

# Water Recycling Agreement Expenses Audit

July 22, 2024



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## Transmittal Letter

July 22, 2024

Board of Supervisors  
Monterey County Water Resources Agency (MCWRA)  
168 West Alisal St., 1st Floor  
Salinas CA 93901

Board of Directors  
Monterey County Water Resources Agency  
1441 Schilling Pl.  
North Bldg.  
Salinas, CA 93901

Rupa Shah, CPA  
Auditor-Controller  
County of Monterey  
168 West Alisal Street, 3rd floor  
Salinas, CA 93901

Dear MCWRA Board of Supervisors and Board of Directors, and Auditor-Controller Shah,

At the request of the Water Resources Agency (WRA), the Auditor-Controller's Office engaged GPP Analytics to conduct this audit to assess the accuracy and compliance of M1W's reported expenses. The Auditor-Controller's Office also helped administer the contract during the course of the audit.

I am pleased to present the audit report for the "Water Recycling Agreement Expenses Audit" conducted by GPP Analytics Inc. for the Monterey County Water Resources Agency and the Monterey County Auditor-Controller's Office. This report covers a detailed review of Monterey One Water (M1W) expenses from Fiscal Year 2018–19 to Fiscal Year 2021–22, focusing primarily on adherence to the terms of the Amended and Restated Water Recycling Agreement Between Monterey Regional Water Pollution Control Agency and Monterey County Water Resources Agency (the Agreement).

Our audit was conducted in compliance with the International Professional Practices Framework (IPPF) of the Institute of Internal Auditors and the Generally Accepted Government Auditing Standards (GAGAS) of the U.S. Government Accountability Office.

The primary objectives of our audit were to assess the accuracy and compliance of M1W's reported expenses. We employed a comprehensive methodology, including detailed data analysis, interviews, and reviews of relevant documentation.

**Finding 1: Noncompliant Indirect Cost Methodology.** We identified a difference in M1W's calculation of indirect costs compared to the methods outlined in the Agreement. This resulted in an estimated \$1,110,117.41 overcharge to the WRA in total for the four audit years. We recommend that M1W and the WRA revise and finalize its indirect cost plan to align with the requirements of the Agreement and return the overcharged amount to the WRA.

**Finding 2: Inconsistent Time Records.** M1W did not use a consistent method for recording and tracking time billed to the WRA. Moreover, we identified discrepancies between time recorded in the payroll system with independent entries into the work order system. While the work order system is not intended to replicate the payroll system in all instances, some of the discrepancies identified indicate that the payroll system cannot be assumed accurate. Because the information in the two systems was so discrepant, we could not determine if M1W over or under-billed the WRA for employee time. We recommend that M1W enforce internal controls for verifying time records for each payroll period and that it furnish detailed records to the WRA monthly.

**Finding 3: Noncompliance With Required Monthly Reporting.** Our analysis of monthly reports from M1W to the WRA, as required in the Agreement, ceased for a ten-month period. This was a breach of the Agreement and undermines the ability of WRA to monitor M1W's spending and use of the WRA's program resources. We recommend that M1W adopt a formal procedure for monthly reporting, assign it to a staff member, and develop a backup/succession plan for key deliverables due to the WRA to ensure long-term adherence to the Agreement.

**Finding 4: Accounting Practices and Limited Transparency.** We observed accounting practices that do not comply with the Agreement, and lack of transparency in M1W's handling of WRA's finances, leading to inconsistent financial reporting and questionable account balances reported by M1W. Disparities in cash balances indicate that M1W's accounting does not meet the requirements for segregating and tracking funds. The misalignment between reported financial data provided to the WRA and M1W's annual audits exacerbates this lack of clarity. Our recommendations include amending the Agreement for clear procedures, segregating WRA funds into distinct enterprise funds, and performing a separate annual financial audit of the WRA funds managed by M1W.

**Finding 5: Percent Overcharged.** Based on Finding 1, indirect cost methodology, we believe M1W overcharged the WRA by a total of \$1,110,117.41 for the four-year audit period. During each of the four years this was \$64,226.76 or 1.5% of FY 2018–19 expenses, \$175,362.29 or 3.7% in FY 2019–20, \$343,192.18 or 6.3% in FY 2020–21, and \$527,336.19 or 8.6% in FY 2021–22. We recommend that, per the Agreement, M1W reimburse the WRA for the total amount overcharged.

**Finding 6: Weak Control Environment.** Based on Findings 1-4, we do not believe M1W possesses an appropriate financial system and internal controls to effectively record, monitor, and allocate operational and maintenance costs in accordance with the Agreement. We recommend that M1W implement the recommendations detailed in those findings.

**Finding 7: Breaches of the Agreement.** Based on Findings 1-4, we believe M1W specifically breached several areas of the Agreement. We recommend both parties seek an update to the Agreement that will hold both parties more accountable and bring awareness of any problems managing the Agreement to both party's board of directors promptly.

We appreciate the cooperation and assistance provided by the staff of Monterey One Water, the Water Resources Agency, and the Auditor-Controller's Office throughout this audit. Their support was instrumental in the successful completion of this project.

We believe this report will provide valuable insights and recommendations to enhance the effectiveness of the Water Recycling Agreement's financial management. Should you require any further information or wish to discuss the findings in more detail, please feel free to contact us.

Thank you for entrusting GPP Analytics Inc. with this important assignment. We look forward to any future opportunities to assist the MCWRA Board of Supervisors and Board of Directors, and Auditor-Controller's Office.

Sincerely,

A handwritten signature in black ink, appearing to read "Julian Metcalf". The signature is fluid and cursive, with the first name "Julian" and last name "Metcalf" clearly distinguishable.

Julian Metcalf  
Partner and CEO  
GPP Analytics Inc.

## Introduction

This audit report presents the findings of the "Water Recycling Agreement Expenses Audit" conducted for the Monterey County Auditor-Controller by GPP Analytics Inc. The audit focused on reviewing Monterey One Water (M1W) expenses over four fiscal years (FY 2018–19 to FY 2021–22) and assessing compliance with the provisions of the Amended and Restated Water Recycling Agreement Between Monterey Regional Water Pollution Control Agency and Monterey County Water Resources Agency (the Agreement).

## Standards of Audit

This audit was conducted in accordance with the Institute of Internal Auditors (IIA) Professional Practices Framework (IPPF) and the U.S. Government Accountability Office's (GAO) Generally Accepted Government Auditing Standards (GAGAS);<sup>1, 2</sup> these standards require that we plan and perform the audit to obtain sufficient and 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.

## Audit Objectives and Methodology

The audit's objectives were to evaluate M1W's expenses during four fiscal years for compliance with the provisions of the Agreement. Key aspects included verifying if expenses for the Salinas Valley Reclamation Project (SVRP), Castroville Seawater Intrusion Project (CSIP), and Salinas River Diversion Facility (SRDF) were reasonably incurred, verifying direct and indirect costs were accurately documented, and assessing financial systems and internal controls. The audit aimed to verify proper record keeping, accurate reporting, accurate reconciliations, and compliance with the Agreement overall.

## Audit Timeline

The audit process was structured as follows:

**Entrance Conference:** August 24, 2023

**Submission of Planning Memo:** September 27, 2023, and revised on October 9, 2023

**Commencement of Testing Phase:** October 18, 2023

**Draft Report Submission to WRA staff:** January 31, 2024

**Draft Review Meeting with WRA staff:** February 9, 2024

**Draft Submission to M1W staff:** March 5, 2024

**Draft Review Meeting with M1W staff:** April 9, 2024

**Review of Additional Information From M1W staff concluded:** May 3, 2024

**Revised Draft Submission to WRA staff:** May 14, 2024

**Revised Draft Submission to M1W staff:** June 7, 2024

**Written response from M1W received:** June 26, 2024

**Final Report Submission to WRA:** July 22, 2024

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1 Institute of Internal Auditors, International Professional Practices Framework 2017.

2 United States Government Accountability Office's Government Auditing Standards 2018 Revision.

**In Phase 1**, our team focused on initial planning and data gathering. This involved comprehensive reviews of relevant documentation, such as the Water Recycling Agreement, financial reports, and internal policies. We conducted interviews with key M1W personnel to understand operational processes and the allocation of expenses. Additionally, we performed a preliminary analysis of M1W's financial systems and controls, laying the groundwork for in-depth testing in the subsequent phase.

**In Phase 2**, we conducted detailed fieldwork. This included a thorough examination of financial transactions, verification of compliance with the Water Recycling Agreement, and an in-depth assessment of internal controls and accounting practices. We assessed the accuracy of reported costs, scrutinized indirect cost allocation methods, and reviewed the documentation and timeliness of financial reporting. We performed two onsite visits to M1W facilities to gather and inspect records stored onsite. Near the conclusion of this phase, we met with M1W financial leadership where we shared our preliminary observations and provided copies of workpapers to allow M1W the opportunity to provide any preliminary feedback about their accuracy.

**In Phase 3**, the team focused on drafting the audit report, reflecting our comprehensive findings, analyses, and recommendations. This stage involved stringent quality control checks to ensure the report's accuracy and thoroughness. The draft underwent multiple reviews by the audit team, ensuring that all findings and recommendations were thoroughly substantiated and aligned with our audit standards.

After the exit conference held on April 8, 2024, M1W indicated that they had information to provide that was previously not provided to our audit team. Over the course of April 2024, we met with representatives of M1W to receive, review, and discuss new information, and listen to their additional feedback. Even though we had frequently met with M1W's financial leadership prior to providing them a draft copy of the audit report, and discussed our testing methodologies and hypothesis throughout the audit phases, M1W provided different feedback and some new material information. Despite the additional time this added to the audit process, we felt it was critical to hear their feedback and review the information. We concluded this additional review period following a meeting with M1W held on May 3, 2024. Thereafter we revised the draft report to reflect the new information provided.

## Results From Randomized and Judgmental Sample Analysis

There were several topics in the audit scope, related mostly to direct costs, which we determined could be analyzed together in the initial audit phase using a series of random and judgmental samples. These topics included segregated direct and indirect costs, the timing and categorization of expenditures, and the proper recording of financial transactions. The random and judgmental sample testing and analysis sought to verify the exclusion of non-reimbursable activities, ensure proper support for financial documentation, and assess the accuracy and appropriateness of reported costs in line with the requirements and agreements governing the projects.

At the end of the initial audit phase, we included the following sample plan to test these areas as detailed in Figure i.1 below.

**Figure i.1: Samples Calculated at a Confidence Level of 95% and a Confidence Interval of +/- 10%**

|   | FY 2018–19     | FY 2019–20     | FY 2020–21     | FY 2021–22     |
|---|----------------|----------------|----------------|----------------|
| <b>Sum of Invoices</b>  | \$2,415,771.45 | \$3,675,689.40 | \$4,368,585.42 | \$4,857,270.45 |
| <b>Count of Invoices</b>  | 878            | 673            | 740            | 700            |
| <b>Recommended Samples Size</b><br>(95% Confidence Level; 10% Margin of Error)  | 87             | 85             | 86             | 85             |
| <b>Judgmental Sample Size of Journal Entries</b><br>(related to expenses not otherwise included in invoices or employee time) | 10             | 10             | 10             | 10             |

*Source: Information drawn from reports in M1W's financial system run by the audit team.*

Our analysis found only minor problems with the invoices and journal entries. Our review of journal entries corroborated other areas of inquiry. For example, journal entries related to indirect cost charges lacked sufficient backup documentation, but that problem is discussed in Finding 1: Noncompliant Indirect Cost Methodology. Other journal entries corroborated our analysis of areas such as the amortization of debt, and application of interest earning, which did not result in an audit finding.

