THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

Report
Office of the General Auditor
October 31, 2012

Internal Audit Report for October 2012

Summary

Three reports were issued during the month:

- **Computer Software Accounting and Costs Analysis Audit Report**
- **Diamond Valley Recreation Facilities Audit Report**
- **Audit Department Quality Assurance Review**

Discussion Section

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

Computer Software Accounting and Costs Analysis Audit Report

Background

Computer software is an intangible asset that consists of a collection of computer programs, procedures, documentation, and related data that is concerned with the operation of the data processing system. These assets are often developed in-house or are the product of efforts by third-party programmers on behalf of a contracting entity. In either case, computer software associated with these projects is classified as being internally generated for financial reporting purposes. In addition, commercially available software that is purchased or licensed by an entity and is modified using more than minimal incremental effort before being put into operation is also classified as being internally generated. This distinction is critical, as it impacts the nature and timing of the accounting for the associated costs of these assets.

Metropolitan operating policies and a Government Accounting Standards Board pronouncement provide guidance regarding the identification, accounting, and reporting of costs associated with internally generated computer software. Operating Policy (OP) I-03, Accounting of Costs for Computer Software, establishes guidelines for accounting for the costs of computer software developed or obtained for internal use, including upgrades and enhancements. In addition, OP I-04, Software Acquisition, establishes policies for acquiring computer software to ensure compatibility with existing computer systems.

Finally, the Government Accounting Standards Board (GASB) Statement 51, Accounting and Financial Reporting for Intangible Assets, provides guidance for computer software acquired through commercially available off the shelf, or developed by an outside contractor or internal staff. This pronouncement became effective for fiscal periods beginning after June 15, 2009.

The Controller Section of the Chief Financial Officer is responsible for determining the appropriate accounting for computer software costs. The Information Technology (IT) Project Management Unit of the Business Services and Technology Group manages Metropolitan's computer software projects, including proper charging of costs.

Opinion

In our opinion, the accounting and reporting for Computer Software Accounting and Costs Analysis 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 during the period from July 2009 through May 2012. Although this opinion is an acceptable rating, we do express concern over the overstatement of Capital and Operation & Maintenance (O&M) project costs by $110,156 and $28,761, as of the audit date. In addition, we noted undocumented changes to project resources; significant budget variances at the task level; lack of formal procedures for closing projects; and incomplete project documentation.

Comments and Recommendations

OVERSTATEMENT OF COMPUTER SOFTWARE PROJECT COSTS

GASB Statement 51, Accounting and Financial Reporting for Intangible Assets provides guidance for computer software acquired through commercially available off the shelf or developed by an outside contractor or internal staff. The statement requires that outlays incurred should be capitalized only when the activities in the preliminary project stage are completed and management has authorized and committed to funding the project. Further, it states that capitalization of such outlays should cease when the software is substantially complete and operational and became effective June 15, 2009.

In addition, Metropolitan's OP I-03 establishes guidelines for accounting for the costs of computer software developed or obtained for internal use, including upgrades and enhancements. IT project management ensures that the costs charged to the projects comply with the capitalization requirements of GASB Statement 51 and OP I-03. We reviewed 12 software projects (6 Capital projects and 6 O&M projects) and noted:

1. Project costs charged to the Materials Interface Project included $44,950 for the consultant's annual software maintenance and warranty costs. This results in an overstatement of capitalized costs per Paragraph 62 of GASB Statement 51. The pronouncement requires that the outlays incurred for maintenance should be expensed as incurred, as these are costs of operating the software and should not be considered ancillary to the development of the programs. Moreover, GASB Statement 51 directs that warranty costs are to be treated as prepaid assets and expensed over the time period for which the warranty extends.

2. Project costs charged to the Enterprise Learning Management/Employee Relations Module (ELM/ERM) Implementation Project included charges of $10,206 for the consultant's postproduction support of W-2 and end-of-year processing, and for assistance with end-user training materials and classes during deployment of the ELM/ERM Implementation Project.

However, these charges result in an overstatement of capitalized costs per Paragraphs 10, 12, and 62 of GASB Statement 51. The pronouncement requires that outlays incurred for postproduction support and training should be expensed as incurred, as these are costs of operating the software and should not be considered ancillary to the development of the software.

3. O&M projects costs charged to the Integrated Budget Management, Water Quality Monitoring, and E-Discovery projects included charges of $28,761 that were incurred after the completion of the O&M project, or after funding authorization by the Board for the related capital projects. These charges resulted in an overstatement of O&M costs and a corresponding understatement of capitalized costs. Paragraph 11 of GASB Statement 51 requires that outlays incurred for project activities, after the management authorized or committed funding and completion of O&M project should be capitalized.

