THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

Report
Office of the General Auditor
April 30, 2012

Internal Audit Report for April 2012

Summary

Six reports were issued during the month:

- **Capital Program for Projects Costing Less Than $250,000 Audit Report and Management Response**
- **Energy Management - Colorado River Aqueduct Power Contracts Audit Report**
- **Oxidation Retrofit – Skinner Audit Report**
- **Audit Quality Assurance - Audit Plan Update**
- **Payroll Records Review**
- **Official Statement for the Water Revenue Refunding Bonds, 2012 Authorization, Series B**

Discussion Section

This report highlights the significant activities of the Internal Audit Department during April 2012. In addition to presenting background information and the opinion expressed in the audit reports, a discussion of findings noted during the examinations is also provided.

Capital Program for Projects Costing Less Than $250,000 Audit Report

Background

Metropolitan's Capital Investment Program (CIP) is a multiyear planning document that is based on a systematic evaluation of facilities, structures, equipment, and systems. This plan serves as a guide to ensure the efficient and effective use of capital expenditures by outlining a timeline and financing schedule of capital projects for the near future. The CIP is made up of many capital improvement projects and is revised and updated on an annual basis to ensure that it remains operationally relevant and adequate to meet business needs.

In addition to the CIP, Metropolitan has also implemented the Capital Program for Projects Costing less than $250,000 (Minor Capital Program) to fund, authorize, and expedite smaller unscheduled capital projects. Under this Minor Capital Program, management can approve projects that require rapid response to address unanticipated failures, urgent safety or regulatory compliance concerns, or to take advantage of shutdown opportunities to minimize the risk of costly repairs or service disruptions, without seeking additional board approval.

Each project included in the Minor Capital Program must also be evaluated by the CIP Team. Minor Capital Program appropriations and number of approved projects from fiscal year 2006/07 through fiscal year 2010/11 are:

Fiscal Year	Appropriation Number	Appropriation Amount	Approved Projects
2006/07	15433	$5,600,000	42
2007/08	15448	5,000,000	36
2008/09	15454	4,825,000	26
2009/10	15460	4,150,000	26
2010/11	15468	3,500,000	19

Opinion

In our opinion, the administration of the Minor Capital Program provides for a less than satisfactory internal control structure. This opinion is primarily the result of the lack of Minor Capital Program controls that would ensure that the projects approved within the Minor Capital Program were completed on a timely basis. In addition, we noted that program reporting was summary based rather than detail orientated, which limited board and management disclosure of program schedule slippage, budget and cost variances, or project cancellations. Moreover, we noted instances of missing or incomplete project documentation. It should be noted that our test work did not reveal improprieties or inaccuracies related to Minor Capital Program charges.

Our review consisted of Minor Capital Program projects approved between July 1, 2007 and September 30, 2011. Management has initiated remedial actions in response to our concerns, and we will assist in the evaluation of solutions addressing these internal control weaknesses.

Comments and Recommendations

PROJECT MANAGEMENT AND REPORTING

Project management involves the planning, organizing, securing, and managing of resources to achieve specific goals. The challenge of project management is to satisfy project goals and objectives while complying with scope, time schedules, and financial constraints. Periodic reporting of project results and deliverables is necessary for disclosure of Minor Capital Program schedule slippage, budget and cost variances, or project cancellations.

During our review of Minor Capital Program activity for fiscal year 2006/07 through fiscal year 2010/2011, we noted an inordinate number of projects that were not completed during the year in which they were approved or in a time certain soon after fiscal year-end. This seems incongruent with the intent of the Minor Capital Program which is to fund, authorize, and expedite smaller, unscheduled capital projects. It is also inconsistent with the need to complete projects that require rapid response to address unanticipated failures, urgent safety or regulatory compliance concerns, or to take advantage of shutdown opportunities.

Our review also revealed that board and management reporting did not always disclose Minor Capital Program schedule slippage, budget and cost variances, or project cancellations. Finally, we noted instances of missing or incomplete project documentation.

