THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

Report

Office of the General Auditor
May 31, 2009

- Internal Audit Report for May 2009

Summary

Four reports were issued during the month:

- **Skinner Oxidation Retrofit Shimmick/Obayashi Contract 1609 Audit Report**
- **Revenue Cycle Audit Report**
- **Eurest Dining Services Contract 44191 and 87568 Audit Report**
- **Official Statement for the Water Revenue Refunding Bonds, 2009 Authorization, Series A-1 and A-2**

Discussion Section

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

Skinner Oxidation Retrofit Shimmick/Obayashi Contract 1609 Audit Report

Background

In June 2005, the Board authorized Contract 1609 with Shimmick/Obayashi for a $184.7-million contract to construct the Skinner Oxidation Retrofit Project (Skinner ORP) and related structures and facilities. The Skinner ORP is one of the four oxidation retrofit projects implemented by Metropolitan. The oxidation retrofit projects provide the treatment plants an alternative disinfectant process (i.e., ozone) that would remove blend restrictions and substantially lower disinfection by-product levels for compliance with Stage 1 and Stage 2 of the United States Environmental Protection Agency's Disinfectant/Disinfection By-Products Rule.

Skinner ORP's Shimmick/Obayashi contract is comprised of four separate projects. Washwater Reclamation Project 1 involved the construction of a complete ozonation system to treat the existing plant capacity of 630 million gallons per day. This system consists of inlet control and plant rejection structures, ozone contactors, ozone generation building and destruction facility, liquid oxygen and chemical storage and feed systems, power substation and switchgear building, cooling water pumping station, access road, and reclaimed washwater return pumping station. Washwater Reclamation Project 2 included the replacement of horizontal paddle-wheel flocculators with vertical hydrofoil units, construction of access platforms and supports for the new flocculators, and replacement of existing tube settlers. Washwater Reclamation Project 3 involved the construction of an influent valve structure, a metering and chemical injection structure, and two trains of flocculation and sedimentation basins. Washwater Reclamation Project 4 is the construction of a new coal removal structure to reduce the rate of wear of Washwater Reclamation Project moving-part equipment, during the filter backwash process.

In July 2008, Metropolitan's Board authorized the General Manager to execute Change Orders to Contract 1609 and to increase the contract amount to $15.3 million (increase represents 8.27 percent of the original contract amount). These Change Orders were issued to resolve differences in actual conditions from what was shown on original drawings, correct discrepancies or errors in the design documents that were discovered during construction, modify or enhance contract drawings, and for the completion of Metropolitan-requested work. The construction of Skinner ORP and the three related facilities are scheduled to be completed in May 2009.

As of December 2008, Metropolitan has paid $174.4 million, including extra work orders of $8.8 million to Shimmick/Obayashi for this contract. Additionally, Metropolitan has paid $186.8 million, including extra work orders of $11.9 million on this contract through April 2009.

Opinion

In our opinion, the accounting and administrative procedures 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 December 2008.

Although this report expresses an acceptable opinion, concern is noted over the complex and aggressive project schedule that was necessitated by the nature of the work performed at the Robert A. Skinner Water Treatment (Skinner) Plant. In addition to the Skinner Oxidation Retrofit Project (Shimmick/ Obayashi Contract 1609), the Skinner plant was rehabilitating existing plant facilities, expanding the plant's treatment capacity, and constructing new chemical tank farms and chlorine and containment facilities. The operations of the Skinner plant could have been negatively impacted by these major construction projects, simultaneously undertaken within the confined space of the existing plant site. Through the joint efforts of the Water System Operations and the Corporate Resources Groups' Management and staff, the Skinner plant remained on-line during the construction of the above projects. While we commend Management and staff for their professionalism and competence, we recommend that Management take greater care in scheduling future projects in order to better stage complex construction schedules to avoid conflicting or overlapping projects.