Figure i.2 shows the results from our random testing of invoices. The limited problems we did identify for M1W's accounts payable practices fall into two categories: method of cost allocation and a data entry error. First, we identified 11 invoices where the method for allocating the cost between M1W and WRA was not well-documented and appeared arbitrary. However, this problem mainly occurred for minor expenses, such as printer toner, where costs were evenly split between M1W and one of the WRA programs. The 11 invoices only accounted for a total of \$4,279.52 across the four audit years. If we extrapolate this out to the entire cost of all invoices in this period, it only represents 0.26% of costs. Given the small dollar amount, we do not believe it would be worth the time for M1W to develop, document, and implement a more sophisticated allocation method for these minor expenses.

Second, we found one invoice where the delivery date of the goods was mis-entered into M1W's financial system by three months. Due to the timing, this error did not change the fiscal year of the transaction and had only a minor impact. However, this one error was for an invoice valued at \$18,264.69, so it represents 1.09% of the costs across the four-year audit period. While that percentage on a dollar-basis could impact costs if the error occurred across a fiscal year, it was the only instance of the error out of 343 invoices reviewed, and we do not expect it to occur frequently.



**Figure i.2: Summary of Randomized Testing Results for All Four Audited Years**

| <b>Results</b>   | <b>Number of Samples</b> | <b>Amount Sampled</b>  | <b>Percentage of Sampled Amount</b> | <b>Extrapolated Amount if Applied to All</b> |
|--|--------------------------|------------------------|-------------------------------------|--|
| Passed   | 331                      | \$1,654,453.00         | 98.66%                              | \$15,131,868.95                              |
| Had limited or no allocation justification             | 11                       | \$4,279.52             | 0.26%                               | \$36,358.42                                  |
| Delivery date entered in system incorrect              | 1                        | \$18,264.69            | 1.09%                               | \$149,089.35                                 |
|  |                          |                        |                                     |  |
| <i>All invoices sampled</i>                            | <i>343</i>               | <i>\$1,676,997.21</i>  | <i>100.00%</i>                      | <i>\$15,317,316.72</i>                       |
|  |                          |                        |                                     |  |
| <i>Total population of all invoices for four years</i> | <i>2,264</i>             | <i>\$15,317,316.72</i> | <i>n/a</i>                          | <i>n/a</i>                                   |

*Source: Audit team analysis of M1W's financial records.*

## Findings

### Finding 1: Noncompliant Indirect Cost Methodology

#### Indirect Cost Methodology Established in the Agreement

The Monterey County Water Resources Agency (WRA) and Monterey One Water (M1W), which at the time was referred to as the Regional Water Pollution Control Agency (PCA), entered into a formalized agreement titled “Amended and Restated Water Recycling Agreement Between Monterey Regional Water Pollution Control Agency and Monterey Resources Agency” (“The Agreement”). The Agreement established the method to be used by M1W in charging the WRA for indirect costs incurred in the operations of the Castroville Seawater Intrusion Project (CSIP), the Salinas River Diversion Facility (SRDF), and the Salinas Valley Reclamation Project (SVRP).

*“The consideration paid by WRA shall be the dollar amount that equals 100% of the annual costs reasonably and necessarily incurred in connection with the SVRP, CSIP, and SRDF (including both direct and indirect expenses) and no more.”<sup>3</sup>*

The Agreement also identified the functions to be considered as indirect costs. The Agreement states:

*“PCA [M1W] shall identify the specific functions that are typically considered administrative or supportive in nature. These functions or departments shall include Human Resources, Finance, Administration, Information Technology, and Safety. The annual budgeted costs of these functions will be allocated proportionally to all operational activities based on a percentage relational to the services provided to SVRP, CSIP, SRDF, and all other PCA activities. A sample overview is provided in Exhibit J, attached hereto made a part hereof.”<sup>4</sup>*

Exhibit J, referred to above, is a seven-page appendix to the Agreement. Exhibit J is titled Cost Allocation Plan (“the Plan”). The word “Draft” appears on the Plan’s title page. The Plan includes brief descriptions of each administrative service department categorized as an indirect cost, as well as the prescribed allocation methodologies. The department and their allocation methodologies as established in Exhibit J are described in Figure 1.1.

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<sup>3</sup> Amended and Restated Water Recycling Agreement Between Monterey Regional Water Pollution Control Agency and Monterey Resources Agency, Section 7.02 Amounts to be paid. Page 19.

<sup>4</sup> Ibid.

**Figure 1.1: Indirect Charge Allocation Methodology Defined in Exhibit J of the Agreement**

| Indirect Charge Department  | Method in Agreement's Exhibit J   |
|---|---|
| <b>Administration</b>   | 1. "The Administration Department budget, net of excludable line items, is charged to operational departments based on their percentage of the operational budgets."  |
| <b>Finance</b>  | 1. "Chief Financial Officer and Accountant's salaries; along with a proportional share of the Finance Department expenses are allocated based on the operational units percentage of the budget.<br>2. Accounting Technician, Procurement Specialist, and Administrative Support Specialist salaries; along with a proportional share of Finance Department expenses are allocated based on a three-year average of invoices processed by the operational units.<br>3. Accounting Specialist – Payroll, along with a proportional share of Finance Department expenses are allocated based on the percentage of full-time equivalent positions in each operating department." |
| <b>Regional Treatment Plant (RTP) Administration</b>                          | 1. "[Assistant] General Manager salary and proportional share of expenses based on the operational department's percentage of the budget."<br>2. "Administrative Support Specialist salary and proportional share of expenses based on the average percentage of budget and full-time equivalency positions with each operational department."  |
| <b>Human Resources (HR), Information Systems (IS), and Safety Departments</b> | 1. "Costs associated with the Human Resources are allocated based on the percentage of full-time equivalent positions in each operation departments."   |

*Source: Amended and Restated Water Recycling Agreement Between Monterey Regional Water Pollution Control Agency and Monterey Resources Agency.*

### *M1W Applied a Singular Non-Compliant Methodology*

Instead of performing each separate calculation for each department, M1W applied the methodology prescribed for the Administration Department to all six indirect cost departments. This meant that M1W only calculated the percentage of total agency operational costs attributable to each of the three WRA programs.<sup>5</sup> That percentage was then applied to the total costs of the six indirect departments and WRA was charged the resulting amount. As discussed further below and seen in figure 1.2, the simplified calculation used by M1W resulted in a significantly higher amount charged to the WRA than would have been calculated had M1W used Exhibit J as described in the Agreement.

### *Cause and Start of Non-Compliance Unclear*

Because of prior staff turnover at M1W, we could not determine the reason M1W did not use the methodology described in Exhibit J, nor could M1W provide any records of when they may have previously complied with and used the methods defined in Exhibit J. The M1W Chief Financial Officer (CFO) explained that upon being given the task, he was shown the non-compliant methodology currently in use and he continued to use that method.

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<sup>5</sup> Operational costs exclude debt service and overhead.

The complexity of the Appendix J model may have led to the decision to use the simpler method. The Agreement does allow the parties to agree to use a different methodology, but the non-compliant method that M1W used during the audit period did not meet these alternative requirements. The Agreement states:

*“PCA [M1W] and WRA retain the right to transition from the cost allocation plan identified in 8.02 (b) to a cost allocation model that is compliant with the Office of Management and Budget (OMB) Circular A-87 – Cost Principles for State, Local, and Indian Tribe Governments or a subsequent revision. Any cost allocation subject to this provision shall be accompanied by a Certificate of Cost Allocation Plan and in compliance with Title 2 CFR, Part 200. All indirect costs charged to functional activities will be applied consistently with the results of this plan to ensure equity between costs centers and conformance with OMB standards; provided, however, no allocation of any indirect cost unrelated cost to SVRP, CSIP or SRDF shall be made.”<sup>6; 7</sup>*

Neither M1W nor the WRA have any records or staff recollection of either party agreeing to the method that M1W used during the audit period, and there is no record of the methods M1W used during the audit period having a certificate stating compliance with Title 2 CFR, Part 200.

### *Sample and Draft Language*

Moreover, inclusion of the phrase “sample” in the table of contents and Section 8.03, and use of the word “Draft” on the Exhibit J title page do create a question whether the cost allocation methodology described in Exhibit J represents the finalized agreement as to the method to be used to determine the amount of indirect costs. However, there is no evidence that indicates M1W and WRA agreed to use an alternative methodology over the methodology described in Exhibit J. Further, the Agreement was approved by the boards representing M1W and the WRA and was signed by their respective Board Chairs and legal counsel. This suggests that despite being labeled a “draft” or “sample” Exhibit J represents the type of plan which both party’s boards sought to implement in the Agreement absent the alternative options outlined in the Agreement.

### *Non-Compliant Method Resulted in Overpayment*

Based on our analysis, the methodology used by M1W resulted in WRA being charged an estimated \$1,110,117.41 more than it would have been charged had the Exhibit J methodology been used.<sup>8</sup> Figure 1.2 below provides the amounts charged, the amounts that would have been charged if the Exhibit J methodology had been used, and the resulting overpayments.

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6 Amended and Restated Water Recycling Agreement Between Monterey Regional Water Pollution Control Agency and Monterey Resources Agency, Section 8.03 (4) Direct and indirect costs. Page 23.

7 The reference to Section 8.02 appears to be a typo as Section 8.03 is the section in which direct and indirect costs are addressed. Section 8.02 addresses financial reporting.

8 The audit team used data from M1W’s financial system, its annual financial audit reports, payroll records, and its proposed budget reports to reconstruct what the indirect costs would have been according to the method outlined in Exhibit J of the Agreement.

**Figure 1.2: Comparison of Calculated Indirect Cost Allocations**

|   | FY 2018–19         | FY 2019–20          | FY 2020–21          | FY 2021–22          | Four-Year Total       |
|---|--------------------|---------------------|---------------------|---------------------|-----------------------|
| Total Actual Charged by M1W   | \$761,034.26       | \$853,193.00        | \$1,019,609.88      | \$1,129,332.29      | \$3,763,169.43        |
| Total Due Per Exhibit J as calculated by the audit team with supporting documentation | \$696,807.50       | \$677,830.71        | \$676,417.70        | \$601,996.10        | \$2,653,052.02        |
| <b>Difference/Amount of Overpayment</b>   | <b>\$64,226.76</b> | <b>\$175,362.29</b> | <b>\$343,192.18</b> | <b>\$527,336.19</b> | <b>\$1,110,117.41</b> |

*Source GPP Analysis, M1W Detailed Budgets, and internal financial reports.*

The indirect cost amount of the WRA programs, as shown in Figure 1.3, revealed that in certain years, like FY 2021–22, these charges accounted for over 18% of the project's operating costs. In this one example, the amount charged was nearly double what was suggested by the methodology in Exhibit J.

**Figure 1.3: Comparison as a Percentage of WRA Project Operating Expenses**

|                                     | FY 2018–19 | FY 2019–20 | FY 2020–21 | FY 2021–22 | Four Year Average |
|-------------------------------------|------------|------------|------------|------------|-------------------|
| Total Actual Charged by M1W         | 17.5%      | 17.9%      | 18.6%      | 18.4%      | <b>18.1%</b>      |
| Total Due Per Exhibit J Methodology | 16.0%      | 14.2%      | 12.3%      | 9.8%       | <b>13.1%</b>      |

*Source GPP Analysis and M1W Detailed Budgets.*

### Differing Perspective on the Application of the Exhibit J Methodology

As noted in the introduction of the audit report, we shared with M1W both our initial conclusion that M1W did not adhere to the cost allocation plan established in Exhibit J of the Agreement and our subsequent calculation as to the dollar amount that should have been charged based on the methodology prescribed in Exhibit J.

