



- Internal Audit Report for April 2009

Summary

Three reports were issued during the month:

- **Accounts Payable Audit Report**
- **Chemical Management Audit Report**
- **Mussel Containment Program Audit Report**

Discussion Section

This report highlights the significant activities of the Internal Audit Department during April 2009. In addition to presenting background information and the opinion expressed in the audit reports, a discussion of findings noted during the examination is also provided.

Accounts Payable Audit Report

Background

The Accounts Payable (AP) Unit provides administrative and fiscal support to assure that the liabilities of Metropolitan are met and properly recorded on the financial records. In addition, AP is responsible for processing payments for Metropolitan's financial obligations from approved invoices or purchase orders. It also ensures the timely payment of vendor invoices and director and employee expense vouchers, and maintains accurate records and control reports. Finally, AP is responsible for the review of applicable accounting reports and accounts payable registers to ensure accuracy and propriety.

For the period January 1, 2006 through December 31, 2008, the Accounts Payable Unit processed 67,246 invoices totaling \$2.7 billion for water costs, payroll, and goods and services (excluding State Water Project payments totaling \$1.5 billion). It should be noted that vendor payments decreased by \$120 million (12%) in 2008, compared to 2006 (from \$976.2 million in 2006 to \$856.2 million in 2008). This decrease was mainly due to completion of a number of major construction projects during the three-year period under review.

Opinion

In our opinion, the accounting and administrative procedures over the Accounts Payable Unit 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 2006 through December 2008.

Comments and Recommendations

COMPLIANCE WITH ESTABLISHED POLICY – LOST DISCOUNTS

Compliance with established policy is necessary to ensure accurate accounting records, proper supporting detail, and adequate control over the Accounts Payable Unit function. Prudent expenditure controls serve to assist Metropolitan in meeting cash flow objectives, as payment streams are maximized between float considerations and investment strategies. Incumbent with these practices, invoices should

be paid in accordance with their contractually specified payment terms (neither early nor late) to optimize cash flow, take advantage of early payment discounts, and ensure good vendor relations. The Accounts Payable Unit Handbook prescribes such practices, as it requires that invoices be paid within 30 days of receipt to obtain any cash discounts available.

Our review of the Invoice History Report for the period January 2006 through December 2008 revealed that 13,500 of 67,246 invoices (20%) were paid from 6 to 740 days late. Furthermore, our review of the Discounts Taken and Lost Report for the same period revealed that late payments on 777 invoices resulted in lost discounts of \$20,300. Metropolitan did, however, take vendor discounts of \$499,400 on 10,126 other invoices paid during this time period.

We understand that the Accounts Payable Unit is evaluating new imaging software that may assist in expediting the invoice approval and payment processes. We encourage Management to complete this evaluation and implement changes that facilitate timely payment of invoices. We also recommend that the Accounts Payable Unit Management remind employees of the importance in complying with prescribed accounts payable practices.

ACCOUNTS PAYABLE AGING REPORT

An Accounts Payable Aging Schedule is a list of accounts showing vendor/service providers, past due amounts, and the length of time they have been outstanding. The Accounts Payable Aging Report is used to reveal patterns of delinquency and identifies points where payment efforts should be concentrated. Metropolitan's Accounts Payable Unit performs a weekly review of the Accounts Payable Aging Report. Further, department procedures require that past due items be researched to resolve the payment "hold" status and initiate timely payment.

Our review of the Accounts Payable Aging Report, as of February 13, 2009 revealed that 596 of 1,738 (34%) outstanding invoices were 31 to 502 days past due, with the oldest invoice dated August 2007. Past due invoices totaled \$10.5 million as of that date.

We recommend that the Accounts Payable Unit Management work with the Group Managers to resolve these past due items. We also recommend that Accounts Payable Unit Management remind employees of the importance in complying with prescribed accounts payable practices

REVIEW AND APPROVAL OF INVOICES

Review and approval controls are designed to verify the accuracy of billings for goods and services, provide assurance as to the propriety of transactions, and ensure that follow-up procedures for exceptions exist. The reviewer and/or approver should review expenditures listed on the invoices for propriety and agree them to the source documents to ensure the accuracy and completeness of transactions.

We reviewed 30 invoices totaling \$1.7 million and noted that they were all reviewed and approved for payment by the appropriate level of Management. However, we noted that one of these invoices (from

Ecology Control Industries for slurry mix) was overbilled by \$16,500. The Agreement Administrator immediately requested a refund of this overbilling from the vendor.

