



THE METROPOLITAN WATER DISTRICT  
OF SOUTHERN CALIFORNIA

## Report Office of General Auditor

### Internal Audit Report for June 2020

#### Summary

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Two reports were issued during the month:

1. **Real Property - Lease Management Audit Report**
2. **Non-Audit Initiatives Memo**

#### Discussion Section

This report highlights the significant activities of the Internal Audit Department during June 2020. In addition to presenting background information and the opinion expressed in the audit report, a discussion of findings noted during the examination is also provided.

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### Real Property - Lease Management Audit Report

The Audit Department has completed a review of the accounting and administrative controls over Real Property - Lease Management as of November 2019.

#### Scope

Our review consisted of evaluating the accounting and administrative controls over lease management. Specifically, we evaluated compliance with the Administrative Code, internal policies and procedures, and terms and conditions of lease agreements.

#### Background

The Real Property Group manages the operation, control, maintenance, and oversight of Metropolitan's Real Property assets. The authority for these activities is set forth in Administrative Code §8230 and Board-approved strategic policies and principles. Rules and guidance are provided for acquiring, managing, and divesting real property.

Within the Real Property Group, the Lease Management section seeks to minimize operational costs while protecting water conveyance, treatment, and storage systems. These efforts include identifying revenue-generating opportunities in agriculture, telecommunications, energy development, film production, sustainable technology, and research.

The Real Property Group shares responsibility with the Controller Section of the Office of the Chief Financial Officer for the billing, collecting, and accounting for property leases. As of

February 2020, the Real Property Lease Tracking Database tracked 381 leases, licenses, and entry permits, with an annual lease income of \$5.2 million.

### **Opinion**

In our opinion, the accounting and administrative procedures over Real Property - Lease 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 control for the period of July 2017 through November 2019. Although this opinion is an acceptable rating, we do express concern over lessee screening and accounts receivable management.

### **Comments and Recommendations**

#### **LESSEE SCREENING**

Prudent real property lease procedures should include detailed creditworthiness analysis that evaluates the applicant's ability to meet their financial obligations. These techniques serve to determine the level of risk associated with the prospective tenant and assess the likelihood that the lessee will fulfill the terms and conditions of the lease agreement and adequately manage the real property under contract.

Traditionally, credit quality analysis includes an assessment of various aspects of a business, such as its profitability, liquidity, and solvency. Further, these methods usually conform to sound Commercial Credit Analysis methodology and assess the character, capacity, capital, collateral, and conditions of a prospective business partner. The analysis aims to predict the probability that the borrower will default on their financial obligations and the level of losses that the lessor will suffer in the event of default. These processes culminate in a decision to approve the lease, approve the applicant conditionally (such as requiring additional collateral), or to deny the deal.

Our review consisted of ten lease transactions and associated documentation. We could not locate evidence of a creditworthiness analysis for eight lease agreements. Further review revealed that real property operating practices did not include an evaluation of a prospective lessee partner's credit quality, such as their profitability, liquidity, and solvency. We understand that management has since revised lessee review practices.

Failure to conduct a thorough creditworthiness analysis of prospective lease partners could result in a financial loss to Metropolitan.

We recommend that management establish procedures to ensure that a creditworthiness analysis is completed on all lease applicants. This analysis should evaluate the profitability, liquidity, and solvency of each potential lessee. It should also assess the likelihood that the lessee will fulfill the terms and conditions of the agreement and adequately manage the real property under contract. Finally, we recommend management conduct periodic reviews to ensure compliance.

## ACCOUNTS RECEIVABLE

An accounts receivable aging is a report that lists unpaid invoices by date ranges, typical increments of 30 days. Aging receivables is the primary management tool used to identify overdue invoices and measure credit and collection effectiveness; it also allows management to estimate potential bad debts. Toward these goals, the Controller's office sends a monthly report to Real Property, identifying past due receivables, unapplied payments, and credits requiring attention.

Our review of the Controller's Monthly aging report revealed outstanding invoices, some dating back to 2014. Further, we noted that in September 2019, the Controller's section implemented new procedures that included progressive escalation of unresolved/uncollected invoices up to the Section and Group Managers.

