THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

**Report**
Office of the General Auditor

## Audit Department Report for April 2014

**Summary**

Six reports were issued during the month:

- **Commercial Conservation Program Audit Report**
- **Payroll Audit Report**
- **CIP-PCCP Rehabilitation and Replacement Program 15471 Audit Report**
- **Audit Quality Assurance - Audit Plan Update**
- **Internal Controls Over Financial Reporting Review**
- **Accounts Payable and Payroll Records Review**

**Discussion Section**

This report highlights the significant activities of the Audit Department during April 2014. In addition to presenting background information and opinions expressed in the audit reports, a discussion of findings noted during the examination are also provided.

# Commercial Conservation Program Audit Report

**Background**

The Audit Department has completed a review of the accounting and administrative controls over the Commercial Conservation Program (Program), as of December 31, 2013.

Our review consisted of evaluating the Program's accounting and administrative controls by testing compliance with established policies and procedures. We also tested compliance with the terms and conditions of the agreement with Electric and Gas Industries Association (EGIA), for the administration of the Conservation Rebate Program. Finally, we reviewed management's reporting process to ensure that rebate expenditure data was reported accurately and timely.

Recent drought conditions and restrictions on Bay-Delta pumping have caused a strain on Metropolitan's water supplies. These developments have reinforced the importance of conservation, to help achieve water savings consistent with Metropolitan's 2010 Integrated Resources Plan (IRP). The Long-Term Conservation Plan was designed to support the IRP goals, includes the Program as one element to assist in achieving needed water savings.

Towards these goals, the SoCalWater$mart Regional Water Conservation (SoCal) Program was implemented to help ensure adequate, reliable, and affordable water supplies for Metropolitan's service area. This SoCal Program uses financial incentives to promote residential and commercial water savings, by offering rebates to customers to replace water devices and fixtures with newer, more efficient models. Incentives are calculated based on the value of water saved over the life of the device. Member agencies may add supplemental funds to Metropolitan's rebates to make these incentives more attractive financially. Devices eligible for rebates under the Program include irrigation controllers, rotary nozzles, high-efficiency toilets, zero water and ultralow water-use urinals, dry vacuum pump ice machines, and cooling tower controllers.

In May 2012, the Board authorized a five-year, $90-million agreement with EGIA to administer a combined regional conservation rebate program. Under the agreement, EGIA provides regional administration for both residential and commercial device retrofits including rebate processing, website development and updates, database management, customer service, and reporting. In addition, EGIA disburses Metropolitan funds budgeted for the Program, as well as participating member agency supplemental funds. Metropolitan paid $12.3 million to EGIA for the period of November 2012 through December 2013. These totals included member agency supplemental funds.

**Opinion**
In our opinion, the accounting and administrative procedures over the Program 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 of November 2012 through December 2013.

**Comments and Recommendations**
There were no material findings to report.

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## Payroll Audit Report

**Background**
Our review consisted of evaluating the internal controls over Payroll activities including timekeeping, payment processing, and employee data changes. We also tested compliance with Metropolitan policies and procedures, and examined reconciliation and reporting processes to ensure sound financial controls. Lastly, we reviewed user access to Payroll data to confirm appropriate data security controls. In addition to internal control testing, we also performed data analytical reviews of overtime and special leave payments during calendar years 2011, 2012, and 2013. The objective of our analyses was to evaluate historical overtime payment trends, and identify potential improprieties for further review and discussion with management.

The Human Resources Group is responsible for establishing and maintaining employee records, which includes updating employee compensation and benefit information, securing the personnel and employee benefit files, authorizing user access, and assigning user rights in the PeopleSoft Payroll System. The Payroll Administration Team of the Controller Section administers the Payroll process, which includes processing paychecks, complying with tax laws, and maintaining appropriate Payroll records. In addition, they are responsible for reviewing Payroll information entered into the WorkTech Timekeeping System.

As of December 31, 2013, Metropolitan had 1,810 employees: 1,737 regular full-time employees, 4 regular part-time employees, 30 temporary full-time employees, and 39 temporary part-time employees. Labor expenses totaled $186.7 million for the calendar year ending December 31, 2013, including $10.5 million of overtime payments.

**Opinion**
In our opinion, the accounting and administrative procedures over Payroll 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 of January 1, 2013 through December 31, 2013.

