



- **Internal Audit Report for June 2008**

Summary

One report and one Comfort Letter were issued during the month:

- **Residential Toilet Programs Audit Report**
 - **Official Statement for the Water Revenue Refunding Bonds, 2008 Authorization, Series B**
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Discussion Section

This report highlights the significant activities of the Internal Audit Department during June 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.

Residential Toilet Programs Audit Report

Background

In 1992, Metropolitan entered into separate agreements with Member Agencies to provide financial incentives to residents who installed ultra-low flush toilets (ULFT). These financial incentives were provided in the form of credits on Metropolitan's water invoices to Member Agencies based on the number of ULFTs installed, after the Member Agencies provided cash rebates to their residential customers. This program continued unchanged through 2002. In July 2003, Metropolitan authorized three-year master residential funding agreements with Member Agencies to expand the program to provide financial incentives for installing high-efficiency toilets (HET), high-efficiency clothes washers, weather-based irrigation controllers, and other water saving devices. In July 2006, Metropolitan entered into nine year master residential 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 also by modifying the amount of the financial incentive and establishing alternate funding sources.

As noted, Metropolitan began the ULFT incentive programs in October 1992. The incentivized ULFT units are water-saving toilets that use 1.6 gallons per flush, compared to the 3.5+ gallons per flush for conventional (non-conserving) toilets. The incentive programs were implemented through the Member Agencies to provide ULFTs to residents via distribution events and rebate programs. To make the program work effectively, Member Agencies worked with vendors and community-based organizations to promote the water saving units. These efforts were successful in exchanging about two-thirds of the ULFTs through distribution events where residential customers exchanged their conventional toilets for ultra-low flush units. The remaining retrofits were the result of rebate programs where residents received a cash rebate from Member Agencies for ULFTs they purchased on their own. Metropolitan provides a financial incentive of \$60 for each ULFT installed, with an additional amount of financial assistance (from \$0 to \$50) provided by the Member Agency. Therefore, the total financial incentives range from \$60 to \$110 for each ULFT installed. The ULFT program will end in December 2008.

Next, Metropolitan initiated a new retrofit program in 2005 that emphasized the use of HET. The HET units use 1.28 gallons or less per flush and conserve about 20% more water than ULFTs. Metropolitan provides an incentive of \$165 for each HET installed, with an additional amount ranging from \$0 to \$235 received from Member Agencies.

In February 2006, Metropolitan received Proposition 50 grant (\$1 million) from the Department of Water Resources. This grant provides an additional financial incentive of \$100 for each HET installed. Therefore, the total financial incentive for installing a HET ranges from \$165 to \$500 (\$165 + 235 + 100) per unit. During the audit period, Metropolitan has credited Member Agencies \$10.5 million for their participation to the ULFT and HET programs. During this period, 116,304 ULFTs and 21,347 HETs were installed within Metropolitan's service area which has resulted in lifetime (20 years) water savings of approximately 106,000 acre-feet.

Opinion

In our opinion, the accounting and administrative procedures over Water Conservation Program – Residential Toilet Replacement 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 2005 through June 2007.

Comments and Recommendations

REVIEW AND APPROVAL OF TRANSACTIONS

Our review and analysis of Member Agency database information for rebated ULFTs revealed that Metropolitan overpaid Los Angeles Department of Water and Power (LADWP) by \$18,780. This overpayment represents ineligible ULFT rebates included in LADWP's January 2007 invoice to Metropolitan. These rebates were ineligible for funding by Metropolitan because they did not comply with the supplemental purchase specification requirements under the rebate program, such as exchange of replaced conventional (non-conserving) toilets.

We recommend the Regional Supply Unit obtain reimbursement from LADWP for the \$18,780 overpayment. We also recommend the Regional Supply Unit conduct periodic analysis of database information and thorough review of member agency invoices and supporting documentation.

COMPLIANCE WITH TERMS AND CONDITIONS OF THE AGREEMENTS

Compliance with contractual terms (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 36 rebates issued by 6 Member Agencies (6 rebates each) revealed:

1. Supporting documentation (rebate application and purchase receipt) for 11 of 36 rebate payments could not be located. These rebates were dated in 2005 and were submitted by Inland Empire Utilities Agency (6 instances) and LADWP (5 instances). In addition, we noted that the rebate processor contracted by Inland Empire in July 2006 went out of business

in February 2007. As a result, the supporting documentation for rebates (approximately \$110,000) processed by this contractor from July 2006 through January 2007 were not available for review. This lack of rebate supporting documentation is in contrast to Section 9.2 of both the prior and current master residential funding agreements that requires Member Agencies to make available for inspection by Metropolitan all records, books, computer files, and other documents relating to the rebate program.

2. Invoices from the Inland Empire Utilities Agency and the West Basin Municipal Water District were submitted on a quarterly, semiannual or annual basis. This is in contrast to Section 8.1 of the current master funding agreements that requires Member Agencies to submit monthly invoices to Metropolitan on or before the 15th day of the following month. In addition, we also noted sporadic delays in the submission of monthly invoices from the LADWP.
3. Closeout procedures utilized by Water Resources Management do not provide for timelines or due dates to closeout agreements. As a result, agreements that ended in June 2006 with three Member Agencies (Central Basin/West Basin Municipal Water Districts, Municipal Water District of Orange County and San Diego County Water Authority) have not been closed as of March 2008. Further, five other agreements with Member Agencies (Calleguas Municipal Water District, City of Beverly Hills, City of Pasadena, City of Santa Monica and Las Virgenes Municipal Water District) were closed from 9 to 19 months after the agreements' June 2006 termination. These procedures include verifying rebate data and agreeing conservation credits memos to water invoices.

We recommend the Regional Supply Unit work with the Member Agencies to resolve the lack of rebate supporting documentation and untimely submission of invoices issues. We also recommend the Regional Supply Unit develop timelines for closing out agreements and include them to the existing closeout procedures.

Official Statement for the Water Revenue Refunding Bonds, 2008 Authorization, Series B

The Audit Department has completed a review of the Official Statement for the Water Revenue Refunding Bonds, 2008 Authorization, Series B. This review was undertaken to provide the underwriters of the Water Revenue Bonds (Bonds) "comfort" that the Official Statement for the Bonds is complete, consistent with supporting financial records, and accurate in all material respects. This review was completed and no exceptions were noted. We issued letters describing the agreed upon procedures, and the results obtained, to the underwriters of the Bonds.

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. We also reviewed the procedures designed to dispose of salvaged equipment to ensure the safeguarding of assets and the propriety of the processes. 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

We continued our assistance to 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. For fiscal year 2007/08, these efforts involved over 2,000 hours of internal staff time and are nearing completion. Accordingly, I will present an opinion on the internal controls over financial reporting at the conclusion of the External Audit in August 2008.