Comments and Recommendations

SIGNIFICANT INCREASE IN UNRIPPABLE ROCK EXCAVATION COST

Article 67 of General Conditions for Specifications 1483 (Skinner Oxidation Retrofit Project and related facilities) specifies that the number of units and quantities contained in the bidding sheet are approximate only, and final payment shall be made for the actual number of units and quantities used or handled. In the event that work or materials for unit price bid items required to be furnished are in greater or lesser quantities than are indicated in the bidding sheet, such work or materials shall be paid in accordance with the unit prices quoted in the bidding sheet. Effective and prudent budgeting practices dictate that Project Management thoroughly research and investigate the work and materials for unit price bid items, prior to accepting the bid proposal to control construction costs.

Our review of selected progress payments totaling $72.1 million, as of December 2008 revealed a significant increase in contract cost for Bid Item 3, "Unrippable Rock Excavation", from an estimated $150,000 to $7 million (a 4,667 percent increase from the budgeted amount). Further review revealed that this increase was due to a mistake in the bid for rock quantities to be excavated from an original estimate of 750 cubic yards, to the actual total of 35,224 cubic yards.

We recommend that Corporate Resources Group Management remind Project Management to conduct a thorough review of bid estimates to ensure reasonableness, accuracy, and completeness of contract bids.

Revenue Cycle Audit Report

Background

Power Scheduling and Accounting Program staff, within the Water System Operations (WSO) Group's Operation Planning Unit, administers hydroelectric plant and excess power contracts. Real Estate Services Unit staff, within the Real Property Development and Management (RPDM) Group, is responsible for administering lease agreements. Staff from WSO and RPDM monitors power and rental activities. Requests for invoices are sent to the Revenues and Receivables Unit in the Controller's Section. Controller Section staff provide administrative and fiscal support to assure that the invoices are accurately prepared, processed, and recorded on the financial records. Additionally, Revenues and Receivables Unit staff perform month-end reconciliations of revenue and receivable transactions; reviews periodic accounts receivable aging reports for accuracy and completeness; and performs follow-ups of outstanding balances to ensure timely collection.

For the period July 1, 2008 through March 31, 2009, Metropolitan generated approximately $934.4 million in revenue, of which $823.1 million was operating revenue and $111.3 million was other revenue. Accounts receivable, as of March 31, 2009, was $187.7 million (20 percent of total revenue) of which $53.4 million (28 percent) was over 90 days past due. The past due balance consists of $40 million in Proposition 50 and $13.3 million in Proposition 13 grant billings to the State of California. Due to the state fiscal crisis, payment on these projects has been deferred although the state budget has been approved.

Opinion

In our opinion, the accounting and administrative procedures over Revenue Cycle 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, 2008 through March 31, 2009.

Comments and Recommendations

ACCOUNTS RECEIVABLE AGING – PAST DUE ACCOUNTS AND OUTSTANDING CREDITS

An Accounts Receivable Aging Report is a periodic report showing outstanding invoices issued to each customer, receivable balances, and the length of time they have been outstanding. Accounts Receivable Aging Reports reveal payment patterns of customers and identify where collection efforts should be focused, to ensure that Metropolitan will have funds in hand by a given date to meet its financial obligations. The Accounts Receivable Aging Report can also indicate the financial health of the customer and when it may be time to sever a relationship with a customer. The Controller's Revenues and Receivables Unit staff perform weekly review of the periodic aging, follow-ups with appropriate parties to initiate collection, or write-off the outstanding balances as bad debts.

Our review of the Accounts Receivable Aging Report, as of March 31, 2009, revealed that approximately $53.4 million (28 percent) of Metropolitan's receivable balances were at least 90 days past due. The past due balance includes $53.3 million due from the State of California and its agencies. Due to the state fiscal crisis, payments from the state have been deferred although the state budget has been approved. The past due amounts include:

Customer	Past Due Amount	Days Outstanding (Range)
California Department of Water Resources – Prop 13	$ 13,300,949	116-2939
State of California – Prop 50	$ 40,000,000	103
Arizona/California Railroad	$ 36,000	109-3553
Dominguez Technology Center	$ 21,215	235
State Board of Equalization	$ 7,759	2042-2404
Various	$ 8,324	117-2243
Total	$ 53,374,247	

We also noted:

1. The city of San Fernando has a credit balance of $428,923 that is to be applied against future water deliveries. Management stated that it will follow-up with city Management to confirm application of this credit.