M1W performed its own calculation using the Exhibit J methodology with results that differed from ours. These differences resulted from a combination of differing interpretations of the Agreement and Exhibit J, differing opinions as to whether a portion of some specific M1W costs should be allocated to WRA, and our exclusion of certain costs that could not be evidenced by supporting documentation.

Figure 1.4 below presents the results of both our calculations and M1W's calculations when the Appendix J methodology is used to determine indirect costs allocations retroactively. For comparison purposes, the amounts M1W charged WRA are also included in Figure 1.4.

**Figure 1.4: Comparison of Calculated Indirect Cost Allocations**

|   | FY 2018–19   | FY 2019–20   | FY 2020–21     | FY 2021–22     | Four-Year Total       |
|---|--------------|--------------|----------------|----------------|-----------------------|
| Total Actual Charged by M1W   | \$761,034.26 | \$853,193.00 | \$1,019,609.88 | \$1,129,332.29 | <b>\$3,763,169.43</b> |
| Total Due Per Exhibit J as <b>calculated by the audit team with supporting documentation</b>  | \$696,807.50 | \$677,830.71 | \$676,417.70   | \$601,996.10   | <b>\$2,653,052.02</b> |
| Total Due Per Exhibit J as <b>calculated by M1W without complete supporting documentation</b> | \$792,915.11 | \$799,325.15 | \$910,605.46   | \$1,025,219.75 | <b>\$3,528,065.46</b> |

*Source GPP Analysis, M1W Detailed Budgets, internal financial reports, and M1W calculations.*

In general, we interpreted the Appendix J Cost Allocation Plan as narrowly defining the costs to be considered indirect costs. For example, we noted that the Cost Allocation Plan Overview lists the Board of Directors as being a direct or operational cost center and not an indirect or administrative cost center, though it is common to consider the Board of Directors to be an indirect cost. This exclusion suggested to us the Agreement intends to limit what is to be included as an indirect cost. Moreover, we also noted that Exhibit J establishes the requirement that M1W conduct “A review of the line-item expenditures as conducted within each department to determine whether there are any significant costs which should be excluded or included as overhead.” This also suggested to us that the Agreement intended there to be a close review by M1W of expenses to be included. Our interpretation suggests to us that M1W is responsible for annually reviewing the expenses to include as indirect costs and that this review should adhere closely to the definitions outlined in the Exhibit.

In contrast to our approach, M1W indicated to us that it interprets Section 8.03 of the Agreement, which states “PCA [M1W] shall identify the specific functions that are typically considered administrative or support in nature,” as superseding any details included in Exhibit J and allowing M1W a higher degree in latitude in determining what costs to include.

The factors which contributed to the differences between our and M1W’s calculations using the Appendix J methodology are discussed below.

### *Use of Full-Time Equivalents (FTE) Versus Use of Staff Persons in the Denominator*

Exhibit J involves multiple calculations that rely on the concept of Full-Time Equivalents or FTE to determine the allocation of indirect costs to WRA. For example, Exhibit J states that “Costs allocated with the Human Resources department are allocated based on the percentage of full-time equivalent positions in each operating department.” Similarly, FTE allocations are used to determine the portion of Information Systems and Safety Departments costs to be charged to WRA.

To perform calculations based on FTE, we used all the hours in the M1W payroll system divided by full time hours in a year to calculate FTE. In contrast, M1W used a pay period average of total staff persons per year. We disagree with M1W’s approach, which uses persons instead of FTE, and the averaging on a pay period basis instead of using the total annual hours entered into the system. Their calculation methods result in a material difference that changes the cost output from the plan and does not align with Exhibit J’s requirement to use FTEs in staff-related calculations of the Indirect Cost Plan.

### *Use of Operating Versus Operating and Capital Personnel in Denominator*

M1W excluded all staff time related to capital projects from the denominator used in several indirect cost calculations. On the surface, this makes logical sense, but it conflicts with their inclusion of staff who usually work in capital functions that directly bill to the WRA programs when calculating the numerator of the ratio. The audit team believes it is more mathematically accurate to include the same basis of FTE staff hours in the denominator of calculations.

Finding 2 of this report discusses the problems of M1W’s timekeeping records and the limitations of what we can assess based on their inconsistent records. If the current Indirect Cost Plan is maintained or a more effective plan is adopted later, any improved timekeeping records, as we recommend in Finding 2, would provide a more accurate input for determining indirect costs.

### *Amount of Distribution Mechanics’ Time to be Included*

M1W asserts that two Distribution Mechanics are dedicated to WRA-related work and therefore 2.0 FTE should be included when determining the ratio of M1W employees allocated to WRA. M1W further asserts that because these two employees are dedicated to WRA-related work, M1W practice does not require the employees to record whether their time was spent on WRA projects or non-WRA projects.

However, work order records do not support the assertion that these employees only worked on WRA projects. Moreover, M1W acknowledged that for much of the audit period these employees were furloughed from 40 hour to 36 hours per week as a result of COVID-19 safety measures.

Section 7.04 of the Agreement requires that “Back-up information (original paid invoices, payroll records, time sheets, and vehicle costs) will be maintained by PCA [M1W] to support each direct charge.” Assuming the requirement that back-up information be maintained applies to indirect as well as direct charges, then it is only appropriate to include the Distribution Mechanics’ time that is supported by work orders. Figure 1.5 compares the amount of time supported by documentation to M1W’s assertion regarding the Distribution Mechanics’ time.

**Figure 1.5: Distribution Mechanic Time in Work Order System**

|  | FY 2018–19    | FY 2019–20    | FY 2020–21      | FY 2021–22      |
|--|---------------|---------------|-----------------|-----------------|
| Total Hours in System Related to the WRA Programs  | <b>160.75</b> | <b>520.15</b> | <b>2,020.50</b> | <b>1,466.65</b> |
| Hours Calculated as Full-Time Equivalents for Indirect Cost Model by Auditors <sup>9</sup> | <b>0.10</b>   | <b>0.31</b>   | <b>1.22</b>     | <b>0.89</b>     |
| <i>FTE that M1W Asserts Should be Included</i>   | <b>2.0</b>    | <b>2.0</b>    | <b>2.0</b>      | <b>2.0</b>      |

*Source GPP Analysis of M1W work order records.*

### *Exclusion Versus Inclusion of Outreach Department*

M1W asserts that if they had complied with Exhibit J, they would have included their Outreach Department as a cost allocated using the same methodology as their Administration Department. M1W states that the Outreach Department serves the WRA by providing legislative advocacy, grant funding advocacy, tours of program facilities, and classroom presentations about the programs. However, as discussed further below, M1W was not able to provide any documentation to validate or estimate the level of services the Outreach Department provides to the WRA.

Per M1W, the Outreach Department was a function within the Administration Department when Exhibit J was added to the Agreement in 2015 and that Outreach became its own department subsequent to Fiscal Year 2018–19.

We disagree with M1W’s approach that Outreach should be included as an indirect cost because of its original placement within the Administrative Department. We disagree because the narrative contained within Exhibit J specifies the administrative costs to be included. It states:

*“...Costs include legal counsel, insurance, contract services, and utility costs for the Harris Court administrative offices.”*

Moreover, Exhibit J specifically excludes certain general administrative and legislative expenses, such as those related to the Board of Directors. Instead, we believe the costs associated with the Outreach Department and its functions should be direct costs per our interpretation of the Agreement and Exhibit J.

According to M1W, they assumed that the Outreach Department was covered under indirect costs and did not document or track their time as direct charges. Such documentation and tracking, even if an indirect charge, would have been important in our opinion. This is because the department experienced considerable growth after becoming independent from the Administrative Department, as illustrated in Figure 1.6 below. During the audit period, the costs escalated from \$27,852 in FY 2018–19 to \$790,443 in FY 2021–22. Given the ambiguities surrounding the Outreach Department and its potential benefits to the WRA, it would have been prudent for M1W to disclose these escalating costs to the WRA. Such

<sup>9</sup> Based on our understanding of M1W’s maximum annual vacation, holiday, sick, and admin leave time we used 1,656 hours to calculate each FTE. A full year of full-time work with no leave considered is 2,080 hours for comparison.



transparency could have facilitated a consensus on whether to amend the Agreement to explicitly include these costs, ensuring proper financial oversight and alignment with agreed protocols in the Agreement. With this in mind, we do not believe it is appropriate to include the Outreach Department as a cost when retroactively estimating Exhibit J.

**Figure 1.6: Reported Costs of M1W’s Outreach Department**

|                            | Integrated with<br>Administration<br>Department | Independent Outreach<br>Department Formed |            |            |
|----------------------------|---|---|------------|------------|
|                            | FY 2018–19                                      | FY 2019–20                                | FY 2020–21 | FY 2021–22 |
| Reported Outreach<br>Costs | \$27,852 <sup>10</sup>                          | \$502,645                                 | \$614,982  | \$790,443  |

*Source: Reported M1W Analysis.*

#### *Amount of Regional Treatment Plant Admin Support Personnel to be Included*

Exhibit J explicitly defines some calculations for the RTP (Regional Treatment Plant) Administration Costs to be based on proportional costs related to the staff roles of the Assistant General Manager and the Administrative Support Specialist. M1W asserts that this calculation should also include the salary of a staff member with the title of RTP Administrative Analyst because they were substituting for the Administrative Support Specialist for a period of time.

We disagree with including this cost for three reasons:

1. Despite M1W’s assertion that this was a substitution, the Administrative Support Specialist, as named in Exhibit J, did have a part-time salary that we included in our calculations. Adding another salary from a position not named in Exhibit J did not seem appropriate without more supporting evidence.
2. The RTP Administrative Analyst also directly billed time to the WRA programs. There is no documentation related to their time or assigned duties to determine if their directly charged activities were appropriately billed or if they should also be billed indirectly without the risk of double counting their time. Further, we have seen no documentation showing that they were temporarily assigned to substitute the Administrative Support Specialist role during the audit period.
3. Had M1W followed the Agreement and used Exhibit J, it is possible that M1W would have communicated this substitution to the WRA during their operations. If that had occurred, then the WRA may have had an opportunity to evaluate the appropriateness of including the different position as a substitution. Since there are no records of this occurring and M1W has stated that they did not follow Exhibit J, it does not seem appropriate to retroactively consider costs not named in Agreement.

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<sup>10</sup> The audit team excluded the reported Outreach costs from the Fiscal Year 2018–19 costs used in our analysis of the Administration Department to be consistent with our interpretation of Exhibit J and our exclusion of the Outreach Department costs in the other three years.

### *Future Costs*

Besides some technical differences we noted in how calculations are performed, the other key differences relate to M1W documentation of costs. If the current Agreement remains unchanged, M1W may improve its documentation of some of these costs in question. If this occurs, one would expect the costs to increase. For example, if the two Distribution Mechanics are truly performing exclusive full-time work on the WRA programs these costs should be better documented and accounted for as they relate to both direct and in-direct charges. As mentioned above, we believe the costs of the Outreach Department should currently be considered direct costs based on the Agreement and Exhibit J. If those costs are tracked, documented, and included in the annual budget, it may be appropriate for the WRA to pay for those costs too.