Minor Capital Program activity for the five-year period:

	2006/07	2007/08	2008/09	2009/10	2010/11
Appropriation number	15433	15448	15454	15460	15468
Amount appropriated	$5,600,000	$5,000,000	$4,825,000	$4,150,000	$3,500,000
Number of projects approved by management	34	33	22	23	19
Number of projects started within the Fiscal Year	30	32	22	22	10
Number of projects that started after fiscal year-end	4	1	0	1	9
Number of projects completed through September 30, 2011	26	30	18	17	3
Percentage of projects completed	76% (or 26/34)	91%	82%	74%	16%

Minor Capital Program expenditures for the five-year period:

	2006/07	2007/08	2008/09	2009/10	2010/11
Amount appropriated	$5,600,000	$5,000,000	$4,825,000	$4,150,000	$3,500,000
Expenditures for each appropriation by fiscal year-end (by 6/30/xx)	$588,030	$1,598,167	$1,669,430	$1,189,951	$552,508
Expenditures for each appropriation through September 30, 2011	$3,627,262	$3,994,016	$3,320,923	$2,780,698	$691,232
Expenditures as a % of appropriated amount	65% (or $3.63/5.6)	80%	69%	67%	20%

In summary, Minor Capital Program appropriations totaling $23,075,000 were authorized by the Board during the five-year period. Capital expenditures against these appropriations totaled $14,414,131 through September 30, 2011. Moreover, 131 projects were proposed and approved by management, with 116 of the projects being started in the same fiscal year. Finally, as of September 30, 2011, 94 of these projects have been completed. Additional detail on these findings:

1. Our test work revealed that while most projects started in the same year that they were approved, less than 25 percent had been closed out in any given year. Moreover, 15 projects started after the year when money was appropriated.

2. For fiscal year 2006/07, of the 42 approved projects, eight are being implemented under other Capital Investment Programs because project cost estimates were anticipated to exceed the maximum $250,000 allowed under the Minor Capital Program. Of the remaining 34 projects, 26 (76 percent) are complete. While eight projects are still ongoing, six of these projects are in construction process. Construction of all eight projects is scheduled to be completed during the current fiscal year 2011/12.

3. For fiscal year 2007/08, of the 36 approved projects, 3 projects are being implemented under other Capital Investment Programs, because project cost estimates were anticipated to exceed the maximum $250,000 allowed under the Minor Capital Program. Of the remaining 33 projects, 30 (91 percent) are complete. While three projects are still ongoing, two of these projects are in construction process. Construction of all three projects is scheduled to be completed during the current fiscal year 2011/12.

4. For fiscal year 2008/09, of the 26 approved projects, 4 projects are being implemented under other Capital Investment Programs, because project cost estimates were anticipated to exceed the maximum $250,000 allowed under the Minor Capital Program. Of the remaining 22 approved projects, 18 (82 percent) are complete, while 4 projects are still ongoing.

5. For fiscal year 2009/10, of the 26 approved projects, 3 projects are being implemented under other Capital Investment Programs because project cost estimates were anticipated to exceed the maximum $250,000 allowed under the Minor Capital Program. Of the remaining 23 approved projects, 17 (74 percent) are complete, while 6 projects are still ongoing.

6. For fiscal year 2010/11, of the 19 approved projects, 3 (16 percent) are complete, while 16 projects are still ongoing. These projects are scheduled to be completed in the fiscal years 2011/12 and 2012/13.

7. While all projects had expected completion dates, they were often extended and documentation supporting the schedule changes could not always be located.

8. All five appropriations (fiscal year 2006/07 through fiscal year 2010/11) remain open as some projects are yet to be completed.

We understand that most Minor Capital Program projects approved by the CIP Evaluation Team are considered essential to the reliability of Metropolitan's distribution system and treatment plants. In addition, as described in several board letters, the Minor Capital Program "supports timely and essential repairs and upgrades". While these projects are considered critical, not all projects are considered urgent or require immediate response.

We also understand that the failure to complete projects on a timely basis may be due to many factors such as: staff availability, change in the scope of work, or the need to coordinate the work with other contractors or Metropolitan staff. It is important to note that urgent projects had been completed in a timely manner and there were no service interruptions or emergency repairs that occurred, as a result of late completion of critical projects.

Failure to complete projects timely could result in increased risks of service interruptions or costly emergency repairs to Metropolitan's distribution system and treatment plants. Failure to close out the appropriations on a timely basis could result in unrelated costs being charged to the projects and financial losses to Metropolitan due to fraudulent, erroneous, or unauthorized transactions.

