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TO: HONORABLE BOARD OF DIRECTORS  
SOUTH SAN LUIS OBISPO COUNTY SANITATION DISTRICT

FROM: GERE SIBBACH, AUDITOR-CONTROLLER 

DATE: OCTOBER 21, 2011

SUBJECT: FOCUSED INTERNAL CONTROL REVIEW

Our office recently completed a focused internal control review of the South San Luis Obispo County Sanitation District (SSLOCS).

In its 2010-2011 report titled "The South San Luis Obispo County Sanitation District" the San Luis Obispo County Grand Jury recommended "the County of San Luis Obispo's Audit Division should consider conducting an audit of the District that would include an independent professional assessment of whether the District has the controls in place to mitigate the financial risks inherent in a conflict of interest."

On June 22, 2011 I responded to the Grand Jury, stating I would assign staff from the County's Audit Division to perform a focused review of internal financial controls at the District.

Executive Summary

The Grand Jury report identified a perceived conflict of interest between the contracted District Administrator who also serves as District Engineer. Therefore, we focused our review on procedures and controls that could mitigate the perceived conflict.

We assessed the District's internal financial controls, and in our opinion there are reasonable controls in place and operating adequately to mitigate the perceived conflict. We noted that the District had implemented some changes in contract controls, enhanced reporting, and controls of check signers over the course of the last fiscal year.

We identified some areas of improvement which we list in our Findings and Recommendations below:

Background

The Sanitation District was formed in 1963 and currently provides wastewater services to approximately 39,000 residents in Arroyo Grande, Grover Beach, and Oceano. The District's Board of Directors consists of three members, one from each of the represented areas. The District employs approximately 8 staff persons and contracts with Wallace Group for Administration and Engineering Services. John Wallace, one of the owners of Wallace Group, is the Administrator and District Engineer of the wastewater treatment plant. Total payments to Wallace Group for administrative services, engineering, reimbursables, and major budget projects for Fiscal Year 2010-2011 were \$829,563.

The District maintains its own set of detailed financial records; however, as funds are deposited and kept with the County, the District requests that most transactions, exclusive of payroll, be processed through the County's financial system. The County's role in the financial operation of the District is limited to maintaining the cash balances and processing vendor payments. County staff reviews the payment requests for two signatures. Vendor invoices are not attached to the payment request. Therefore the County does not review the District's invoices or reconcile payments with the District's budget. The District's payroll is handled by an outside firm and is not entered into the County's financial system.

#### Scope

The scope of our review was an examination of the internal financial controls relating to the control environment and accounting and purchasing control activities. Our test work primarily encompassed Fiscal Year 2010-11, however we used information and resources from both Fiscal Years 2008-09 and 2011-12 as needed.

#### Methodology, Results, and Recommendations

##### **Control Environment**

An entity's control environment consists of the attitudes and actions of the board and management regarding the importance of controls within the organization. Our review of the control environment consisted of an examination of the District's structure, financial reports; accounting, purchasing, conflict of interest and code of conduct policies, as well as the District's contracts for District Administrator and District Engineer. Additionally we considered the CA 700 Statement of Economic Interests forms for designated officers and employees, and we conducted interviews with members of District staff and the current governing Board.

We concluded that the District has a clear and well understood organizational structure. Accounting and purchasing policies were followed regularly and staff members were aware of the District's Code of Conduct policy.

The designated officers and employees who are required by the District's Conflict of Interest policy and State Law to make certain disclosures on the CA 700 Statement of Economic Interests form did so for calendar year 2010. All forms had been filed and economic interests have been disclosed.

We verified that the District has complied with the Grand Jury's recommendation to rotate external auditors. The Board has selected a new outside auditor to audit the financial statements for up to three fiscal years starting with Fiscal Year 2010-11.

#### Findings & Recommendations - Control Environment

1. Review of the District Administrator and District Engineer Contracts:

The newly revised District Administrator and District Engineer contracts took effect on July 20, 2011 and remain in effect until terminated by the Board or by the voluntary resignation of the District Administrator/District Engineer. Because the contracts are intended for multiple years, specific dollar amounts for each year are not part of the contract but are instead included in the annual budget. A common practice is to set a not-to-exceed amount in the contract itself but the district determines an annual maximum as a part of the budget process.

Recommendation:

The contractor providing the services should continue to identify a not-to-exceed amount for each year the contract is in place. This amount can either be part of the contract itself or modified each year in the budget. Any contract overruns should be approved by the District's Board before the overrun occurs except in an emergency situation when overruns should be approved by the Board as soon as feasibly possible.

