THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

Report
Office of the General Auditor
August 31, 2011

Internal Audit Report for August 2011

Summary

Three reports were issued during the month:

- **Employee and Director Expense Reports Audit Report**
- **Quarterly Financial Analysis – Third Quarter FY 2010/11**
- **Audit Department Internal Quality Assessment**

Discussion Section

This report highlights the significant activities of the Internal Audit Department during August 2011. 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.

Employee and Director Expense Reports Audit Report

Background

Metropolitan's Administrative Code and Travel Guide specify travel policies, expense reporting procedures, and guidelines for preparing and submitting expense reports. Expense reports are processed through the Travel Expense Reporter (TER) system for employees and directors who have incurred travel expenses and operating expenses on behalf of Metropolitan. The Accounts Payable Team from the Controller Section in the Office of the Chief Financial Officer administers and records expense reports and issues payments. For the fourteen months ended May 31, 2011, expenses totaling $3.1 million were processed through the TER system for employees, directors, and Blue Ribbon Committee (BRC) members. This represents a 7 percent increase over the prior periods. These transactions were comprised of 5,968 employee expense reports totaling $2.8 million, 168 director expense reports totaling $237,500, and 20 BRC member expense reports totaling $8,400.

Opinion

In our opinion, the accounting and administrative procedures over Employee and Director Expense Reports 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 April 1, 2010 through May 31, 2011.

Comments and Recommendations

LATE SUBMISSION OF TRAVEL EXPENSE CLAIMS, UNFILED TRAVEL EXPENSE REPORTS, AND RECONCILIATION OF PREPAID EXPENSES

Section 6331 (b)(2) and (3) of the Administrative Code requires that employee and director expense claims be submitted to the Office of the Chief Financial Officer and the Office of the Board Executive Secretary no later than 60 days following the day the employee or director incurred the expenses or participated in an activity for which Metropolitan funds were utilized on the employee's or director's behalf.

We evaluated the timely submission of 34,849 expense-line items which were claimed on 6,156 TERs by employees, directors, and BRC members. Of this number, 6,046 TERs were approved and processed (5,866 employees, 161 directors, and 19 BRC members) and 110 were submitted but not processed.

1. Employee Expense Reports: 2,218 expense-line items claimed on 386 TERs were submitted late (beyond the 60-day standard). This is an increase of 3 percent from the prior periods.

No. of Days Expense was Incurred	No. of Expense Items	No. of Expense Reports (TERs)	Expenses Claimed
61 to 90 days	1,082	226	$ 109,342
91 to 180 days	637	79	79,412
181 to 365 days	499	81	77,014
Total	2,218	386	265,768
Total for period	31,860	5,968	$2,841,441*

* Represents submitted, approved, and processed TERs ($2.7 million) and in progress TERs ($97,137).

2. Director Expense Reports: 723 expense-line items claimed on 60 TERs were submitted late (beyond the 60-day standard). This is an increase of 13 percent from the prior periods.

No. of Days Expense was Incurred	No. of Expense Items	No. of Expense Reports (TERs)	Expenses Claimed
61 to 90 days	402	36	$ 33,237
91 to 180 days	293	19	25,978
181 to 365 days	28	5	2,709
Total	723	60	61,924
Total for period	2,877	168	$237,481**

** Represents submitted, approved, and processed TERs ($221,662) and in progress TERs ($15,819).

We also reviewed 3,248 expense-line items for expenses prepaid by Metropolitan and incurred by employees and directors as of August 15, 2011, but for which TERs had not been filed. These items were prepaid through check payments or agency issued credit cards. Our analysis revealed:

3. Outstanding Prepaid Expenses: 37 employees and 54 directors (including 21 former directors) have yet to file TERs for expenses totaling $417,215 ($308,267 for employees and $108,948 for directors) prepaid by Metropolitan. These expenses remained unreported in the employee and director TERs from 61 to 3,236 days of their prepayments through August 15, 2011.

