



John Keel, CPA
State Auditor

An Audit Report on

Bexar Metropolitan Water District Expenditures

October 2008

Report No. 09-010



An Audit Report on

Bexar Metropolitan Water District Expenditures

SAO Report No. 09-010
October 2008

Overall Conclusion

The Bexar Metropolitan Water District's (District) Board and its management did not establish adequate management and financial controls to safeguard the District's assets and ensure that the District's expenditures were reasonable and necessary. The District does not keep an official, Board-approved budget and overspent its fiscal year 2007 operating budget by \$8.8 million without amending the budget.

Although the District's procurement policies comply with state law, the District did not consistently implement these policies in fiscal years 2007 and 2008. The District also did not adequately track and monitor its contracts, and it was unable to provide auditors with the total number and value of all current contracts. The District lacked adequate controls over its expenditures, and it made a number of unnecessary or questionable expenditures in fiscal years 2007 and 2008, including \$2.4 million in legal service payments and settlement claims.

Although the District's external auditor identified significant control weaknesses in the District's procurement, inventory, and payroll functions since at least fiscal year 2006, the District did not develop a formal plan to address these weaknesses. The District's Board should establish an audit committee and an internal audit function. This should include hiring an internal auditor who would report directly to the audit committee and monitor the correction of weaknesses identified to ensure the financial integrity of the District.

Key Points

The District overspent its fiscal year 2007 operating budget by \$8.8 million.

For example, during fiscal year 2007, the District spent \$2.0 million more than it budgeted on construction and maintenance projects and \$1.5 million more than it

Bexar Metropolitan Water District

About the District

The Bexar Metropolitan Water District (District) was created in 1945 to control, conserve, protect, preserve, distribute, and utilize storm and flood waters within the District. The District is governed by an elected, seven-member Board, which has delegated day-to-day activities to the District's general manager.

The District serves more than 88,000 customers in four counties and employs more than 330 people.

Management Changes

The District's Board terminated the general manager for cause and recently appointed an interim general manager.

House Bill 1565 (80th Legislature)

Because of concerns about the management and operation of the District, the 80th Legislature approved House Bill 1565, which established the Joint Committee on Oversight of Bexar Metropolitan Water District (Committee). The Committee is charged with monitoring the District and preparing a comprehensive report for the House and Senate natural resources committees about the District's ability to meet service and financial standards and any changes needed in the District's authority or governance.

budgeted on legal and engineering services. District management did not submit any budget amendments to the Board to address the overspending.

The District did not comply with state procurement laws and did not adequately monitor its contracts.

Auditors tested 26 of the 274 contracts that the District's management was able to identify and found that the District did not consistently award contracts in accordance with state laws or sufficiently monitor its contracts. Specifically:

- The District incorrectly classified a public relations contract as a professional service, which allowed the District to avoid state competitive procurement requirements.
- The District executed a contract for water in March 2007 that lacked an established price. The contract required a minimum payment that was not defined at the time the contract was executed. A year after the contract was executed, the Board agreed to pay the contractor \$2.1 million to settle a payment dispute.
- The District did not have a database or other central listing of contracts and could not provide auditors with a complete list of its current contracts. A total of 35 contracts on which the District paid \$1.8 million in fiscal years 2007 and 2008 were not included on the list of contracts initially provided to auditors. Auditors did not consider those 35 contracts for audit testing.
- For 7 of 26 (27 percent) contracts tested, the District made a total of \$371,336 in payments that were either above the contracted amounts or were not approved by the Board.
- The District lacked adequate documentation to support its compliance with state procurement laws.

The District did not ensure that expenditures were reasonable or necessary for the operation and maintenance of the District.

Auditors reviewed District expenditures for fiscal years 2007 and 2008 and noted the following:

- The District spent \$2.4 million on legal service payments and settlement claims in fiscal years 2007 and 2008.
- The District spent \$1.9 million for project management engineering services during fiscal year 2008 partly because the District did not ensure that it filled key vacancies within its engineering department.
- The District spent at least \$584,641 on lobbying and other services related to House Bill 1565 (80th Legislature) during fiscal years 2007 and 2008.

- The District spent \$5,000 for an advertisement in a Barcelona, Spain newspaper that did not benefit the District or its ratepayers.
- Seventy-four of 172 (43 percent) expenditures tested did not have sufficient documentation to substantiate the reasonableness and necessity of the expenditures.
- A total of 144 of 273 (53 percent) credit card transactions lacked adequate documentation, including \$5,717 for out-of-state travel.

Summary of Management's Response

The District generally agreed with the recommendations in this report. The District provided a summary of its responses that is presented in Appendix 6 on page 45 of this report, and its responses to the specific recommendations in this report are presented immediately following each set of recommendations in the Detailed Results section of this report.

Summary of Information Technology Review

Auditors tested access controls over the District's automated accounts payable, timekeeping, and payroll systems. Auditors also reviewed input, processing, and output controls over the District's purchasing and payroll processes. The District did not have adequate access controls over its automated systems, and did not have appropriate controls over its accounts payable system to ensure segregation of duties.

Summary of Objective, Scope, and Methodology

The audit objective was to conduct a financial-related audit of the District, as mandated by House Bill 1565 (80th Legislature).

The audit scope was limited to the District's expenditures and included fiscal year 2007 and 2008 expenditures. This included expenditures related to contracts, leave and overtime paid, and all payments made during fiscal years 2007 and 2008. The scope also included the analysis of general ledger expenditures from fiscal year 2006 through fiscal year 2008.

The audit methodology included analyzing and testing samples of payments, contracts, assets, and employees' timesheets.

Contents

Detailed Results

Chapter 1	Inadequate Board Oversight and Significant Internal Control Deficiencies Increase the District’s Risk of Fraud, Waste, Theft, and Abuse	1
Chapter 2	The District Should Improve Oversight of Its Expenditure Approval and Documentation Process	19
Chapter 3	The District Lacked Adequate Internal Controls Over Stand-by, Overtime, and Vacation Pay	26
Chapter 4	Significant Weaknesses in the District’s Automated Systems Jeopardize the Integrity and Security of Financial Data	29
Chapter 5	List of All Recommendations in This Report	30

Appendices

Appendix 1	Objective, Scope, and Methodology	34
Appendix 2	Bexar Metropolitan Water District Demographic Information	37
Appendix 3	Bexar Metropolitan Water District Board of Directors and Executive Officers	40
Appendix 4	Bexar Metropolitan Water District’s Summary of Expenditures	42
Appendix 5	Bexar Metropolitan Water District’s Summary of Debt	44

Appendix 6

Bexar Metropolitan Water District's Summary of
Management's Response..... 45

Detailed Results

Chapter 1

Inadequate Board Oversight and Significant Internal Control Deficiencies Increase the District's Risk of Fraud, Waste, Theft, and Abuse

The Bexar Metropolitan Water District's (District) Board and management did not provide adequate financial and management oversight of the District. Specifically, the Board did not sufficiently review the District's budget or the general manager's contract, and it did not adequately address weaknesses in the District's purchasing and contracting functions.

The Board's lack of adequate oversight resulted in significant internal control deficiencies that prevent the District's Board and management from ensuring that (1) the District gets the best available goods and services at the best price, (2) purchases are reasonable and necessary for the operation and maintenance of the District, (3) the District can safeguard its assets, and (4) the District complies with state laws and District policies.

Chapter 1-A

The District's Board and Management Did Not Adequately Monitor or Amend District Budgets

The District's Board did not amend the District's annual budgets as required by the District's financial policies (see text box). The District overspent its fiscal year 2007¹ operating budget by at least \$8.8 million or 18 percent of its total budget. For example, in fiscal year 2007, the District overspent its budget for construction and maintenance by \$2.0 million and its budget for legal and engineering services by \$1.5 million (see Chapter 2 for additional detail). The Board did not approve any operating budget amendments to address its overspending and to ensure that the increases were reasonable and that the District had the necessary resources to cover the additional expenditures. In addition, the Board approved the District's fiscal year 2007 budget in May 2006, rather than approving it in April 2006 as required by District policy.

District Administrative Policies on Financial Management

Section 6.04.02: Budget amendments shall be submitted to the Board for (1) any department or budget category that will exceed the adopted budget amount or (2) any overall (total) expenditure level which causes an annual budget cycle to exceed the Board's adopted budget amount.

District Purchasing Procedures

Section B.1: Funding for all purchases must be included in the current District's approved budget, or secured via a budget amendment.

In fiscal year 2008, the District underspent its operating and capital budgets by approximately \$17.3 million, or 16 percent of its total budget. According to District management, the District underspent its overall budget because it did not start several capital projects.

¹ The District's fiscal year is from May 1 through April 30.

The Board President stated that the seven-member Board relied on the Board's three-member Finance Committee, which regularly received budget and other financial information. However, the Finance Committee did not keep minutes of its meetings; therefore, the extent of its budget and financial review is unclear.

Board members and District management stated that the Board reviews and approves all expenditures of more than \$5,000 as required by District policy. However, the Board cannot properly evaluate the District's overall financial situation by reviewing only individual expenditures. While an individual expenditure may be allowable, the Board may not be aware that a category of expenditures is exceeding its budget, or it may not be aware of the impact of total transactions on the overall budget.

If the Board does not amend its budget as necessary, it limits its ability to (1) ensure that the District is effectively utilizing its resources, (2) ensure that the District has the necessary revenues to cover additional expenditures, (3) determine the reasonableness of any increases in spending, or (4) identify mismanagement in a timely manner.

The District also did not retain an official copy of its fiscal year 2007 and 2008 Board-approved budgets or record either the total approved budgets or total approved amounts for individual budget categories in Board minutes as it did in previous years. Instead, it used a "current budget," whose line items and totals were updated throughout the year. As a result, Board members, rate payers, or third-party reviewers cannot verify the details of the approved budget and cannot hold the District accountable for its financial management. For this report, auditors used the fiscal year 2007 budgets provided by the District's finance director in June 2008, which had a total operating budget of \$49,163,245 and a capital budget of \$30,665,953, for a total of \$79,829,198. The fiscal year 2008 budgets used included an adjusted operating budget of \$56,623,813 and a capital budget of \$36,305,000, for a total of \$92,928,813.

Recommendations

The Board should:

- Amend the budget as required by the District's policy so that it reflects the District's approved spending plan.
- Approve a hard copy of the budget that is signed and dated by the Board President, Board Treasurer, and General Manager.
- Record approved budget totals in the Board minutes and publish the budget on the District's Web site.
- Ensure that the Board's Finance Committee:

- ♦ Documents its meetings with detailed, written minutes.
- ♦ Provides quarterly updates about the status of the budget to the full Board.

Management's Response

Amend the budget as required by the District's policy so that it reflects the District's approved spending plan.

District management accepts the SAO recommendation. In December 2008, the Finance department will submit a proposal to the Board to amend the District's budget policy by requiring budget amendments to be approved for excesses by major budget category, as opposed to by line item, thus having the policy correspond with current practice. Management acknowledges that budget amendments were not submitted to the Board in FY 2007 as dictated by policy despite numerous ignored recommendations to the previous General Manager to do so, who is ultimately responsible for taking said action (see text box). Nevertheless, during FY 2008, staff took steps to correct those accounts which had gone over budget by reallocating from other accounts that had excess funds. On March 31, 2008, the Board approved the reallocation of funds within the budget to correct those accounts that were over budget at that time.

