



Audit Department Report for October 2014

Summary

Three reports were issued during the month:

- **Legal Contracts and Settlements Audit Report**
- **Audit Quality Assurance – 1st Quarter Audit Plan Update**
- **Audit Quality Assurance – Annual Self-Assessment Review**

Discussion Section

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

Legal Contracts and Settlements Audit Report

Background

The Audit Department has completed a review of the accounting and administrative controls over Legal Contracts and Settlements, as of March 31, 2014. Our review consisted of evaluating controls over the selection process and contract administration for special counsel, investigator, and technical expert agreements. We also evaluated the propriety of invoices for compliance with contract terms and conditions, and payment timeliness. In addition, we reviewed legal claims and settlements for proper authorizations and management reporting to the Board of Directors for accuracy and completeness. The General Counsel's Powers and Duties are set forth in Administrative Code Sections 6430 through 6438. These sections include:

1. Section 6431 – Authority to Obtain Expert Assistance. The General Counsel is authorized to employ special counsel and investigators to advise him/her or assist him/her in representing Metropolitan, and such technical experts as necessary for proper preparation and presentation of Metropolitan's interest in any court action, special proceedings, legislative hearings, or other proceedings whether in or out of court where the assistance of technical experts may be necessary in order to represent Metropolitan adequately, so long as the amount to be expended in fees, costs, and expenses in any one year in connection with any assignment will not exceed \$100,000.
2. Section 6433 - Authority to Litigate, Compromise, and Settle Claims By and Against Metropolitan
 - (a) Settlement of Claims or Suits Generally. The General Manager, with the approval of the General Counsel, is authorized to allow, compromise, or settle any claim or suit by or against Metropolitan not provided for elsewhere in this Code, if the amount to be paid does not exceed \$125,000. The General Manager or the General Counsel may perform any functions placed on the Board by Part 3 of Division 3.6 of Title 1 of the Government Code. The General Manager, with the approval of the General Counsel, may delegate the authority to settle claims involving payment of an amount not exceeding \$1,000 to an independent contractor.

3. Section 6434 – Writing off Uncollectible Claims. The General Manager, after receiving the advice of the General Counsel, is authorized to determine that claims and accounts receivable of Metropolitan are not collectible, and to direct the writing off of such items in order to adjust Metropolitan accounts provided that such action with respect to items in excess of \$125,000 shall be subject to approval by the Board.
4. Section 6436(a) - Annual and Quarterly Reports to Legal and Claims Committee. The General Manager and General Counsel shall report quarterly to the Legal and Claims Committee the exercise of any power delegated to them by Sections 6433 and 6434. The General Counsel shall report quarterly to the Legal and Claims Committee the exercise of any power delegated to him or her by Section 6431.

As of March 31, 2014, the Legal Department employed 20 attorneys who administered 104 agreements with special counsel, investigators, and technical experts. For the audit period from July 1, 2011 through March 31, 2014, payments on these agreements totaled \$23.7 million. The majority of these agreements have term limits of one to three years, although several have been in effect for 10 years or more. Additionally, payments on claim settlements totaled \$5.5 million during the audit period.

Opinion

In our opinion, the accounting and administrative procedures over Legal Contracts and Settlements 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 March 31, 2014.

Comments and Recommendations

POLICIES AND PROCEDURES

Operational policies and procedures are established to provide the framework for achieving organizational goals and objectives. Procedures provide guidance for consistent performance of daily operations, assist in training new employees, and provide a source of reference for experienced personnel. The Legal Department Powers and Duties are set forth in Administrative Code Sections 6430 through 6838. These include:

The Legal Department Procedures Manual provides guidelines based on these Powers and Duties for initiating, tracking, executing, amending, and terminating agreements with special counsel, investigators, and technical experts. Our review consisted of a limited review of 104 active agreements, and a detailed review of 13 agreements. We noted:

1. Annual and Quarterly Reports to Legal and Claims Committee (LCC) did not always account for contracts on a timely basis. We noted that seven agreements with a maximum amount payable of \$100,000 or less, were reported to LCC 11 to 137 days past quarter-end of date that contractor was employed. Administrative Code Section 6436(a) states the General Counsel shall report quarterly to LCC the exercise of any powers delegated to them by Sections 6431, 6433, and 6434. Section 6431 authorizes General Counsel to employ special counsel, investigators, and technical experts as necessary so long as amount to be expended in fees, costs, and expenses in any one year in connection with any assignment will not exceed \$100,000.