### *Ambiguous Definitions*

Our interpretation of Exhibit J is grounded in an adherence to the available evidence regarding the intentions of both boards of directors. The application of this document has highlighted structural and methodological deficiencies that introduce ambiguities. Ideally, M1W would have engaged with the WRA annually to clarify these ambiguities as they arose and seek possible updates to the Agreement, but such interactions did not occur. We now recommend that both M1W and the WRA jointly review Exhibit J to develop and adopt a more effective indirect cost allocation plan and present it in a proposed amendment to the Agreement and clearly label it as a final and conclusive version of the plan if adopted. This updated plan should accurately reflect the current scope of programs and services and their associated costs, comply with Title 2 CFR, Part 200 as required in the Agreement, and facilitate clearer and more effective financial governance.

### *Recommendations*

The Water Resources Agency should:

- 1.1 Seek a refund in the amount of \$1,110,117.41.

The Water Resources Agency and Monterey One Water should:

- 1.2 Agree to and document the method to calculate indirect costs to be used in future years and amend the Agreement to reflect this decision. The selected method should be compliant with the requirements set Section 8.03 of the Agreement, and the Agreement should include a final version of the methodology and exclude words such as “sample” and “draft”.
- 1.3 Amend the Agreement to require that M1W must submit working papers that support and document the calculation of the indirect cost allocation amount charged to the WRA. The working papers should include sufficient detail for the WRA to verify how all calculations were made and any assumptions that were used in the calculations.

## Finding 2: Inconsistent Time Records

### The Agreement Established That Backup Information Will Be Maintained by M1W

The Agreement between Monterey County Water Resources Agency (WRA) and Monterey One Water (M1W) states in section 7.04, Payment procedures Part 3, that “...Back-up information (original paid invoices, payroll records, timesheets, and vehicle costs) will be maintained by PCA [M1W] to support each direct charge.”

### Salary and Benefits Represent a Quarter of All Operating Expenses

During the four years of the audit scope, M1W spent on average 25.2% of the three WRA program’s operating expenses on salary and benefit costs for M1W staff, see Figure 2.1 below. This illustrates that salary and benefit costs are a significant portion of the operating costs and warrant backup documentation as required by the Agreement for these direct charges.

**Figure 2.1: Salary and Benefits Were a Quarter of WRA Project Operating Costs**

|   | FY 2018–19                   | FY 2019–20     | FY 2020–21     | FY 2021–22     |
|---|------------------------------|----------------|----------------|----------------|
| <b>Salary and Benefit Expenditures WRA Projects</b>     | \$1,055,000.00 <sup>11</sup> | \$1,179,004.25 | \$1,425,827.74 | \$1,4666,10.62 |
| <b>Total Operating Expenses for WRA Projects</b>        | \$4,351,925.00               | \$4,767,198.00 | \$5,488,494.00 | \$6,125,172.00 |
| <b>% of Operating Expenses From Salary and Benefits</b> | <b>24.2%</b>                 | <b>24.7%</b>   | <b>26.0%</b>   | <b>23.9%</b>   |

*Source: Salary and benefits calculated from M1W’s financial system records. Total Operating Expenses calculated from M1W’s Combining Schedule of Revenues, Expenses, and Change in Net Position presented in the unaudited Other Supplementary Information section of their Annual Comprehensive Financial Reports.*

### M1W Uses Two Systems That Record Time

M1W employs two separate systems that record staff time: the asset-focused work order system called Lucity (a computerized maintenance management system or CMMS) and a timesheet system within the payroll module of Eden (M1W’s financial system). The two systems are not integrated at this time, but M1W staff said they could be integrated in the future.

Among other functions, Lucity tracks hours on asset and infrastructure work orders. M1W does not require a supervisor or managerial review of hours entered in the CMMS for work orders.

Conversely, Eden, M1W’s financial system, allows employees to record hours worked by billable function in timesheets for the agency’s biweekly payroll. Time entered by employees requires their manager’s biweekly review and approval. The time entered in the payroll module is the time used to charge labor costs to the WRA projects.

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<sup>11</sup> As discussed in Finding 4 on page 25 of this report, M1W managed the WRA program funds within its General Fund in FY 2018-19 and in years prior. Since Figure 2.1 is provided for contextual purposes, we displayed that year’s salary and benefit costs based on what M1W reported as actual expenditures to the M1W Board. The other three years, beginning in FY 2019-20, we displayed expenditures we calculated from M1W’s financial system for the years when the WRA programs were held in the separate Reclamation Fund.

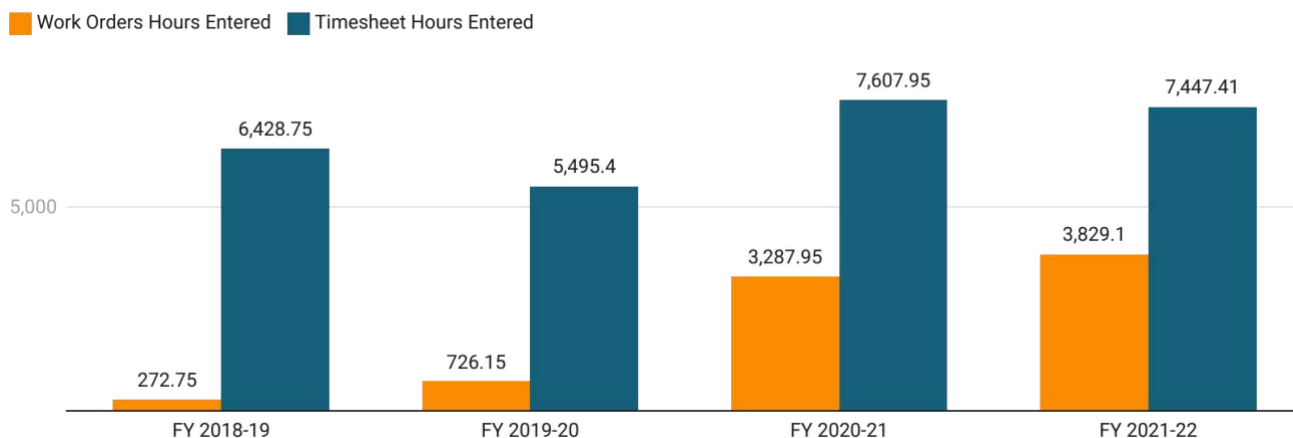
Though Lucy is intended for asset management and not payroll purposes, hours recorded in both systems should be roughly similar to each other since most work performed on the projects should otherwise be tracked and managed with work orders according to M1W's practices. In total, we would expect work order hours to be somewhat smaller since supervisors and managers may have administrative time related to managing staff and those hours would not be recorded in the Lucy work order system. However, in no instances would we expect a payroll record and a Lucy record to show contradictory entries for a specific block of time.

### The Two Systems Show Significant Disparities

We compared the time entered in both systems and found significant discrepancies. The patterns of their differences suggest that both systems are inaccurate since both systems are missing records from one-another. For example, in Fiscal Year 2021–22 the CMMS recorded 3,829.10 hours versus 7,447.41 in Eden, a 51.4% difference. In the same year, there are 13 personnel with hours in CMMS but not in Eden's timesheet, and 21 names in Eden but absent in CMMS for the same period.<sup>12</sup> These differences are much larger than expected. Given the number of staff who do not enter time in one or the other system, we think the difference is due to a larger systemic problem with M1W's time recording practices and controls.

Figure 2.2 below shows a comparison of the hours entered in each of the systems for each of the four years included in the audit scope. Figure 2.3 compares the number of staff entering hours into each system. Figure 2.4 shows the difference in reported time between the two systems and WRA's program by their estimated full-time equivalents (FTE).

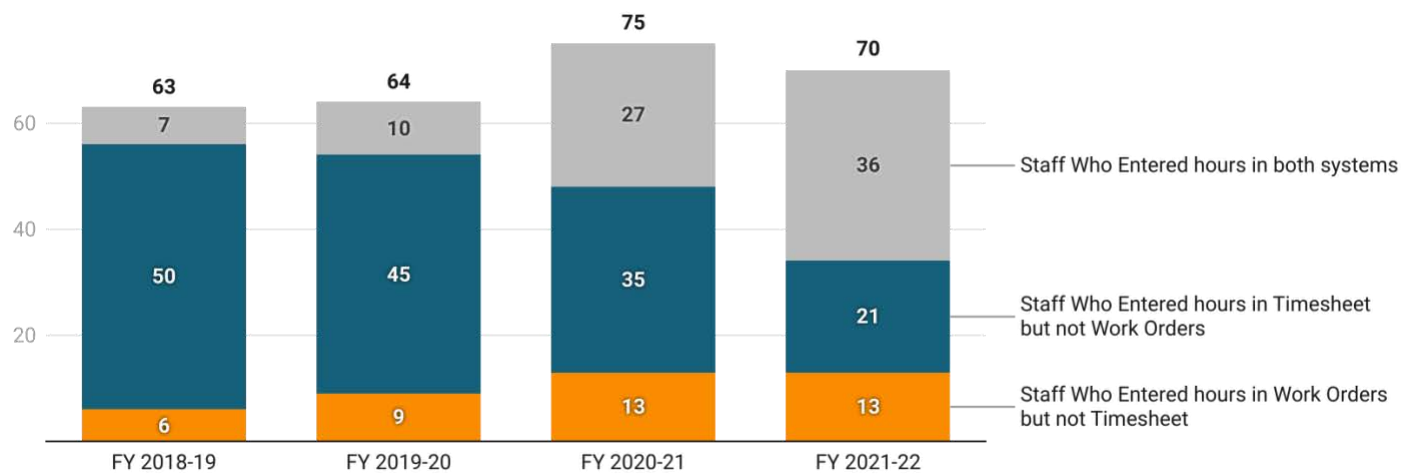
**Figure 2.2: Most Staff Enter Time in Timesheet Systems for WRA Projects but Not Work Order System**



*Source: Audit team analysis of M1W's Lucy (CMMS) work orders and payroll (Eden) timesheet records.*

<sup>12</sup> Both the CMMS work order data and the payroll timesheet data discussed here include only hours entered by M1W staff and excludes any work that may have otherwise been performed by outside vendors and contractors.

**Figure 2.3: Some Staff Only Enter Time in One System and Not the Other for WRA Projects**



Source: Audit team analysis of M1W's Lucity (CMMS) work orders and payroll (Eden) timesheet records.

**Figure 2.4: Difference in Reported Time Between System and Program Shown as Full-Time Equivalents (FTE)<sup>13</sup>**

|                            | FY 2018–19  | FY 2019–20  | FY 2020–21  | FY 2021–22  |
|----------------------------|-------------|-------------|-------------|-------------|
| <b>Work Order (CMMS)</b>   | <b>0.16</b> | <b>0.44</b> | <b>1.99</b> | <b>2.31</b> |
| CSIP                       | 0.00        | 0.14        | 1.16        | 1.27        |
| SRDF                       | 0.16        | 0.29        | 0.40        | 0.12        |
| SVRP                       | 0.01        | 0.00        | 0.43        | 0.93        |
| <b>Timesheet (Payroll)</b> | <b>3.88</b> | <b>3.32</b> | <b>4.59</b> | <b>4.50</b> |
| CSIP                       | 0.48        | 0.46        | 1.11        | 1.09        |
| SRDF                       | 0.55        | 0.24        | 0.19        | 0.02        |
| SVRP                       | 2.85        | 2.62        | 3.29        | 3.38        |

Source: Audit team analysis of M1W's Lucity (CMMS) work orders and payroll (Eden) timesheet records.

<sup>13</sup> FTE estimated based on 1,656 possible working hours per full-time equivalent staff.