Employees:

No. of Days Expense Was Incurred	No. of Expense Items	Expenses Claimed for Employees
61 to 90 days	167	$47,855
91 to 180 days	124	18,280
181 to 365 days	418	103,605
366 days to 3 years	363	117,925
More than 3 years	108	20,602
Total	1,180	$308,267

Directors:

No. of Days Expense Was Incurred	No. of Expense Items	Expenses Claimed for Directors
61 to 90 days	12	$2,412
91 to 180 days	27	5,187
181 to 365 days	41	4,043
366 days to 3 years	263	47,714
More than 3 years	212	49,592
Total	555	$108,948

4. Reconciliation of Prepaid Expenses: 649 expense items totaling $105,094 that were prepaid through Metropolitan issued credit cards and reported on TERs have not been reconciled to the monthly credit card statements by the Accounts Payable Team. These expenses were incurred between August 2010 and July 2011.

We recommend that management emphasize the importance of submitting TERs within the 60-day guidelines and conduct periodic tests to ensure compliance. We also recommend that the Accounts Payable Team, through coordination with the Unit Managers, Section Managers, and Board Executive Secretary, follow up on outstanding prepaid expenses to employees and directors.

REVIEW AND APPROVAL

Review and approval controls serve to protect against unauthorized, inaccurate, or duplicate transactions or requests; identify items that require correction; and ensure that follow-up procedures exist for exceptions. For TERs, authorized personnel review for compliance to policies and procedures, check attached documentation for completeness, and examine the expenses for propriety. Our review of 30 directors’ and 30 employees’ TERs submitted between April 1, 2010 and May 31, 2011 revealed:

1. We could not locate supporting itemized receipts for meals and communication expenses totaling $2,973 ($1,497 for employees and $1,476 for directors) claimed on 15 TERs. These expenses were paid through employee or director credit cards or Metropolitan issued credit cards and supported only by credit card receipts.

2. Unallowable alcoholic beverages ($13) were claimed on two employees TERs. It should be noted the Accounts Payable Team is in the process of obtaining a refund from these employees.

3. Cancelled airfares ($767) for two guests who did not attend the State Water Project Inspection Trip in March 2011 have not been refunded to Metropolitan by the airline as of May 31, 2011. We understand that staff has already filed for a refund.

4. TERs totaling $348 were claimed twice by three employees. We noted that these expenses were claimed twice on the same TER or on TERs submitted on different dates by these employees. Employees have reimbursed Metropolitan for these funds.

5. Lastly, we noted inconsistency in director travel authorization requirements between the Travel Guide and Section 6324(a) of the Administrative Code. The Travel Guide requires approval of directors' business travel within Arizona, California, and Nevada; whereas, under Section 6324(a), directors are authorized to travel anywhere within these states on district business without prior authorization.

We recommend that the Accounts Payable Team conduct a thorough review of expense reports to ensure the validity and accuracy of reported claims. Further, we recommend that management revise the Travel Guide to ensure consistency of travel approval requirements with the Administrative Code.

Quarterly Financial Analysis – Third Quarter FY 2010/11

Background

We have completed an analysis of the financial statements for the Metropolitan Water District of Southern California (Metropolitan) for the three months ending March 31, 2011. Our review focused on monitoring changes to balance sheet accounts as well as income and expense accounts from the prior quarter. We also identified and researched account balances that differed from expectations. Finally, we prepared financial ratios to evaluate the key metrics related to the financial condition of Metropolitan.

Metropolitan records and reports financial transactions and results using Oracle Financial Software, including the General Ledger, Accounts Receivable, Revenue Accounting and Fixed Assets, Purchasing, Inventory Control, and Accounts Payable modules. Management reports audited results on an annual basis. It should be noted that Metropolitan is not required to report quarterly results. As part of our annual audit plan, we performed an analysis of the general ledger for the third quarter of fiscal year 2010/11.

Comments and Recommendations

QUARTERLY ANALYSIS

During our review, we ran a trial balance in Oracle of all subaccounts for the third quarter of fiscal year 2010/11 and compared changes to the balances from the second quarter to identify subaccounts that warranted further investigation. We then selected four subaccounts with variances for further analysis.

These subaccounts included water sales (311000), direct costs of water (4100010), investments (1121010), and accounts payable to vendors (2110501).

