THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

Report
Office of the General Auditor

Audit Department Report for September 2014

Summary

Three reports were issued during the month:

- **Fuel Supply Management Audit Report**
- **Accounting For and Billing of Reimbursable Projects Audit Report**
- **Stores Inventory Audit Report**

Discussion Section

This report highlights the significant activities of the Audit Department during September 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.

Fuel Supply Management Audit Report

Background

The Audit Department has completed a review of the accounting and administrative controls over Fuel Supply Management, as of October 31, 2013. Our review consisted of evaluating internal controls over the bid and selection process for suppliers of bulk fuel and reviewing purchase, delivery, usage, reconciliation, and reporting of fuel supplies. We also evaluated invoice payment validity and propriety for compliance with contract terms, and assurance that amounts billed were properly calculated and adequately supported. Finally, we performed analytical procedures designed to search for unusual patterns in the data.

The Fleet Services Unit (Fleet) of the Operations Support Services Section within the Water System Operations (WSO) Group is responsible for managing diesel fuel and gasoline supplies for use in Metropolitan vehicles and equipment. While diesel fuel is used in vehicles and emergency back-up generators, gasoline is utilized in vehicles and equipment (e.g., air compressors). These fuel supplies are dispensed at nine fleet service centers and four fuel dispensing locations at treatment plants, pumping plants, and the Sunset garage.

In addition, Fleet staff utilizes the Fuel Management System (FMS) to initiate fuel purchases and track and monitor fuel usage at pumps. FMS limits fuel access to authorized users through use of card readers, restricts dispensing to Metropolitan vehicles and equipment, and collects fuel usage data. Fleet staff prepares monthly Perpetual Fuel Inventory (PFI) reports summarizing fuel deliveries, fuel usage, and inventory balances.

PFI reports are submitted to Reporting and Operations under the Controller Section in the Office of the Chief Financial Officer, and Environmental Program within the Operational Safety and Environmental Services Section of WSO. Reporting and Operations uses PFI reports to compute diesel fuel tax, allocate fuel usage costs to various field locations, record adjustments to fuel inventory accounts, and issue payments to fuel suppliers. The Environmental Program relies on PFI reports to monitor fuel levels and variances to detect potential storage tank problems, operational issues, or environmental concerns. From July 2011 through October 2013, Metropolitan's fuel purchases totaled $5.9 million and fuel inventory value on October 31, 2013 was $317,705.

Date of Report: September 30, 2014

Opinion

In our opinion, the accounting and administrative procedures over Fuel Supply Management 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 controls from July 1, 2011 through October 31, 2013.

Although this opinion is an acceptable rating, we express concerns over the failure to verify fuel charges to ensure Metropolitan was billed competitive prices, review invoice fuel prices and quantities, resolve inventory variances, and reconcile fuel inventory records to FMS. It should be noted that Fleet Services Unit (Fleet) management of the Operations Support Services Section within the WSO Group, has initiated actions in response to our concerns.

Comments and Recommendations

REVIEW AND APPROVAL

Review and approval controls are designed to verify billing accuracies of goods and services, provide transaction propriety assurance, confirm compliance with contractual terms and conditions, and ensure follow-up procedures exist for exception processing. For fuel purchases, procedures require Fleet staff compare unit prices on supplier invoices against the Oil Price Information Service Index (OPIS) report to determine reasonableness of fuel charges prior to payment. This ensures Metropolitan is billed competitive prices for fuel purchases, and that costs are within industry benchmarks.

We reviewed 20 invoices totaling $308,973 paid from July 2011 through October 2013, and noted:

1. We were unable to locate supporting documentation for verification of fuel charges against the OPIS. We also noted that OPIS reports for 12 of 20 invoices reviewed were missing, or submitted only when requested during the review.

2. Fuel unit prices on eight of 20 invoices did not match OPIS, plus appropriate supplier margins. This discrepancy resulted in a $195 overpayment on four invoices, and $164 underpayment on four invoices.