2. Year-end Report:

We evaluated the financial reporting information provided to the Board. We noted quarterly reports provided to the Board; however, we were unable to find a distinct 4<sup>th</sup> quarter or year-end report showing budget to actual variances. The FY 2011-12 budget does identify 2010-11 amended budget to estimated 2010-11 totals. However, when the Board does not receive separate information on 4<sup>th</sup> quarter or year-end final variances, Board members and the public may have difficulty forming a comprehensive picture of the District's prior year fiscal standing.

Recommendation:

We recommend that a 4th quarter or year-end report showing fiscal year actuals compared to budget be provided to the Board separately from the proposed subsequent year budget, and that the Board take separate action on the report.

3. Follow-up for Employee Acknowledgement of the District's Core Values and Code of Conduct:

Because the District's Core Values and Code of Conduct were recently implemented, employees are aware of the policy; however the District does not have an on-going plan to ensure continued employee awareness. If employees are unaware of the District's Code of Conduct policy, they may act in a manner inconsistent with the values and ethics of the organization. Such actions may cause legal, ethical or other personnel problems for the employee and the organization.

Recommendation:

The District should develop and implement a practice to annually ensure that employees reaffirm the District's Core Values and Code of Conduct policy.

## **Expenditures**

Our review of the District's expenditures included an examination of the Fiscal Year 2010-11 District payroll reports, Wallace Group invoices, District Warrant Registers and EFS Authorizations to Draw Warrants. A Warrant Register is the District's listing of checks to be issued during a particular time period. The Warrant Registers are presented to the Board at regular meetings. EFS Authorizations to Draw Warrants are the documents instructing the County to process a payment on behalf of the District. We also analyzed the Wallace Group administrative charges, engineering fees and hourly rates.

We verified that no Wallace Group employees were being paid as employees of the District and that no District employees were included on Wallace Group invoices. We found the Wallace Group invoices to be extremely comprehensive. Our testing of random Wallace Group invoices revealed that all selected charges related to District operations.

We calculated the percentage increase of Wallace Group hourly rates between July 2003 and March 2009. Rate increases over that time period appear reasonable.

We traced the process of Wallace Group invoices from receipt of the invoice to approval by the Board and payment by the County (on behalf of the District). We found that in all cases the Warrant Register accurately reflected the amount of payments to the Wallace Group per the Wallace Group invoices and the EFS Authorizations to Draw Warrants.

#### Findings & Recommendations – Expenditures

1. SSLOCSD Warrant Register Signatures:

In one out of twenty-three instances reviewed the District's Warrant Register was not signed by two Board members as is the District's practice. In this case the warrant register was only signed by one Board Member. When the Board does not follow its practice of having two members sign the District's Warrant register an appearance of improper oversight may be created.

Recommendation:

We recommend The Board of Directors ensure that two Board Members sign the District's Warrant Register.

2. EFS Authorizations to Draw Warrants for Payments to Wallace Group Signed by Contractor:

In three of thirteen instances reviewed, the EFS Authorization to Draw Warrant requesting warrants to be paid to Wallace Group was not signed by two Board Members. In each of the three instances the EFS Authorizations to Draw Warrants were signed by one Board Member and by John Wallace as the District Administrator. The District's practice is to have two authorized signers sign the EFS Authorizations to Draw Warrants. While John Wallace was an authorized signer during the time these Authorizations were processed, best accounting practices dictate that the District Administrator should not sign for payments to be made to his own company.

Recommendation:

After our fieldwork, we were notified, and we subsequently verified, that beginning in August 2011, the District Administrator is no longer authorized to sign EFS Authorizations to Draw Warrants. We support the District's change and encourage the policy to remain in place as long as the District Administrator is an outside contractor.

3. Charges for Administrative Services Exceeded Budget:

Total administrative costs reimbursed for Fiscal Year 2010-11 were \$167,451 which is \$17,451 over the Board approved budget of \$150,000. Every fiscal year the SSLOCSD adopts a budget with a line item for Administrative Services. The budget may be amended throughout the year by the Board. However, the budget exceeded amount was not reported until the subsequent year's budget was adopted. Budget overruns on contracts should be approved by the District's Board prior to any payments being made.

Recommendation:

The District Administrator should request a budget adjustment from the Board if it appears that charges for Administrative Services or any other line item are going to

exceed the adopted budget in a given fiscal year before the budget is exceeded. We noted this procedure is mandated in the new Administrative and Engineering contracts.