2. Various credits totaling $11,362. Controller's Revenues & Receivable Unit staff is in the process of resolving these credit balances.

We recommend that the Controller's Revenues and Receivables Unit Management work with the Group Managers to resolve these past due items/credits and consider writing off amounts deemed uncollectible. We also recommend that Management remind employees of the importance in complying with prescribed revenue collection practices. We also recommend that Management consider not providing further goods or services to customers that consistently show having trouble paying invoices, unless outstanding receivable balances are brought up-to-date or some sort of payment arrangements are made.

COMPLIANCE WITH ESTABLISHED PROCEDURES

Operational policies and procedures are established to provide a framework for achieving Metropolitan's goals and objectives. Procedures provide guidelines for consistent performance of daily operations, assist in the training of new employees, and provide a source of reference for experienced personnel. Compliance with established procedures is necessary to provide for accurate and complete accounting records, proper supporting detail, and adequate control over Metropolitan's financial transactions. We reviewed 19 revenue generation invoices and noted:

1. Amount shown on one of three selected power revenue generation invoices (Invoice 35901) did not agree to the Energy Management System (EMS). Specifically, one of the invoice line items showed $102,080, while EMS showed $105,600 because the system only allows one field for the energy sell price. Staff also manually tracks power transactions in an Excel spreadsheet; however,

2. Invoice detail for one power revenue generation invoice still referenced an old contract number (SCE invoice 35906; contract A01434) instead of the new one (AR1093), which was effective June 20, 2008.

We recommend that Operations Planning Management remind employees of the importance in complying with established procedures and prescribed business practices. We also recommend that Management conduct periodic reviews to ensure compliance. Furthermore, we recommend that Management work with Information Technology Management to resolve noted EMS issue.

Eurest Dining Services Contracts 44191 and 87568 Audit Report

Background

In November 2001, Metropolitan entered into an agreement with Eurest Dining Services (Eurest) to provide food services to Metropolitan's employees, board members, and authorized guests at Metropolitan. This agreement, in effect from September 2001 through September 2007, was a cost-reimbursable contract that provides for payment of allowable incurred costs plus administrative fee. This agreement was amended several times to increase maximum amount payable from the initial maximum of $150,000 to $350,000 per year, change Agreement Administrator and Eurest key personnel, and to extend contract period through September 2007.

In October 2007, Metropolitan entered into a new agreement (87568) with Eurest to provide the same type of services as in prior agreement, with effective date from October 2007 through October 2009 as amended. This agreement, however, is a straight profit and loss rather than a cost-reimbursable contract. That is, Eurest receives and retains all income derived and bears all operating expenses resulting from its operations. Eurest's gross sales totaled $1.12 million, $1.15 million and $1.12 million in FY 2005/06, FY 2006-07 and FY 2007-08, respectively. As of December 2008, Metropolitan has paid a total of $1.4 million to Eurest under the two agreements.

Opinion

In our opinion, the accounting and administrative procedures over Eurest agreements provide for a less than satisfactory internal control structure. This opinion is the result of missing supplier invoices and employee time detail reports that support the contractor's reimbursable charges; missing catering orders and catering requests that support the contractor invoices; late payment of contractor invoices by Metropolitan; and the lack of documentation in support of shared cost components of the monthly billings. This opinion is also the result, in part, of the employee survey which rated the Eurest food service as "fair to good". It should be noted that Management has initiated remedial actions in response to our concern, and we will assist in the evaluation of solutions addressing this internal control structure concern while meeting operational needs.