Date of Report: April 30, 2014

**Comments and Recommendations**

HUMAN RESOURCES PROCEDURES – EMPLOYEE SEPARATIONS

Written policies and procedures should be established and documented to provide the framework for achieving compliance with regulatory requirements, Metropolitan Administrative Codes, and department goals and objectives. Procedures assist management in the training of new employees, provide guidance for the consistent performance of daily responsibilities, and provide a source of reference for experienced personnel. Human Resources procedures should document processes related to personnel matters including recruitment, promotions, and benefits. These procedures should also address activities concerning voluntary or involuntary employee separations, or terminations. During our review, we could not locate the Employee Separation Procedures, as referenced in Operating Policy H-05, Employee Separation.

We recommend that management document these procedures to ensure proper processing of separations, and compliance with related legal requirements.

ESCHEATMENT OF UNCLAIMED FUNDS

The State of California established an unclaimed property or escheatment regulation (Unclaimed Property Law, California Government Code Section 50050), that stipulates that funds unclaimed for three years are the property of the local agency, after notice has been served. Further, Metropolitan's Administrative Code Section 5113, Escheat to District of Unclaimed Funds, states that such funds shall be transferred to Metropolitan's General Fund following board approval and published notice. Unclaimed personal property in this context includes vendor payments, or Payroll checks not cashed and considered abandoned. During our review, we noted that 40 Payroll checks totaling $5,314 issued between 2001 and 2010 remained unclaimed. We could not locate evidence that notice had been served regarding these unclaimed funds. Further, the funds had not been transferred to Metropolitan's General Fund.

We recommend that the Controller Section management resolve the outstanding checks, and establish related procedures to ensure compliance with state regulations and the Administrative Code.

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## Capital Investment Plan – Prestressed Concrete Cylinder Pipe Rehabilitation and Replacement Program Appropriation 15471 Audit Report

**Background**

The Audit Department has completed a review of the accounting and administrative controls over the Capital Investment Plan (CIP) – Prestressed Concrete Cylinder Pipe (PCCP) Rehabilitation and Replacement Program (Appropriation 15471), as of December 31, 2013. Our review consisted of evaluating project administration, reporting practices, change authorizations, and closeout processes. Further, we evaluated the accuracy of invoice payments for assurance that amounts billed were properly calculated, and adequately supported. Finally, we reviewed the Actual versus Budgeted Costs on a project-by-project basis and compared these totals to the appropriated amounts and management reports.

Metropolitan's water delivery system includes approximately 830 miles of pipelines, of which 163 miles are PCCP lines. Metropolitan installed these lines between 1965 and 1985, in both dense-urban areas and remote regions. These PCCP lines range between 54 and 201 inches in diameter.

Date of Report: April 30, 2014

During the 1990s, water systems throughout the country experienced an increasing number of PCCP line failures. These incidents compelled PCCP line owners to develop inspection, monitoring, and repair programs to ensure the reliability of such pipelines. These efforts aided in the accurate identification of the condition and stability of the PCCP lines, along with characterization of their true-service life.

Metropolitan developed the PCCP Inspection Plan under its Infrastructure Reliability Protection (Infrastructure) Program to respond to these concerns about the reliability of the PCCP lines. Accordingly, the Board authorized a capital program in December 1996, to assess the condition of Metropolitan's PCCP lines. After assessing 163 miles of PCCP lines, management ranked the PCCP lines most in need of repair. The Engineering Services Group (ESG) initiated the PCCP Rehabilitation and Replacement Program in September 2011 to inspect, monitor, repair, and rehabilitate its PCCP lines. The Second Lower Feeder was the first PCCP Rehabilitation and Replacement project initiated under this Infrastructure Program.

The Second Lower Feeder delivers treated water from the Robert B. Diemer Treatment Plant in Yorba Linda, to the Palos Verdes Reservoir in Rolling Hills Estates. Constructed in 1967, the Second Lower Feeder supplies water to the Central Pool portion of Metropolitan's distribution system. In addition, it has 11 service connections for deliveries to the cities of Long Beach, Los Angeles, Torrance, the Central Basin Municipal Water District, and the Municipal Water District of Orange County. Approximately 30 miles of this 39-mile line are constructed of PCCP, with diameters ranging from 78 to 84 inches.

