



## **Internal Audit Report for April 2015**

### **Summary**

---

Four reports were issued during the month:

- **Inland Feeder and Lakeview Pipeline Intertie Appropriations 15480 and 15488 Project Audit Report**
- **Internal Controls Over Financial Reporting Review**
- **Quarterly Board Reports Review**
- **Audit Quality Assurance – 3<sup>rd</sup> Quarter Audit Plan Update**

### **Discussion Section**

This report highlights the significant activities of the Internal Audit Department during April 2015. In addition to presenting background information and the opinions expressed in the audit reports, a discussion of findings noted during the examination is also provided.

---

## **Inland Feeder and Lakeview Pipeline Intertie Appropriations 15480 and 15488 Project Audit Report**

### **Background**

The Audit Department has completed a review of the accounting and administrative controls over the Inland Feeder and Lakeview Pipeline Intertie Appropriations 15480 and 15488 Project (Project), as of January 31, 2015. This Project is part of the Conveyance and Distribution System Rehabilitation and Water Delivery System Improvements Programs. Our review consisted of evaluating internal controls over the contractor selection process, reviewing agreement administration, reporting practices, and testing compliance with contract terms and conditions. We also reviewed Project authorizations and Actual vs. Budgeted costs. Lastly, we evaluated the validity and propriety of progress payments for assurance that amounts billed were properly calculated, and source documents were accurate and complete.

The Henry J. Mills Water Treatment (Mills) Plant relies exclusively on deliveries from the East Branch of the State Water Project (SWP). However, the statewide drought and associated low water allocation of SWP supplies has had a detrimental impact on raw water deliveries to Mills plant. Moreover, relief from this shortage cannot be secured from local supplies at Diamond Valley Lake (DVL), as a result of system piping constraints. Accordingly, Metropolitan initiated the Project under the Conveyance and Distribution System Rehabilitation and Water Delivery System Improvements Programs to supply Mills plant with water stored at DVL. This Project was divided into two phases:

- Phase I included construction of an intertie from the Inland Feeder to the Lakeview Pipeline, at the Pressure Control Structure Facility (PC-1). Phase I also included installation of a surge protection system at the Perris Pumpback Facility, and fabrication of approximately one mile of steel pipe to be used to line a portion of the Lakeview Pipeline known as the Bernasconi Tunnel. In June 2014, the Board awarded J. F. Shea Construction, Incorporated (Shea) a contract for \$20.4 million to perform this work. As of January 31, 2015, Shea's contract is 86 percent complete and has been paid \$17.5 million.

- Phase II included installation of 4,900 feet of a 114-inch diameter steel liner within the Bernasconi Tunnel, and procurement of three 60-inch diameter valves for the Project. The steel liner for the tunnel will allow the pipes to withstand increased hydraulic pressure, due to the high water levels at DVL. Two valves will also be installed at PC-1 to isolate the structure for repairs and maintenance, while the third valve will be installed for the surge protection system at the Perris Pumpback Facility. Lining of the Bernasconi Tunnel is to be completed by May 2015. The installation of three 60-inch diameter valves is scheduled for mid-2016 due to the 15-month lead time required to fabricate the valves, and installation of valves during a planned shutdown of the Bernasconi Tunnel. In August 2014, the Board awarded Shea a second contract for \$4.1 million for installation of 4,900 feet of a steel liner within the Bernasconi Tunnel. As of January 31, 2015, Shea's contract is 58 percent complete and has been paid \$2.4 million.

### **Opinion**

In our opinion, the accounting and administrative procedures over the Project include those practices usually necessary to provide for a satisfactory internal control structure. The degree of compliance with such policies and procedures provided effective controls from January 2012 through January 2015.

---

## **Internal Controls Over Financial Reporting Review**

We have completed a limited review of the internal controls over financial reporting for fiscal year ending June 30, 2014. Specifically, 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. The review was required by Administrative Code Section 6451(d)(3), Audit Department Charter responsibilities which directs the Audit Department to issue an opinion on internal controls over financial reporting on an annual basis.

The Institute of Internal Auditors International Standards for the Professional Practice of Internal Auditing requires that auditors evaluate the risk exposure, adequacy, and effectiveness of controls relating to the reliability of financial information. It should be noted that the review was for the limited purpose of assessing controls over financial reporting.

In accordance with these requirements, our review procedures were based on the internal controls integrated framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission. Utilizing this framework:

- First, we analyzed the results of the fiscal year 2013/14 Audit Plan which included completion of 25 audits, 14 monitoring reports, 5 bond Comfort letters, and 5 special projects. As part of the audit results review, we also evaluated management's responses to ensure they were timely and that management had effectively addressed all 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 Report to the Executive Committee on the effectiveness of the District's internal control system, including information technology security and control. 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, 2014. We considered the results of this review a part of the assessment. Lastly, we evaluated the scope and results of the substantive testing performed for the external auditors during fiscal year 2013/14 financial statements audit. The testing provided evidence used in the evaluation of financial reporting controls.

- Second, we analyzed selected financial statement accounts and transactions based on risk and materiality. We also performed process walkthroughs 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 was made for the limited purpose described in the first paragraph, and would not necessarily disclose all material weaknesses in the system. Accordingly, we did not express an opinion on the system of internal controls taken, as a whole. Based on the results of the review, there is reasonable assurance that internal controls on June 30, 2014 were adequate to achieve reliable financial reporting.