RATIO ANALYSIS

We also prepared ratio analyses of assets, liabilities, sales, and accounts receivable accounts as indicators of the health and performance of Metropolitan's finances. Specifically, we evaluated:

- Current ratio (current assets/current liabilities).
- Cash ratio (cash and cash equivalents/current liabilities).
- Receivables turnover (sales/accounts receivable).
- Average collection period (365/receivables turnover).
- Debt ratio (debt/assets).
- Interest coverage (EBIT/interest charges).

Conclusions
Documentation or explanations in support of all variances were obtained that satisfactorily addressed differences noted. Accordingly, our review did not reveal any variances that warranted further investigation or follow up. Further, our evaluation of key financial ratios did not disclose any metrics outside the parameters of expected performance.

Audit Department Internal Quality Assessment – General Conformance

Background
To ensure professionalism, independence and integrity, Audit Department staff implemented a Quality Assurance and Improvement Program (QA&IP) in 2008. This quality program, which is required by the *International Standards for the Professional Practice of Internal Auditing (Standards)* set forth by The Institute of Internal Auditors (IIA), encompasses all types of audit activities. Major elements of the QA&IP include training and ongoing reviews, periodic internal assessments, and external assessments every five years of audit operations and processes.

As part of the QA&IP, we recently conducted the 2010/11 Annual Internal Quality Assessment of department processes. Our principal objectives were to provide reasonable assurance that department activities conform to the *Standards;* evaluate our effectiveness in carrying out the Audit Department mission (as set forth in the Audit Department Charter); and identify opportunities to enhance audit processes. Utilizing the IIA's Internal Quality Assessment guidance, we reviewed audit communications with the Board, the Audit and Ethics Committee, and management; evaluated risk assessment and audit planning processes; and assessed audit policies, procedures, and internal communication methods. Additionally, we conducted anonymous surveys of both audit clients and audit staff to obtain feedback and identify both strengths and areas for improvement. Central to our assessment was a detailed review of a selection of audit work papers and audit reports in comparison with the *Standards*.

Conclusions

The Audit Department's processes are well-established and the *Standards* are understood by the staff. Additionally, several initiatives to support quality improvement in audit processes have been implemented. Among these tools and practices are automated audit work papers and time charging (TeamMate); ongoing training to ensure a well-qualified audit staff; continuous focus on risk in audit planning and reporting; and an emphasis on professionalism, which we observed in interactions and communications with clients. Our comments are intended to build on the foundation already in place in the department. Further, it should be noted that several comments relate to vacancies in the audit management positions during much of the year under review. Additionally, it is important to recognize improvement in several areas following last year's internal quality assessment, including:

- Improved quality of audit work papers.
- Expanded monitoring and documentation of ongoing audit quality improvement activities.
- Implemented tracking of auditors' continuing professional education credits.
- Enhanced periodic assessment of risk and resource levels in the Audit Plan.

Our overall assessment is that the Audit Department generally conforms to each section of the *Attribute Standards,* the *Performance Standards,* and the *Code of Ethics*. The ranking of "generally conforms" is the highest ranking possible. According to the IIA's Quality Assessment guidelines, "generally conforms" means that an internal audit activity has policies and processes that are viewed to be in accordance with the *Standards*, with some opportunities for improvement. Specifically, we noted that the Audit Department partially conforms to three individual *Performance Standards* including:

- *Standard 2020 – "Communication and Approval"*, with a recommendation to more formally communicate the status of the Audit Plan achievement and "significant changes" in risk profiles to the Audit and Ethics Committee.

- *Standard 2240 – "Engagement Work Program" and Standard 2340 – "Engagement Supervision",* with recommendations to remind auditors of the need to obtain approval of work programs and work papers at established check points and to ensure evidence of audit supervision.

We also noted several recommendations related to Practice Advisories, or best practices. These include a reminder that it is time to update the existing Audit Department Policies and Procedures Manual to reflect current practices and methods. Additionally, we noted that auditors should be encouraged to attend continuing professional education classes in accordance with department standards in order to keep skills current in a changing industry. These observations and recommendations, which we believe will further strengthen the professionalism of the Audit Department, were discussed in detail with audit staff. Our audit management team has prepared an Implementation Plan to address these recommendations.