We recommend that the Agreement Administrator ensure that the \$16,500 overbilling is deducted from the vendor's next invoice to Metropolitan. We also recommend that the Unit Manager remind the Agreement Administrator, and the administrative staff of the importance of a thorough review of invoices to ensure the accuracy of billed charges and completeness of supporting documentation. We also recommend that the Agreement Administrator perform periodic test of vendor invoices to ensure compliance.

Chemical Management Audit Report

Background

Chemical Management responsibilities are shared between the Corporate Resources and Water System Operations Group. The Contracting Unit in the Business Services Section of the Corporate Resources Group oversees the execution and administration of chemical purchase contracts; whereas, the Water System Operations Group staff is responsible for the ordering, delivery, handling, and use of chemicals throughout the conveyance and distribution system and in the water treatment plants.

Within the Water System Operations Group, the Water Treatment Section oversees the use of chemicals at the water treatment plants and is responsible for the Chemical Unloading Facility in Perris. The Chemical Unloading Facility is used for the delivery, storage, and transport of chlorine to the Robert B. Diemer Water Treatment Plant, Robert A. Skinner Water Treatment Plant, and Henry J. Mills Water Treatment Plant. The Conveyance and Distribution Section oversees the use of chemicals along the Colorado River Aqueduct, and at the treated water reservoirs within the distribution system. Finally, it is the responsibility of the Water System Operations Group, Business Support Teams (which support the water treatment plants and Conveyance and Distribution units) to obtain Management approval for day-to-day chemical orders, review vendor bill of ladings, and record chemical receipts prior to the payment of invoices by the Accounts Payable Unit.

Metropolitan's treatment plants, conveyance system, and distribution reservoirs use bulk chemicals for a variety of purposes including water disinfection, coagulation, pH (hydrogen ion concentration) level adjustment, quagga mussel control, etc. For example, the treatment plants use over 9,000 tons of chlorine per year to disinfect the State Water Project and Colorado River waters. Other chemicals used include alum, ferric chloride, sulfuric acid, sodium hydroxide, sodium hypochlorite, ammonia, fluorosilicic acid, hydrogen peroxide, and oxygen (for the production of ozone). Chemical purchases for FY 2007/08 and for the six months ended December 2008 totaled \$22 million and \$15 million, respectively.

The Process Safety Management Program section of the Health, Safety and Environmental Manual establishes general policies, responsibilities, and requirements for complying with laws and regulations related to the use, storage, and handling of chlorine gas. Moreover, the Water Treatment Chemical Delivery/Security Protocol memorandum establishes practices for bulk water treatment chemical deliveries to ensure physical security, safety, quality assurance, and environmental compliance at

Metropolitan facilities. In addition, the Operating and Process Safety Procedures for Chlorine Manual establishes the procedures for storage, handling, and transportation of chlorine, as well as for preventing or minimizing the consequences of chlorine release at the water treatment plants and the Chemical Unloading Facility. Lastly, the Chemical Response Program Manual provides direction to Metropolitan employees for response to releases or potential releases of hazardous substances.

Opinion

In our opinion, the accounting and administrative procedures over Chemical Management 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 2006 through December 2008.

Comments and Recommendations

POLICIES AND PROCEDURES

Operational policies and procedures should be established and documented to provide for a framework for achieving Metropolitan's goals properly and adequately. Procedures provide Management with guidelines for consistent performance of daily operations, assist in the training of new employees, and provide a source of reference for experienced personnel. For the Water System Operations Group, formal chemical management policies would provide for consistent processes over the purchasing, delivery, storage, physical security, and use of chemicals.

While we recognize that Management has issued delivery/security protocol memoranda that prescribe safety practices for bulk chemical deliveries, and specific operating practices for chlorine handling, detailed formal chemical management policies that address the purchase, delivery, storage, physical security, and use of chemicals have not been developed.

We recommend that Management develop comprehensive chemical management policies and procedures. This chemical management policy could include other documents by reference to avoid duplication of existing procedures.

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 agreements. 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 agreements.

Our review of 70 invoices (30 invoices from Rhodia, Incorporated; 20 invoices from Olin Corporation; and 20 invoices from Ciba Specialty Chemical, Incorporated) totaling \$515,300 revealed three invoices totaling \$12,600 that were paid 33 to 102 days, after receipt of the invoice. Specifically, two Rhodia invoices were paid 33 to 39 days late, and one Olin invoice was paid 102 days late. This is in contrast to the payment terms of the agreements that require payment within 30 days after receipt of the invoice. We reviewed the Accounts Payable Aging Report as of December 2008, and noted that the four other

Olin invoices totaling \$23,563 were over 180 days old. It should be noted that the four Olin invoices were paid in March 2009.