District Administrative Policies on Financial Management

Section 6.04.02: Budget Amendments shall be required for submission by the General Manger/CEO to the Finance Committee prior to submission to the Board of Directors at anytime for 1) any department or budget category that will exceed the adopted budget amount. Such budget amendment recommendations and supporting documentation and justification submitted by the General Manager/CEO upon requirement for such amendment.

Approve a hard copy of the budget that is signed and dated by the Board President, Board Treasurer, and General Manager.

District management accepts the SAO recommendation. Although the District does present an official bound copy of the fiscal year budget, the document does not include a signature page for the Board President, Treasurer and General Manager to sign. The Finance department will ensure that the budget document approved for FY 2010 includes an acknowledgment page that reflects Board approval.

Record approved budget totals in the Board minutes and publish the budget on the District's Web site.

District management accepts the SAO recommendation. All approved budgets to date are now posted on the District's website. As to the FY 2010 budget, a draft of the budget document will be made available to the public via the website a minimum of 30 days prior to adoption by the Board to allow the public an opportunity for review and comment. The final adopted budget will be posted upon approval.

Ensure that the Board's Finance Committee:

- Documents its meetings with detailed, written minutes.
- Provides quarterly updates about the status of the budget to the full Board.

District management accepts the SAO recommendations. As of September 2008, the District videotapes Finance Committee meetings to maintain an accurate account of the progress of each meeting. The Board administrative staff will use this recording to create written minutes. As to the recommendation for quarterly budget reports to the Board, the District has a budget reporting process already in place. The Finance department provides both the Finance Committee and the full Board with budgetary information by means of financial reports for the current month and the year-to-date as well as other pertinent financial information. These reports are submitted to the Board prior to the Board meeting and approved on a monthly basis.

Chapter 1-B

The Board Did Not Adequately Evaluate the General Manager's Performance Before Extending His Contract and Approving a Salary Increase

The Board did not adequately evaluate the general manager's performance as required in the contractual agreement. The contract stated that Board members shall (1) establish written performance objectives; (2) evaluate the general manager's performance; (3) provide him a written evaluation and present it to him in person; (4) identify in writing any areas that need improvement; and (5) specify how the Board expects the general manager to improve in those areas. However, the Board did not establish any written performance objectives, identify in writing any areas that need improvement, or specify its expectations for how improvements should be made. By not establishing clear and written performance objectives for the general manager, the Board lacked a basis to adequately monitor and evaluate the District's and general manager's performance.

Furthermore, while six of the seven Board members provided written evaluations of the general manager's performance during the first year of his contract, these evaluations were not based on pre-established or written performance objectives as required by the contract. Each Board member evaluated the general manager's performance using his or her own criteria. Only three Board members provided written evaluations after October 2005 (see Table 1).

Table 1

General Manager Contractual Dates and Salary					
Document	Start Date	End Date	Evaluation Due Date	Number of Written Evaluations Provided	Salary
Original Contract	April 29, 2005	April 28, 2006	October 28, 2005	6	\$160,000
1st Amendment:					
Year 1	April 10, 2006	April 27, 2007	October 28, 2006	0	\$164,000
Year 2	April 28, 2007	April 28, 2008	October 28, 2007	3 ^a	\$164,000
2nd Amendment:					
Year 1	October 29, 2007	October 29, 2008	April 29, 2008	0	\$195,000
Year 2	October 29, 2008	October 29, 2009	April 29, 2008	Not Applicable	\$200,000
^a One evaluation was dated November 26, 2007, and two evaluations were dated December 13, 2007. All three evaluations were dated after the start date for the second amendment.					
^b This amendment was ratified on December 13, 2007.					

Source: Bexar Metropolitan Water District general manager's contract and amendments.

The general manager's contract did not have a mechanism to evaluate compensation. The general manager's compensation was not tied to his performance.

The Board increased the general manager's annual salary in October 2005 by \$4,000 and again in October 2007 by \$31,000 for the first year of the second contract amendment. It increased the salary by an additional \$5,000 for the second year of the contract's second amendment.

The Board terminated its contract with the general manager after the general manager was indicted on charges of alleged wiretapping, misapplication of funds, and sexual harassment in August 2008.

Recommendations

The Board should:

- Establish clear performance expectations in writing for the District's general manager.

- Evaluate the general manager's performance against pre-established objectives to ensure that the general manager is meeting performance expectations.
- Ensure that future general manager contracts base compensation on the general manager's performance.

Management's Response

The Board should Establish clear performance expectations in writing for the District's general manager.

District management accepts the SAO recommendation. Management will prepare a presentation for the Board to assist them in establishing measurable performance objectives for the General Manager. Management will recommend to the Board at the December 2008 meeting that these objectives be incorporated into the employment contract of the General Manager.

The Board should evaluate the general manager's performance against pre-established objectives to ensure that the general manager is meeting performance expectations.

District management accepts the SAO recommendation. Management will recommend to the Board at the December 2008 meeting an amendment to the Board Administrative Policies that will establish a uniform procedure in the evaluation process of the General Manager.

The Board should ensure that future general manager contracts base compensation on the general manager's performance.

District management accepts the SAO recommendation. As part of the amendment to the Board Administrative Policies, management will recommend to the Board at the December 2008 meeting that the General Manager's compensation must be based upon pre-established performance objectives.

District Management Failed to Adequately Manage and Supervise the Purchasing Process, Which Increases the Risk of Fraud, Waste, Theft, and Abuse

The District's management delegated oversight of purchases to the District's individual departments without establishing sufficient internal controls to reduce the risk of fraud, waste, theft, and abuse (see text box). Each

The Purpose of Internal Controls

Internal controls serve as a defense in safeguarding assets and in preventing and detecting errors; fraud; violations of laws, regulations, and provisions of contracts and grant agreements; or abuse as defined in *Government Auditing Standards*.

department is responsible for ordering, approving, receiving, and taking inventory of goods. However, the District did not implement adequate controls to oversee the departments' purchases. As a result, District management cannot ensure that all purchases are reasonable and necessary for the operation and maintenance of the District. The District lacks controls to:

- Ensure that purchases comply with state laws and regulations.
- Verify that goods purchased by departments were recorded on the District's inventory lists.

In addition, the District's purchasing manager position has been vacant since September 2007. The purchasing manager is an important part of the District's procurement function. The decentralization of the purchasing function and the lack of a purchasing manager also significantly limit the District's ability to detect errors or irregularities in a timely manner and during the normal course of performing duties.

Audit Committee

The Texas Water Code, Section 49.199 6(B), requires the District to establish an audit committee. Although the Texas Water Code does not provide specific audit committee responsibilities, these typically include:

- Selecting external financial auditors.
- Overseeing the audit process.
- Hiring and supervising the work of an internal auditor.
- Ensuring organizational ethics.
- Reviewing financial reports on a regular basis.
- Monitoring internal control policies and procedures.
- Conducting oversight of risk management.

The lack of internal controls in the purchasing function was previously communicated to the District's Board and its management by the District's external auditors. However, neither the Board nor management adequately addressed those weaknesses. The Board formally accepted the external auditors' results, but the Board did not require District management to develop and implement a plan of action to address the weaknesses identified.

In addition, the District did not have an internal auditor² and the Board's Finance Committee did not provide a mechanism to track and periodically report the status of the District's implementation of auditor recommendations to the Board. Board policy states that the Board's Finance Committee would perform the functions expected of an audit committee. An audit committee independent from the Finance Committee, as well as an independent internal audit department, could monitor the correction of weaknesses

² Although the District is not subject to Texas Government Code, Chapter 2102, this statute requires a state agency that has an annual operating budget exceeding \$10 million, has more than 100 full-time employees, or receives and processes more than \$10 million in cash in a fiscal year to establish a program of internal auditing.

identified and help ensure the financial integrity of the District (see text box). (A copy of the external auditors' *Report on the Conduct of the 2007-08 Financial Audit* can be found on the District's Web site at <http://www.bexarmet.org/financial>.)

The District did not always comply with state purchasing laws and regulations.

Auditors identified one instance in which the District purchased a vehicle for \$97,000 without conducting an evaluation of potential vendors as required by Texas Water Code, Section 49.273 (d).

Additionally, for 13 of 20 (65 percent) purchasing transactions, the District did not follow its policy requiring phone solicitation of at least three vendors to obtain the best price for goods costing less than \$15,000.

The District lacked sufficient controls to track and safeguard its vehicles and information technology equipment.

Auditors conducted inventory testing on District vehicles and information technology equipment. Fifty-four of 56 vehicles tested were located. According to District's management, one of the two missing vehicles was retired and the other vehicle was totaled in an accident. However, the District did not have documentation to verify that the latter vehicle was totaled and disposed. Both vehicles should have been removed from the District's inventory list kept by the accounting department.

The District's Information Technology Department did not maintain a complete list of its equipment. Twelve of 43 (28 percent) information technology inventory items identified by auditors were not on that department's inventory list. This included seven computers, four printers, and one switch/router. Additionally, four employees (9 percent) had a different computer than the computer assigned to them according to the Information Technology Department's inventory list. District personnel later provided auditors an accurate, updated list that included all employees and the computers assigned to them. Auditors identified other weaknesses, including the following:

- None of the 25 printers on the Information Technology Department's inventory list was assigned to an individual or department. Although these printers are located in individual employees' offices or a department (for example, payroll and accounting), no one is assigned responsibility for the printers.
- The District lacked policies and procedures to manage the issuance, tracking, and proper disposal of its equipment. For example, one laptop was listed as stolen on the inventory list maintained by the Information Technology Department. The laptop was written off from the District's inventory list with no documentation to support that it was stolen. The District also did not document the disposal of items or require employees

to sign a form acknowledging that they were taking responsibility for a particular item, such as a computer. Both of these processes would help the District ensure that it is accurately tracking its inventory and holding employees accountable for assigned equipment.

Recommendations

The Board should:

- Establish and document specific responsibilities for the Board's Finance Committee.
- Establish an audit committee, pursuant to the Texas Water Code, Chapter 49, to ensure that the District addresses identified internal control deficiencies in a timely manner.
- Hire an internal auditor and establish an internal audit function that reports directly to the audit committee.

The District should:

- Establish internal controls to ensure that purchases are reasonable and necessary for the operation and maintenance of the District.
- Hire a qualified purchasing manager to oversee its purchasing and contracting functions.
- Develop a corrective action plan to address audit findings. This corrective action plan should (1) set a timeline, (2) assign responsibility for each corrective action to a specific department or staff member, and (3) hold the department or staff member accountable for complying with the action plan.
- Ensure that all expenditures subject to advertisement and bid requirements meet state laws and District policy requirements.
- Conduct an inventory of its information technology equipment to ensure it has a complete and accurate record.
- Establish policies and procedures to address the issuing, tracking, and proper disposal of inventory. These procedures should include:
 - ♦ Requiring employees to sign an equipment accountability form and holding employees accountable for all equipment assigned to them.
 - ♦ Establishing an equipment disposal process that clearly identifies (1) the disposed equipment by serial number, (2) the reason for disposal, and (3) the approving authority.