We recommend that management review the program objectives and revise the Minor Capital Program to ensure that it meets operating needs and satisfies time schedules. We also recommend that management revise board/management reporting to ensure disclosure of Minor Capital Program schedule slippage, budget and cost variances, or project cancellations. Finally, we recommend that management perform closeout procedures for projects that are complete, canceled, or transferred and conduct periodic reviews to ensure compliance.

POLICIES AND PROCEDURES

Compliance with established procedures is necessary to ensure accurate accounting records, proper supporting detail, and adequate control over the administration of the Minor Capital Program. The Project Coordination Office Manual provides guidelines and procedures to be used for the submission of project proposals, evaluation and approval of projects, and management of approved projects. We tested 10 of 72 Minor Capital Program projects approved between fiscal year 2008/09 and fiscal year 2010/11 and noted:

1. Evaluation Forms used to score new or existing projects were incomplete for six of ten projects reviewed. The missing information includes project scores or recommendations made by the CIP Evaluation Team.

2. We could not locate the "Project Authorization/Change Request Form" and the "Request/Notice for Project Completion/Cancellation" for five of ten projects reviewed. These forms are required to document the changes in project manager, estimated cost, completion date, or project status. It is important to note that subsequent to our review, management has located the above forms for three projects.

3. We could not locate the "Project Management Plan" for eight of ten projects reviewed. This document is required prior to start of projects, as it defines the managerial aspects of running the project and outlines the scope, team, schedule, and budget.

PROJECT STATUS, BUDGET AND CLOSEOUT

Project management entails planning, organizing, and managing resources to bring about the successful completion of specific goals and objectives. It involves monitoring and controlling activities from project initiation to closeout. Projects should be closed after all project requirements have been met, all invoices have been accrued or paid, and Metropolitan has discharged all obligations. We reviewed the project costs and status for all projects authorized in fiscal year 2008/09 through fiscal year 2010/11 under the Minor Capital Program and noted:

1. One ongoing project was over budget by $27,076, as of September 30, 2011. We could not locate the "Change Request Form" for the increase in estimated cost. It is important to note that subsequent to our review, management has located the missing form.

2. Status of 18 projects that were canceled, discontinued, or completed was not reflected properly in the Project Management Information System or Project Accounting and Grant Management System. It is important to note that subsequent to our review, management has resolved the above issue for seven projects.

We understand that program management has established procedures for timely closeout and change order submission to the Project Accounting and Grant Management System.

Energy Management - Colorado River Aqueduct Power Contracts Audit Report

Background

The Metropolitan Water District Act (Section 139) allows Metropolitan to acquire, construct, operate, and maintain facilities, equipment, and other property needed to generate and deliver electric power for the purposes of developing, storing, and distributing water to its member agencies. The Metropolitan Water District Act also allows Metropolitan (Section 139.1) to sell and exchange electric power to federal, state, public agency, private corporation, or person.

Approximately 70 percent of the power requirements for pumping at-full capacity of 1.25-million acre-feet of Colorado River Aqueduct (CRA) water is secured through long-term contracts with the United States Government for energy generated from the Hoover and Parker Power Plants, and with Southern California Edison. The remaining 30 percent of power requirements is obtained through supplemental energy purchase agreements, with municipal and investor-owned utilities or from power marketers at wholesale market cost.

The Metropolitan Administrative Code (Section 8122 (e)) and Energy Risk Management Policy authorize the General Manager to negotiate and execute power and transmission contracts for supplemental energy in an amount not-to-exceed $50 million within any 24-month period, unless authorized by the Board.

The Operations Planning/Power Resources Unit of the Water System Operations Group manages Metropolitan's power resources, contracts, and scheduling functions. Specifically, the Operations Planning/Power Resources Unit records and reconciles energy entitlements, exchanges, and purchases for the CRA against actual energy deliveries to Metropolitan's system. These excel-based spreadsheets are used to account for energy hedging transactions and are the basis for entries made against the Water Inventory Account.

Metropolitan used approximately 2,041 gigawatt hours (GWh), 1,970 GWh, and 535 GWh for fiscal year 2009/10, fiscal year 2010/11, and fiscal year 2011/12 (through September 30, 2011), respectively, to move water along the CRA. Expenditures for electric power for the CRA were $43.4 million, $46.7 million, and $7.2 million during those periods.