---

## Quarterly Board Reports Review

We reviewed the Report of Professional Services Agreements (Professional Services Report) and the Report of Contracts for Equipment, Materials, Supplies, and Routine Services of \$250,000 or Above Contracts (Contracts Report) for the Second Quarter of Fiscal Year 2014/15 published by the Business Technology Group, Administrative Services. The purpose of this review is to gain reasonable assurance that information included in these quarterly reports is accurate, complete, timely, and in compliance with the Metropolitan Water District Administrative Code.

### PROFESSIONAL SERVICES AGREEMENTS REPORT

#### **Background**

Administrative Code Section 2720(a)(2) requires the General Manager report to the Engineering and Operations Committee on the employment of any professional and technical consultant, the extension of any professional and technical consulting agreement, and on the Exercise of Authority under Sections 8121(c) and 8122(h) during the preceding calendar quarter. The Administrative Code also requires the Professional Services Report indicate when a consultant is a former Metropolitan employee. Administrative Code Sections 2721 - 2723 require the General Counsel, General Auditor, and Ethics Officer report quarterly to their respective committee concerning any expert or professional service agreements executed pursuant to their authority under the Administrative Code.

The Professional Services Report is prepared on a quarterly and annual basis to comply with these Administrative Code requirements and identify those contracts administered by the General Manager, General Counsel, General Auditor, and Ethics Officer. For the period ending December 31, 2014, the Professional Services Report disclosed that \$51.7 million was paid for consulting and professional services, and \$28 million of that amount was incurred during the Second Quarter. It should be noted that totals reported under the General Counsel's authority exclude payments related to the San Diego County Water Authority litigation, which is accounted for under the Self-Insurance Retention Fund.

We also noted that 59 of 374 active agreements were sole-source agreements totaling \$6,590,167, or 13 percent of total fiscal year-to-date expenditures. The Fraser Communication Agreement 143867 was \$4.4 million of the total sole-source agreement amount, and an audit of this contract is currently in process.

FY 2014/15	General Manager	General Counsel	General Auditor	Ethics Officer
Contract Expenditures	\$51,133,072	\$250,459	\$305,031	\$23,490
Active Agreements	345	30*	1	4
Agreements Terminated	24	2	0	0

\* Agreements with transactions during current fiscal year.

### **Testing Procedures Performed**

Our procedures included a cursory review of the reasonableness of professional service expenditures and an analysis of consultants with multiple active agreements, to determine whether an agreement was split into smaller contract amounts to circumvent established approval limits. We also evaluated whether statistics in the Professional Report were adequately supported. Finally, we assessed the timeliness of board reporting.

### **Testing results**

Our review did not reveal any agreements that appeared to be unreasonable or split to override established approval limits. In addition, our review did not reveal any material differences between reported amounts and supporting documentation. However, we recommend management consider labeling sole-source agreements with a unique identifier for easy reference. Finally, we noted that the board report was issued on March 10, 2015.

## **CONTRACTS FOR EQUIPMENT, MATERIALS, SUPPLIES, AND ROUTINE SERVICES OF \$250,000 OR ABOVE REPORT**

### **Background**

Administrative Code Section 2720(b)(2) requires the General Manager report to the Finance and Insurance Committee on the execution of any contract authorized under Section 8122(g) - Contracts for Equipment, Materials, Supplies, and Routine Services. This code section states that the General Manager may execute contracts for purchase of materials, supplies, and other consumable items such as fuels and water treatment chemicals generally identified in the budget regardless of dollar value, provided sufficient funds are available within the adopted budget for such purchases.

The Contracts Report is prepared on a quarterly basis to report on contracts that comply with these Administrative Code requirements. During the quarter ending December 31, 2014, the Contracts Report disclosed six contracts fitting these criteria. We noted the total maximum amount payable for these contracts was \$7.5 million. Three of these contracts were awarded as a result of competitive bidding, and three were sole-source agreements authorized under Administrative Code Section 8140 - Competitive Procurement.

### **Testing Procedures Performed**

Our procedures included a cursory review of the reasonableness of expenditures. We also verified that all contracts of \$250,000 or more for the specified items were included in the Contracts Report, and adequately supported. Further, we reviewed sole-source agreements for justification and approval. Finally, we assessed the timeliness of board reporting.

### **Testing results**

Our review did not reveal any discrepancies between contracts and amounts shown in the Contracts Report, and supporting documentation. However, we noted that the Contracts Report included AT&T Contract 146149 effective July 18, 2014, and California Department of Fire Contract 121407-03 with July 1, 2014 renewal date.

Date of Report: April 30, 2015

These contracts should have been reported in the First Quarter instead of Second Quarter, to comply with the Administrative Code reporting requirements. We also noted that policies and procedures for competitive bidding, cooperative agreements, and awarding sole-source agreements are in place. Finally, we noted the Contracts Report was issued to the Board on March 10, 2015.

---

### **Audit Quality Assurance – 3<sup>rd</sup> 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 review 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 nine months ending March 2015 and noted that 27 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 60 percent was consistent with the rate assumed in the Plan. Finally, we evaluated the 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 a final update on our progress versus the Plan at year-end.

---