## Discrepant Records Caused by Several Factors

There are several factors that may have caused M1W to maintain inconsistent time records. First, M1W has no written policies or procedures for time entry in either system.<sup>14</sup> Without such a policy, M1W has no formal mechanism to hold employees accountable for regular and accurate time entry in either system.

Second, there is no effective process or control in place by which time billed to WRA is reviewed or compared to time recorded in the work order system. Certain reviews occur, but these reviews are limited in nature and do not serve to ensure accuracy or consistency between the time keeping and work order systems. The reviews are:

- Work order system information is reviewed but not compared to other information such as employee timesheets, according to the work order system manager.
- Supervisors approve individual timesheets of their direct reports on a biweekly basis, but there is no comprehensive or summary review of time billed to specific projects or programs.
- The Payroll Manager reviews timesheet entries but does not compare the entries to entries in the work order system.

## Poor Record-keeping Undermines Validity and Suggests the Time Billed to WRA Is Inaccurate

The discrepancy between the work order system and timekeeping system suggests that the time billed to the WRA programs is inaccurate, and it undermines the validity of either system, meaning neither serves as effective backup information as required in the Agreement. Between the two, we expect the payroll's timesheet information to be the most accurate since staff have a stronger incentive to report time worked in that system. Even with that consideration, the timesheet information may not be accurate given how many staff report time in only one system and not the other. Without more reliable backup information, the WRA has no way of evaluating if the time M1W billed to the WRA is accurate or should be higher or lower.

If the issues identified are not addressed, several significant risks and consequences could arise. Firstly, continued discrepancies in timekeeping records may lead to financial losses for either the WRA or M1W, due to inaccurate billing. Secondly, the lack of transparent and accurate timekeeping undermines trust and credibility, which are crucial for maintaining a positive working relationship between the WRA and M1W.

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<sup>14</sup> The only record we could identify of M1W directing staff to enter time regularly was from August 2022, when the manager of the work order system presented a training to operational staff that asked employees to "Add your time and materials daily for all work performed, if the Documentation of the time spent performing Maintenance and Operations tasks shall be recorded daily to ensure accuracy and accountability...".

## Recommendations

Monterey One Water should:

- 2.1 Write and implement an organization-wide policy where supervisors of staff who directly bill time to the WRA's projects review all work order time entered and timesheet time prior to approving timesheets for payroll. If the supervisor sees a possible discrepancy, the policy should direct them to reconcile the information in both systems before approving the timesheet. This will help improve the accuracy of data in both systems.
- 2.2 Once any necessary corrections have been made to work order or timesheet information, M1W should provide the WRA with detailed monthly reports of time from both systems. This will allow the WRA to monitor M1W's progress and better assess the accuracy of time billed.
- 2.3 Seek to integrate its work order time entry with its timesheet entry for payroll. Such an integration will improve staff compliance while also saving staff time by entering their billable hours in a single place.

## Finding 3: Noncompliance With Required Monthly Reporting

### The Agreement Requires M1W to Provide WRA With Monthly Expenditure Reports

The Monterey County Water Resources Agency (WRA) and Monterey One Water (M1W) entered into the Amended and Restated Water Recycling Agreement Between Monterey Regional Water Pollution Control Agency and Monterey County Water Resources Agency (the Agreement). Section 8.02 of the Agreement states that "by the last day of each month PCA [M1W] will provide to WRA a report on expenditures made during the previous month and year-to-date, for each line item in the SVRP, CSIP, and SRDF budgets [...]".

### Ten Month Gap in Reporting to WRA

Our audit documented that M1W failed to submit the required monthly expenditure reports to WRA for ten consecutive months, spanning from June 2022 to March 2023. This noncompliance was discovered through an examination of emails and reports provide to us from both M1W and WRA. While the condition occurred outside of the audit's four-year period, we determined that it was important to include it because of the recency of the occurrence, only months before the start of the audit, and it is illustrative of other reporting and transparency problems discussed throughout the audit report.

### Lack of Written Procedures and No Succession Planning

During our discussions with M1W personnel, it became apparent that the lapse in compliance was likely a result of the vacant Controller position at M1W. This lapse reveals a broader problem in M1W's Finance Department, which is that M1W lacks written procedures for critical duties related to the Agreement and lacks succession planning for key roles such as the Controller position. These circumstances are common among small departments, but the negative effects of them can still be mitigated through improved documentation and planning.

### Undermines Oversight and Is a Breach of the Agreement

This failure undermined the WRA's ability to conduct effective financial oversight of M1W's management of its funds and is a breach of the terms of the Agreement.

### Recommendations

Monterey One Water should:

- 3.1 Implement a formal procedure for monthly reporting, assigning this responsibility explicitly to designated staff.
- 3.2 Develop a backup plan or succession strategy for critical roles and responsibilities in the Finance Department, ensuring continuity in fulfilling key requirements of the Agreement, including the monthly expenditure reports.



## Finding 4: Accounting Practices and Limited Transparency

Our review of the processes by which Monterey One Water (M1W) accounts for and reports the financial activities of the Water Resources Agency (WRA) programs identified several shortcomings that resulted in multiple interconnected issues. These issues prevent transparency and impede oversight from occurring. As a result, and because processes have changed over time, the accuracy of the current WRA program account balance, as reported by M1W, is questionable.

A brief overview of the process by which M1W budgets and tracks WRA program expenditures and payments provides the context necessary to explain these issues.

### Contextual Background of Budget and Payment Process

The Agreement establishes that WRA shall pay “...the dollar amount that equals 100% of the annual costs reasonably and necessarily incurred in connection with the SVRP, CSIP, and SRDF (including both direct and indirect expenses) and no more”.<sup>15</sup> M1W is required to make reasonable efforts to stay within or below the amounts budgeted, and any budgeted savings are to apply to the following year’s budgets.

The budget for each WRA program consists of: amortization of any loans and any other financing; anticipated costs for operations, maintenance, repair, replacement, power, capitalized equipment, and capital improvements; contingencies; and reserves.<sup>16</sup> M1W submits a preliminary budget estimate to the WRA in December, in accordance with the Agreement.

The Agreement establishes that two annual payments are to be made for operation, maintenance, reserve, and all other budgeted costs. Payment is due on March 1 for costs incurred in the preceding July–December and payment is due September 1 for the preceding January–June period.

After fiscal year end, M1W submits an annual true-up report, referred to as a reconciliation statement.<sup>17</sup> The reconciliation statement serves to determine the extent to which WRA payments exceeded the amount expended during the year (referred to as ‘budget savings’). Budget savings are applied as payments to the following year’s budget.

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15 Amended and Restated Water Recycling Agreement Between Monterey Regional Water Pollution Control Agency and Monterey Resources Agency, Section 7.02.

16 Section 9.01 of the Agreement requires PCA [M1W] to establish a reclamation reserve fund for the repair and modification of SVRP, CSIP, SRDF and New Source Water Facilities and related facilities.

17 In this context, use of the term ‘reconciliation’ does not refer to a traditional bank reconciliation. The M1W reconciliation provides a reporting of the prior year’s expenditures and financial position.

## Reconciliation Statement Not Defined in Agreement

The Agreement does not establish the methodology by which the reconciliation statement is to be produced nor does the Agreement establish the reporting format. The Agreement just states:

*“Unused funds received from WRA will be placed by PCA [M1W] in an interest-bearing account. All interest earned from WRA accounts will be applied for WRA’s benefit on a monthly basis. PCA [M1W] will adjust the second semi-annual billing and year-end reconciliation statement by any interest earned on WRA accounts. [...]”<sup>18</sup>*

In theory, the reconciliation statement should be a reconciliation between the budgetary (cash) basis of accounting used to charge and receive funds from the WRA and the accrual basis used for accounting and reporting in an audited financial statement for each program. This reconciliation is equivalent to the Cash Flow Statement for each program, that would be included in a separately audited financial statement. However, as discussed further below in this report, the programs are not presented by M1W in a separately audited financial statement. Instead, the reconciliation statements have been provided by M1W using calculations that have varied between iterations. This limits the WRA’s ability to effectively monitor M1W’s use of WRA funds and their compliance with the Agreement.

Further, we identified several inter-related conditions and their resulting effects, which will be discussed below. They combine to reinforce the need to modify the Agreement to require M1W to produce a separate audited statement of the WRA programs to ensure full transparency and accountability.

## Inter-Related Problems We Identified

### *Conflicting Versions of Reconciliation Statements Sent by M1W*

In 2022, M1W sent several iterative versions of the reconciliation statements based on feedback from the WRA about how the available balance should be calculated. Each version had significantly different cash balances and calculated available funds. While the calculation of available funds could be interpreted differently because it is not specified in the Agreement, the cash balances should not have changed between versions. However, each version calculated the cash balance based on different cash accounts held by M1W. We think this occurred because cash and investments are an input into the calculation of available funds, and the differing versions of cash and investments appear to be drawn from different funds held by M1W. These reporting variances are only compounded by M1W’s accounting and reporting problems discussed further below in this finding. The combined problems limit the WRA’s ability to monitor M1W’s use of the WRA’s funds.

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18 Amended and Restated Water Recycling Agreement Between Monterey Regional Water Pollution Control Agency and Monterey Resources Agency, Section 7.02 part 3.

Figure 4.1 shows how the cash balances, which should not be a subjective calculation, changed between the initial and the final versions.

**Figure 4.1: Three Different Versions of Reconciliation Statements Submitted By M1W**

|   | Version 1 Revised<br>Reconciliation – Sent<br>by M1W 2/4/2022 | Version 2 Revised<br>Reconciliation – Sent<br>by M1W 2/9/2022 | Final Version Revised<br>Reconciliation – Sent<br>by M1W 5/22/2022 |
|---|---|---|--|
| <b>Fiscal Year 2018–19<br/>Cash Balance</b> | \$555,988.84  | \$555,988.84  | \$332,519.84   |
| <i>Difference from previous</i>             |   | 0.00%   | -67.20%  |
| <b>Fiscal Year 2019–20<br/>Cash Balance</b> | \$1,690,903.65  | \$1,690,903.66  | \$1,464,229.00   |
| <i>Difference from previous</i>             |   | 0.00%   | -15.48%  |
| <b>Fiscal Year 2020–21<br/>Cash Balance</b> | \$2,662,228.69  | \$2,662,228.69  | \$2,642,448.69   |
| <i>Difference from previous</i>             |   | 0.00%   | -0.75%   |

*Source: Analysis of emails and documents from M1W to WRA.*

#### *WRA Program Funds Never Properly Segregated*

Section 8.01 of the Agreement requires that the following occur:

*“PCA [M1W] will maintain an accounting system that in conformity with generally accepted accounting principles (GAAP) and will allow for the segregation and tracking of all revenues and direct costs relate to the SVRP, CSIP, and SRDF.”*

Full segregation of the SVRP, CSIP, and SRDF programs has not occurred, though improvements have been made. For the years prior to and including Fiscal Year (FY) 2018–19, M1W accounted for the three WRA programs within M1W’s General Fund. In FY 2019–20, M1W segregated WRA-related financial transactions from other M1W financial transactions by moving WRA programs into a separate fund known as the Reclamation Fund. The Reclamation Fund only includes the three WRA programs.

Although M1W has established several program-specific accounts within the Reclamation Fund, the cash balances of the three programs are maintained in a pooled cash account titled “02-000-1010 RECLAMATION ACCOUNT.” This practice is not compliant with the requirement that accounting practices “allow for the segregation and tracking of all revenues and direct costs related to the SVRP, CSIP, and SRDF,” as stated in Section 8.01 of the Agreement, if the statement is interpreted as meaning that the finances of each program should be segregated from the finances of the other two programs.