We recommend that Accounts Payable, the Business Services Contracting Unit, and Water System Operations Group, Business Support Teams establish procedures to ensure that invoices are paid within the time period provided by the agreement. We also recommend that Management conduct periodic reviews to ensure compliance.

MAINTENANCE AND RETENTION OF RECORDS AND DOCUMENTS

Record retention policies and procedures are necessary to ensure that Metropolitan can document its historic business activity, summarize and analyze facts and figures to support Management reports, and chronicle strategic conclusions. Retention policies also ensure that necessary records and documents are adequately protected and maintained, and ensure that records no longer needed or that are of no value are discarded at the proper time. These policies are also for the purpose of aiding employees in understanding their obligations in retaining electronic documents including e-mails, Web files, text files, sound and movie files, PDF documents, and all other formatted files. Finally, Record Retention Schedules ensure that Metropolitan complies with applicable laws and regulations.

Our review revealed that Management has not established Record Retention Schedules for the Chemical Delivery Form (Checklist) used by the Chemical Unloading Facility and for the transport, storage, and use of chemicals at the water treatment plants.

We recommend that Management establish record retention policies for chemical deliveries, and storage and usage.

Mussel Containment Program Audit Report

Background

In February 2007, the Board authorized the Quagga Mussel Containment Program (QMCP) in response to the discovery of quagga mussel infestation within the Colorado River Aqueduct. The growth of quagga mussels, if unchecked, would reduce the hydraulic capacity of canals, siphons, and pipelines, and would also require regular shutdowns and millions of dollars annually for physical cleaning. The purpose of QMCP was to develop a comprehensive plan that incorporates enhanced detection, surveillance, and mitigation strategies. QMCP is administered by the Water Quality Section of the Water System Operations Group. As of December 2008, the costs incurred for the QMCP totaled \$6.1 million of the \$9.6 million budget. QMCP is conducted in three phases.

Phase I consisted of surveillance, investigative study, and vulnerability assessment of the water conveyance system conducted during the first six months of the program. It also included feasibility studies for managing recreational facilities at Diamond Valley Lake and Lake Skinner. During Phase I, staff developed a surveillance program for the conveyance system and in-house capability to conduct veliger (larval stage) analyses. Staff conducted a vulnerability assessment of the conveyance system to establish a risk-based prioritization of facilities for preventive infrastructure upgrades and for control

measures. In addition, staff developed a comprehensive plan for management of invasive mussels, with input from federal agencies and universities. As part of Phase I, staff placed into service temporary chlorine feed systems at the outlets of Copper Basin and Lake Mathews.

Phase II consisted of short-term needs for the next three years of infrastructure upgrades and a comprehensive, multi-year approach for mussel management. These included the construction of infrastructures identified by the vulnerability assessment conducted in Phase I. In September 2007, the Board authorized \$5.5 million for the design and construction of interim chlorine feed systems at the outlets of Copper Basin and Lake Mathews to enhance Phase I's temporary facilities. Additional funding of \$1.9 million was authorized by the Board to complete the construction of Lake Mathews' facilities. In February 2008, the Board authorized \$1.8 million for the design, procurement, and construction of the new chlorine injection point at Lake Skinner. Construction of Copper Basin and Lake Mathews' facilities was completed in June and October 2008. Construction of the Lake Skinner facility is in progress.

Lastly, Phase III will implement prioritized infrastructure upgrades identified by work conducted in Phase II and optimize costs. Phase III will also incorporate, as appropriate, strategies for the management of quagga mussels as identified by in Phase II.

Opinion

In our opinion, the accounting and administrative procedures over the Quagga Mussel Containment 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 from February 2007 through December 2008.

Comments and Recommendations

POLICIES AND PROCEDURES

Operational policies and procedures should be established and documented to provide for a framework for achieving Metropolitan's goals properly and adequately. Procedures provide Management with guidelines for consistent performance of daily operations, assist in the training of new employees, and provide a source of reference for experienced personnel. For Water System Operations, formal Quagga Mussel Containment policies and procedures would provide for consistent processes over the testing, delivery of chlorine, and acceptable levels of containment.

While we recognize that Management has just begun to deliver chlorine treatment to combat the quagga mussel infestation, detailed formal policies that address the chlorine delivery, testing, and acceptable benchmarks have not been developed.

We recommend that Management develop comprehensive Quagga Mussel Containment policies and procedures.

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. These meetings included extensive discussions on the progress of obtaining pipe hauling permits from the city of San Bernardino and the impact that these efforts have on project costs. 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 Manager reports on contractors' claims currently in litigation and other potential claim issues to the Board monthly.