2. During our audit of quarterly LCC reporting, we noted two claims totaling \$36,555 were settled and paid through Third-Party Administrator Carl Warren from August 2011 through October 2011. These claims were not included in any quarterly reports through December 31, 2013. This is in contrast to Administrative Code Section 6436. It should be noted that these items were included in the June 30, 2014 quarterly report.
3. During our review of active agreements, we noted that six agreements with effective dates prior to July 1, 2011 were not utilized for over 30 months through December 31, 2013. Further review revealed that three of these agreements were held in active status as their Scope of Work related to ongoing insurance matters, Brown Act questions, and one involved the Sacramento Regional County Sanitation District litigation. Business needs dictated these contracts remain active to facilitate a quick response to legal queries, although infrequent and uncommon. It should be noted the remaining three agreements were terminated by May 2014.

We recommend General Counsel management remind personnel the importance of compliance with reporting requirements, and conduct periodic checks to ensure compliance.

COMPLIANCE WITH TERMS AND CONDITIONS OF THE AGREEMENTS

Compliance with contractual requirements is necessary to ensure accurate accounting records, proper supporting details, and adequate controls over administration of agreements. Compliance with contractual terms and conditions also ensures parties fully discharge their duties and obligations, and exercise their rights associated with the agreements. We examined 30 invoices totaling \$2.2 million and noted:

1. Payments on 27 of 30 invoices tested with a total billing of \$2 million were paid 36 to 170 days, after invoice receipt. We understand payments to special counsel, investigators, and technical experts often require extensive review by Legal staff. However, payment delays noted are in contrast to agreement terms and conditions, which require payment within 30 days of invoice receipt.
2. Billing details for four of 30 invoices totaling \$204,251 were itemized by staff name, rather than by title/job labor classification. This is in contrast to contract Fee Schedule terms and conditions.
3. We could not locate required monthly Litigation Status Reports for three of 13 agreements reviewed. This is in contrast to agreement Scope of Work Section which requires special counsel, investigators, or technical experts to submit monthly Litigation Status Reports with each invoice.
4. We could not locate the required case estimate or budget for eight of 13 agreements reviewed. This is in contrast to agreement Scope of Work provisions, which requires the agreement administrator approve the estimate or budget in advance of contract work.

We recommend General Counsel management remind personnel of the importance of compliance with agreement terms and conditions, and to conduct periodic checks to ensure compliance.

Audit Quality Assurance – 1st Quarter Audit Plan Update

In April 2014, the Audit and Ethics Committee and the Board of Directors reviewed and approved the fiscal year 2014/15 Audit Plan (Plan), which allocated audit resources to areas of greatest perceived risk. In keeping with professional auditing standards, we reviewed our progress versus the Plan on a quarterly basis 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.

We evaluated the Audit Department's performance for the three months ending September 2014 and noted that 10 audits, special reviews, and bond Comfort Letters were completed. Our analysis of audit resource levels determined that Audit Department resource levels were tracking to Plan assumptions. Our review of auditor time charging to audits revealed the charge-out rate of 62 percent was consistent with the rate assumed in the Plan.

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 2014/15 Plan. We will continue to monitor risks and resources, and provide updates on our progress versus the Plan on a quarterly basis through the end of the year.

Audit Quality Assurance - Annual Self-Assessment Review

Background

In order to ensure the Audit Department (Department) continues to contribute to Metropolitan's risk management control and governance activities, we implemented a Quality Assurance and Improvement Program (QA&IP) in 2007. The principles behind this program are set forth by The Institute of Internal Auditors (IIA) in the International Standards for the Professional Practice of Internal Auditing (*Standards*). Compliance with these mandatory guidelines include the Definition of Internal Auditing, Code of Ethics, and detailed *Standards* ensures the Department provides independent, professional, and objective audits and reviews that help Metropolitan achieve its objectives.