As of December 31, 2013, the PCCP Rehabilitation and Replacement Program consisted of four Second Lower Feeder projects and nine inspection/repair/replacement projects. Five projects have been completed and eight projects are in progress, with project costs totaling $13.3 million out of $29.6 million appropriated. To date, the PCCP Rehabilitation and Replacement Program is within budget and on schedule. It should be noted that ESG staff estimates that the total PCCP Rehabilitation and Replacement Program will cost more than $2 billion.

## Opinion

In our opinion, the accounting and administrative procedures over the CIP - PCCP Rehabilitation and Replacement Program include those practices usually necessary to provide for a generally satisfactory internal control structure. The degree of compliance with such policies and procedures provided effective control for the period of January 1, 2012 through December 31, 2013.

## Comments and Recommendations

### PROJECT COMPLETION AND CLOSEOUT

Project management is in the process of planning, organizing, and controlling resources to achieve project objectives. It involves monitoring and controlling activities from project initiation to completion. The Oracle System Project (Oracle) account should be closed, once a project has been completed and Metropolitan has discharged its obligations. Our review of thirteen projects revealed that Projects 104392, 104398, and 104399 were completed between 2012 and 2013. However, Oracle showed these projects open as of December 31, 2013. It should be noted that ESG staff has closed these projects.

We recommend project management establish procedures to ensure projects are closed out on a timely basis, and conduct reviews to ensure compliance.

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PROJECT BUDGET

Project budget control is the process established for developing and tracking cost goals for all contractually authorized work. Major components of this process include defining project scope, setting time schedule, and establishing cost limits. Project budget controls measure actual events against these goals to track and report on the progress of the project. Our review of thirteen projects revealed that Project 104392 was overbudget by $101,472 (18 percent), without an approved Change Request Form. It is important to note that overall PCCP Rehabilitation and Replacement Program expenditures were less than the board-appropriated amount at all times.

We recommend that management remind personnel of the importance of complying with established procedures. We also recommend that project management conduct periodic tests to ensure compliance.

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## Audit Quality Assurance - Audit Plan Update

In June 2013, the Audit and Ethics Committee and the Board of Directors reviewed and approved the fiscal year 2013/14 Audit Plan (Plan), which allocates audit resources to the areas of greatest perceived risk. In keeping with professional auditing standards, we reviewed our progress versus the Plan on a quarterly basis in order to identify significant changes in audit resource levels, risk profiles, or Plan directives. Such changes could result in a recommendation to the Audit and Ethics Committee and the Board to adjust the Plan, in order to direct audit resources appropriately.

Our review of the Audit Department's performance for the nine months ending March 2014 disclosed that 30 audits, special reviews, and bond Comfort Letters were completed. Our analysis of audit resource levels determined that audit resources were tracking to Plan assumptions. Further, our review of auditor time charging to audits revealed that the charge-out rate of 58 percent was slightly higher than the rate assumed in the Plan, which compensated for budget overages on several audits.

Finally, we evaluated planned audit work for the remainder of the fiscal year for significant changes to risk profiles or directives. We did not identify any such changes, and believe the Audit Department will fulfill its responsibilities to complete the fiscal year 2013/14 Plan. Therefore, we do not believe the Plan requires adjustment, and will continue to monitor risks and resources through the end of the year.

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## Internal Controls Over Financial Reporting Review

We completed a review of the internal controls over financial reporting for fiscal year ending June 30, 2013. We performed procedures to provide a level of assurance to the Board and management that controls related to the reliability and integrity of financial reporting are effective. Our review was required by Metropolitan's Administrative Code Section 6451(d)(3), Audit Department Charter, which directs the Audit Department to issue an annual opinion over such controls. Moreover, professional auditing standards require that auditors evaluate the risk exposure, adequacy, and effectiveness of controls relating to the reliability of financial information.

In accordance with these requirements, our review procedures were based on the internal control integrated framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission. Utilizing this framework, we first analyzed the results of the fiscal year 2012/13 Audit Plan which included completion of 27 audits, 7 bond Comfort Letters, and 12 special projects. As part of our review of audit results, we also evaluated management's responses to ensure they were timely and that management had effectively addressed our concerns.