4. Charges for Positions not listed on Fee Schedule:

We noted Wallace Group charges for six positions which did not appear on the Board approved fee schedule. While there is a provision on the Fee Schedule that states "Wallace Group may find it necessary to occasionally add new personnel classifications to our Schedule of Fees," billing for positions not listed on the fee schedule may create confusion.

Recommendation:

The Wallace Group fee schedule should be updated at least annually to include all positions for which services are being billed, and the updated schedule should be reviewed by the Board.

5. Contract Administrator versus Full-Time District Employees:

In the May 31, 2011 Grand Jury report, the Grand Jury recommends the Board should evaluate and compare all operational alternatives for services provided to the District. In the course of our fieldwork, we noticed administrative and engineering charges by Wallace Group for major budget items as well as the general administrative and engineering contracts. It appears possible that administrative or engineering charges that were coded to major budget items (major projects) could be absorbed by a general administrator and/or general engineer hired as full-time district employees. We noted that members of Wallace Group staff code approximately 43 hours per week to Administrative charges. Additionally, the District should evaluate the benefit of having a full-time administrator and engineer onsite versus a part-time onsite contract administrator and/or engineer.

Recommendation:

We concur with the Grand Jury recommendation to evaluate and compare all operational alternatives including the advantages and disadvantages of hiring a full-time administrator and/or engineer as a District employee versus contracting out for these services.

6. Expenditures Exceeding Revenue:

We reviewed the audited financial statements for Fiscal Years 2008, 2009, and 2010. We noted that expenditures exceeded revenue for all of the fiscal years reviewed primarily because of large capital expenditures. As a result, the District's cash balances decreased by approximately 1.8 million dollars over the three years reviewed. Revenue should exceed expenditures to cover current operations and future plans for capital projects.

Recommendation:

The District should review operations to determine if expenditures can be reduced or revenues can be increased. Significant capital projects or unforeseen emergencies could quickly reduce the District's cash balances. The District's cash balance as of August 31, 2011 was \$4,282,142 per the Monthly Financial Statement presented to the Board.

### **Cash Handling (Deposits) and Reconciliations**

Our review of the District's deposits and reconciliations identified general compliance with accounting processes.

#### Findings & Recommendations – Reconciliations

1. Monthly Reconciliations:

The District records its revenues, expenses, and cash accounts on its own financial systems. The transactions are mirrored on the County's financial system in order to process deposits and payments. The County Treasurer maintains the District's operating cash in the County Treasurer Investment Pool. The District also keeps a State Local Agency Investment Fund (LAIF) account and a bank account used for payroll. Deposits are made to the bank account from LAIF and other payments received for charges for services. We found that the District's monthly reconciliations of revenue, expenditures, and cash balances as reported in the District's books compared to the revenue, expenditures, and cash balances contained in the County's financial records revealed differences between the two systems. However, the differences were not analyzed to determine if they were a result of timing of transactions or potential errors. Normal reconciliation practices dictate that when a difference is determined its cause is investigated and any timing variances are identified to rule out the existences of errors.

Recommendation:

Monthly reconciliations should be completed to verify both sets of records are in agreement, and adjustments must be made where appropriate. The reconciliation process would be streamlined and more comprehensive if payments for services and LAIF disbursements were deposited directly to the County Treasury. The outside bank account could then be used only as a payroll revolving account. The outside bank account should be set up with a balance to cover approximately two pay periods and be replenished by County warrant for the actual amount withdrawn by the District's payroll provider. No other funds should be deposited or expended from the outside bank account.

### **Major Budget Items**

In our consideration of Major Budget Items we inspected the reporting of Major Budget projects. We traced the progress of two projects from the Fiscal Year 2010-11 budget through Board reports and actions to the Fiscal Year 2011-12 budget.

#### Findings & Recommendations – Major Budget Items

1. Major Budget Item Reporting:

Costs for Wallace Group services were not always easily identifiable or separated from other project costs. However, we noted the information provided in both the budget and the Board reports improved in Fiscal Year 2011-12. For example, the FY 2011-12 budget provides more multi-year detail and project phase information. Additionally, recent progress payments presented for the Board's approval include cumulative project budget and actual expenditures. Also expenditures are delineated by type and change orders are clearly identified in a table format with the associated cost listed for each order.

Recommendation:

To address the concerns of the Grand Jury and the District's constituents, the Board should acknowledge that Wallace Group costs are now being provided to the Board separately and distinctly for each Major Budget Item as well as for general administrative and engineering costs.

We would like to thank the Board and the staff of the SSLOSD for their cooperation during our review:

Cc: SLO County Grand Jury  
SLO County Board of Supervisors  
SLO County Administrator