This quality program is comprehensive and thorough. It covers all types of audit processes such as staff supervision and development, preparation and execution of the Annual Audit Plan, and internal and external reporting. Individual elements of the QA&IP include conducting training and improvement activities, performing annual internal self-assessments, and contracting for an external audit assessment every five years according to IIA *Standards*. The most recent external Quality Assurance Review was performed by IIA in June 2012, with the Department being judged to be in overall general compliance with IIA *Standards*; the highest rating possible.

This review covers the recently completed FY 2013/14 Internal Quality Self-Assessment utilizing IIA's assessment methodology. The broad objectives of this review were to examine our conformity to IIA's mandatory guidance and Department procedures; evaluate our effectiveness in carrying out the Department's mission, as set forth in the Department Charter; and identify opportunities to strengthen the Department's value to Metropolitan.

We reviewed audit communications with the Board and management, evaluated risk assessment and audit planning processes, examined audit policies and procedures, and analyzed audit performance and staff management processes. We also surveyed clients and Department staff to obtain feedback, and identify strengths and areas of improvement. Finally, central to our assessment was a review of selected audit work papers in comparison with IIA *Standards*.

Conclusions

It is our overall opinion that the Department generally conforms to the Definition of Internal Auditing, Code of Ethics, and IIA *Standards*. This rating means the Department's Charter, policies and procedures, and processes are judged to be in conformance with IIA *Standards*. However, we noted opportunities for improvement related to IIA Practice Advisories, or best practices. These observations are related to the Department's compliance with policies and procedures, and methods to enhance effectiveness.

COMPLIANCE WITH POLICIES AND PROCEDURES

In order to ensure high quality and professional audit work, auditors should conform to established Department policies and procedures. These procedures ensure audit work is properly supervised so that project objectives are achieved, compliance with IIA *Standards* is accomplished, and staff is provided with feedback on audit techniques. Additionally, Department training policies require auditors obtain Continuing Professional Education (CPE) to ensure auditors remain current in industry knowledge and proficient in audit skills.

Our review of a sample of audit work papers indicated evidence of audit supervision, such as electronic work paper sign off could be improved. In one instance, an audit report was issued without supervisory approval of all work papers. We also noted that some staff did not complete their CPE requirements, in accordance with Department procedures. Finally, Department staff surveys revealed the need to improve auditor training that would include on-the-job training, in-house seminars, and external seminars.

We have developed actions to strengthen compliance with Department policies and procedures. We will remind auditors of current procedures related to reviewing and approving work papers, and obtaining required professional education. Department management will also develop, and identify courses providing the greatest benefit to the Department. It should be noted that we have developed a Code of Ethics Training for Department staff, scheduled before December 2014.

ENAHNCE DEPARTMENT EFFECTIVENESS

The Department has established internal management, communication, and monitoring processes to provide for Audit Plan accomplishment and assure Department resources are effectively deployed. These processes include establishment of audit project budgets, and tracking of actual time applied to audits. We also monitored the duration or audit-cycle time, as measured from audit inception date to audit report issued date.

As part of our self-assessment, we requested anonymous feedback from audit clients regarding recent audits, relationships with Department staff, and perception of value added of audits. Our clients provided high marks in promoting customer orientation by providing quality work and audit professionalism. However, we received lower evaluations in audit report duration and timeliness.

Our analysis of the duration or audit-cycle time of audits completed during FY 2013/14 indicated an overall improvement versus the prior year. Further analysis suggested an opportunity to continue reducing audit-cycle time, particularly audit monitoring and reporting activities. Finally, additional audit-cycle time was not always requested and approved by Department management, which is contrary to internal procedures. We will continue to monitor audit-cycle time, and strive to enhance audit efficiency. Additionally, Department management will evaluate the drivers behind the increase in audit reporting cycle time, and identify potential enhancements. Finally, we will remind auditors to follow procedures related to requesting adjustments to audit time budgets.