Opinion

In our opinion, the accounting and administrative procedures over Energy Management - CRA Power Contracts 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 July 2009 through September 2011. Although this opinion is an acceptable rating, we do express concern over the lack of reporting practices that would evaluate forward energy purchase strategies and practices with actual results (gain/loss) on hedged transactions. While we recognize the financial rationale to net energy transaction results against the Water Inventory Account, we believe that a more detailed reporting of the results is necessary for full board disclosure and thorough policy discussions.

Comments and Recommendations

REVIEW AND APPROVAL

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 exist for exception processing. The reviewer or approver should review invoiced items for propriety and agree them to source documentation for accuracy. We reviewed supplemental energy purchases for selected six months and noted:

1. Realized gains of $13,900 and losses of $399,500 from supplemental energy purchases were not reported to the Controller's Office or to the Risk Oversight Committee for recording or monitoring purposes. We understand that all other CRA energy transactions are reported to the Chief Financial Officer's and Controller's staff, and a valuation report of supplemental energy transactions is provided to the Risk Oversight Committee. The realized gains and losses are shown in more detail below:

	Month	Energy Contractor	Transaction	KWH	Sale Unit Price ($)	Purchase Unit Price	Difference in Unit Price	Gain (Loss)
1	Jun 2010	Morgan	Curtailment	24,000	$0.03330	$ 0.02742	$0.00588	$ 141
2	Jun 2010	EDF	Curtailment	412,000	0.04511	0.02263	0.02248	9,262
3	Jun 2010	BP	Curtailment	188,000	0.03175	0.01773	0.01402	2,636
4	Jun 2011	JP Morgan	Bookout	400,000	0.03650	0.03175	0.00475	1,900
			Total					13,939
5	Jun 2011	Powerex	Bookout	1,600,000	0.02688	0.03150	(0.00462)	(7,392)
6	Jun 2011	SRP	Bookout	3,200,000	0.02838	0.03300	(0.00462)	(14,784)
7	Sep 2011	Powerex	Bookout	8,000,000	0.02825	0.03910	(0.01085)	(86,800)
8	Sep 2011	JP Morgan	Bookout	8,000,000	0.02860	0.03455	(0.00595)	(47,600)
9	Sep 2011	SRP	Bookout	8,600,000	0.02653	0.03900	(0.01247)	(107,242)
10	Sep 2011	SRP	Bookout	7,000,000	0.02653	0.03825	(0.01172)	(82,040)
11	Sep 2011	Cargill	Bookout	8,000,000	0.02750	0.03420	(0.00670)	(53,600)
			Total					($399,458)

Note: Terms used in the Transaction column are: "Curtailment" is a real time reduction in the delivery of scheduled energy between two contracting parties. Metropolitan can be compensated for curtailments, if the value of real time energy is higher than the scheduled energy. "Bookout", on the other hand, refers to those instances when prior to commencing a physical delivery of energy under a confirmation agreement, Metropolitan and the other "contracting party" enters into a transaction to offset the contractual obligation. Metropolitan can incur a loss to book out a confirmed energy transaction, if the market price of energy is less than the price of the confirmed energy transaction or a gain if the market price is higher. These amounts are included in the contractor billings and net payments are recorded in the "Water Inventory" general ledger account.

2. Curtailment of 6,000 kilowatt-hours (KWh) in May 2010 with Coral Power was not reflected as a deduction in the CRA Energy Account Excel Workbook maintained by the Operations Planning Unit. It should be noted that the corresponding amount of $196.50 was properly deducted from the contractor's invoice in June 2010.

Failure to properly account for energy purchases and corresponding gains and losses could result in misstatement of electric power cost, water inventory and operating income. Failure to report gains and losses could result in ineffective evaluation and decision making of supplemental Energy Management Program.

We recommend that Operations Planning/Power Resources management, in consultation with the Controller's Office, develop procedures to ensure proper accounting and reporting of realized gain/loss from bookouts and curtailments. We also recommend that management conduct periodic reviews to ensure accuracy of reported energy purchases and compliance with the accounting and reporting procedures.

MONITORING, TESTING, AND READING OF METERING EQUIPMENT

Metropolitan's CRA power contracts require the U.S. Department of Energy's Western Area Power Administration and Southern California Edison to maintain the metering equipment that measures delivery into and from Metropolitan's transmission system. They also require that meters be inspected and tested at least once each year. For Metropolitan's metering equipment used at the pumping plants, the Power Support Unit of the Operations Support Services Section should provide routine maintenance; inspection, testing, and calibration of power meters; and maintain records of such activities.