- ♦ Developing and implementing policies and procedures to address lost or stolen items.

Management's Response

The Board should establish and document specific responsibilities for the Board's Finance Committee to help ensure that the District addresses identified internal control deficiencies in a timely manner.

District management accepts the SAO recommendation. In December 2008, Management will recommend to the Board that the Board Administrative Policy (see text box) regarding the function of the Finance Committee will include a provision requiring the Committee to monitor management's progress on the implementation of auditor recommendations. Regarding the District's lack of implementation of the recommendations of the external auditors, management has made progress in correcting issues identified by the auditors, as evidenced by the reduction in the number of comments made in the FY 2008 Conduct of the Audit Report compared to FY 2007. Recurring issues as well as those identified for the first time were the result of limited personnel resources. As a result, the correction of these issues were delayed due to requests made for pending investigations, immediate infrastructure needs, legislative contests, and subsequent HB1565 reporting requirements. Current management is taking measures to prevent internal control deficiencies from reoccurring.

District Administrative Policies on Financial Management

Section 5.04: BexarMet Board Finance Committee will oversee the process for the selection of auditors and the performance of all audits, and will review each confidential working copy of the draft audit or draft management letter prior to its decision or submission to the Board for its approval. It will perform other functions as may be expected of an Audit Committee. The Board of Directors shall select the accountant to perform the annual audit, consistent with Sec. 2254.006 of the Texas Government Code; but the Board is free to advertise requests for qualifications (RFQs) from accounting firms.

The Board should establish an audit committee, pursuant to the Texas Water Code, Chapter 49, to ensure that the District addresses identified internal control deficiencies in a timely manner.

District management accepts the SAO recommendation. The District's current Board Administrative Policies designate the Finance Committee to serve as the audit committee as well. In order to separate this function, management will recommend to the entire Board that an independent Board Audit Committee is formed to work in conjunction with the Finance Committee to resolve all audit recommendations.

The Board should hire an internal auditor and establish an internal audit function that reports directly to the audit committee.

District management accepts the SAO recommendation. The newly formed Audit Implementation Team (AIT), in response to a recommendation made in the Management Audit, has designed a new organizational structure for the

District. As part of the new structure, management has created a new internal auditor position, which will report directly to the Board Audit Committee.

The District should establish internal controls to ensure that purchases are reasonable and necessary for the operation and maintenance of the District.

District management accepts the SAO recommendation for establishing internal controls to ensure the relevance of all purchases to the District's operations and recognizes the importance of said controls. Standard operating practices are in place to authenticate all purchases to include authorization from management based on the amount of the expenditure, review and acceptance of all requisitions by the purchasing agent, as well as the verification of invoices and relevant documentation in the accounting department. Although some of these practices are not formally documented, the District does have administrative policies approved by the Board that, if followed, mitigate the lack of documented internal controls. Primarily, it was the lack of adherence to the prescribed policies by the previous General Manager that led to the circumstances behind most of the key findings by the SAO. The District's new Contracts Administrator and Planner, in collaboration with other senior managers, are currently working on procedures to formally document the internal controls in practice and are reviewing the entire procurement process to include any improvement where necessary. These procedures are expected to be completed and presented to the Board in December 2008.

The District should hire a qualified purchasing manager to oversee its purchasing and contracting functions.

District management accepts the SAO recommendation. Management has published the available position and has received some response. In addition to the hiring of a qualified purchasing manager, the District is mitigating the issues brought up by the SAO audit with regard to contracts by utilizing the newly created position of Contracts Administrator to review proposed contracts before they are approved and carried out.

The District should develop a corrective action plan to address audit findings. This corrective action plan should (1) set a timeline, (2) assign responsibility for each corrective action to a specific department or staff member, and (3) hold the department or staff member accountable for complying with the action plan.

District management accepts the SAO recommendation. Management has now formed an Audit Implementation Team (AIT) to address recommendations made by each audit and develop a guide outlining the plan of action to address all audit findings. In doing so management will have better control over the completion of the tasks to which it has committed. The AIT will serve

to assist Management in staying on task as well as help the Board ensure that the recommendations are addressed.

The District should ensure that all expenditures subject to advertisement and bid requirements meet state laws and District policy requirements.

District management accepts the SAO recommendation. Recognizing the significance of adhering to these policy requirements, management is in the process of revising the standard operating procedures for the Purchasing department, which will describe the required steps to take for all purchases. By December 2008, this written manual will be distributed to all managers.

The District should conduct an inventory of its information technology equipment to ensure it has a complete and accurate record.

District management accepts the SAO recommendation. By the end of January 2009, a complete inventory of the District's information technology (IT) equipment will be carried out by the IT department. This inventory listing will be maintained independently from that already kept by the Finance department, which accounts for all of the District's non-depreciable assets. The Finance department listing accounts for all office equipment including furniture, printers, computers, etc. and is updated throughout the year with the use of the "Change in Status of Tagged Item" (CSTI) form that identifies where the inventoried items are currently located, where they are being moved to, and to whom the equipment is now assigned. This list is reconciled on an annual basis through the completion of a physical inventory. However, in order to improve upon the tracking of all of the District's non-depreciable assets, including the IT equipment, the Finance department will incorporate a quarterly physical inventory and coordinate with the IT department to reconcile both lists and ensure that all equipment is accounted for.

The District should establish policies and procedures to address the issuing, tracking, and proper disposal of inventory. These procedures should include:

- Requiring employees to sign an equipment accountability form and holding employees accountable for all equipment assigned to them.
- Establishing an equipment disposal process that clearly identifies (1) the disposed equipment by serial number, (2) the reason for disposal, and (3) the approving authority.
- Developing and implementing policies and procedures to address lost or stolen items.

District management concurs with the SAO recommendation to develop procedures with regard to inventory. These procedures will formally document the District's current practices and incorporate the changes in process previously mentioned, such as more frequent inventory counts. The

Finance department will continue to use the Change in Status of Tagged Item form currently available, which already requires the information the SAO is recommending we obtain, and make it more widely available to District employees. If an item is being disposed of, an additional "Asset Disposal Form" is to be completed and attached to the documentation related to the disposal. In doing so, management will have better documentation that the appropriate disposal process was in fact followed. For instance, in the case of the two "missing" vehicles the SAO mentioned in their comment, the file for the totaled vehicle had the paperwork from the insurance company and the Accounting department was in the process of removing vehicles from the asset listing for FY 2008 when the documentation was requested by the SAO. However, as the Accounting department had not received the insurance paperwork nor relinquished the original vehicle title to the insurance company by fiscal year end, the vehicle was not removed from the asset listing. The Accounting department is working with the garage manager to formalize will ensure that the process for retiring vehicles and equipment is completed on a timely basis. These procedures are expected to be completed and presented to the Board by December 2008.

Chapter 1-D

The District Did Not Ensure That Its Contracting Practices Comply with State Laws and District Policy and Did Not Adequately Monitor Its Existing Contracts

The District's contracting policies complied with statutorily established procurement requirements. However, the District did not consistently enforce these contracting policies. Auditors tested 26 contracts and identified instances in which the District's Board and management did not adhere to state solicitation requirements. The District also failed to adequately safeguard its interests by entering into contracts that did not have an established price. The District's ability to track and monitor its contracts is hindered by the lack of a central file or database of all of its contracts. The

<p>Professional Services</p> <p>Texas Government Code, Section 2254.002(2)(A), defines professional services as those related to:</p> <ul style="list-style-type: none"> ▪ Accounting. ▪ Architecture. ▪ Landscape architecture. ▪ Land surveying. ▪ Medicine. ▪ Optometry. ▪ Professional engineering. ▪ Real estate appraising. ▪ Professional nursing.

District also overpaid its contractors and paid for services that were not provided. Because the District did not initially provide auditors with a complete list of its contracts, auditors were not able to consider at least 35 contracts for audit testing.

The District's contracting practices did not consistently comply with state laws and District policies.

The District's Board and management contracted for public relations services without following state contracting laws. The public relations contract was erroneously classified as a professional service even though it did not meet the criteria established for professional services by Texas Government Code, Section 2254.002 (see text box). If the contract had been classified correctly, the District would have been required to advertise its request for proposals, accept bids, evaluate the proposals, and

award the contract based on the results of the evaluation. By avoiding this process, the District's Board and management may have awarded the contract to a vendor that may not have been the best option.

In addition, the District did not follow state procurement law because it did not adequately advertise or evaluate bidders for a sidewalk repair services contract. The District solicited bids for the service; however, it did not perform an evaluation of the proposals and it did not advertise the bid for 21 days as required by state purchasing laws and regulations. Three bidders were selected to provide the service as primary, secondary, and tertiary vendors based on estimated costs.

The Board did not ensure that contracts sufficiently protect District assets.

The District's Board and management executed a 40-year contract for water in March 2007 with uncertain payment terms. Subsequent to a dispute, the District reached a settlement with the contractor in April 2008 and the District agreed to pay the contractor \$2.1 million to cover the minimum payments due through March 2008.

In addition, at the contractor's request, the Board approved a contract amendment in which it waived the District's immunity to liability from lawsuits for breach of contract, potentially increasing the District's exposure to liabilities. District management stated that the Board agreed to waive the District's immunity because the contractor expressed concerns about potential negative effects for its business if the Legislature approved House Bill 1565 (80th Legislature).

The District lacked a comprehensive database or central listing of current contracts.

The District could not determine at any given time the number of current contracts it had because it relies on each individual department to monitor its own contracts. A lack of a districtwide contract tracking system hinders the District's ability to adequately manage its contracts or determine its need for additional services.

The District took more than a month to compile a list of current contracts that included basic information such as vendor name, total contract price, starting and ending dates, and purpose of the contract. Not all information requested was provided for each contract. In addition, 35 contracts on which the District made more than \$1.8 million in payments during fiscal years 2007 and 2008 were not included in the initial list provided to auditors and, therefore, were not considered for audit testing.

The District had inadequate controls over payments made to contractors.

For 7 of 26 (27 percent) contracts tested, auditors identified \$371,336 in payments that were either above the contracted amount or were not approved by the Board.

The District also made payments on contracts without requiring that adequate supporting documentation be submitted. For example:

- The District's management approved reimbursement payments totaling \$74,869 for its public relations contract even though the contractor's invoices did not provide sufficient documentation to confirm that the expenditures were valid. Some of these payments included items for which the contractor was already being paid under a \$10,000 monthly retainer fee. Furthermore, the contractor did not provide most of the services outlined in the contract; instead, according to District management, the contractor worked on issues regarding House Bill 1565. District management also paid the contractor \$5,000 to redesign the District's Web site even though the Board had previously disapproved this proposal.
- The District's management approved payments of \$71,532 to one of its contracted lobbyist even though the lobbyist did not submit written weekly reports as required by its contract. The contract also required the lobbyist to submit monthly invoices, including a brief description of all work performed in sufficient detail to adequately inform the District about the services provided. However, all invoices for payment submitted by the lobbyist contained the description of work performed only as "State Legislative Representation Services." District management asserts that the lobbyist provided verbal reports about the work performed.