4. Labor charges totaling 1,384 hours for the period of July 2009 through May 2012 (approximately $55,000) incurred by an IT senior administrative analyst were charged to Capital projects. We understand that these charges include reviewing and reconciling monthly consultant invoices, establishing and monitoring IT budgets, compiling and analyzing project costs, obtaining and researching project data, and developing and maintaining project schedules. However, GASB Statement 51 requires that labor hours incurred for administrative support services be classified as General and Administrative Costs, which are to be expensed in a computer software project regardless of the phase in which they were incurred.

5. OP I-03 was last updated in 2008 and management is in process of updating this policy to reflect the provisions of GASB Statement 51.

We recommend the IT project management and the Controller's Office resolve the noted overstatement of project costs. We also recommend that the Controller's Office and IT project management revise OP I-03, and to develop a list of frequently asked questions and answers to ensure proper accounting of computer software project costs.

ADDITIONS OR CHANGES TO PROJECT RESOURCES

A Project Plan describes what the job is, how it will be executed, and the manpower resources required. The resource list or "Roles and Responsibilities" element of the Project Plan outlines the critical details associated with the manpower resources. This data is among the most frequently changed or modified. The resource list should be updated continually during the project to direct ongoing team member development actions.

We reviewed the staff's labor charges incurred for selected capital projects against the resource list of the Project Plan for respective projects. Our review revealed that up to 13 employees who worked for the selected projects were not listed in the resource list as project team members, and up to 13 employees who were listed had no labor hours charged to each project selection.

We understand that the project managers do not update the resource list on an ongoing basis, as the changes in resources are discussed during the regular Project Team Meetings. In addition, IT project management indicated that the project managers have been verifying the accuracy and propriety of labor charges for their respective projects via monthly labor reports. However, supporting documentation that evidenced project manager's performance of these procedures could not be located.

We recommend the IT project management establish procedures to ensure that the resource lists are modified on a timely basis for additions or changes to the project resources.

SUBSTANTIALLY COMPLETE AND COMPLETED PROJECT PROCEDURES

Written procedures should be established and documented to provide a framework for achieving Metropolitan's goals and objectives. Procedures assist management in the training of new employees or cross-training of staff, provide guidance for consistent performance of daily responsibilities, and provide a source of reference for Metropolitan personnel. We reviewed the trial balance for software projects against IT notification memos for substantially complete and completed projects, and the Notice of Completion forms for the period from July 2009 through May 2012 and noted: Although five software projects totaling $11.3 million were completed in FY 2009/10 and FY 2010/11, we noted that these projects remained in the Construction-In-Progress "CIP" Account 12155 rather than in the Completed Features Account 12198, as of May 31, 2012.

Item	Project No.	Description	Amount	Work Completed	IT Memo* Date
1	103824	Billing System Upgrade	$ 3,195,592	08/31/09	12/03/09
2	103867	Integrated Budget Mgt Sys	4,205,463	08/31/09	12/03/09
3	103989	Inventory Bar Coding Sys	1,145,441	09/30/10	10/10/10
4	103928	Materials Interface	1,722,437	05/31/11	06/06/11
5	104029	ELM/ERM Implementation	1,047,888	3/21/11	06/06/11
		Total	$11,316,821		

*Notification to Controller's Office for substantially complete projects

Further review revealed that both "in process" and "substantially completed" projects were recorded to the CIP account and then transferred from the CIP account to Completed Features Account 12198, when the projects are added into the Oracle Asset Tracking System. We understand that this practice then requires IT project management to notify the Controller's Office and the Project Coordinating Office when an IT capital project is substantially complete or administratively closed, in order to complete the transfer of these projects to the "Completed Features" account. Finally, we noted that these practices have not been codified into written procedures or desk briefs.

We recommend that IT project management, Project Coordinating Office, and Controller's Office work together to formalize procedures for substantially complete and completed capital projects to ensure consistency and proper recording of projects and the related depreciation expense.

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. We reviewed the billings for selected software projects (O&M and Capital) and the related cost by Project/Task Reports generated from the Project Management Information System. Our review revealed:

1. CBH Invoice 210509 and Autonomy Invoice 7849ANA totaling $80,683 were paid from 5 to 66 days of their due dates. These invoices were paid under completed project 103867 Integrated Budget Management and active project 104182 E-Discovery. According to IT project management, Autonomy's invoice was held 66 days until testing of deliverables was completed. These actions are in contrast to the terms and conditions of the contracts.

2. Payment of Autonomy's Invoice 9553ANA for $65,000 under active project 104182 E-Discovery was incorrectly coded to Task L03-IB System Design 1b, rather than the budgeted task L06-IB-V Ph 1 B Analysis Design.