Moreover, the Gene Dispatch Team of the Conveyance and Distribution Section should ensure accurate readings and recordings of the pumping plants' meter equipment. We reviewed the annual test reports and meter readings and noted:

1. The annual test reports could not be located for two power meters at the Mirage Substation and five power meters at the Eagle Mountain Substation. These test reports were for calendar years 2010 and 2011. The seven power meters are owned, operated, maintained, and tested by Southern California Edison.

2. Meter readings recorded in the CRA Energy Account Excel Workbook were inconsistent with the on-line Pump Plant End-of-Month (PPEOM) Reports (79,224,711 KWh vs. 26,382,764 KWh). These meter readings were for the months of July 2009 and December 2010. The PPEOM Report shows that the monthly power meter readings for the pumping plants were completed by Gene Dispatch. We understand that the discrepancy of 52,861,947 KWh was caused by the failure to update the on-line PPEOM reports, with the correct values shown on the Workbook.

We recommend the Operations Planning/Power Resources management work with Southern California Edison to ensure compliance with the metering equipment requirements of the agreement. We also recommend the management remind staff of the importance of accurate and complete recording, reconciling, and reporting of meter readings. Lastly, we recommend that management conduct periodic reviews to ensure compliance and consistency.

SUPPLEMENTAL ENERGY RISK MANAGEMENT POLICY AND DELEGATION OF AUTHORITY

Metropolitan's Administrative Code (Section 8122 (e)) and Energy Risk Management Policy allow the General Manager to execute supplemental energy contracts with terms of not more than 24 months, and at maximum total obligation of $50 million unless authorized by the Board. The Energy Risk Management Policy also directs the General Manager to establish a committee to provide regular oversight and guidance over the supplemental energy purchasing activities.

Further, this policy requires the General Manager to establish purchasing guidelines for the Risk Oversight Committee and the Operations Planning/Power Resources manager, and to develop risk management reports and tools. During our review, we noted:

1. A formal energy risk management policy has not been developed, since it was described in the board letter dated October 2002 and later amended in March 2011. This policy should state the policy objectives, key internal control points (e.g., separation of duties), permitted transactions, tolerable risk limits, and accounting and administration of supplemental energy activities.

2. Purchasing guidelines, including dollar and contact term limits for the Operations Planning/ Power Resources manager have not been established. Moreover, the Operations Planning/Power Resources manager had been entering into supplemental energy purchase agreements, without written delegation of authority established by the General Manager. These purchase contracts were within board-approved amount and contract term.

We recommend that Metropolitan management establish a formal supplemental energy risk management policy and purchasing guidelines to provide guidance and authority to staff for the purchase and management of electric power. We also recommend that management conduct periodic review to ensure compliance.

DESK PROCEDURES

Procedures assist management in the training of new employees and cross training of staff, provide guidance for consistent performance of daily responsibilities, and provide a source of reference for Metropolitan personnel. Written procedures should be established and documented to provide a framework for achieving Metropolitan's goals and objectives.

During our review, we noted that the Operations Planning/Power Resources management is in the process of developing desk procedures for the CRA power operations. These "desk procedures" should contain staff roles and responsibilities, process descriptions, instructions for the performance of tasks, and related monitoring and reporting activities.

We recommend that Operations Planning/Power Resources management expedite the completion of the detailed "desk procedures" to minimize operational impact resulted from unexpected employee turnover. We also recommend that management consider cross-training its staff to ensure smooth operating activities.

Oxidation Retrofit – Skinner Audit Report

Background

The Robert A. Skinner Treatment Plant (Skinner plant) is located in the city of Winchester and was placed into service in 1976 to supply treated water to Riverside and San Diego Counties. The Skinner plant is one of three "blend" plants that treat a blend of State project water and Colorado River water. Member agencies that receive water from Skinner plant include Eastern Municipal Water District, Western Municipal Water District of Riverside County, and San Diego County Water Authority.

In 2005, Metropolitan entered into service agreements with Parsons Water and Infrastructure, Incorporated (PWI) and Parsons Constructor, Incorporated (PCI). PWI performed inspection services over the construction of a washwater reclamation plant and the ORP facilities at Skinner. PCI oversaw compliance with the Project Labor Agreement by contractors working on Skinner Oxidation Retrofit Program (Skinner ORP), to ensure adherence to quality standards and schedules for the duration of the project.