The District's management did not retain sufficient procurement documentation.

The District did not maintain documentation supporting the procurement of 5 of 26 (19 percent) contracts tested; therefore, auditors could not determine whether the District complied with request for proposal solicitation requirements in Texas Water Code, Chapter 49, for these 5 contracts.

The District also did not keep the final evaluations for a financial services contract and an engineering project management contract. District management evaluated several vendors' proposals for both services. However, in both cases, the vendor with the best evaluation was not awarded the contract. According to District's management, the District's Board selected a different vendor based upon additional review. However, the District was unable to provide any documentation of the evaluation used for the final selection.

Recommendations

The District should:

- Implement its contracting policies to ensure proper solicitation of goods and services, evaluations to select vendors, and communication with vendors that were not awarded contracts.
- Clarify its contracting policy regarding professional services and ensure it adheres to state requirements.
- Ensure that a firm price is established before executing contracts.
- Develop a central database to track and monitor its contracts
- Monitor its contracts to ensure that it:
 - ♦ Approves and makes payments according to contract terms.
 - ♦ Does not pay vendors above contracted amounts.
 - ♦ Receives all contracted services before making a final payment.
- Develop and implement a record-keeping and record retention policy to ensure that contracting documentation is retained for the life of a contract.

Management's Response

The District should implement its contracting policies to ensure proper solicitation of goods and services, evaluations to select vendors, and communication with vendors that were not awarded contracts.

The District management accepts the SAO recommendation to implement policies with regard to awarding contracts. As mentioned by the SAO, the District has policies in place that outline the requirements that must be met when entering into a contract. Nevertheless, these policies were not always applied uniformly, typically upon the direction of the District's previous General Manager. Regarding the WECO contract, for instance, the previous General Manager went against the advice of external legal counsel and recommended the approval of the agreement as requested by WECO. Henceforth, the District will ensure that all Board, State and Federal guidelines are adhered to when awarding a contract.

The District should clarify its contracting policy regarding professional services and ensure it adheres to state requirements.

District management accepts the SAO recommendation to expand upon the District's contracting policy. A thorough review of the District's contracting

policy will be completed by the Legal department to ensure that the District complies with all Board, State and Federal guidelines and any modifications that are required will be proposed to the Board of Directors by December 2008. Regarding the lack of compliance cited in the SAO comment, as in the case of the public relations services agreement, the contracting policies established by the Board were not strictly adhered to. Consequently, the contracting policy will be modified to ensure that this situation does not occur in the future.

The District should ensure that a firm price is established before executing contracts.

District management accepts the SAO recommendation. The District's Contract Administrator, in collaboration with the Legal, Engineering, and Finance departments, is developing guidelines to outline contracting procedures. These procedures are scheduled to be completed by the end of October 2008.

The District should develop a central database to track and monitor its contracts.

District management accepts the SAO recommendation. The District is currently evaluating contract management software packages. The implementation of a software package will assist staff and management log and track the District's contracts as soon as they are finalized. A cost proposal will be presented at the January 2009 meeting for approval.

The District should monitor its contracts to ensure that it:

- *Approves and makes payments according to contract terms.*
- *Does not pay vendors above contracted amounts.*
- *Receives all contracted services before making a final payment.*

District management accepts the SAO recommendation. The contract management guidelines will ensure that payments are approved according to contract terms, that vendors are not paid above contracted amounts and that all contracted services are budgeted before a final payment is made.

The District should develop and implement a record-keeping and record retention policy to ensure that contracting documentation is retained for the life of a contract.

District management concurs with the SAO recommendation regarding the retention of records for the appropriate length of time. The District currently has a Board approved record retention policy in place. The Legal department will research State and Federal mandates on contract record retention and

propose any necessary changes to the Board by the end of January 2009 for approval.

The District Should Improve Oversight of Its Expenditure Approval and Documentation Process

The District's Board and management did not provide sufficient oversight of its approval and documentation process for expenditures. The District did not consistently (1) ensure expenditures were reasonable and necessary, (2) maintain supporting documentation for its expenditures, (3) record financial transactions in the proper account, and (4) ensure financial duties were adequately segregated. In addition, the District was not consistent in how it classified and recorded expenditures. (See Appendix 4 for additional information on expenditures.)

The District did not ensure that expenditures were reasonable or necessary.

Auditors reviewed District expenditures for fiscal years 2007 and 2008 and noted the following:

- The District paid \$2,438,464 for claim settlements, external legal services, and District Legal Department employee salaries during fiscal years 2007 and 2008. This amount was approximately 9 percent of the District's payroll for both fiscal years. This amount included:
 - ♦ \$1,702,406 paid for external legal services, which included \$40,688 to represent the general manager in certain labor and employment law matters connected to the performance of his official duties as general manager. Although the cost of legal representation is covered under the District's insurance policy, the District's contract with the general manager allowed the general manager to hire his own attorney at an additional cost to the District.
 - ♦ \$378,100 for the District's legal department payroll.
 - ♦ \$357,957 paid by the District in settlements, which included \$67,500 to settle lawsuits filed by former District employees for age discrimination, retaliation, and sexual harassment.
- In addition to the \$2,438,464, the District's insurance carriers paid \$870,204 in settlements, which included \$791,750 for the personnel law suits noted above. Although the District did not pay this amount directly, these settlements may affect the amount of the District's future insurance premiums.
- The District paid \$1.9 million for engineering project management services in fiscal year 2008. The District contracted with an engineering firm because the District did not have the necessary engineers on staff to manage its projects. From June 2007 to May 2008, the District did not have a Director of Engineering, a Chief Engineer, or a Professional

Engineer. The District paid \$904,430 to its engineers during fiscal years 2007 and 2008. While the District may need the contracted services of engineers for some projects, its total engineering costs could be reduced if the District fully staffed its engineering department.

- The District paid at least \$584,641 for lobbying and other services related to House Bill 1565. Auditors could not determine whether the District paid for other costs associated with House Bill 1565 because the District did not consistently record expenditures in the appropriate accounts. For example, the District recorded some expenditures incurred by a District lobbyist in its travel and conferences account instead of recording it as professional services (as it did for all other expenditures related to this contract).
- The District paid at least \$49,766 for food and gifts for employees during fiscal years 2007 and 2008. These expenditures were approved in the District's budget and included meals for meetings, meals for training, and Thanksgiving and Christmas dinners for employees. It also included gift cards, entertainment, kitchen supplies, candy for management, and decorations.
- The District paid \$5,000 for an advertisement in a Barcelona, Spain newspaper. The advertisement did not benefit the District or its ratepayers. The advertisement described the purpose of the District and the area it serves. Furthermore, the advertisement contained erroneous information about the District. The general manager and the Board president confirmed that they did not review the advertisement's content prior to its publication or payment.

The District lacked sufficient oversight and documentation of its expenditures.

The District did not consistently maintain supporting documentation and evidence of approval for expenditures to ensure compliance with District procurement policies. The District should ensure that all employees, including its Board members and management, provide adequate support to justify expenditures.

Auditors tested 175 transactions from fiscal years 2007 and 2008 and identified invoices that lacked sufficient documentation or were not approved according to District policies. Specifically:

- 74 of 172 (43 percent) transactions did not have sufficient documentation to support the payment. Three of the transactions tested did not require documentation.
- 55 of 174 (32 percent) transactions were not properly approved. One transaction tested did not require approval.

- 47 of 174 (27 percent) transactions were not properly coded. One transaction could not be tested because it was a credit for a prior payment.

The District did not have sufficient support for its credit card purchases.

During fiscal years 2007 and 2008, District management did not maintain sufficient documentation to validate the appropriateness of its American Express credit card purchases. The District also miscoded the general manager's meals that were paid for with the credit card. Auditors tested 273 transactions totaling \$55,091. Out of these transactions:

- 144 transactions totaling \$23,540 did not have sufficient supporting documentation, including 16 transactions totaling \$5,718 for out-of-state travel. The out-of-state travel included 10 payments for a total of \$4,677 for travel to New York City and Albuquerque, New Mexico. Because of insufficient documentation, auditors could not determine whether the trips were for business-related purposes.
- 175 transactions totaling \$21,092 were not recorded to the appropriate account. Specifically:
 - ♦ 139 transactions totaling \$8,385 for non-travel-related meals were recorded to an incorrect account. Of these, 136 transactions (\$4,386) were incorrectly charged to travel-related accounts and 3 were charged to other accounts. According to District management, these meals were recorded to the travel and conference account to conceal the expenditures instead of recording them to a more appropriate account, such as a meals and entertainment account.
 - ♦ Four transactions totaling \$7,688 for making copies were recorded as miscellaneous charges, legislative oversight expenditures, or travel and conference expenditures. These expenditures should have been recorded in the District's printing account.

The District's accounting processes did not ensure that similar transactions were recorded in the same manner within its accounting system.

The District did not record similar transactions in a consistent manner. While the method used for each transaction may not be incorrect, similar transactions should be consistently recorded. Specifically:

- The District recorded its purchase of \$50,400 of season tickets to amusement parks as an accounts receivable, and it reduced the account balance as funds were collected through employee payroll deductions. The District served as an intermediary for the purchases of these tickets on the behalf of its employees.

- The District recorded its purchase of \$17,446 for apparel as an expenditure, and it recorded the funds collected from the sale of apparel to employees as revenue.
- The District recorded its uniform and laundry cost of \$118,325 as an expenditure, and it recorded the funds collected from employees for laundry services as a reduction to the expense account.

The District did not adequately segregate financial responsibilities or limit these responsibilities to accounting department employees.

The District had 16 user accounts with full access to its automated accounts payable ledger. All 16 user accounts had access rights to:

- Enter, review, and post transactions.
- Authorize payments and eliminate the audit trail.
- Print and void checks after posting of a transaction.
- Review and change vendor information.

Furthermore, 4 of the 16 user accounts were generic accounts, which allowed anyone with knowledge of the username and password to access the accounts payable ledger. This reduces the District's ability to ensure (1) the security and validity of accounts payable information or (2) users' accountability for any changes made.

In addition, the same accounting employees who had the access described above also were responsible for reconciling the District's bank statements and its general ledger. A lack of adequate segregation of duties increases the risk that inaccurate, inappropriate, or fraudulent financial transactions may be processed without detection.

Recommendations

The District should:

- Ensure that key management vacancies are filled on a timely basis.
- Provide better oversight of its expenditure function by:
 - ♦ Ensuring that all expenditures are reasonable and necessary for the operation and maintenance of the District, as required by District policy.
 - ♦ Ensuring it records transactions to the correct account.