Moreover, when M1W has provided annual reconciliation statements to WRA, it has not routinely shown this pooled account, and instead performed a redistribution of the funds associated with each program. This practice lacks transparency and inhibits outside verification of the accuracy of the reported number, as illustrated in Figure 4.2.

**Figure 4.2: Pooled Cash Account Not Reported in Reconciliation Statements to the WRA, June 30, 2022, Balance**

|  | GPP Calculated   | Reconciliation Statement |
|--|------------------|--------------------------|
| 02-000-1010 RECLAMATION ACCOUNT                                    | -\$719,970       | <i>Not listed</i>        |
| 02-000-1192 INVEST. RECLAMATION O & M -LAIF                        | \$819,387        | <i>Not listed</i>        |
| 02-000-1193 INVEST-RECLAM O&M-CSIP-LAIF                            | \$337,863        | <i>Not listed</i>        |
| 02-000-1199 INVEST. SRDF O & M -LAIF                               | \$401,594        | <i>Not listed</i>        |
| SVRP   | <i>n/a</i>       | \$39,519                 |
| CSIP   | <i>n/a</i>       | -\$406,389               |
| SRDF   | <i>n/a</i>       | \$1,211,622              |
| <b>Cash Balance TOTAL</b><br>(excluding Capital and Debt Reserves) | <b>\$838,874</b> | <b>\$844,752</b>         |

*Source: GPP Analytics ran trial balance reports on M1W's financial system and compared them to a copy of revised reconciliation statement provided by WRA and M1W on July 21, 2022.*

M1W acknowledges the issues related to this practice and reports that it plans to move each program into its own fund at the start of Fiscal Year 2024–25. We agree with this approach and believe it will improve M1W's management of the funds and better enable WRA to fulfill its oversight responsibilities. However, given that errors occurred during the previous transition to the Reclamation Fund, we recommend that the WRA play an active role in first approving and reviewing how all WRA monies are redistributed into these separate funds.

#### *The Reclamation Fund Misstatement*

The FY 2021–22 Annual Consolidated Financial Report (ACFR) reported an error of \$600,428 reported by M1W to its financial auditors. The restatement occurred in the unaudited section of the ACFR that reports the WRA programs. The basis of the restatement comes from M1W reporting that in the FY 2019–20 transfer of WRA-related funds to the newly formed Reclamation Fund was “pulled incorrectly from liability instead of cash accounts.”

M1W's financial audit firm provided us with the following explanation regarding the error:

*“[...] it looks like our documentation references a discussion with [M1W] in FY 2022 regarding a multi-year reconciliation performed by the District. We noted that the District identified assets that should be recorded more appropriately in the General Fund rather than the Reclamation Fund. We did not detail out those assets because it did not impact the overall beginning net position of the main financial schedule.”*

During the course of our audit, M1W was not immediately able to provide any documentation regarding the alleged error, how they calculated it, or why they believe the amount that they restated is correct. However, during M1W's review of the draft audit report in April 2024, they were able to provide some additional documentation related to the cause of the misstatement. While the funds in question may have been appropriately returned to the M1W's general fund, the new information is further evidence of M1W's weak controls and oversight during the audit period.

According to emails sent from M1W's financial auditor:

*"[...] Looks like it was to correct M1W not posting an entry in FY 2019/2020."*

After speaking with M1W further, they recalled that the financial auditor had suggested the transfer should occur in Fiscal Year 2019–20 to offset a possible negative balance of cash and investments in the Reclamation Fund. However, M1W allegedly determined such a transfer was not needed, but stated that their financial auditor erroneously still posted the transfer in the ACFR for the Fiscal Year 2019–20. Thus, the ACFR in Fiscal Year 2020–21 needed to restate their erroneous posting.

The narratives from M1W and their financial auditor seem to put each other at fault, respectively. Reportedly, staff from the financial auditor who worked on the years in question are no longer with the firm to comment. In our opinion, this series of errors are unusual regardless of who is at fault. Had the WRA programs been managed in separate funds, and annually audited and reported as separate funds in the ACFR or other annual audit report, we believe this problem would have been avoided. This is because managing them and reporting them as separate funds would have resulted in the financial auditors considering all of M1W funds as distinct categories of money. In contrast, the financial audits that occurred during our four-year audit period were reported only on an agency-wide basis. This meant that the financial auditor did not have a reason to provide an opinion at the fund-level related to the WRA programs because the total overall financial schedules were in balance. Separately auditing these as distinct funds annually, as we recommend below, will help prevent similar problems and add greater financial transparency.

As a result of the limited and conflicting evidence, we are unable to make a recommendation about the final ownership of these funds. This is similar to Finding 2 related to the staff time records, where the poor quality of records and other conflicting records make us unable to make a determination at this time. Looking forward, to help M1W prevent similar errors in the future, it is critical that the WRA money M1W manages is audited and reported separately from its agencywide annual financial audits, and that M1W adopt the various other control recommendations in this report.

#### *Encumbrances Are Included When the Reconciliation Statements Are Prepared*

M1W's practice has been to account for encumbrances (amounts the organization reasonably plans to expend in the coming year based on existing contracts) when calculating the year-end balance, which was used to then calculate the available balance for the upcoming fiscal year. However, including encumbrances may lead to double-counting certain planned expenditures and incorrectly inflate the amounts subject to be paid by the WRA.

Instead, if our recommendation that M1W produce a separately audited statement of the WRA's programs is adopted, reporting encumbrances would no longer be necessary. By using the audited statements as the basis for comparison, both parties would be able to compare the budgeted amounts (prepared on a cash basis) against the actual expenses incurred by M1W as reported in the audited financial statements. The difference between the two would form the basis of the reconciliation and any resulting refund.

As such, we recommend that the Agreement be amended to require that the separately audited financial statement be used as the basis for the annual reconciliation and calculating any resulting refund due to the WRA. This eliminates the inclusion of encumbrances in the reconciliation statement and avoids the risk of incorrectly reporting the amounts subject to be paid by the WRA.

### *Reclamation Fund Information Is Not Subjected to Full Audit Procedures*

M1W reports the financial activities of the Reclamation Fund as part of a schedule known as a “Combining Statement” in the “Other Supplemental Information” section of its ACFR. The information is compiled by M1W’s financial auditors, but the auditors do not audit these numbers, nor do they provide an audit opinion whether the reported numbers are materially correct.

We recommend that the Agreement be modified to require that the WRA program funds be reported as individual enterprise funds and audited separately. This recommendation would enable the creation of Cash Flow Statements for each fund (created to track each WRA program) capturing the reconciling items in the audited Cash Flow Statements. It would also relieve both parties of separately performing the complex reconciliation steps between the cash basis and accrual basis of accounting, reducing the risk of error, and keeping the accounts, records, and reports clean and transparent. In doing so it would alleviate the need for interactive requests/explanations, monitoring, and disagreements between the parties.

We note that had this recommended practice been in place, the aforementioned issue of the \$600,428 misstatement may have been resolved in a timely manner or never occurred. In conjunction with this recommendation, we also recommend that the Agreement be modified to specify that the associated audit costs be included in the program’s annual budget.

### *Use Audited Financial Statements for Reconciliation Statement*

With an audited financial statement available for each of the WRA programs, a reconciliation statement is produced in the form of Cash Flow Statement, by comparing the budgeted program costs, which in turn represent the amount paid by the WRA to M1W, against the actual amount incurred in the audited statements. As stated previously, this alleviates both parties of complex calculations in the reconciliation process, reduces error risk, and adds assurance that the information used in the calculation is accurate and consistently calculated. We recommend that both the audited financial statements and the resulting reconciliation statement be due to the WRA by December 31 of each year. This provides M1W with six months after the end of the fiscal year to close its books, have the audit performed, and provide the information to the WRA. We recommend that the cost of the audits be included in the annual program budgets and thus paid for by the WRA. Even though the need for the audits is due to M1W’s prior control weaknesses, we believe that as an ongoing cost it is appropriate for this to be paid by the WRA to prevent even a small subsidy from M1W’s other programs and rate payers. We believe the additional cost of the audit to the WRA is worthwhile since it will improve accuracy during the annual reconciliation, and overall effectiveness to WRA’s oversight of the programs run by M1W.

### *Application of Reconciliation Statements and Refund*

The Agreement establishes that “all budgetary savings will be applied to the following year’s budgets,” meaning that each year’s savings rolls into the next year. However, given the demonstrated problems with M1W’s management and reporting of the WRA’s funds, we recommend that the Agreement be modified to require that following the issuance of the reconciliation statement that M1W issue the WRA a refund of any savings each year. This will help both parties better delineate the finances of each year and avoid the reporting challenges M1W faces when managing the WRA’s cash year-to-year. Since we also recommend that the reconciliation statements be provided to the WRA by December 31<sup>st</sup>, that means any refund that M1W issues would be halfway through the new fiscal year and alleviate the risk of any cash flow problems for M1W related to issuing a refund any earlier.

## Reserves

If our recommendation to perform an annual refund instead of rolling forward budget savings into the coming year is adopted, M1W may still require some level of reserves for cashflow purposes. The current agreement does not specify exact reserve amounts.

Instead of M1W holding reserves, as implied by the current Agreement, we recommend that the Agreement be updated so that the WRA instead holds reserve amounts for all operational, maintenance, and capital costs. The level of reserves should be calculated as 45 days working capital and the money held in Restricted Cash accounts. The 45 days working capital is based on the Government Finance Officers Association recommended best practice for “heavily subsidized” enterprise funds, such as those that are supported by an outside organization.<sup>19</sup> The operational reserve held by the WRA will allow the WRA to better monitor M1W’s spending and adherence to annual budgets. Section 7.02 of the Agreement says that the “PCA [M1W] will make all reasonable efforts to stay within, or below, the amounts budgeted [...]”. It is reiterated again in paragraph two of the section “[...] so long as the total budget amounts are not exceeded.” In our opinion, this implies that if M1W expects to exceed the budgeted amount, it should be communicated with the WRA. Given M1W’s history of financial reporting and documentation challenges, we believe that moving the operational reserve to the WRA will help ensure compliance with Agreement and work as an additional spending control. This would modify various portions in chapter seven of the Agreement.

In addition, we recommend that the Agreement be updated to specify that M1W hold reserve amounts based on all legally required debt service reserves. These reserves should be held in Restricted Cash accounts and be funded by the WRA at a level that will satisfy requirements related to the US Bureau of Reclamation loan and other future debt if issued.

## Recommendations

As discussed above, several changes are needed to achieve transparency, allow for oversight, and ensure the accuracy of the SVRP, CSIP, and SRDF financial records. A full list of our recommendations follows.

Monterey One Water and the Water Resources Agency should:

### 4.1 Amend the Agreement to reflect the following:

- Require that any funds related to the WRA's programs should be audited annually and reported in a separate annual audit report on these funds due to the WRA no later than December 31<sup>st</sup> of each year. The WRA's programs should be charged for these additional auditing costs.
- Require that the reconciliation statement be provided by M1W to the WRA annually by December 31<sup>st</sup> of each year.
- Require the reconciliation statement be produced by comparing the budgeted program costs against the actual amount incurred in the audited statements. This reconciliation statement shall be produced in the form of Cash Flow Statements in separate audited Financial Statement of WRA programs and will form the basis of any resulting refund.