3. Tasks billed on Tetra's invoices (50503289) under active project 104219 Water Quality Monitoring and Rapid Event Detection System were inconsistent with the tasks established in the Project Administration and Grants Management system.

4. We reviewed Budget vs. Cost by task code for active project 104219 and noted significant variances for each task code. For example, task codes L11 to L23 were budgeted for $955,973; however, the actual costs were zero as of May 31, 2012. Further review revealed, however, that these payments have already been made to the consultant. In addition, task code L06 System Development Configuration, which was budgeted for $65,010 had costs incurred of $692,936. We understand that the budget variances at the task level were due to miscoding of project costs by task, and that IT project management indicated that the project remained underbudget at the project level.

5. Lastly, we could not locate the Project Authorization Request, Request for Project Completion and the Notice for Project Completion Forms for completed O&M Project Human Resource Improvement Program.

We recommend that IT project management unit remind the project managers of the importance of timely payment of vendor invoices and complete documentation for project authorization and completion. We also recommend that IT project management remind staff to ensure proper and consistent use of project task codes for all computer software projects.

Diamond Valley Recreation Facilities Audit Report

Background

The Diamond Valley Lake (DVL) Reservoir is located near Hemet, California and was completed in 2000, with a capacity of 800,000 acre-feet at a cost of approximately $2 billion. As Southern California's largest surface water storage reservoir, DVL Reservoir provides for up to six months of water supply for use in times of emergency or severe drought. In addition, the DVL Reservoir provides for greater operational flexibility and improved reliability to help ensure adequate supplies of high-quality water to meet the needs of the Metropolitan service area.

The DVL Reservoir consists of three dams, delivery pipeline, pumping plant, environmental reserves, and recreational facilities. These facilities offer amenities such as boat rentals, sport fishing, two hiking trails, an Aquatic Center, and a concessionaire retail store. Since its opening in 2003, approximately 508,000 anglers and sport fishermen have fished at the DVL Reservoir, and over 131,000 private boats have been launched into the lake. Moreover, some 46,000 of these boat launches have been made since the extension and reopening of the boat ramp in December 2009.

In July 2003, the Board authorized the execution of a contract with Urban Park Concessionaires (UPC) for the operation of a concession store and boat rental service at DVL Reservoir. The contract also provided that UPC collect park entrance fees, oversee lake security, and manage sanitation, waste removal, and general maintenance of the recreation facilities. This contract was an expense reimbursement arrangement that averaged about $14,000 per month. In October of 2011, Metropolitan entered into a lease agreement with UPC in which UPC agreed to pay 7 percent of the gross receipts of parking and entrances fees, trail fees, and concession sales as rent to Metropolitan. Since entering into this agreement, Metropolitan has received an average of $7,000 per month in lease income.

Opinion

In our opinion, the accounting and administrative procedures over the UPC lease agreement include those practices usually necessary to provide for a satisfactory internal control structure. The degree of compliance with such policies and procedures provided effective control for the period covering July 2011 through June 2012.

Comments and Recommendations

There were no material findings to report.

Audit Department Quality Assurance Review

In June 2012, the Audit and Ethics Committee and the Board of Directors reviewed and approved the FY 2012/13 Audit Plan, which allocates resources to the areas of greatest perceived risk for Metropolitan. We recently evaluated the Audit Department's performance versus the Audit Plan for the first quarter and noted that eight audits, special reviews, and comfort letters have been completed.

In keeping with industry standards, we then evaluated the Audit Plan to identify significant changes in risk profiles or resource levels, which could result in a recommendation to the Audit and Ethics Committee and the Board to adjust the Audit Plan. Our analysis of audit resources for the quarter revealed that total resources (4,402 hours) were below Audit Plan levels by 543 hours, primarily due to one auditor's long-term disability leave. Further analysis of auditor time charging for the quarter indicated a higher charge-out rate to projects of 60 percent, as compared with 58 percent in the Audit Plan. We also noted that several audits had more hours charged than budgeted and we will continue to monitor the effect of these factors to ensure the efficient execution of audits.

We then evaluated each scheduled audit for changes to the risk profile, considering emerging risks, management discussions, and results of recent audits. We also considered the effect of several new audits that will require additional audit resources. We believe the Audit Plan is tracking to schedule and, therefore, modification to the Audit Plan is not required.

Further, we believe that the Audit Department will fulfill its responsibilities to complete the FY 2012/13 Audit Plan, as presented to the Audit and Ethics Committee and the Board. We will continue to monitor risk and resources and provide formal updates on at least a quarterly basis through the end of the fiscal year.