- ♦ Ensuring it maintains sufficient documentation to support its expenditures prior to payment, including evidence of approval.
- ♦ Establishing accounts that reflect the purpose of the expenditures, such as expenditures related to meals.
- ♦ Ensuring that similar transactions are recorded in a consistent manner and follow accounting principles, as required by Texas Water Code, Section 49.192, and District policies.
- ♦ Developing policies to address which employees should have access to the District's automated accounts payable ledger and what level of access should be granted.
- ♦ Deactivating all generic user accounts.
- ♦ Ensuring that financial duties are properly segregated.

Management's Response

The District should ensure that key management vacancies are filled on a timely basis.

District management concurs with the SAO recommendation. The District is aggressively seeking qualified candidates for each position by advertising vacancies in a wide range of arenas, such as the internet, newspaper, and the State's "Work in Texas" program.

The District should provide better oversight of its expenditure function by:

- Ensuring that all expenditures are reasonable and necessary for the operation and maintenance of the District, as required by District policy.

District management accepts the SAO recommendation. The Contract Administrator is currently revising existing procedures that define appropriate actions and processes in all departments. This procedure, expected to be completed by December 2008, requires the completion of a risk assessment based on established District guidelines and criteria.

- Ensuring it records transactions to the correct account.

District management accepts the SAO recommendation. The Finance department will include brief descriptions of each budget account into the accounts payable procedures expected to be completed by November 2008. This will assist managers in correctly classifying their purchases. In addition, more descriptive expense line items will be set up in the chart of accounts to assist staff in classifying expenses correctly.

- Ensuring it maintains sufficient documentation to support its expenditures prior to payment, including evidence of approval.

District management accepts the SAO recommendation. The Contracts Administrator is developing contract procedures, in conjunction with existing purchasing procedures, which define the documentation required for all categories of expenditures. As previously stated, these procedures will be completed by December 2008.

- Establishing accounts that reflect the purpose of the expenditures, such as expenditures related to meals.

District management accepts the SAO recommendation. As part of the preparation process for the implementation of new accounting software, Finance staff is currently reviewing the chart of accounts for the possibility of changing the numbering structure for the general ledger. Management will review the expenses typically charged to each of these accounts and assess the need for additional general ledger accounts. This assessment is expected to be complete by January 2009.

- Ensuring that similar transactions are recorded in a consistent manner and follow accounting principles, as required by Texas Water Code, Section 49.192, and District policies.

District management accepts the SAO recommendation. Finance department staff works to ensure that all transactions posted to the general ledger are reviewed and recorded pursuant to District policies, the Texas Water Code, and generally accepted accounting principles (GAAP). Accordingly, the transactions accounting for benefits are recorded differently, as, although it may appear otherwise, they are not the same. For instance, the season tickets mentioned in the SAO report and the apparel purchased for re-sale to the employees are recorded differently because the District does not actually purchase the tickets for the employees. These tickets are sent to the District by the respective vendors and provided to the employees upon signing a payroll deduction form authorizing the District to deduct the cost of the tickets from their paycheck over a pre-established period of time. Once the full cost of the tickets is deducted, the District then pays the vendor for the tickets. Apparel on the other hand, is purchased by the District upfront and is sold to the employees. Any funds received from those sales are recorded as revenue as required. The Finance department is developing procedures, expected to be complete by December 2008, that explain the function of the benefits provided to District employees and how they will be recorded.

- Developing policies to address which employees should have access to the District's automated accounts payable ledger and what level of access should be granted.

District management accepts the SAO recommendation. The Finance department, in conjunction with the IT department, is revising existing IT procedures to address the security issues regarding the accounting software and the level of access employees should have to all subsidiary ledgers. A form is being created to accompany these procedures which outline by position what access an employee should have. This form will be submitted to the IT department to create the User ID, password and account permissions based on the guidelines specified in the procedures. In doing so, the lowest level of access required to perform the employee's job function will be permitted. Further, account permissions in the system will be consistent with procedures ensuring a segregation of duties amongst the department.

- Deactivating all generic user accounts.

District management accepts the SAO recommendation. The Finance department has implemented this recommendation and disabled all generic accounts as well as those of terminated employees.

- Ensuring that financial duties are properly segregated.

District management accepts the SAO recommendation. The Finance department is documenting the District's standard operating practices and reviewing current processes to ensure that all duties are properly segregated.

The District Lacked Adequate Internal Controls Over Stand-by, Overtime, and Vacation Pay

The District lacked sufficient controls over its processes for stand-by, overtime, and vacation pay. Specifically, the District did not:

- Document its policies related to stand-by (“on call”) pay.
- Implement its policies regarding preapproval of employees’ accrual of overtime and preapproval of employees’ use of vacation leave.
- Ensure that maintenance supervisors accurately coded employee timesheets.

The District did not document its policies related to stand-by pay.

The District paid \$688,292 and \$569,008 in stand-by overtime pay during fiscal years 2007 and 2008, respectively. However, based on the employee handbook provided to auditors in March 2008 (which had an effective date of May 2007), the District did not have documented policies and procedures to assist District employees in managing stand-by pay or how to process it. In addition, the District did not specify any restrictions or guidance on which employees could receive stand-by pay. Currently, stand-by pay is approved by a supervisor when he or she approves an employee’s timesheet.

District policies addressed the expectation that employees should be available to “provide uninterrupted, around-the-clock service to [District] customers,” on weekends and/or after regular working hours. However, the policies did not specify the procedures to be used for processing stand-by pay (see text box).

Calculating Stand-by Pay

Employees who are on call receive eight hours of stand-by pay, as well as overtime pay for any overtime worked while on call. This overtime pay is calculated as time-and-a-half plus 10 percent. For example, an employee who earns \$10 an hour and in one week works 45 hours, including 8 hours of stand-by time, would be paid:

- \$10 an hour for the first 40 hours worked.
- \$10 an hour for the 8 hours of stand-by pay.
- \$16.50 an hour for the 5 hours of overtime.

The District’s payroll department did not have a record of employees who were on call; therefore, it cannot verify whether employees who received stand-by pay were actually on call. According to District employees, supervisors verify that an employee was on call by approving the employee’s timesheet.

Auditors analyzed timesheets of employees who were paid stand-by pay during fiscal years 2007 and 2008. Auditors found that, on average, six crews with approximately four employees each were on call during each week of fiscal years 2007 and 2008.

The District did not sufficiently implement its policies regarding the preapproval of overtime and vacation.

During fiscal years 2007 and 2008, District management did not sufficiently implement the District’s policy that requires employees to obtain preapproval before working overtime or using vacation leave. The District did not require

documentation of preapproval for overtime until September 2007; therefore, auditors could not test for compliance with the policy prior to this date. Overtime pay decreased from \$756,592 in fiscal year 2007 to \$379,140 in fiscal year 2008.

Auditors selected 60 overtime and vacation transactions paid in fiscal year 2008 for testing; however, 21 could not be tested because District management had not required documentation of overtime preapprovals. Of the 39 overtime and vacation transactions that could be tested, 17 (44 percent) were not preapproved by a supervisor. Eleven of 13 (85 percent) vacation transactions tested for fiscal year 2007 were not preapproved.

The District did not correctly code employee timesheets, resulting in erroneous payments.

Managers and supervisors responsible for reviewing and submitting employees' timesheets did not consistently use the correct leave and overtime pay codes. As a result, the District made incorrect payroll payments to employees. Of 95 timesheets tested for fiscal years 2007 and 2008, 63 (66 percent) timesheets were coded incorrectly. The errors identified included the following:

- Forty-four timesheets did not correctly account for a total of 83 hours of overtime worked. As a result, some employees were paid at their regular rate when they should have been paid at the applicable overtime rate.
- Twelve timesheets did not correctly code leave taken. A total of 99 hours of vacation and 27.75 hours of sick leave were incorrectly coded. As a result, the employees' vacation and sick leave balances were not appropriately reduced.
- Two employees were overpaid for a total of 5.75 hours because their timesheets were incorrectly coded.

Recommendations

The District should:

- Document its policies and procedures for stand-by pay, including guidance on which employees can receive stand-by pay.
- Ensure that its payroll department has a record of employees who were on call to verify against approved timesheets.
- Review its leave and overtime policies regarding preapproval.
- Train the employees who are responsible for coding payroll to ensure that all items are coded correctly.

Management's Response

The District should document its policies and procedures for stand-by pay, including guidance on which employees can receive stand-by pay.

District management accepts the SAO recommendation. The Human Resources department, in collaboration with all District departments, will establish a procedure by December 2008 to identify which employees qualify for stand-by duty and a process to notify the Payroll department that this type of pay is applicable.

The District should ensure that its payroll department has a record of employees who were on call to verify against approved timesheets.

District management accepts the SAO recommendation. As previously stated, a process will be developed and implemented by December 2008 that will ensure that the Payroll department is provided with a list of on-call employees on a weekly basis to verify the payment of stand-by time.

The District should review its leave and overtime policies regarding preapproval.

District management accepts the SAO recommendation. The Human Resources department, in collaboration with the Payroll department, will review the current policies in place and make any necessary revisions to address all types of paid leave as well as documenting the authorization of additional employee pay. These policies will be ready for implementation by December 2008.

The District should train the employees who are responsible for coding payroll to ensure that all items are coded correctly.

District management accepts the SAO recommendation. By January 2009, the Payroll department will complete the development of a manual outlining the correct coding of employee time as well implement a training program for all supervisors signing off on time. Further, Payroll will coordinate with the Human Resources department to determine when additional training sessions are required.

Significant Weaknesses in the District's Automated Systems Jeopardize the Integrity and Security of Financial Data

The District had significant weaknesses in access controls over its automated systems. The weaknesses identified increased the risk of inadvertent or deliberate alteration or deletion of data, which could affect the District's ability to ensure the integrity of its data. Auditors identified opportunities for improvement in the following areas:

- Access control.
- Segregation of duties.
- Information system policies and procedures.
- System recovery plan.

To minimize the risks associated with public disclosure, auditors communicated in writing details regarding information systems directly to the District.

Recommendation

The District should address the weaknesses identified in access controls over its automated systems.

Management's Response

District management accepts the SAO recommendation. The IT department is examining current access policies and procedures to implement or modify those policies and procedures as needed to ensure that access to all its online systems is as secure as possible. The IT department, by December 2008, will evaluate its disaster recovery plan to ensure that appropriate testing is performed and documented.

List of All Recommendations in This Report

All of the recommendations in this report are listed below.

Chapter 1

The Board should:

- Amend the budget as required by the District's policy so that it reflects the District's approved spending plan.
- Approve a hard copy of the budget that is signed and dated by the Board President, Board Treasurer, and General Manager.
- Record approved budget totals in the Board minutes and publish the budget on the District's Web site.
- Ensure that the Board's Finance Committee:
 - ♦ Documents its meetings with detailed, written minutes.
 - ♦ Provides quarterly updates about the status of the budget to the full Board.
- Establish clear performance expectations in writing for the District's general manager.
- Evaluate the general manager's performance against pre-established objectives to ensure that the general manager is meeting performance expectations.
- Ensure that future general manager contracts base compensation on the general manager's performance.
- Establish and document specific responsibilities for the Board's Finance Committee.
- Establish an audit committee, pursuant to the Texas Water Code, Chapter 49, to ensure that the District addresses identified internal control deficiencies in a timely manner.
- Hire an internal auditor and establish an internal audit function that reports directly to the audit committee.