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<sup>19</sup> Government Finance Officers Association, “Working Capital Targets for Enterprise Funds”, February 28, 2011. <https://www.gfoa.org/materials/working-capital-targets-for-enterprise-funds>. Accessed on February 29, 2024.

- Require that if budget savings are identified in the reconciliation statement, that such savings are applied by issuing a refund to the WRA no later than January 31<sup>st</sup>.
- Require M1W to maintain each WRA program, including any future programs or facilities, in separate enterprise funds for each program.
- Prohibit M1W from including encumbered funds in the annual reconciliation statements submitted to the WRA.
- Require that M1W cannot move monies between each individual enterprise fund established for each Water Resources Agency program.
- Require that the WRA hold reserve amounts in separate “Restricted Cash” accounts for each program to provide for an operational, maintenance, capital, and all other non-debt service costs based on 45 days working capital.
- Require that M1W hold reserve amounts in separate “Restricted Cash” accounts for each program funded by the WRA and based on all legally required debt service reserves.

Monterey One Water should:

- 4.2 Continue its required monthly reporting as discussed in Finding 3 of this audit report.
- 4.3 Move each program of the WRA into individual enterprise funds starting in Fiscal Year 2024–25. Prior to moving these funds, M1W should first get approval from the WRA on the specific redistribution of any pooled cash to be redistributed to the individual funds.



## Finding 5: Percent Overcharged

The audit scope included a review and quantification of annual expenses for the purposes of determining “whether M1W [Monterey One Water] overcharged annual costs to MCWRA [Monterey County Water Resources Agency (WRA)] by more than 5%” determining whether “M1W has been charging direct and indirect costs accurately to the three programs/facilities.”

### Indirect Cost Finding

As discussed in Finding 1 regarding the indirect cost methodology, we determined that the methodology used by M1W resulted in WRA being charged a cumulative \$1,110,117.41 more than it would have been charged had M1W used the methodology described in the Wastewater Recycling Agreement (the Agreement).

### Accounting and Reporting Practices Finding

A draft version of this audit report recommended that without documentation related to a misstatement of \$600,428 as discussed in Finding 4 that M1W should restate the amounts and reimburse it to the WRA. During the April 2024 review of the audit report, M1W provided additional information. While the information they provided was not conclusive, it was enough to suggest that the rightful ownership of the money and the reasons for its transfer into and then out of the WRA programs’ fund is not clear. As such, in our final audit report we do not recommend at this time that M1W reimburse the monies and we have not calculated it as an overcharge in this report.

### Other Findings and Testing

As discussed in Finding 2 regarding the problems with M1W’s time tracking systems, we found problems with direct charges of salary and benefits. However, in the case of Finding 2, we were unable to determine a fiscal impact because the problem could indicate that M1W was either over or under-charging direct salary and benefit costs to the WRA.

As discussed in the Introduction section of this audit report, we performed testing of M1W’s accounts payable processes, focused on M1W’s invoice processing and allocation. Directly charged goods and services accounted for the majority of expenditures charged to the WRA. Our analysis identified only a few minor discrepancies with the invoices and journal entries for the accounts payable processes. The discrepancies were not material and were an uncommon occurrence. It suggests that the expenditures related to goods and services were not overcharged to WRA and our analysis suggests that most of these costs are carefully allocated between the three programs based on their documentation.

## Overcharged Amount

Based on Finding 1, we calculated that during two of the four years we audited M1W overcharged WRA by more than five percent of the total dollar amount of expenses actually incurred. During those two years specifically, we estimate this amount was \$870,529.36, and for all four years, it totaled \$1,110,117.41. See Figure 5.1.

**Figure 5.1: Annual Operating Expenditures Compared to Amount Overcharged**

|   | FY 2018–19     | FY 2019–20     | FY 2020–21     | FY 2021–22     |
|---|----------------|----------------|----------------|----------------|
| <b>Total Operating Expenses for WRA Programs</b>                | \$4,351,925.00 | \$4,767,198.00 | \$5,488,494.00 | \$6,125,172.00 |
| <b>Overpayment of Indirect Costs as Calculated in Finding 1</b> | \$64,226.76    | \$175,362.29   | \$343,192.18   | \$527,336.19   |
| <b>Percent Difference From Expenses Charged</b>                 | <b>1.5%</b>    | <b>3.7%</b>    | <b>6.3%</b>    | <b>8.6%</b>    |

*Source: Operating Expenses from Annual Comprehensive Financial Report's Supplementary Information's Combining Statement and audit team calculations.*

Section 8.06 of the Agreement states that “if any audit shows that an undercharge or an overcharge has occurred, each agency will have 90 days to comply with the audit findings.” We interpret this to mean that for the entire four-year audit period, each year’s overcharges are due to the WRA from M1W.

## Recommendations

Monterey One Water should:

- 5.1 Reimburse the WRA for the \$1,110,117.41 it overcharged for indirect costs during the four audit years, as stated in Finding 1.

## Finding 6: Weak Control Environment

The audit scope included a review of the control environment for the purposes of determining if Monterey One Water (M1W) possesses appropriate financial systems and internal controls to effectively record, monitor, and allocate operational and maintenance costs and determining whether contract clauses or other modifications to the Amended and Restated Water Recycling Agreement Between Monterey Regional Water Pollution Control Agency and Monterey County Water Resources Agency (the Agreement) are necessary to provide clarification for contract compliance.

### Findings Suggest Overall Control Weaknesses

Based on the previous findings, which are listed below, we do not believe M1W possesses appropriate controls.

- **Finding 1**, regarding the indirect cost methodology, found that M1W was allocating indirect costs using a methodology that was out of compliance with the Agreement. As such, no controls were in place by M1W to ensure these costs were allocated according to the Agreement.
- **Finding 2**, regarding M1W's time tracking, found that the time tracking systems had inconsistent and inaccurate information, the systems were not regularly reviewed, and there was no internal check of comprehensive time reporting to ensure accuracy and completeness. We did observe that controls, such as supervisory approval of staff time, exist. However, the significance of the disparities we identified suggests that, overall, the existing controls are insufficient.
- **Finding 3**, regarding M1W's required monthly reporting to the Water Resources Agency (WRA), found that compliance has been inconsistent and includes a documented ten-month gap in reporting spanning from June 2022 to March 2023. This failure undermined the WRA's ability to conduct effective financial oversight of M1W's management of its funds and is a breach of the terms of the Agreement. Further, it highlights an internal control weakness within M1W as the lack of external reporting suggests there is no or limited internal monitoring by M1W of the WRA's program activities.
- **Finding 4**, regarding M1W's annual reporting of reconciliation statements to WRA, shows several internal control problems. These include the use of pooled cash accounts shared between the WRA programs, misstatements during prior fund transitions, transparency concerns, and M1W's use of shared accounting funds that limit its internal and external reporting ability. All of these factors serve to undermine the integrity and reliability of financial oversight and decision-making between M1W and the WRA.

Taken cumulatively, these findings suggest that M1W has not established sufficient internal controls and monitoring practices to ensure compliance with the Agreement. M1W's control environment related to the three WRA programs increases the risks of misallocation of funds, over or under spending by M1W, and does not allow for the WRA to monitor M1W's compliance with the Agreement.

### Recommendations

Monterey One Water and the Water Resources Agency should:

- 6.1 Implement the recommendations made in Findings 1-4.

## Finding 7: Breaches of the Agreement

The findings in this audit report suggest that Monterey One Water (M1W) has not established sufficient internal controls and monitoring practices to ensure compliance with the Wastewater Recycling Agreement. These findings indicate several breaches of the Agreement have occurred. The specific sections of the Agreement that have been breached are discussed in the following findings:

- **Finding 1**, Section 7.02 Amounts to be paid, Section 8.01 Accounting system, and Section 8.03 Direct and indirect costs.
- **Finding 2**, Section 7.04 Payment procedures.
- **Finding 3**, Section 8.02 Financial reports.
- **Finding 4**, Section 7.02 Amounts to be paid and Section 8.01 Accounting system.

## Enforcement Tools in Agreement

The Agreement between M1W and the Water Resources Agency (WRA) includes Article XIII Dispute Resolution, which includes an initial duty to meet and confer, followed by an option for mediation and arbitration. Other sections of the Agreement, as highlighted in previous findings, require regular reporting by M1W to the WRA, which would help the WRA better enforce the Agreement.

## Agreement Has Not Ensured Compliance

Despite the tools in the Agreement that were presumably intended to encourage compliance, our audit findings suggest this has not always occurred. This may be because the WRA had previously not enforced the Agreement fully or because M1W did not respond to its enforcement efforts.

We believe that the Agreement could be modified to have clauses that require reporting to both entities' Boards of Directors. This would have the added benefit of encouraging compliance by M1W and, if future problems arise, the governing bodies would be notified and involved as early as possible to direct staff to resolve problems.

## Recommendations

Monterey One Water and the Water Resources Agency should:

- 7.1 Revise the Agreement to include provisions that if problems arise between the parties and are unresolved for longer than 30 days, they be escalated and reported to both entities' Boards of Directors by email and added to the agendas for discussion at the next scheduled meetings. This might include, but not be limited to, any missed reporting deadlines by any party or ongoing disagreement between staff regarding the accuracy of financial reporting. This will encourage M1W to better adhere to their reporting requirements of the Agreement and more quickly escalate any disagreements about information accuracy to each board. Once reported, the boards will be more informed to enact a solution to resolve any dispute.

## Recommendation List

The following is a table showing all recommendation made in the audit and who they are addressed to.

|     | Recommendation Addressed To                   | Recommendation  |
|-----|---|---|
| 1.1 | Water Resources Agency                        | Seek a refund in the amount of \$1,110,117.41.  |
| 1.2 | Water Resources Agency and Monterey One Water | Agree to and document the method to calculate indirect costs to be used in future years and amend the Agreement to reflect this decision. The selected method should be compliant with the requirements set for the in Section 8.03 of the Agreement, and the Agreement should include a final version of the methodology and exclude words such as “sample” and “draft”.   |
| 1.3 | Water Resources Agency and Monterey One Water | Amend the Agreement to require that Monterey One Water must submit working papers that support and document the calculation of the indirect cost allocation amount charged to the Water Resources Agency. The working papers should include sufficient detail for the Water Resources Agency to verify how all calculations were made and any assumptions that were used in the calculations.   |
| 2.1 | Monterey One Water                            | Write and implement an organization-wide policy where supervisors of staff who directly bill time to the Water Resources Agency’s projects review all work order time entered and timesheet time prior to approving timesheets for payroll. If the supervisor sees a possible discrepancy, the policy should direct them to reconcile the information in both systems before approving the timesheet. This will help improve the accuracy of data in both systems.  |
| 2.2 | Monterey One Water                            | Once any necessary corrections have been made to work order or timesheet information, Monterey One Water should provide the Water Resources Agency with detailed monthly reports of time from both systems. This will allow the Water Resources Agency to monitor Monterey One’s progress and better assess the accuracy of time billed.  |
| 2.3 | Monterey One Water                            | Seek to integrate its work order time entry with its timesheet entry for payroll. Such an integration will improve staff compliance while also saving staff time by entering their billable hours in a single place.  |
| 3.1 | Monterey One Water                            | Implement a formal procedure for monthly reporting, assigning this responsibility explicitly to designated staff.   |
| 3.2 | Monterey One Water                            | Develop a backup plan or succession strategy for critical roles and responsibilities in the Finance Department, ensuring continuity in fulfilling key requirements of the Agreement, including the monthly expenditure reports.   |
| 4.1 | Monterey One Water and Water Resources Agency | <p>Amend the Agreement to reflect the following:</p> <ul style="list-style-type: none"> <li>Require that any funds related to the Water Resources Agency's programs should be audited annually and reported in a separate annual audit report on these funds due to the Water Resources Agency no later than December 31st of each year. The Water Resources Agency’s programs should be charged for these additional auditing costs.</li> <li>Require that the reconciliation statement be provided by Monterey One Water to the Water Resources Agency annually by December 31st of each year.</li> </ul> |