In 2007, Metropolitan entered into an agreement with Johnson Controls, Incorporated to improve electronic security systems throughout the Skinner plant and other Metropolitan facilities**.** These improvements reflect physical security recommendations and requirements of government entities, and also adhere to standards set by the Department of Homeland Security, Federal Bureau of Investigations, U.S. Environmental Protection Agency, Sandia National Laboratories, American Water Works Association, Transportation Security Administration, and ASIS International.

<u>Opinion</u>
In our opinion, the accounting and administrative procedures over Skinner ORP 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 2009 through September 2011.

<u>Comments and Recommendations</u>

FINANCIAL REPORTING - PROJECT ACCOUNTING

The objective of financial reporting over project activity is to provide information about the financial performance and operational status to management. These reports are crucial for assessing performance and managing resources to achieve specific goals and objectives. Financial reports should reflect the effects of transactions and other events on the project's financial performance. Order is imposed on this process by specifying and defining the classes of items (i.e., the classification of expenditures) that encapsulate the effects of those transactions on other events. Adherence to these standards is necessary for full disclosure, to ensure cost control, and assist in problem resolution.

During our testing, we noted that transactions are not always properly classified to the appropriate accounts. For example, we noted that on 19 invoices for inspection services provided by PCI, and 30 invoices for project management services provided by PWI were posted to account "Other" (Account 4540090) rather than "Engineering" (Account 4540010). We also noted 5 invoices for security services provided by Johnson Controls, Incorporated were posted to "Other" (Account 4540090) rather than "Security" (Account 4550020). Expenses charged to the wrong account can cause over/under statement of balances and provide misleading information to management.

We recommend that management establish procedures to ensure that transactions are properly classified and conduct tests to verify the accuracy and propriety of entries.

COMPLIANCE TO 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 rights associated with the agreements. Our review of 55 invoices totaling $3,872,217 revealed 14 instances where invoices were paid, after the prescribed due date. Specifically, we noted:

Contractor	Invoices Reviewed	Amount Reviewed	Invoices Paid After Due Date	Range of days Paid After Due Date
Johnson Control, Incorporated	6	$ 760,263	4	14 to 42
Parsons Constructors, Incorporated	19	$ 75,171	10	2 to 77
Parsons Water & Infrastructure, Inc	30	$3,036,783	0	0

This is in contrast to the Billings and Payments Section of the agreement that requires payment within 30 days after receipt of the invoice.

We recommend that management remind agreement administrators of the need to comply with the terms and conditions of the agreements. Furthermore, we recommend that management establish procedures to ensure compliance to the terms of the agreements and conduct periodic reviews.

Audit Quality Assurance - Audit Plan Update

In June 2011, the Audit and Ethics Committee and Board of Directors reviewed and approved the fiscal year 2011/12 Audit Plan (Plan), which allocates resources to the areas of greatest perceived risk for Metropolitan. We recently evaluated the Audit Department's performance through March 2012 year-to-date versus the Plan and noted that 30 audits, special reviews, and "comfort letters" have been completed.

Additionally, total resources fiscal year-to-date (14,377 hours) were below Plan levels by 2,003 hours primarily due to one open position which we have not filled for budgetary reasons. However, further analysis of Audit Department time charging for the quarter indicated a higher charge out rate to projects of 60 percent, as compared with 51 percent in the Plan.

Lastly, in keeping with industry standards, we evaluated the Plan to identify significant changes in risk profiles or resource levels which could result in a recommendation to adjust the Plan. We do not believe such adjustment is necessary at this time and we will continue to monitor risk and resources through the end of the fiscal year.

Payroll Records Review

We have completed a review of payroll and personnel records of fiscal years 2009/10 and 2010/11 to validate the propriety of selected records and to identify data input errors or discrepancies. In addition, we utilized tests that were designed to search for possible fraudulent transactions by applying analytical procedures to these records and by using inductive reasoning to identify data that contradict logical conclusions/endpoints.

Scope and Methodology

As noted, the scope of our review consisted of payroll activity and associated personnel records for the past two fiscal years. Payroll activity for these years totaled $200,381,676.81 and $199,628,425.97, respectively. Moreover, as of June 30, 2011, Metropolitan's payroll records constitute 1,823 active employees.