The District should:

- Establish internal controls to ensure that purchases are reasonable and necessary for the operation and maintenance of the District.
- Hire a qualified purchasing manager to oversee its purchasing and contracting functions.
- Develop a corrective action plan to address audit findings. This corrective action plan should (1) set a timeline, (2) assign responsibility for each corrective action to a specific department or staff member, and (3) hold the department or staff member accountable for complying with the action plan.
- Ensure that all expenditures subject to advertisement and bid requirements meet state laws and District policy requirements.
- Conduct an inventory of its information technology equipment to ensure it has a complete and accurate record.
- Establish policies and procedures to address the issuing, tracking, and proper disposal of inventory. These procedures should include:
 - ♦ Requiring employees to sign an equipment accountability form and holding employees accountable for all equipment assigned to them.
 - ♦ Establishing an equipment disposal process that clearly identifies (1) the disposed equipment by serial number, (2) the reason for disposal, and (3) the approving authority.
 - ♦ Developing and implementing policies and procedures to address lost or stolen items.
- Implement its contracting policies to ensure proper solicitation of goods and services, evaluations to select vendors, and communication with vendors that were not awarded contracts.
- Clarify its contracting policy regarding professional services and ensure it adheres to state requirements.
- Ensure that a firm price is established before executing contracts.
- Develop a central database to track and monitor its contracts
- Monitor its contracts to ensure that it:
 - ♦ Approves and makes payments according to contract terms.
 - ♦ Does not pay vendors above contracted amounts.

- ♦ Receives all contracted services before making a final payment.
- Develop and implement a record-keeping and record retention policy to ensure that contracting documentation is retained for the life of a contract.

Chapter 2

The District should:

- Ensure that key management vacancies are filled on a timely basis.
- Provide better oversight of its expenditure function by:
 - ♦ Ensuring that all expenditures are reasonable and necessary for the operation and maintenance of the District, as required by District policy.
 - ♦ Ensuring it records transactions to the correct account.
 - ♦ Ensuring it maintains sufficient documentation to support its expenditures prior to payment, including evidence of approval.
 - ♦ Establishing accounts that reflect the purpose of the expenditures, such as expenditures related to meals.
 - ♦ Ensuring that similar transactions are recorded in a consistent manner and follow accounting principles, as required by Texas Water Code, Section 49.192, and District policies.
 - ♦ Developing policies to address which employees should have access to the District's automated accounts payable ledger and what level of access should be granted.
 - ♦ Deactivating all generic user accounts.
 - ♦ Ensuring that financial duties are properly segregated.

Chapter 3

The District should

- Document its policies and procedures for stand-by pay, including guidance on which employees can receive stand-by pay.
- Ensure that its payroll department has a record of employees who were on call to verify against approved timesheets.

- Review its leave and overtime policies regarding preapproval.
- Train the employees who are responsible for coding payroll to ensure that all items are coded correctly.

Chapter 4

The District should address the weaknesses identified in access controls over its automated systems.

Appendices

Appendix 1

Objective, Scope, and Methodology

Objective

The objective of this audit was to conduct a financial-related audit of the Bexar Metropolitan Water District (District), as mandated by House Bill 1565 (80th Legislature).

Scope

The audit scope was limited to the District's 2007 and 2008 expenditures. This included expenditures related to contracts, leave and overtime paid, and all payments made during fiscal years 2007 and 2008. The scope also included the analysis of general ledger expenditures from fiscal year 2006 through fiscal year 2008.

Methodology

The audit methodology included analyzing and testing samples of payments, contracts, assets, and employees' timesheets.

Information collected and reviewed included the following:

- General ledger data (including summaries of data) for fiscal year 2006 through fiscal year 2008.
- Selected contracts, related procurement documentation, and related payment documentation for fiscal years 2007 and 2008.
- Selected vendors' invoices and corresponding documentation to support payments for fiscal years 2007 and 2008.
- Contract, amendments, and corresponding performance evaluations for the District's general manager for fiscal years 2005 through 2008.
- Payroll and salary data for fiscal years 2007 and 2008.
- Lists of vehicles provided by the District's Garage Department and Accounting Department.
- List of information technology equipment provided by the District's Information Technology Department.
- District policies and procedures.

- District Board of Directors (Board) minutes from January 2005 through August 2008.
- District-audited financial statements from the District's external auditors for fiscal years 2005 through 2007.

Procedures and tests conducted included the following:

- Conducted interviews with selected District employees and Board members.
- Reviewed and tested internal controls for purchasing, contracting, and payroll functions.
- Analyzed vendor payments made during fiscal years 2007 and 2008.
- Tested general ledger expenditures, invoices, and supporting documentation for fiscal years 2007 and 2008.
- Reconciled audited financial statements to general ledger detail.
- Tested available employees' leave and overtime timesheets and supporting documentation for fiscal years 2007 and 2008.
- Conducted a physical inspection of vehicles and information technology equipment.
- Tested general and application controls over:
 - ♦ Macola (accounting system).
 - ♦ Kronos (timekeeping system).
 - ♦ Abra (payroll and human resources system).

Criteria used included the following:

- District policies and procedures. Specifically, those covering:
 - ♦ Financial management.
 - ♦ Purchasing procedures.
 - ♦ Employee travel and expenditures.
 - ♦ Information technology acceptable use, security procedures, passwords, and server policy.
- *District Employee Handbook.*

- Texas Government Code, Chapter 2254 (Professional and Consulting Services).
- Texas Water Code, Chapter 49 (Provisions Applicable To All Districts).

Project Information

Audit fieldwork was conducted from June 2008 through August 2008. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

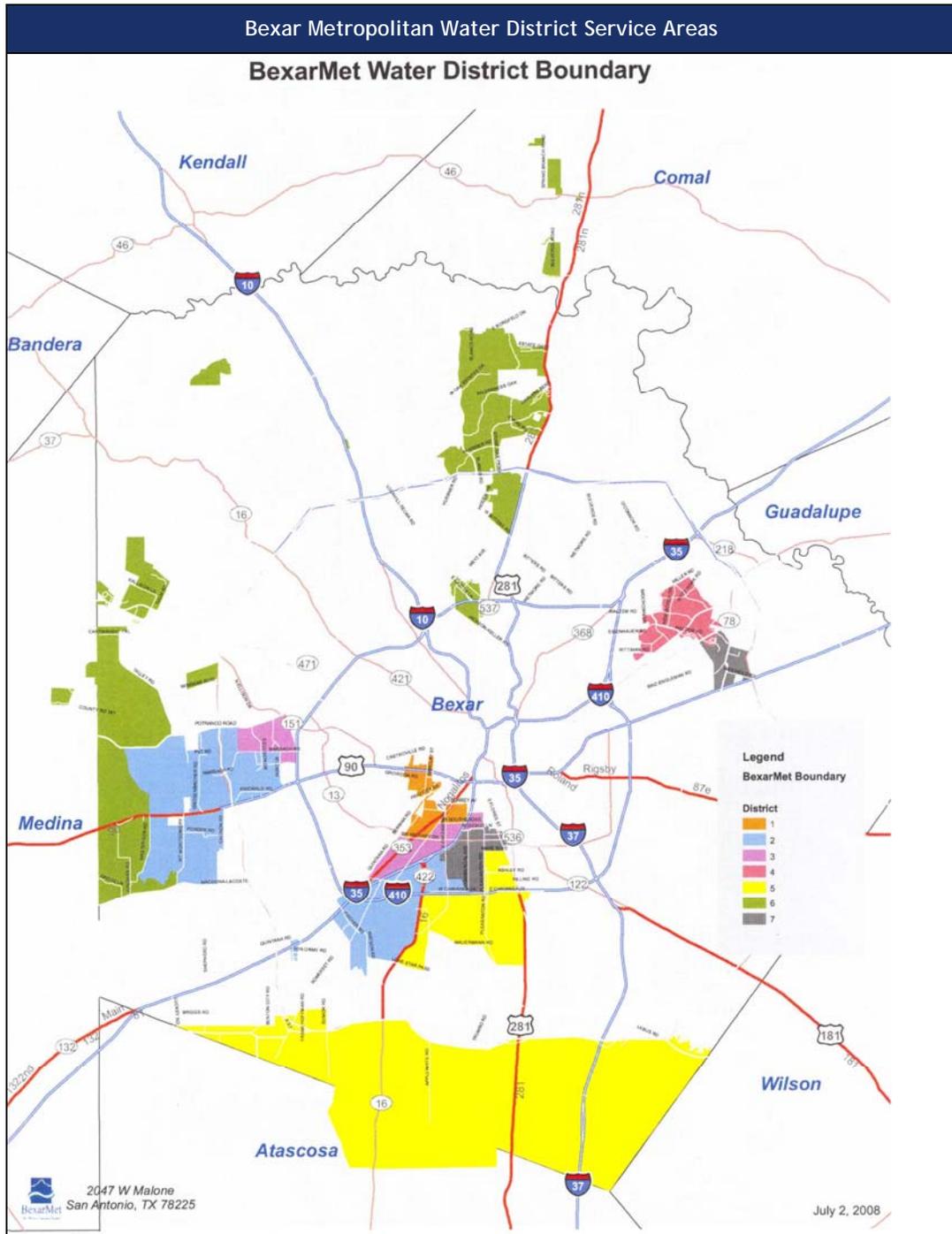
The following members of the State Auditor's staff performed the audit:

- Angelica C. Martinez, CPA (Project Manager)
- Ileana Barboza, MBA, CGAP, CICA (Assistant Project Manager)
- Michelle DeFrance, MA
- Melissa Dozier
- Joseph Mungai, CIA, CISA
- Leslie Ashton, CPA (Quality Control Reviewer)
- John Young, MPAff (Audit Manager)

Bexar Metropolitan Water District Demographic Information

The Bexar Metropolitan Water District's (District) service area is divided into seven districts located in Bexar, Atascosa, Medina, and Comal counties (see Figure 1).

