funding Agreement with the Municipal Water District of Orange County ended in June 2007, the Agreement has not been closed as of November 2007. This was in contrast to the Conservation Team's current practice of closing out agreements within three months of termination. Close out procedures included necessary controls such as verifying rebate data and agreeing conservation credits memos to water invoices.

We recommend the Conservation Team work with the Member Agencies to resolve the duplicate payment and lack of supporting documentation issues noted above. Further, we recommend the Conservation Team conduct periodic analysis of the rebate databases, to detect duplicate payments in the future. Additionally, we recommend the Conservation Team review project files on a regular basis to ensure timely close out of expired or terminated agreements. In addition, we recommend that the Master Funding Agreements be amended to include provisions permitting the Conservation Team to conduct periodic reviews of rebates for compliance with HECW Program guidelines.

Security Practices at Union Station and Other Metropolitan Facilities Follow-up Audit Report

We performed a follow-up review of audit recommendations contained in the Security Practices Audit Report. This audit was rated as "Less Than Satisfactory" and included recommendations in the areas of physical access control and security monitoring, compliance with terms and conditions of the agreement, and review and approval controls.

Our follow-up procedures consisted of verifying that Management's corrective action plans were implemented and functioning effectively. Accordingly, we evaluated revised procedures and retested selected security controls. Revised procedures were deemed adequate and appropriate and review processes were improved. Our retesting of entrance gate security at the Weymouth and Diemer plants, however, resulted in noncompliance to security standards by the Contract Guards. The Security Unit Manager responded immediately to these findings. Specifically, same-day counseling of the guards by Securitas Management was conducted, a meeting between the Metropolitan Security Unit Manager and Securitas Regional Management was initiated, and additional testing of Contract Guards was conducted by Metropolitan personnel.

Continuous Audit Activities (monthly reviews)

Inland Feeder Project

Our review included agreeing actual costs reported to the Board to source documentation, including the general ledger, the Inland Feeder Project (IFP) Monthly Report, and selected contract payments; reviewing estimated costs at completion; analyzing changes in various cost

components; and attending on-site meetings held to review actual costs and discuss current problems. Our review did not reveal any material differences between reported amounts and supporting documentation.

In addition, our ongoing review procedures for potential claims, liability exposures, and other pending issues have been designed to track such items in accordance with applicable reporting requirements under Financial Accounting Standards #5 (Accounting for Contingencies). Accordingly, for all pending legal claims, we consulted with the Chief Financial Officer, IFP management, or General Counsel's office to evaluate the magnitude of potential loss to Metropolitan. It should be noted that the IFP Project Manager reports on contractors' claims currently in litigation and other potential claim issues to the Board monthly.

Internal Controls over Financial Reporting Controls

We assisted the Controller's Section in the completion of an assessment of the internal controls over financial reporting. This assessment is based on the COSO internal control framework and includes identification of general ledger accounts and business processes to be included in the project, documentation and testing of the business processes/control activities, evaluation of operating effectiveness, and communication of any internal control deficiencies.