3. Fuel deliveries for two of 20 invoices were billed at gross rather than net quantities, resulting in $299 overpayment. Fleet management indicated that initial gross order figures may be used for billing purposes, since there were no required corrections to net adjusted delivery volume for deliveries of less than 5,000 gallons. Except for these two invoices, we noted that all invoices reviewed were billed at net delivered quantities by all three fuel suppliers. Further, we could not locate Highway Transportation receipts for three of 20 invoices reviewed.

4. In three of 20 invoices reviewed, fuel deliveries were overstated by 75 gallons in the PFI reports because gross deliveries were used rather than net deliveries. We also noted fuel deliveries for two of 20 invoices were overstated by 14 gallons, because net deliveries were incorrectly recorded in the PFI reports. Lastly, we could not locate the Temperature Compensated reports for three of 20 invoices reviewed.

We recommend the Controller's Office and Fleet management coordinate efforts to verify fuel unit prices and that fuel deliveries match OPIS and Highway Transportation receipts, to ensure the accuracy of supplier invoices. Further, we recommend Fleet management resolve the fuel delivery variances between PFI reports and Temperature Compensated Reports. Lastly, we recommend Fleet management require suppliers submit the required supporting documentation with invoices.

RECONCILIATION OF FUEL DELIVERY, USAGE, AND INVENTORY

Perpetual Fuel Inventory processes were established to track the quantity and value of fuel supplies on hand by reconciling beginning inventories, deliveries, and usage to determine ending inventories. PFI reports were designed to manually reconcile fuel inventories, and identify fuel variances for each fuel tank. Variances may be the result of fuel leaks, and should be investigated. The electronic FMS restricts pump dispensing to authorized individuals through card readers and Metropolitan vehicles through vehicle asset numbers, and records the number of gallons dispensed. Our review of PFI records for 16 fuel tanks from March 2013 through August 2013 revealed:

1. We could not locate fuel usage reconciliations between FMS worksheets and PFI reports for all 16 tanks reviewed. We noted discrepancies in recorded fuel usage between PFI reports and FMS worksheets for these fuel tanks. These resulted in an overstatement of fuel usage reported in the PFI reports by 7,196 gallons for 11 fuel tanks, and an understatement of 206 gallons for the remaining five fuel tanks. We understand management does not rely on FMS to generate total fuel usage data, although actual readings of each dispensing are reliable. Consequently, management performs stick readings of fuel tanks to determine ending fuel inventories.

2. Three fuel tanks had Environmental Compliance Department (ECD) variances ranging from 1.9 percent to 11 percent, during April 2013 and May 2013. These variances resulted from differences between fuel tank stick readings, and automated measurement readings at end of month We noted that operating procedures require explanation and follow-up of ECD variances above 1 percent, plus an additional allowance of 130 gallons. However, we were unable to locate documentation relating to these variances.

3. Month-end inventory for five fuel tanks exceeded the internal target of 80 percent full from March 2013 through July 2013. The excess inventory varied from 1.5 percent to 6.8 percent above target. We understand that although the regulatory requirement is 90 percent of full, Fleet staff manages fuel levels to an internal target of 80 percent of full to avoid fuel leakage or release. We also noted this internal target of 80 percent of full was not documented.

4. Lastly, the fuel usage reported in the monthly PFI reports for Diamond Valley Lake (DVL) fuel tanks did not reconcile with the Daily Fuel Logs. DVL is the only facility still using a manually recorded gasoline dispenser system. We understand FMS is targeted to be implemented by the end of 2014, pending construction activities.

We recommend Fleet management coordinate efforts with Information Technology Services management to resolve the noted reporting issues in FMS. Further, we recommend Fleet management establish procedures to ensure compliance with fuel reorder and fuel tanks maximum capacity requirements, and conduct tests to ensure compliance. Finally, we recommend Fleet management remind Field Office staff to perform periodic fuel reconciliations, and provide variance explanations.