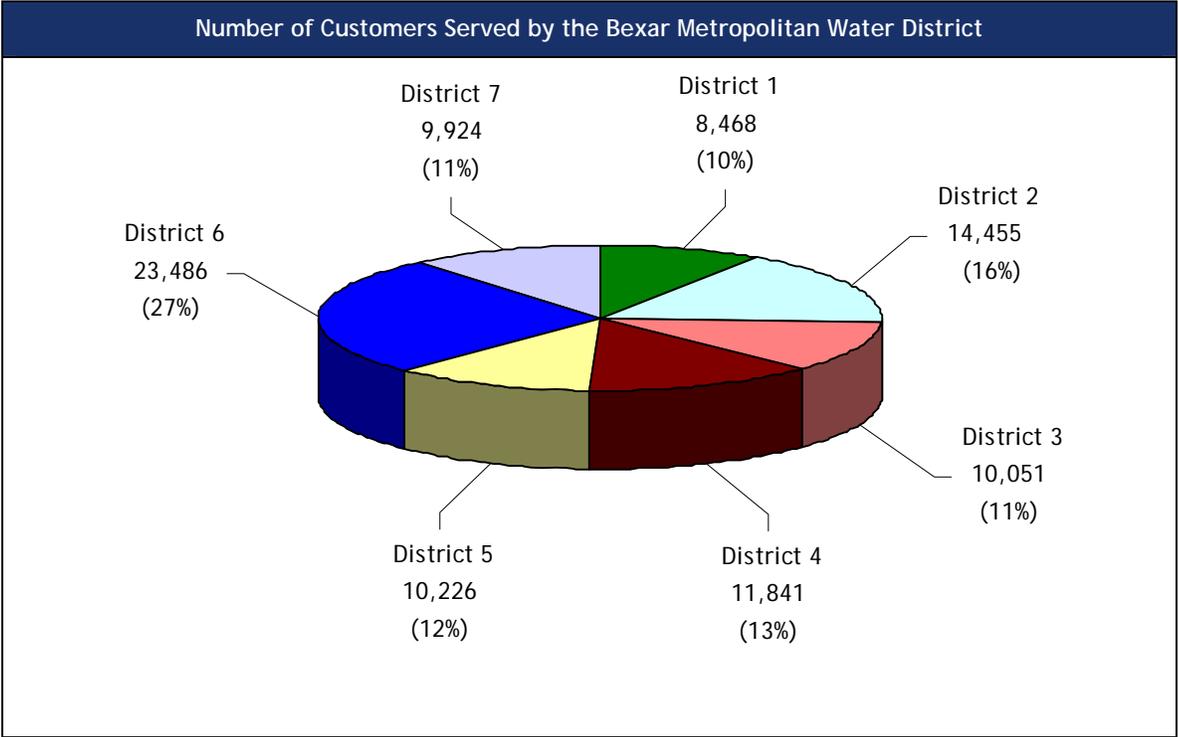
Figure 1



Source: Bexar Metropolitan Water District.

According to information provided by the District, it serves approximately 88,451 customers, of which 84,191 (95 percent) are residential and 4,260 (5 percent) are commercial. As Figure 2 shows, the largest districts are District 2 and District 6, which serve a total of 37,941 customers (43 percent of the District's total customers).

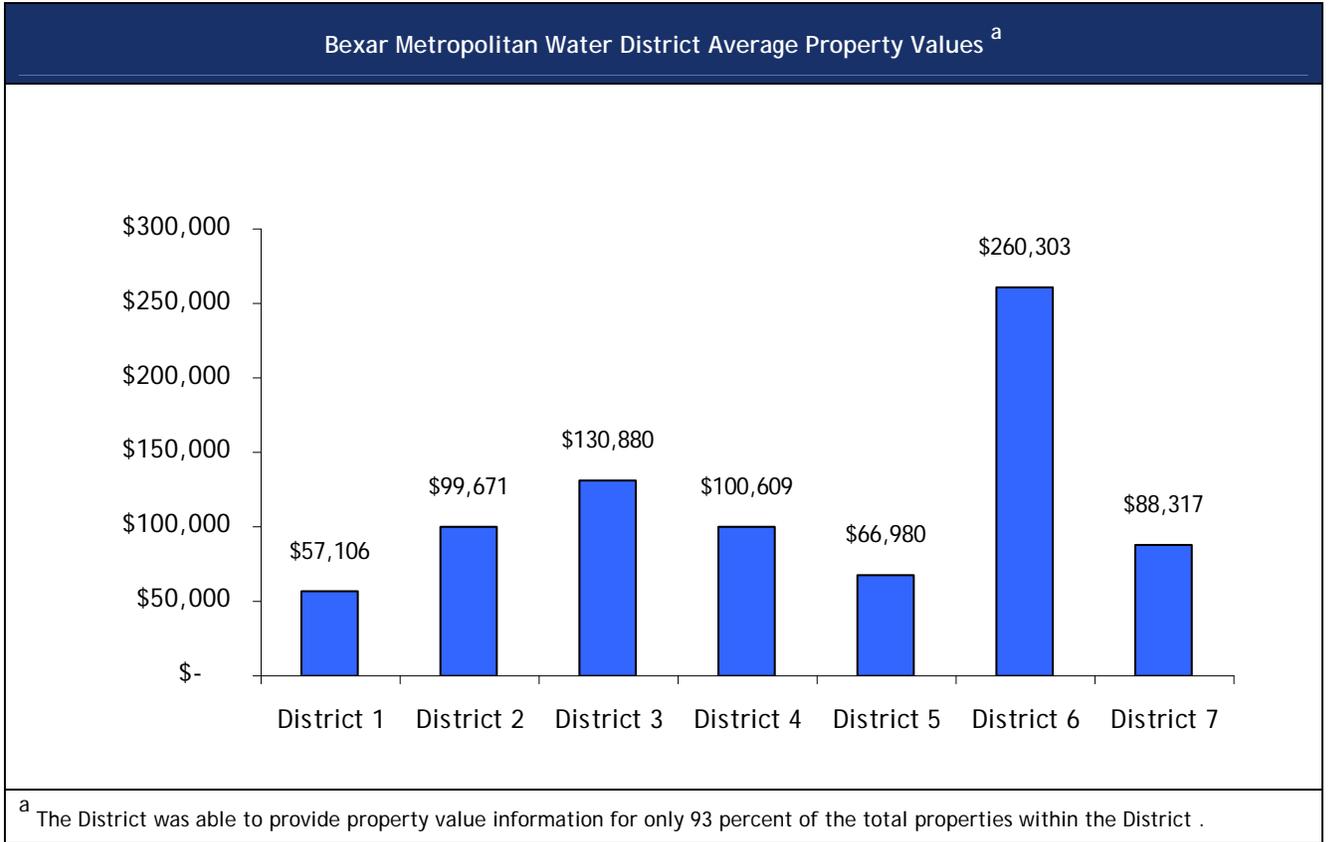
Figure 2



Source: Bexar Metropolitan Water District - Unaudited Data.

According to data provided by the District, the average property values in the area the District serves range from \$57,106 to \$260,303 (see Figure 3).

Figure 3



Source: Bexar Metropolitan Water District - Unaudited Data.

Bexar Metropolitan Water District Board of Directors and Executive Officers

The Bexar Metropolitan Water District (District) is governed by an elected, seven-member Board of Directors (Board). Board members are subject to re-election every four years as of June 30, 2008. Board members representing Districts 1, 4, 5, and 6 are subject to re-election on November 4, 2008. The remaining three Board members are subject to re-election in November 2010. The Board members are not subject to term limits. Board members can receive up to \$7,200 annually in compensation for performing director duties and also can receive reimbursement for expenses incurred while conducting District business. Table 2 lists the current Board members.

Table 2

Bexar Metropolitan Water District Board			
Board Members Name	Current Position	Date First Elected to the Board	District Represented
Victor V. Villarreal	Board President	November 2003	4
Jose "Joe" Gallegos Jr.	Board Member	November 2003	1
Jim Clement	Board Vice President	February 2005	5
Lesley Wenger	Board Member	February 2005	6
Blanche Atkinson	Board Secretary	May 2007	3
Debra Eaton	Board Treasurer	May 2007	7
Andrew "Andy" Carr	Board Member	November 2007	2

Source: Bexar Metropolitan Water District Web Site.

The District's fiscal year 2009³ salaries for management positions total approximately \$1.2 million. Table 3 lists District management by title and corresponding salary as of May 1, 2008.

Table 3

Bexar Metropolitan Water District Management Salaries	
Job Title	Fiscal Year 2009 Annual Salary
General Manager	\$ 195,000
Director of Engineering and Operations	126,819
In-house Counsel	125,182
Director of Finance	100,779
Director of Administration	94,416
Comptroller	90,174
Government and Public Affairs Officer	79,900
Assistant Director of Production	79,569
Assistant Director of Water Resources	77,250
Assistant Director of Construction and Maintenance	74,256
Assistance Director of Regulatory and Compliance	72,100
Assistant Director of Customer Services	63,651
Grand Total	\$1,179,096

The District had vacancies in key management positions as follows:

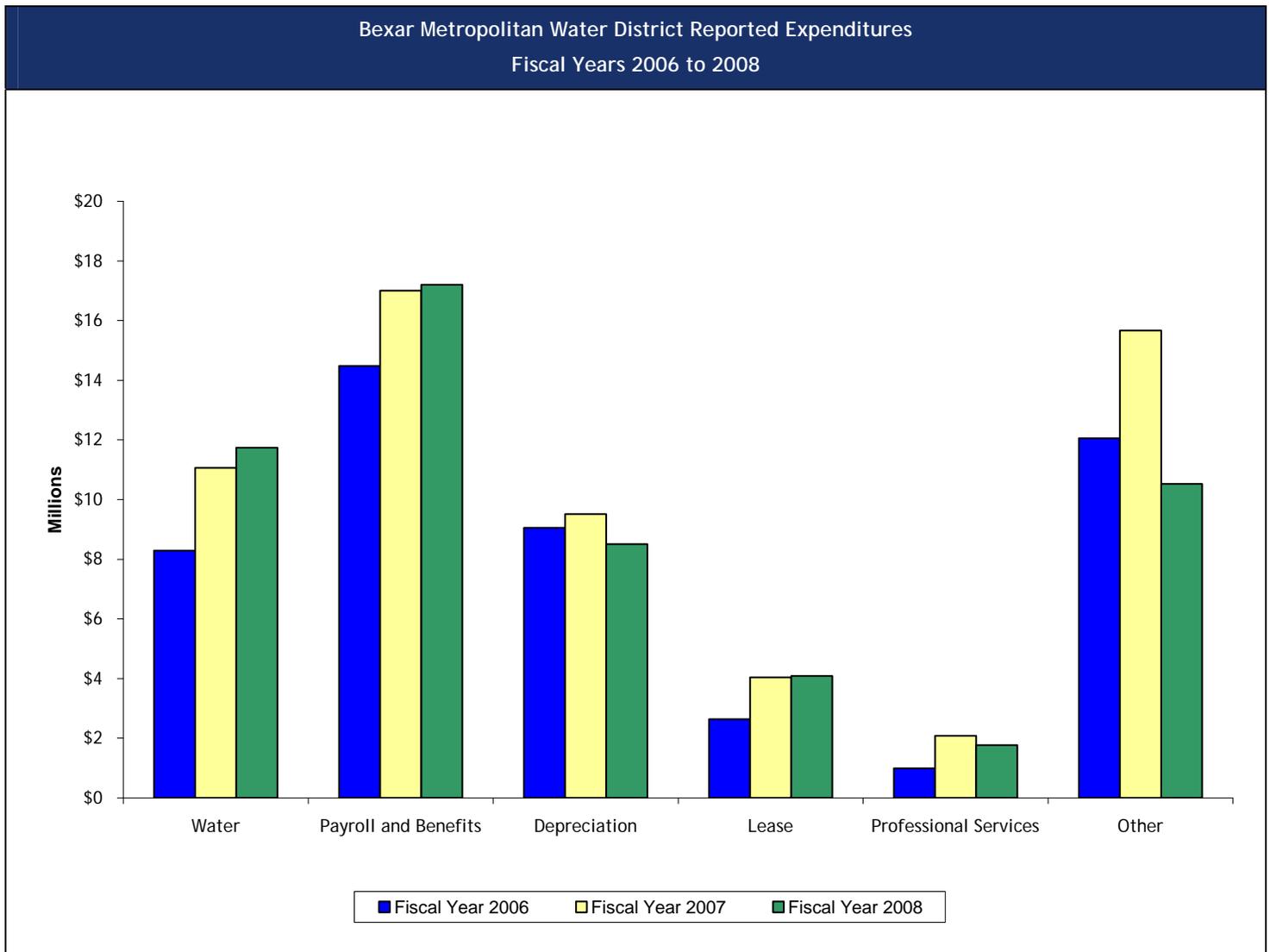
- Director of Engineering, position was vacant from February 2007 to January 2008.
- Chief Engineer, position became vacant in May 2007 and was still vacant as of October 2008.
- Purchasing Manager, position became vacant in September 2007 and was still vacant as of October 2008.
- General Manager, position became vacant in August 2008 and was still vacant as of October 2008. The Director of Finance is performing the functions of interim general manager.
- Comptroller, position became vacant in September 2008 and was still vacant as of October 2008.
- Manager of Information Systems, position became vacant in September 2008 and was still vacant as of October 2008.