We began the review by performing a risk assessment on the payroll processes and developing an audit review program. This program consisted of 14 audit detection steps, 12 of which involved running Microsoft Access queries against payroll data from the PeopleSoft databases maintained by the Information Technology Section, and input to the Audit Department's Microsoft Access databases. This information was reviewed, analyzed, sampled, and verified with the Payroll Team (Payroll) and the Human Resources Group (HR).

We appreciate the cooperation and assistance that these teams provided to us in the design of our tests and in researching, investigating, and resolving "potential" findings. We believe that the framework has been established for these queries to be used on a periodic basis for the detection of and correction of data input errors and personnel record discrepancies. Specifically, we performed:

1. Analytical Tests:

    a. Summarized Payroll Distribution totals from PeopleSoft data files by fiscal year and agreed them to the associated Payroll accounts in the Oracle General Ledger.

    b. Reviewed employee pay rates and annual pay to ascertain if they exceed the ranges stated in the related job classifications.

    c. Reviewed processes for distributions of 401K and 457 accounts and CALPERS medical premium payments for retired and/or deceased employees and tested for accuracy and propriety.

2. Logic Tests (Investigated Data Elements That Satisfied These Arguments):

    a. Duplicate direct deposit bank accounts.
    b. Employees with the same home address and home phone numbers.
    c. Employees on payroll but no tax and benefit deductions.
    d. Employees on payroll but no time-off records within a calendar year.
    e. Employees on payroll but no records of work locations and work phone numbers.
    f. Employees' home address is a post office box.
    g. Employees' home addresses are not in California, Nevada, Arizona, or Washington D.C.
    h. Employees who received pay in a direct deposit account and a paper check.
    i. Terminated employees that are still on the payroll.
    j. Employees' social security numbers that may be invalid (number sequence not authentic).
    k. Matched social security numbers of active employees and retired employees after January 1, 2006 against the Death Master File (DMF) maintained by the U.S. Department of Commerce to identify discrepancies.

<u>Comments and Recommendations</u>

One active employee's social security number matched the listing of the DMF received from the United States Department of Commerce. This error was subsequently corrected and a rerun was made in December 2011, which verified that the employee's social security number was removed from the DMF.

It should be noted that discussions with information technology staff from National Technical Information Services of U.S. Department of Commerce revealed that these types of errors are usually the result of erroneous input from reporting agencies including State governments, hospitals, and the Social Security Administration.

We recommend that the HR Group schedule periodical tests utilizing similar computer assisted techniques to ascertain the propriety of HR records.

Official Statement for the Water Revenue Refunding Bonds, 2012 Authorization, Series B

The Audit Department has completed a review of the Official Statement for the Water Revenue Refunding Bonds, 2012 Authorization, Series B. We performed this review to provide the issuer of the Bonds "comfort" that the Official Statement for the Bonds is complete, consistent with supporting financial records, and accurate in all material respects. We completed our review in accordance with agreed upon procedures specified by the underwriter. We issued letters to the underwriter describing the agreed upon review procedures performed, and the results obtained.

MWD
METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

Date: April 20, 2012

To: Gerald C. Riss, General Auditor

From: Wally M. Lieu, Section Manager, Engineering Services Group (ESG)

Subject: Response to Capital Program for Projects Costing Less Than $250,000

Below are responses to the recommendations contained in the report on Capital Program for Projects Costing Less Than $250,000.

PROJECT MANAGEMENT AND REPORTING

Findings: During our review of Minor Capital Program activity for Fiscal Years 2006/07 through 2010/2011 we noted an inordinate number of projects that were not completed during the year in which they were approved or in a time certain soon after fiscal yearend. This seems incongruent with the intent of the program which is to fund, authorize, and expedite smaller, unscheduled capital projects. It is also inconsistent with the need to complete projects that require rapid response to address unanticipated failures, urgent safety or regulatory compliance concerns, or to take advantage of shutdown opportunities. Our review also revealed that Board/Management reporting did not always disclose program schedule slippage, budget and cost variances, or project cancellations. Finally, we noted instances of missing or incomplete project documentation.

Recommendations: We recommend that management review program objectives and revise the Minor Capital Program to ensure that it meets operating needs and satisfies time schedules. We also recommend that management revise Board/Management reporting to ensure disclosure of program schedule slippage, budget and cost variances, or project cancellations. Finally, we recommend that management perform close out procedures for projects that are complete, canceled or transferred and conduct periodic reviews to ensure compliance.