|     | Recommendation Addressed To                   | Recommendation  |
|-----|---|---|
|     |   | <ul style="list-style-type: none"> <li>Require the reconciliation statement be produced by comparing the budgeted program costs against the actual amount incurred in the audited statements. This reconciliation statement shall be produced in the form of Cash Flow Statements in separate audited Financial Statement of WRA programs and will form the basis of any resulting refund.</li> <li>Require that if budget savings are identified in the reconciliation statement, that such savings are applied by issuing a refund to the Water Resources Agency no later than January 31st.</li> <li>Require Monterey One Water to maintain each Water Resources Agency program, including any future programs or facilities, in separate enterprise funds for each program.</li> <li>Prohibit Monterey One Water from including encumbered funds in the annual reconciliation statements submitted to the Water Resources Agency.</li> <li>Require that Monterey One Water cannot move monies between each individual enterprise fund established for each Water Resources Agency program.</li> <li>Require that the Water Resources Agency hold reserve amounts in separate "Restricted Cash" accounts for each program to provide for an operational, maintenance, capital, and all other non-debt service costs based on 45 days working capital.</li> <li>Require that Monterey One Water hold reserve amounts in separate "Restricted Cash" accounts for each program funded by the Water Resources Agency and based on all legally required debt service reserves.</li> </ul> |
| 4.2 | Monterey One Water                            | Continue its required monthly reporting as discussed in Finding 3 of this audit report.   |
| 4.3 | Monterey One Water                            | Move each program of the Water Resources Agency into individual enterprise funds starting in Fiscal Year 2024–25. Prior to moving these funds, Monterey One Water should first get approval from the Water Resources Agency on the specific redistribution of any pooled cash to be redistributed to the individual funds.  |
| 5.1 | Monterey One Water                            | Reimburse the Water Resources Agency for the \$1,110,117.41 it overcharged for indirect costs during the four audit years, as stated in Finding 1.  |
| 6.1 | Monterey One Water and Water Resources Agency | Implement the recommendations made in Findings 1-4.   |
| 7.1 | Monterey One Water and Water Resources Agency | Revise the Agreement to include provisions that if problems arise between the parties and are unresolved for longer than 30 days, they be escalated and reported to both entities' Boards of Directors by email and added to the agendas for discussion at the next scheduled meetings. This might include, but not be limited to, any missed reporting deadlines by any party or ongoing disagreement between staff regarding the accuracy of financial reporting. This will encourage M1W to better adhere to their reporting requirements of the Agreement and more quickly escalate any disagreements about information accuracy to each board. Once reported, the boards will be more informed to enact a solution to resolve any dispute.   |

## **Attachments – Response from Monterey One Water**



# Monterey One Water

## Providing Cooperative Water Solutions

ADMINISTRATIVE OFFICE: 5 Harris Court, Bldg D, Monterey, CA 93940-5756

MAIN: (831) 372-3367 or (831) 422-1001

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June 26, 2024

GPP Analytics Inc.  
Julian Metcalf  
2478 Tierra Dr  
Los Osos, CA 93402

RE: Water Recycling Agreement Expenses Audit Revised Draft

Dear Mr. Metcalf:

The following is a formal response from Monterey One Water (M1W) regarding the Water Recycling Agreement Expenses Audit Revised Draft dated June 7, 2024 (Audit Report) prepared by GPP Analytics (GPP) for the County of Monterey (County), the Monterey County Water Resources Agency (WRA), and the Auditor-Controller for the County of Monterey (County Auditor-Controller).

M1W takes pride in the services it provides the community, including the production and delivery of recycled water for agricultural irrigation. We value our long-term relationship with WRA in addressing water needs in the County and do not find the audit representative of our 30-year history.

The Report's conclusions are almost exclusively based on a narrow interpretation of an ambiguous agreement. While M1W confidently maintains the audit uncovered no contractual breaches, that does not mean there may be better, more transparent approaches to implement the agreement. Resources would be better spent clarifying the agreement and redefining best practices, with the understanding that M1W is a unique utility service with material differences in its operation when compared to municipalities or counties.

M1W is committed to working with WRA to ensure transparent accounting that represents 100% of the annual costs, direct and indirect, reasonably and necessarily incurred in connection with the Salinas Valley Reclamation Project (SVRP), Castroville Seawater Intrusion Project (CSIP), and Salinas River Diversion Facility (SRDF). Where appropriate, modifications will be made. Where we disagree, we are committed to working with WRA staff to find an amicable path forward.

Regards,

Paul A. Sciuto  
General Manager



## **Water Recycling Agreement Expenses Audit**

### ***Response from Monterey One Water on Revised Draft***

M1W appreciates the opportunities the Audit provides to refine or improve its business and accounting practices. We believe in continuous improvement and provide the following update on M1W's takeaways from this process:

- Time Keeping Policy – M1W's Employee Handbook details the importance of time keeping and accurate reporting of work completed. Management has developed additional time keeping procedures to better define when and how to record project-based hours, like work on SVRP, CSIP, or SRDF. Implementation of the new procedures were developed to ensure accurate inputs, invoicing, and backup related to time spent operating and maintaining the WRA systems.
- Agreement Management – M1W has initiated meetings with WRA staff to build trust and transparency. Within these working sessions, the goal will be to develop clear expectations and templates for monitoring expenditures, direct and indirect, as they relate to work performed throughout the WRA systems. These efforts will also be complementary to the succession planning M1W management has engaged in over the last two years and future staff responsibilities around agreement compliance.
- Terms of the Agreement – Once the Audit Report has been finalized and shared with County, WRA, and M1W leadership, M1W staff will await Board direction on amending the Water Recycling Agreement.
- Exemplary Service – Earlier this year, M1W added a new strategic objective focused on quality service for our community. We define community as more than just residences and businesses but also partners – local, state, federal, industry, and project partners. This objective must be and will be rooted throughout all our interactions with all stakeholders. Further staff workshops on embedding exemplary service in all we do are planned for this year.

The following narrative will focus on areas where we diverge in opinion. While we may differ in our interpretation of the Water Recycling Agreement, we are ready and willing to work with WRA staff through each Finding and Recommendation for a positive and successful future.

#### **Finding 1: Noncompliant Indirect Cost Methodology**

The Water Recycling Agreement is agreeably unclear with “structural and methodological deficiencies that introduce ambiguities.” Yet conclusions were drawn based the Auditor's interpretation of the Agreement without legal opinion or history of how the agreement was developed.

M1W maintains there is nothing in the express language of the Water Recycling Agreement that required M1W to use the methodology set forth in Exhibit J. The current methodology, modeled after Exhibit J, has been used since at least 2018 without objection from WRA.

The basis of the Audit Report is indirect costs and the methodology set forth in Exhibit J. However, the Report focuses on whether M1W legally adhered to Exhibit J rather than whether M1W charged WRA more than 100% of the annual costs, direct and indirect, incurred to operate and maintain the SVRP, CSIP, and SRDF. Legal clarity on Section 8 of the Water Recycling Agreement, especially as it relates to Exhibit J and the missing section 8.02 (b), should be obtained before Recommendations for this Finding are executed.

#### **Finding 2: Inconsistent Time Records**

Lucity is not a time recording system. It is an asset management system designed to track assets through their full lifecycles. It is a powerful tool and M1W is working to integrate it into daily workflow to track its capital assets. Until that process is complete, it should not be used to track time, and it should not be described as a time keeping system.

Also, M1W has started the process to update our ERP, Enterprise Resource Planning System. This is the software system that assists all our departments in the management and integration of core operations such as accounting,

billing, asset management, etc. As part of the new ERP system, we will pair Lucity, or another asset management system, with a new time-keeping system. Eden, our current time-keeping system, is being phased out. This new system will bring more transparency in how we track what projects our employees are working on and how much time they are spending on them. This multi-year capital project was initiated prior to the audit with estimated completion in Fiscal Year 2026-2027.

**Finding 3: Noncompliance With Required Monthly Reporting.**

M1W requested this entire Finding be removed as the ten missed reports occurred outside of the Audit period of Fiscal Years 2019 – 2022. The missed reports were the result of an extenuating circumstance, as explained to the Auditor, and the issue was remedied prior to the start of GPP’s work.

**Finding 4: Accounting Practices and Limited Transparency**

The random sampling of direct costs showed M1W’s current accounting processes are accurate and appropriate with no audit findings. Additional journal entries showed other areas such as the amortization of debt and application of interest earning, also did not result in an audit finding.

Pursuant to the Agreement, M1W maintains an accounting system that is in conformity with generally accepted accounting principles (GAAP) and allows for the segregation and tracking of all revenues and direct costs related to the SVRP, CSIP, and SRDF. WRA funds are segregated in their own enterprise account; they are not co-mingled with wastewater or other funds managed by M1W. Within the WRA enterprise fund, expenditures are further tracked by activity (SVRP, CSIP, SRDF). These are interrelated operations that impact the cost of water, not independent services like public works vs fire services.

M1W takes no issue in WRA providing new direction related to the segregation and tracking of revenues, but M1W views this Finding as misleading given WRA funds are held in an independent, restricted account and the Agreement references best practices, not specific terms.

**Finding 5: Percent Overcharged**

GPP’s Findings ultimately stem from one topic – indirect costs. But the analysis of indirect costs hinges on one assumption – the Auditor’s legal conclusions related to Exhibit J.

M1W requested in the draft review to remove this Finding as it was presented in Finding 1. It is a restatement of previous analysis, and the only recommendation is to implement a previous recommendation.

We appreciate the additional data provided in The Reclamation Fund Misstatement within Finding 4 and referenced in Finding 5. To further clarify, M1W will meet with WRA staff to explain and review the source files. This will show the error originated from a proposed change made by M1W’s auditors to address an anticipated negative cash balance for the Reclamation Fund. While this proposal got included in the 2021 ACFR, the transfer was not made in the General Ledger because there was a positive end cash balance. The 2022 ACFR corrected the mistake in the 2021 ACFR while the General Ledger remained accurate.

**Finding 6: Weak Control Environment**

This Finding is a summation of Findings 1, 2, 3, and 4 and not a stand-alone Finding. The duplication of Findings concerns M1W that this Report was commissioned with a preconceived bias. Again, it is a restatement of previous analysis, and the only recommendation is to implement a previous recommendation.

**Finding 7: Breaches of the Agreement**

M1W believes the legal conclusions reached in this Report exceed the scope of the audit. It is widely noted the Agreement is vague. To definitively interpret the ambiguous terms without proper legal analysis is unjustifiable.

The Report also raises the lack of enforcement by WRA but doesn't conclude whether WRA waived the issues, noting:

*"Despite the tools in the Agreement that were presumably intended to encourage compliance, our audit findings suggest this has not always occurred. This may be because the WRA had previously not enforced the Agreement fully or because M1W did not respond to its enforcement efforts."*

M1W was not required to use the methodology in Exhibit J, and WRA through its inaction accepted the methodology used by M1W.

While we diverge on the assumptions and generalizations in the Report, M1W remains a committed partner in providing cooperative water solutions and will continue a close working relationship with WRA staff to ensure transparent operations.