Date of Report: September 30, 2014

Accounting For and Billing of Reimbursable Projects Audit Report

Background

The Audit Department has completed a review of the controls over the Accounting For and Billing of Reimbursable Projects (Reimbursable Projects), as of January 31, 2014. Our review consisted of evaluating the internal controls over Reimbursable Projects authorization, billing, collection, and close out processes. We also tested compliance with the terms and conditions of Grant and Letter agreements with federal and state agencies, member agencies, project proponents, and other outside entities. In addition, we performed analytical reviews of billed and reimbursed amounts, grants and advance deposits received, and subsequent collections recorded to the general ledger. Finally, we agreed management reports to source documents for accuracy.

Reimbursable Projects are contractual relationships under which Metropolitan provides a product or service to another party, and all of the related costs are paid by the contracting entity. These Reimbursable Projects may originate in any Metropolitan group and include construction-related activities, water quality research grants, water planning and conservation programs, and water-related initiatives.

The Engineering Services (ES) Group and Water System Operations (WSO) Group are assigned responsibility to administer construction and water quality research projects; Water Resource Management (WRM) Group is responsible for administering water planning and conservation projects; and Bay Delta-Initiatives administers Bay-Delta projects. Contracting or originating entities may include member agencies, nonmember public or private agencies, federal or state grantors, and nonprofit organizations.

Within ES, WSO, WRM Groups and Bay Delta Initiatives, project managers are assigned to administer Reimbursable Projects including monitoring project activities, reviewing expenditures, approving cost reimbursement requests, initiating project billing and cost transfers, and preparing management reports. As support for these activities, the Project Coordination Office of the ES Group is assigned responsibility for establishing and closing projects at project manager's request. In addition, Controller Section staff is responsible for activating account numbers for new projects, and processing periodic billings and Cost Transfers upon project manager's request.

Metropolitan's Operating Policy C-01, Accounting For and Billing of Reimbursable Projects, and Administrative Code Sections 4700 (a-f) establish the policies and procedures for administration of Reimbursable Projects. In addition, Operating Policy C-09, Remittance Handling Processing, establishes policies for collecting and reporting remittances such as advances and reimbursements. Finally, Operating Policy C-21, Accounting and Administration of Federally Funded Grants and Accounting and Administrative Procedures for Federally Funded Grants, establish policies and procedures specific to federal grants.

REIMBURSABLE PROJECT TYPES

Reimbursable Projects consist of three categories: those requiring an advance deposit prior to initiation of work; those requiring eligible costs be accumulated and billed pursuant to claims and contract terms; and those requiring cash advances to employees be reconciled after completion of travel or activity.

Opinion

In our opinion, the controls over Accounting For and Billing of Reimbursable Projects 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 controls from July 1, 2011 through January 31, 2014.

Although this opinion is an acceptable rating, we express concerns over unbilled Reimbursable Project charges of $175,420, uncollected contract administration fees of $105,069, and $5,099 of uncollected office rent. We also noted that uncollectible costs of $1,661,594 were accounted for as Reimbursable Projects. On the surface, these findings catalog inconsistent management of Reimbursable Projects across operational units. However, given the fact that these concerns are consistent with findings noted in a prior audit report, these conditions reflect a lack of management oversight over Reimbursable Project activities. We recommend that a more holistic approach to address these risks is warranted.

Comments and Recommendations

COMPLIANCE WITH POLICIES AND PROCEDURES AND TERMS AND CONDITIONS OF AGREEMENTS

Operational policies and procedures are established to provide the framework for achieving organizational goals and objectives. Procedures provide guidelines for consistent performance of daily operations, assist in training new employees, and provide a source of reference for experienced personnel. Compliance with these policies and procedures and terms and conditions of Reimbursable Project contracts is necessary to ensure accurate accounting records, proper supporting details, and adequate controls over agreement administration. Compliance with contractual terms and conditions of agreements also ensures parties fully discharge their obligations and exercise their rights.