Response: The Minor Capital Projects Program is intended to streamline administrative procedures, reduce costs, and enable capital projects less than $250,000 to move forward without delay. ESG agrees with the recommendations that the objectives of the Minor Capital Projects Program should be reviewed, and that the objectives should be clearly defined. In recognition that the procedures required to manage and report on a smaller project may differ from those of a large project, ESG is currently developing guidelines to streamline project management and improve reporting on the status of the Minor Capital Projects Program. In addition, project close-out activities have begun for remaining projects which have been completed. In the next request for authorization of the upcoming fiscal year's Minor Capital Projects Program, the Board Letter will state that project timing for minor projects may extend several years, for example when shutdowns must be scheduled or construction contracts must be developed. In addition, the letter will note that final project close-out is dependent on a number of activities such as preparation of record drawings, which are not considered urgent activities, but are typically scheduled based on efficient utilization of resources.

POLICIES AND PROCEDURES

Findings: We tested 10 of 72 minor capital projects approved between FY 2008/09 and FY 2010/11 and noted:

- Evaluation Forms used to score new or existing projects were incomplete for six of ten projects reviewed. The missing information includes project scores and/or recommendations made by the CIP Evaluation Team.
- We could not locate the "Project Authorization/Change Request Form" and the "Request/Notice for Project Completion/ Cancellation" for five of ten projects reviewed. These forms are required to document the changes in project manager, estimated cost, completion date, or project status. It is important to note that subsequent to our review, management has located the above forms for three projects.
- We could not locate the "Project Management Plan" for eight of ten projects reviewed. This document is required prior to start of projects, as it defines the managerial aspects of running the project and outlines the scope, team, schedule and budget.

Failure to comply with policies and procedures could result in inaccurate records, or project delays.

Recommendations: We recommend that Program Management resolve the issues on incomplete evaluation form and the missing project management plan and forms. We also recommend that Program Management remind the Project Managers to comply with the project management procedures to ensure timely preparation, approval and\or completeness of project authorization requests and project plan. Lastly, we recommend that Program Management conduct periodic reviews to ensure compliance.

Response: ESG generally concurs with the recommendations. A new program manager has been assigned and has been proactively tracking and monitoring the program. In addition, new guidelines to streamline project authorization/change and project completion/cancellation forms are being developed and steps are being taken to ensure Project Management Plans are being prepared and implemented. All project managers have been reminded to comply with project management procedures, and periodic reviews will be conducted. Further, the Project Coordination Unit will verify that both scores and recommendations are recorded on Evaluation Forms.

PROJECT STATUS, BUDGET AND CLOSE OUT

Findings: We reviewed the project costs and status for all projects authorized in FY 2008-09 through FY 2010-11 under the Minor Capital Program and noted:

- One on-going project was over budget by $27,076, as of September 30, 2011. We could not locate the "Change Request Form" for the increase in estimated cost. It is important to note that subsequent to our review, management has located the missing form.
- Status of 18 projects that were canceled, discontinued or completed was not reflected properly in the Project Management Information System (PMIS) and\or Project Accounting and Grant Management System (PAGM). It is important to note that subsequent to our review, management has resolved the above issue for seven projects.

We understand that Program Management has established procedures for timely close-out and change order submission to the PAGM system.

Failure to update cost estimate could result in project cost overruns. Failure to maintain an effective reporting process could result in delays in identifying program issues and in taking timely corrective action.

Recommendations: We recommend that management remind staff of the importance of maintaining accurate information in the accounting system. We also recommend that management resolve the reporting inconsistency of project status between the PMIS and PAGM Systems. Lastly, we recommend that Program Management remind the Project Managers to comply with the modified project management procedures to ensure timely updates and close-out of projects and conduct periodic test to ensure compliance.

Response: Management will continue to remind staff of the importance of maintaining accurate information and timely updates and project close-outs; and conduct periodic reviews of the program to ensure compliance with project management procedures. In addition, we will work with the Finance Group regarding the inconsistent data in the PMIS and PAGM reporting. As part of the solution we have initiated an effort to evaluate the replacement of the current project reporting systems which may mean retiring PMIS. It should be noted that the project managers have monitored project costs and none of the minor cap projects have exceeded their budgets.

We thank the Audit Department for the diligent review on Capital Program for Projects Costing Less Than $250,000. Should you have additional questions concerning our response, please contact Arleen Arita at extension 76460.

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