While we recognize improvement in the timely collection of invoices, we encourage management to continue to monitor, report, and follow up on unpaid accounts receivable. Finally, we recommend management resolve the noted receivable dated 2014.

## COMPLIANCE WITH TERMS AND CONDITIONS

Compliance with contractual requirements is necessary to ensure accurate accounting records, proper supporting detail, and adequate control over the administration of the agreements. Metropolitan's lease agreements require the lessee to provide and maintain insurance against claims for injuries to persons or property throughout the lease period.

We could not locate evidence of adequate insurance for 3 of 10 files tested. Specifically, we noted:

- For RL4066, there was no evidence of auto insurance.
- For RL818 and RL1724, there was no evidence of worker's comp insurance.

Non-compliance with established terms and conditions of the agreement could result in financial losses to Metropolitan due to uninsured injury and damage claims.

We recommend that management remind the Real Property Reps of the importance of documenting compliance with contractual requirements and conducting periodic reviews to ensure compliance.

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## Non-Audit Initiatives Memo

The Corona Virus pandemic continues to affect Metropolitan's work environment in ways that are both profound and unprecedented. Acting quickly to protect the health and welfare of its employees without compromising our high standards of service, General Manager Jeff Kightlinger declared a state of emergency on March 16. In doing so, he ordered non-critical and non-essential employees to begin working from home.

No one can accurately predict how long the current situation will persist or what Metropolitan's work environment will look like in the weeks and months to come. Nevertheless, Executive Management used the best information available to adjust its operations in response to the events since March 2020. The Business Transition Team was formed to address the changing needs of the workforce and to establish appropriate operating policies and practices. Deputy General Auditor Kathryn Andrus has been an active participant in this effort. Understandably, the Audit Department must consider the impact that the new realities of teleworking will have on Metropolitan's internal controls.

Consequently, we initiated two non-audit reviews; they will not result in formal audit reports, nor will they generate audit opinions. The first initiative is to assess the segregation of duties within the Oracle Financial System. The second initiative is to assist management in evaluating the strength and viability of critical suppliers and service providers. We believe that supply chain processes to be a significant emerging risk

### **Segregation of Duties Within the Oracle Financial System**

A critical component of every internal control system is the segregation of duties. The basic premise underlying this control is that no employee should be in a position to commit and conceal errors or fraud in the ordinary course of their work. Organizations segregate duties through a variety of means, including a well thought out organization structure, appropriate assignment of responsibility, a reasonable delegation of authority, and by requiring supervisory approval to execute critical transactions.

For example, are the individuals responsible for the requisitioning, purchasing, and receiving functions different from the individuals responsible for the invoice processing, accounts payable, and general ledger functions?

At Metropolitan, management assigns these functions to specific employees by creating user profiles in the Oracle Financial System. User profiles segregate duties by limiting access to particular tasks, establishing limits on the type and size of transactions they may execute, and by requiring approvals to complete specific transactions.

Under normal circumstances, the interaction between employees and their supervisors strengthens the segregation of duties. With many employees working remotely, ensuring appropriate access to the Oracle Financial System is even more critical. Consequently, we initiated a high-level analysis of Oracle System User Profiles to ensure duties remain adequately segregated. That process is underway, and we will communicate the results of our work to management.

### **Critical Suppliers and Service Providers**

As the pandemic continues to burden the global economy, previously healthy organizations are experiencing unanticipated sales declines and supply chain disruptions; in some cases, these

threats are existential. Metropolitan relies on a network of suppliers and service providers to achieve its mission; in some cases, these relationships are critical to our core responsibilities. Management regularly assesses the performance of Metropolitan's suppliers and service providers through their day to day interaction and frequent communication. Nevertheless, some circumstances that affect supplier performance may not become readily apparent through these activities. In light of current volatile economic conditions, we are evaluating methods to augment management's assessments with additional analysis. We plan to establish news alerts on search engines (e.g., Google News Alerts) for key suppliers and providers and to monitor published financial reports for those traded publicly. We will coordinate these activities with management. Additionally, we will research best practices and propose further procedures as reasonable and appropriate.