Our test work revealed numerous instances of noncompliance with established procedures, terms, and conditions of the Reimbursable Projects contract. We noted that policies and procedures did not clearly define criteria utilized to determine project classification as a Reimbursable Project, or ensure adequate controls over administering Reimbursable Projects. A discussion of these findings is organized by group below.

I. WATER SYSTEM OPERATIONS GROUP

A. Various Units

We reviewed three of 12 Reimbursable Projects with an outstanding balance of $797,317, as of January 2014. Our review revealed that Reimbursable Project charges of $582,924 incurred for the Arroyo Seco Remove Contamination Soil Project and Feeder Station 1908+-40, Leak Investigation and Repair, were determined to be uncollectible as the Water System Operations (WSO) Group staff could not identify responsible entities that caused damage to Metropolitan properties in 1989 and 2009. The Office of the General Counsel (General Counsel) staff was consulted for reviewing charges and a possible write-off.

B. WSO Group Machine Shop and Los Angeles County Department of Public Works

We reviewed all three machine shop projects for the Los Angeles County Department of Public Works (LACDPW). As of January 2014, the outstanding balance for these projects totaled $175,428. Our review revealed:

1. Work was performed on the 48" Hollow Jet Valve Refurbishment Project, after the contract expired on August 10, 2013. A supplemental agreement for reimbursement is under review by LACDPW. In addition, Reimbursable charges of $175,420 incurred for from August 2013 through December 2013 were not billed, as of January 31, 2014. This is in contrast to agreement Payment Section. It should be noted that these charges were billed in April 2014, and payment was received.

2. Reimbursable charges of $47,020 incurred through September 2012 for LACDPW - Manufacture Cat Gate Wheel Project, were not billed at the time of our review. It should be noted that charges were billed in January 2014, and paid the following month.

   We recommend WSO Group management coordinate efforts with Controller Section staff to ensure reimbursable charges are billed on a timely basis. We also recommend management remind the Machine Shop staff to perform work in accordance with contracts.

C. California Department of Water Resources

We reviewed nine of 51 Reimbursable Projects. As of January 2014, the outstanding charges for nine projects totaled $755,932. Our review revealed:

1. Reimbursable charges of $93,277 incurred for the Hyatt U5 Engineering Support Services for Thrust Bearing Project, from November 2012 through June 2013 were not billed, as of January 31, 2014. It should be noted that these charges were billed in March 2014, and payment was received on May 2014.

2. Reimbursable Project charges of $777,424 incurred for four projects were billed to the California Department of Water Resources (California DWR) between 114 and 320 days, after charges were incurred. Project management indicated the delay was due to California DWR's untimely acceptance of Metropolitan's work. The contract allows Metropolitan to bill within 30 days but no longer than 90 days, after satisfactory completion and acceptance of work.

3. We could not locate approved Initial Project Authorization Forms for six of nine Reimbursable Projects reviewed. This is in contrast to Operating Policy C-01, Accounting For and Billing of Reimbursable Projects, which requires management approval prior to project initiation.

4. Project Completion Forms could not be located for four completed Reimbursable Projects reviewed.

D. Federal Emergency Management Agency

We reviewed six of 16 (Federal Emergency Management Agency (FEMA) projects. As of January 2014, the outstanding balance for these six projects totaled $954,182. The Santa Ana River Bridge Crossing on the Upper Feeder Blow-Off Structure, was completed in November 2007, but not closed as of January 31, 2014.

II. ENGINEERING SERVICES GROUP

A. Substructures

We reviewed one of three projects. As of January 2014, the outstanding balance for this project totaled $116,905. Our review revealed:

1. Reimbursable charges of $116,905 incurred in 2003 for the Plan, Review, and Survey of Shell Development Project at Diemer were determined to be uncollectible, as charges were not included in the settlement of claims with property developer. The Engineering Services (ES) Group and Controller Section have agreed to write off the uncollectible charges to Operations & Maintenance (O&M) projects.