Comments and Recommendations

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. Our review of 15 selected contractor invoices totaling $163,000 paid from FY 2002/03 through FY 2007/08 revealed:

1. Metropolitan's "shared costs" of paper products billed on 2 of 15 (13 percent) invoices did not agree to the supporting worksheets provided by the contractor. These billings resulted from a board request to use biodegradable paper products (where possible). The "shared cost" is defined as being equal to the weekly quantity used of biodegradable products, multiplied by the difference in unit cost between these products and regular paper products. Billed amounts for these invoices (1119400163 and 1119400508) totaled $2,634. In addition, we noted that several unit costs used in the worksheets did not agree to supplier invoices.

2. We could not locate documentation approving labor charges of $632 being billed as grocery purchases in invoice 1119400163.

3. We could not locate the supporting catering orders and catering requests for 2 of 15 (13 percent) invoices tested. Billed amounts for these 2 invoices (111945071 and 111945278) totaled $16,062.

4. Invoices were not signed and certified by the contractor and did not contain information regarding maximum amount payable and the total amount previously invoiced, in contrast to the requirements of the Billings and Payments Section of Agreement 44191.

5. 3 of 15 (20 percent) invoices tested were paid from 5 to 147 days late. This is in contrast to the Billings and Payments Section of Agreements 44191 and 87568 that require payment within 10 or 30 days, after receipt of the invoice by Accounts Payable. Further, we noted that 12 of 15 (80 percent) invoices tested were submitted to Accounts Payable by Facilities Services staff from 35 to 271 days of the invoice date.

6. We also noted that a cash advance of $10,000 paid to the contractor was incorrectly recorded to an operating expense account rather than to an advance/prepaid account. This cash advance was required by Agreement 87568 for contractor's working capital needs and will be reimbursed to Metropolitan within ten days following the agreement's termination date.

7. The cost-tracking spreadsheet maintained by Facilities Services was incomplete, resulting in a $3,786 understatement. This spreadsheet is used to track all of Metropolitan's shared costs of paper products charged to Facilities Services operating expenses.

We recommend that the Agreement Administrator resolve the noted differences. We also recommend that the Real Property Development and Management Group Manager remind the Agreement Administrator and administrative staff of the importance of thorough review of invoices to ensure accuracy of billed charges, completeness of supporting documentation, and compliance with the prescribed payable practices. Further, we recommend that the Agreement Administrator perform periodic tests of contractor invoices to ensure compliance. Lastly, we recommend that the Agreement Administrator request the Controller's office to make an adjustment to transfer the $10,000 cash advance to an advance/prepaid account.

COMPLIANCE WITH TERMS AND CONDITIONS OF THE AGREEMENTS

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 contractor's operating statements and selected food, product, and payroll costs incurred from FY 2002/03 through FY 2007/08 revealed:

1. Although the paper product costs reported in the contractor's annual operating statements were consistent in FY 2005/06 ($84,300) and FY 2006/07 ($81,800), these costs decreased significantly to $51,800 in FY 2007/08. Our review of Metropolitan's shared costs for these paper products revealed that the costs soared to $49,100 for the same fiscal year (FY 2007/08). FY 2007/08 was the initial year that Metropolitan shared the cost of biodegradable paper products with the contractor.

2. We could not locate the supplier invoice and supporting documentation for 5 of 10 (50 percent) food and product cost transactions tested. Billed amounts for these 5 invoices totaled $5,141. In addition, the billed amount ($861) for 1 transaction did not agree to the supporting documentation.

3. We could not locate the Employee Time Detail Reports or time records that support the payroll costs for 17 of 19 (89 percent) selected employees. Unsupported payroll costs totaled $22,430 for these 17 employees. In addition, the payroll costs (total $1,980) for 2 of 19 (11 percent) employees tested did not agree to the supporting Employee Time Detail Reports.

We recommend that the Agreement Administrator resolve the noted differences. We also recommend that the Agreement Administrator remind the contractor of the need to comply with terms and conditions of the agreement and conduct periodic reviews to ensure compliance.