³ The District's fiscal year is from May 1 through April 30.

Bexar Metropolitan Water District's Summary of Expenditures

The Bexar Metropolitan Water District's (District) overall operating expenditures increased from \$47.5 million in fiscal year 2006 to \$59.4 million in fiscal year 2007. Operating expenditures decreased by \$5.5 million to \$53.8 million in fiscal year 2008. Figure 4 shows the changes in the District's largest expenditures for water, payroll and benefits, depreciation, leases, and professional services. The majority of expenditures included in the "other" category were for maintenance, utilities, and fuel expenditures.

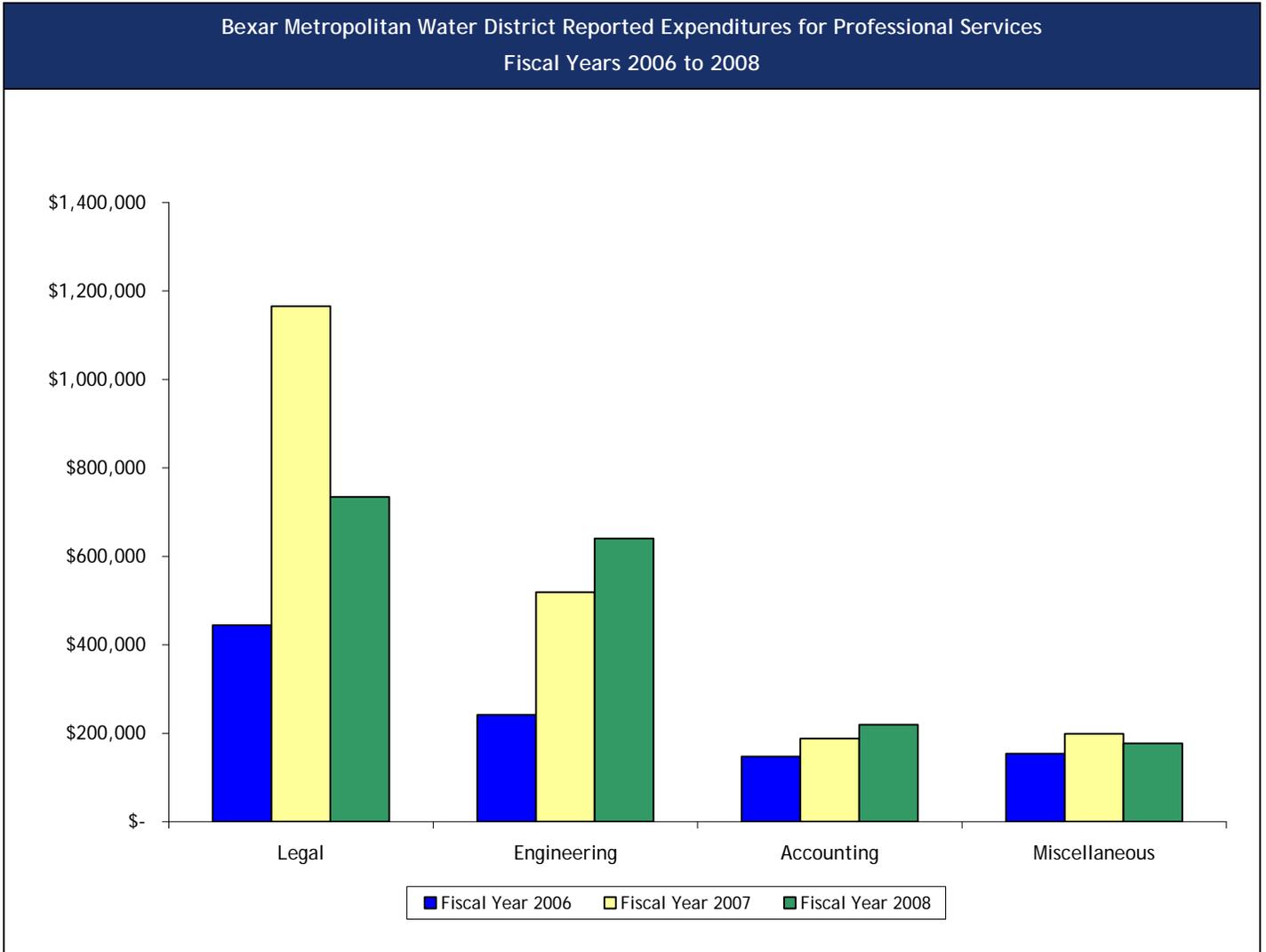
Figure 4



Source: Bexar Metropolitan Water District general ledger data.

The District reported expenditures of \$3,058,590 for professional services during fiscal years 2006 and 2007. It recorded expenditures of \$1,771,765 for professional services in fiscal year 2008. Of these expenditures, \$2,344,306 (49 percent), were for legal services. Figure 5 shows District expenditures per professional service category for each year.

Figure 5



Source: Bexar Metropolitan Water District general ledger data.

The District paid more than \$4,302,128 to its engineering contractors during fiscal years 2007 and 2008. Of those payments, \$1,298,868 was recorded as engineering professional services and more than \$2,921,422 was recorded as construction in progress (which is not included in Figure 5).

Bexar Metropolitan Water District's Summary of Debt

According to the Bexar Metropolitan Water District's (District) audited financial statements for the fiscal year ended April 30, 2008, the District reported debt (current and non-current) of \$244,365,691. This included more than \$233 million in non-current, long-term debt; \$5 million in accrued bond interest payable; and \$4 million for revenue bonds payable due within one year. The non-current, long-term debt included \$30 million of commercial paper and \$192 million in revenue bonds payable as follows:

- \$66,655,403 Waterworks System Revenue Bonds, Series 1998, with \$56,602,217 outstanding at the end of the fiscal year. Interest rates range from 3.75 percent to 5.60 percent and are payable semi-annually on May 1 and November 1.
- \$30,296,424 Water Facility Contract Revenue Bonds, Series 1998, with \$22,941,424 outstanding at the end of the fiscal year, issued by the Bexar Metropolitan Development Corporation. Interest rates range from 4.05 percent to 5.50 percent and are payable semi-annually on May 1 and November 1.
- \$57,700,000 Waterworks System Revenue Refunding Bonds, Series 2002, with \$28,535,000 outstanding at the end of the fiscal year. Interest rates range from 3.000 percent to 5.375 percent and are payable semi-annually on May 1 and November 1.
- \$53,741,387 Waterworks System Revenue Refunding Bonds, Series 2006, with \$53,141,387 outstanding at the end of the fiscal year. Interest rates range from 4.25 percent to 5.00 percent and are payable semi-annually on May 1 and November 1.
- \$31,235,000 Waterworks System Revenue Refunding Bonds, Series 2007, with \$31,235,000 outstanding at the end of the fiscal year. Interest rates range from 4.5 percent to 5.0 percent and are payable semi-annually on May 1 and November 1.

More information about the District's debt is available on the District's Web site at <http://www.bexarmet.org/financial>.

Bexar Metropolitan Water District's Summary of Management's Response

The Bexar Metropolitan Water District submitted this summary of its Management's Response:

Bexar Metropolitan Water District (the "District") has reviewed the comments in the audit report submitted by the State Auditor's Office (the "SAO") and has provided responses (the "responses") herein to each of the recommendations made in the report. In reviewing each of the recommendations in the report, the reader should keep in mind that several factors significantly impacted the operations of the District during its recent history. Subsequent to the introduction of House Bill (HB) 1565 during the 80th Texas Legislature, management worked extensively to respond to the requirements of HB1565 as passed. Amidst the audits and reporting requirements resulting from this significant event, District staff has worked diligently on implementing and modifying existing policies, procedures and standard operating practices.

The numerous projects and changes undertaken in the fiscal years under review required a large amount of staff time to address. As illustrated by the report responses herein, not all of the recommendations resulting from the District's external audit from the prior fiscal year were fully implemented prior to the SAO audit. Nevertheless, management and staff continue to work diligently and move forward with the implementation of the recommendations resulting from both the external and SAO audits expected to be fully implemented by January 2009.

Copies of this report have been distributed to the following:

Legislative Audit Committee

The Honorable David Dewhurst, Lieutenant Governor, Joint Chair
The Honorable Tom Craddick, Speaker of the House, Joint Chair
The Honorable Steve Ogden, Senate Finance Committee
The Honorable Thomas “Tommy” Williams, Member, Texas Senate
The Honorable Warren Chisum, House Appropriations Committee
The Honorable Jim Keffer, House Ways and Means Committee

Office of the Governor

The Honorable Rick Perry, Governor

Bexar Metropolitan Water District

Members of the Bexar Metropolitan Water District Board

Mr. Victor V. Villarreal, President
Ms. Blanche Atkinson, Secretary
Ms. Debra Eaton, Board Treasurer
Mr. Jose “Joe” Gallegos, Jr.
Mr. Andrew “Andy” Carr
Mr. Jim Clement
Ms. Lesley Wenger
Mr. Jesse Morin, Interim General Manager



This document is not copyrighted. Readers may make additional copies of this report as needed. In addition, most State Auditor's Office reports may be downloaded from our Web site: www.sao.state.tx.us.

In compliance with the Americans with Disabilities Act, this document may also be requested in alternative formats. To do so, contact our report request line at (512) 936-9880 (Voice), (512) 936-9400 (FAX), 1-800-RELAY-TX (TDD), or visit the Robert E. Johnson Building, 1501 North Congress Avenue, Suite 4.224, Austin, Texas 78701.

The State Auditor's Office is an equal opportunity employer and does not discriminate on the basis of race, color, religion, sex, national origin, age, or disability in employment or in the provision of services, programs, or activities.

To report waste, fraud, or abuse in state government call the SAO Hotline: 1-800-TX-AUDIT.