III. BAY DELTA INITIATIVES

We reviewed one of four projects and the outstanding balance for Project 701516 totaled $105,069, as of January 2014. Our review revealed that Contract administration fees were earned since 2009, and had not been billed to the California Urban Water Agencies (CUWA).

IV. CHIEF FINANCIAL OFFICER - CONTROLLER SECTION

We reviewed six of 17 Reimbursable Projects. As of January 2014, the outstanding balances for these six projects totaled $574,361. Our review revealed:

A. Reimbursable charges of $118,268 incurred for SB-90 UG Tanks, Install Project and SB-90 UG Tanks, Close/ Removal Project prior to 2009 were determined to be uncollectible, as Metropolitan failed to submit a claim to the state agency by due date. These charges were incurred to install, close, and remove underground tanks to comply with state regulations.

B. Standby Charge refunds totaling $106,078 issued to member agencies in 2009, were erroneously recorded to the Refund of MWD Stand-by Charges rather than as deductions from Standby Charges revenue.

C. Cash advances of $201,271 liquidated by employees prior to fiscal year 2008/09, were erroneously recorded to various O&M projects rather than to the Employee Advances – Temporary Project. It should be noted that erroneous recordings had no impact on the financial statements and account.

D. The MWD Employees Association account was overstated by $6,979 as nonrelated employee association expenses (per diem, meals, lodging) were recorded in error. We also noted the remaining balance of $5,099 due from the American Federation of State, County, and Municipal Employees, AFL-CIO (AFSCME) for rental of office space has been outstanding since fiscal year 2008/09.

E. Our review of the Reimbursable Project Costs spreadsheet which tracks Reimbursable Projects, revealed that two projects were completed, billed, collected, and Notices of Completion were filed by project management in November 1998 and January 2013. These Projects remained open in Oracle, as of January 2014.

V. HUMAN RESOURCES GROUP

A. Risk Management

We reviewed two of 13 Reimbursable Projects as of January 2014 totaling $843,498. Our review of these charges that were incurred in 1995 and 2005, were determined to be uncollectible. Risk Management could not identify responsible parties that caused damage to Metropolitan's properties. General Counsel staff is currently reviewing charges for a potential write-off.

Stores Inventory Audit Report

Background

The Audit Department has completed a review of the accounting and administrative controls over Stores Inventory, as of June 30, 2014. Our review consisted of evaluating the internal controls over periodic inventory counts and physical security of Stores Inventory at the La Verne Warehouse (La Verne). We observed and reviewed physical inventory activities (Cycle Counts) for compliance with operating policies and procedures. We also performed test counts of Stores Inventory, and traced these items to inventory records. Finally, we evaluated physical access controls at the La Verne Warehouse for assuring assets are adequately safeguarded from loss.

The Administrative Services Section in the Business Technology Group is responsible for managing Stores Inventory in eight warehouses. These facilities stock common supplies utilized for maintenance, repairs, and construction activities and include items such as pipe fittings, tools, filters, flashlights, and work boots. Metropolitan utilizes the Oracle Inventory Management System (Oracle Inventory) with bar code readers to track these tools and parts as received at a warehouse, between warehouses, and to personnel needing equipment or supplies. The Oracle Inventory is also used to track use, trigger purchase actions, and conduct Cycle Counts testing.

Inventory control activities are guided by Operating Policy F-08, Stores Inventory Verification, and Warehouse Inventory Cycle Count Procedures established by the Administrative Services Section. Additionally, Cycle Count procedures were performed by Administrative Services Section personnel based on sampling criteria issued by the Controller's Section.