SERVICE AGREEMENTS

Service agreements are a negotiated agreement between two parties designed to create an understanding about services, priorities, and responsibilities. To be effective, service agreements should incorporate service elements and management elements. Service elements clarify the terms and conditions of the agreement and establish service standards and quality expectations. Management elements focus on how service effectiveness will be measured, reported, and addressed. Metropolitan negotiated a service agreement with Eurest Dining Services in November 2001 and October 2007 to provide dining, catering, and vending services to Metropolitan's employees and tenants at Union Station.

As part of our examination, a food survey was sent to over 900 Union Station employees to assess their perceptions of the dining, catering, and vending services provided by Eurest Dining Services. This survey was designed to measure services provided against standards/expectations and was responded to by 392 employees. Responses were tabulated, grouped, and averaged according to type of service with the results indicating that the majority of responders rated the services as "fair to good" (fair was the second lowest of four ratings listed). Furthermore, discussions with Management revealed that these ratings were not within acceptable limits nor did they meet service standards expected of the provider. Below are the summary responses to the survey.

A. Dining Services:

   1. 33 percent of the respondents rated the dining services as fair and another 33 percent rated them good.

   2. 32 percent of the respondents rated the food/beverage prices higher than comparable items and 30 percent rated the prices moderate.

   3. 37 percent of the respondents rated the overall value of the food/beverages purchased as providing for poor overall value and 39 percent rated the overall value as fair.

   4. 31 percent of the respondents rated the customer service as good and 29 percent rated it very good.

   5. 37 percent of the respondents rated the serving and dining areas as good and 34 percent rated them very good.

B. Vending Services & Catering Services were generally rated as being good; however, responses were not statistically sufficient to assess service effectiveness.

C. Overall Assessment:

   1. 32 percent of the respondents rated the overall dining, vending, and catering experience as fair and 32 percent rated it good.

   2. 32 percent of the respondents answered that they will not likely recommend the dining services to their friends and 32 percent responded that they will be somewhat likely to recommend.

   3. 33 percent of the respondents answered that they will somewhat likely purchase again from the food service provider and 31 percent responded that they will likely be repeat purchasers.

These food survey results provide evidence to the failure of the contractor in satisfying service level standards or expectations. While service surveys are useful in measuring service effectiveness, unacceptable results also indicate a failure in complying with agreed upon escalation or conflict resolution clauses.

We recommend that the Facilities Services Management meet with Eurest Dining Services to discuss the results of the food service survey and establish an action plan to improve the level and quality of services provided. Furthermore, we recommend Management use this opportunity to establish an objective basis for gauging service effectiveness so that both parties use the same criteria to evaluate service quality. We also recommend that Management strengthen conflict-prevention procedures to help to avoid or alleviate disputes by providing a shared understanding of needs and priorities. Finally, if conflicts do occur, we recommend that Management establish improved conflict-resolution procedures so that conflicts can be resolved more readily with fewer disputes.

FOLLOW-UP OF PRIOR AUDIT RECOMMENDATIONS

Our follow-up procedures consisted of verifying that Management's corrective action plans were implemented and functioning effectively. We evaluated revised procedures and tested selected controls. Our testing revealed that the Agreement Administrator has taken the necessary steps to address issues noted in our audit report issued in October 2002. We noted, however, that although the Facilities Services Management met with the service contractor to discuss the prior report findings, the agreement was not amended to resolve the inadequately explained charges and unclear terms and conditions of the agreement. Further review revealed that these agreement amendments were postponed due to pending litigation. It should be noted that Agreement 44191, which was the subject of the prior audit, terminated in September 2007.

Official Statement for the Water Revenue Refunding Bonds, 2009 Authorization, Series A-1 and A-2

Background
The Audit Department has completed a review of the Official Statement for the Water Revenue Refunding Bonds, 2009 Authorization, Series A-1 and A-2. This review was undertaken to provide the underwriters of the Water Revenue Refunding Bonds (Bonds) "comfort" that the Official Statement for the Bonds is complete, consistent with supporting financial records, and accurate in all material respects. The 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. 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.