We also evaluated documentation pertaining to key business controls prepared by the Controller's Office, in accordance with their responsibilities specified in Administrative Code Section 2700 (c)(2), General Manager's Annual Reports. The Controller's final assessment concluded that internal controls over financial reporting and information technology security were effective for the 12 months ending June 30, 2013. We considered the results of this review as part of our assessment. We then evaluated the scope and results of the substantive testing that we performed for the external auditors during their fiscal year 2012/13 financial statements audit. This testing provided evidence that was used in our evaluation of financial reporting controls. Next, we analyzed selected financial statement accounts and transactions based on risk and materiality.

We also performed process walk-throughs, and selected testing in key financial areas including revenue and receivables; cost of water and water inventory; property, plant, and equipment; purchasing and payables; debt management; employee compensation and benefits; and financial reporting. Finally, we evaluated application controls over major financial systems; reconciliation controls for major accounts including accounts payable, accounts receivable, and cash; access controls for financial information systems; and controls over documents supporting financial transactions.

Our study and evaluation were made for the limited purpose described in the first paragraph, and would not necessarily disclose all material weaknesses in the system. We do not express an opinion on the system of internal control taken as a whole. Based on the results of our review, there is reasonable assurance that internal controls at June 30, 2013 were adequate to achieve reliable financial reporting.

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## Accounts Payable and Payroll Records Review

We have completed an analysis of the Accounts Payable, Vendor, and Payroll data files for the period of January 1, 2011 through December 31, 2013. This review utilized population stratification techniques, application search engines (queries), and other data-mining methodologies to test transactions processed in the Accounts Payable, Purchasing, and Payroll modules within the Oracle Financial System (Oracle).

The objective of our analyses and queries was to test the propriety of records and to identify data input errors, discrepancies, or improprieties. We investigated results that contradicted expected parameters, or contained anomalous readings. Our test work was limited to these stated objectives and did not include an analysis of the internal control structure, nor did it include those tests necessary to express an opinion on the internal control structure over Accounts Payable and Payroll records. Accordingly, we do not express such an opinion. Metropolitan uses Oracle to manage purchase orders, track vendor invoice processing, and issue Accounts Payable checks. The Purchasing Module within Oracle is used to create and track purchase orders; whereas, the Accounts Payable module is used to control payment processing. These controls ensure that payments are made on a timely basis, after receipt of goods and services. Finally, the PeopleSoft System (PeopleSoft) is used to process Payroll transactions based on timesheets submitted through WorkTech.

This review involved designing and running queries on data records in the Purchasing and Accounts Payable modules of Oracle, and on Payroll data within PeopleSoft. Our scope consisted of transactions for the period of January 1, 2011 through December 31, 2013. During this period, Accounts Payable payments (excluding benefits and taxes) totaled $2.8 billion including Payroll payments of $391 million. We tested all payments made to vendors (60,577 payments) based on 126,751 invoices (one payment may pay several invoices). We also tested Payroll payments throughout the period to employees, who numbered 1,810 active employees on December 31, 2013.

TESTS PERFORMED

Accounts Payable data queries included:

a. Duplicate payments made to the same vendor.
b. Vendors with the same address as an employee address.
c. Invoices paid more than 10 days before the due date.
d. Vendors missing a tax identification number.
e. Multiple requisitions with the same vendor.
f. Vendors who went out of business, or separated employees that were coded Active in the Oracle Procurement Vendor Database.

Payroll data queries included:

a. Multiple employees with the same direct deposit bank accounts.
b. Multiple employees with the same home address and telephone numbers.
c. Employees without deductions for taxes and other benefits.
d. Employees who did not take any type of leave within a calendar year.
e. Employees with invalid social security numbers.
f. Former employees remaining on payroll.
g. Employees who received both direct deposit and paper paychecks.
h. Employees without work locations and work telephone numbers.
i. Employees with PO Box addresses.
j. Employees with addresses outside of Arizona, California, and Washington D.C.

It is important to note that many of these queries returned results that appeared to be discrepancies, and thus required further review and investigation. This additional scrutiny revealed these items were false positives, as they were resolved as being appropriate transactions. We did not investigate all potentially duplicate vendor payments, and we have provided a file to Accounts Payable management for further follow-up. Finally, it should be noted that we designed these queries so that they can be run on a quarterly basis.

Date of Report: April 30, 2014