These Cycle Count processes direct that a subset of inventory items, in a specific location be counted and compared to system records. Cycle Counts contrast with traditional inventory methods in that a full physical inventory may stop operations at a facility, while all items are counted at one time. Cycle Counts are less disruptive to daily operations, provide an ongoing measure of inventory accuracy and procedure execution; and can be tailored to focus on items with a higher dollar value, greater turnover in volume, or to those critical to business processes.

Over the course of each calendar year, Warehouse staff performs Cycle Counts such that low value items of $3 to $50 each are counted once, while high value items of more than $50 each are counted twice. In addition, Accounting Operations Unit performs a surprise Cycle Count at two warehouse locations each quarter, and reconciles results to the Oracle Financial System. From July 1, 2013 through June 30, 2014, Metropolitan staff withdrew $4.1 million of Stores Inventory from the warehouses. The balance of Stores Inventory, as of June 30, 2014 was $6.9 million. These totals excluded chemical inventories, as these assets are controlled separately by the Water System Operations Group.

Opinion

In our opinion, the accounting and administrative procedures over Stores Inventory 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 controls from July 1, 2013 through June 30, 2014.

Although this opinion is an acceptable rating, we express concerns over the accuracy of La Verne Stores Inventory records. We noted multiple instances where inventory Cycle Count results differed from inventory records, resulting in a 25 percent error rate. That is, in 25 percent of the time, Cycle Counts differed from the system totals. We also expressed concerns that physical security controls at the La Verne warehouse did not restrict access to authorized personnel.

Comments and Recommendations

PHYSICAL SECURITY

Physical security controls are designed to provide for the safeguard of facilities, equipment, and resources by restricting physical access to authorized personnel. These controls involve the use of multiple layers of interdependent systems which include electronic surveillance, security guards, protective barriers, locks, and access control protocols. For the La Verne Stores Inventory Facility, physical security controls should restrict access to authorized warehouse staff and consider the operational and business needs of personnel using tools and parts available from the Warehouse.

During our audit of La Verne warehouse, we noted that access to the Stores Inventory Facility was not restricted to authorized personnel and access could be obtained by unauthorized personnel through the Receiving area of the warehouse. We also noted several instances where employees were allowed into the Warehouse, without authorized escorts. Finally, we noted that the Stores Inventory Facility did not have an electronic surveillance system monitoring activities within the Warehouse.

We recommend management establish physical security controls limiting access to authorized personnel, ensure that escorts are provided when non-warehouse personnel are in the Warehouse, and consider installation of electronic monitoring equipment.

PERIODIC INVENTORY AND CYCLE COUNTS

Physical inventory counts ensure the integrity and accuracy of financial records, verifying availability of materials to be consumed during operations. These tests can be conducted on a periodic or cyclic basis, and are used to adjust period ending financial statement balances. Reconciliation of physical inventory to Oracle Inventory System records detects duplicative, unauthorized, or incorrect entries for correction. Physical inventory counts may also affect supply chain decisions and vendor selection processes.

During our Cycle Counts audit of the La Verne Stores Inventory, we noted that 35 of 139 (25 percent) stock supplies did not match Oracle Inventory Records. Further review revealed that in 23 of 35 instances, Oracle Inventory Records were higher than Stores Inventory count. The total Stores Inventory overstatement was $1,266.04. In addition, in 12 of 35 instances, Oracle Inventory Records were lower than Stores Inventory count. The total Stores Inventory understatement was $1,511.26. Operating Policy F-08, Stores Inventory Verification, defines that an Out-of-Tolerance variance exists when an item's dollar value variance exceeds $499. In such cases, additional review, recount, and adjustment approval is required. Our review disclosed that none of the discrepancies noted in our Cycle Counts exceeded the Out-of-Tolerance variance.

We recommend management followup on noted discrepancies and implement actions to improve inventory Cycle Counts accuracies. Further, we recommend management conduct a root-cause analysis to identify reasons for these variances.