

Finance Committee

West Basin Municipal Water District
Carson, California

RECOMMENDATIONS FOR CONSIDERATION

In planning and performing our audit of the financial statements of the **West Basin Municipal Water District** (the "District") as of and for the year ended June 30, 2007, in accordance with auditing standards generally accepted in the United States of America, we considered the District's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the District's internal control. Accordingly, we do not express an opinion on the effectiveness of the District's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the District's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the District's financial statements that is more than inconsequential will not be prevented or detected by the District's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. Our consideration of internal control was for the limited purpose described in the first paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. **We did not identify any deficiencies in internal control that we consider to be material weaknesses.**

However, our understanding of the District's internal control that we obtained during the performance of our audit testing gave us the opportunity to communicate to the District the following best practices for consideration by the District:

(2008-1) Fraud Policy

One of the impacts of new auditing standards that became effective in 2008 require that we expand the scope of the audit to include a consideration of the general ethical culture of the organization being audited.

West Basin Municipal Water District already has in place a number of the best practices recommended by these new auditing standards, including the following:

- Consideration of ethical conduct during employee evaluations
- Periodic Risk Assessment
- Whistleblower Hotline
- Monthly or quarterly financial reports to the Board

The District also has in its administrative code a number of statements addressing the ethical conduct of employees. New auditing standards recommend the consideration of a formal ethics policy to further emphasize management's expectations regarding the ethical conduct of employees. A formal ethics policy can be an effective method of communicating and reinforcing an antifraud culture within the District. An ethics policy communicates to all employees the District's position and policy on matters such as the following:

- Definitions of ethical misconduct, including violation of District policy and intentional misrepresentation of transactions in the District's accounting records;
- Acknowledgement of management's intolerance of ethical conduct, including supervisors' directing subordinates to perform actions that could be construed to be ethically questionable;
- The established protocol for employees to report observed or suspected unethical conduct (including the party or individuals identified to receive this information, such as a member of the Board of Directors, human resources, a designated member of District management, a hotline service, etc.);
- Organizational responsibility to investigate unethical conduct;
- Disciplinary action for violations.

Recommendation

Internal control standards recommend that organizations develop and implement a formal ethics policy. It is recommended that this policy be acknowledged and signed by each employee upon his or her hire date, in conjunction with an orientation that includes an emphasis on ethical conduct. Some organizations also require that employees sign a copy of the policy on an annual basis as evidence of their reaffirmation that they understand the policy and have complied with its provisions. In addition, the District could conduct fraud control training for all employees, not just new employees, and release a periodic message from the General Manager stressing the importance of ethical conduct. We recommend that the District implement procedures that are believed to be appropriate for its size and structure. Management has considerable discretion in determining the extent to which these recommended practices might be appropriate for their organization.

Management's Comments Regarding Corrective Actions Planned or Taken

West Basin recognizes the importance of internal controls that support ethical behavior and has taken certain steps to support it. Staff will review current administrative code to

identify where additional definitions may be necessary. In addition, staff will prepare a policy that consolidates the various ethical considerations, including but not limited to, definitions, management's statement of intolerance to unethical behavior, reporting protocol and disciplinary actions. This policy will be presented to the employees annually to acknowledge the ethics policy.

(2008-2) Controls over Customer Account Postings

The Budget and Finance Officer applies payments to customer accounts and provides the account and routing number to new customers to wire water payments. She also has the ability to make adjustments to customer accounts. Internal controls are maximized when these duties are segregated. West Basin Municipal Water District internal control risk with respect to this issue is mitigated by the infrequency of routing changes (there were none in 2007-08) and by the magnitude of the transactions involving routed funds (which makes the detection of any misrouted funds more readily apparent). Nevertheless, we recommend the consideration of the controls below to further strengthen the District's already strong internal controls for these transactions.

Recommendation

As a refinement to the District's segregation of duties, we recommend that the Accounts Receivable Accountant (or Chief Financial Officer) provide the account and routing number to new customers instead of the Budget and Finance Officer. In conjunction with this change, the system access rights of the Accounts Receivable Accountant (or Chief Financial Officer) should also be changed so that he or she no longer has the ability to post adjustments or payments to customer accounts. We also recommend that the Budget and Finance Officer reconcile deposits to the cash receipt log initially prepared by the receptionist as mail is received and opened.

Management's Comments Regarding Corrective Actions Planned

Staff has modified internal responsibilities regarding account information dissemination and reconciling deposits as described under recommendation. As of part of the implementation of the new financial management system, certain internal controls will be put into place regarding posting adjustments and payments through enhanced security roles per modules and screens.

(2008-3) A Formal Policy with Respect to Which Projects to Capitalize

The District adequately differentiates between capitalizable projects and maintenance projects. To ensure that the quality of this process continues, we provide the recommendation below.

Recommendation

We recommend that the District adopt a formal policy and procedure to set guidelines to assist the District in distinguishing between maintenance projects and capitalizable projects. Such guidelines might include dollar thresholds (for example, only projects greater than \$100,000 will

be considered for potential capitalization, all other projects expensed; how to distinguish maintenance projects from improvement projects; capitalization issues involving replacements; capitalization issues involving projects extraordinarily extending the originally anticipated life of an asset; etc.).

Management's Comments Regarding Corrective Actions Planned

Staff recognizes the importance of a more comprehensive capitalization policy and has initiated the development. Some of the steps to be accomplished are reviewing a history of our recycling water facility maintenance costs; reviewing other capitalization policies for guidelines, limits; and incorporating the results of the Capital Implementation Master Plan. These efforts will support a draft policy to be presented to the Board of Directors for approval.

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This communication is intended solely for the information and use of management, the finance committee, the governing board, others within the organization, and agencies that provide funds to the District and is not intended to be used by other parties. The District's written response to the matters identified herein have not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them. Corrective actions taken to resolve the matters identified above are addressed during the following year's audit.

Irvine, California
October xx, 2008