

SEWER AUTHORITY MID-COASTSIDE  
Staff Report

---

**Subject / Title**

Receive Letter from Mayer, Hoffman and McCann (City of Half Moon Bay Special Audit) and Report on General Counsel Copeland and Possibly Take Action on Response

---

**Staff Recommendation:**

Receive Letter from Mayer, Hoffman and McCann (City of Half Moon Bay Special Audit) and Report on General Counsel Copeland and Possibly Take Action on Response

---

**Fiscal Impact:**

Unknown at this time.

---

**Discussion/Report:**

General Counsel Copeland will review his memo (attached) to Chair Fraser, regarding the City of Half Moon Bay Auditors (Mayer Hoffman McCann, P.C.), (MHM) request to SAM for printing a letter of specific statements provided by MHM, dated April 21, on SAM letterhead and signing said letter, to be returned to MHM.

General Counsel Copeland' recommendations have been conveyed to the SAM Accountants and they (Parsons Accounting) are here to comment on this matter and present their recommendation.

To: Marina Fraser, Chair  
Cc: Jeannette Tracy  
From: Jim Copeland, General Counsel  
Re: City's Audit of SAM  
Date: May 17, 2010

This memo is in response to your request that, in the absence of a Manager, I prepare a staff report for the Board regarding a report prepared by an auditor retained by the City and the auditor's request of SAM related thereto.

As I understand the facts, the City retained the services of an outside auditor, Mayer Hoffman McCann P.C. (MHM), of San Jose, California, to provide to the City a report related to certain accounting records, internal controls and fiscal policies of SAM as of 2009.

In that capacity, MHM submitted to the City its report, dated April 21, 2010, and provided SAM with a copy thereof, which is attached.

In connection with the report, MHM has submitted to SAM a draft letter which it has asked SAM to execute and return to MHM. The letter makes certain representations related to MHM's review of SAM's auditing procedures. A copy of the draft letter is attached.

Staff has placed the matter on the agenda for the Board's consideration.

The language in the form letter is in the nature of a "representation" letter, of the type that an auditor requests of its client. In our case, SAM is not the client of MHM, and SAM did not request the auditing services that have been rendered by MHM. Accordingly, I do not believe it appropriate for SAM to execute the letter as worded.

The report contains numerous comments and findings related to SAM's accounting policies and procedures. Since SAM has been recognized for the quality of its financial reporting, the Board may want to refer the report, as well as the draft representation letter, to its outside auditors and/or Mr. Parsons for their review and comment. Based upon their review and comment, the Board would then be able to determine whether to respond to the report and if so, in what manner.

If that is the decision of the Board, then the Board would defer the matter to its next meeting, and, in the interim, request that its auditors review the documents and advise the Board as to an appropriate response to the report and the representation letter for consideration by the Board at its next meeting.

CC: KA 51310 ST ✓  
CC: SAM BOWEN MAY 200 ST ✓



Mayer Hoffman McCann P.C.

An Independent CPA Firm

84 South First Street, Third Floor  
San Jose, CA 95113  
408-794-3545 ph  
408-295-3818 fx  
www.mhm-pc.com

## INDEPENDENT ACCOUNTANT'S REPORT ON APPLYING AGREED-UPON PROCEDURES

City of Half Moon Bay and  
the Sewer Authority Mid-Coastside

We have performed the procedures enumerated below, which were agreed to by the City of Half Moon Bay (City) and the Sewer Authority Mid-Coastside (Authority) (the specified parties), solely to assist with respect to the accounting records, internal controls and fiscal policies of the Sewer Authority Mid-Coastside in 2009. The Sewer Authority Mid-Coastside's management is responsible for the Authority's accounting records. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of those parties specified in the report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

Our procedures and findings are as follows:

- 1) We obtained the agreements between the City and the Sewer Authority Mid-Coastside and reviewed the Authority's Comprehensive Annual Financial Report (CAFR) and SAS 112 letter issued by the Authority's auditors to obtain an understanding of the organization's operations.

**Comments** – We reviewed the June 30, 2009 CAFR and the SAS 112 management letter issued November 16, 2009 covering the period July 1, 2008 through June 30, 2009. In our review we noted that the Authority received one material weakness finding, one significant deficiency finding, and one additional internal control recommendation in their SAS 112 letter. We discussed with management the status for mitigating these internal control deficiencies.

- Deficiency 2009-1 – Material Weakness – Capital Contributions and Restricted Net Assets – The Authority has not properly recorded and reported assessments in the appropriate classification on the statement of revenues, expenses and changes in net assets. During the year the auditors noted that the Authority was including assessments that are related to capital projects and improvements in operating revenues. In addition, the Authority was not including the amount of these assessments collected and not expended at year end as restricted net assets.
- Deficiency 2009-2 – Significant Deficiency – Capital Assets Policies – The Authority has not consistently applied the Authority's capitalization policy to purchases of capital assets. The Authority's capital asset policy states that purchases of assets in excess of \$1,000 for machinery and equipment and \$5,000 for facility and system improvements are capitalized and depreciated over the related assets estimated useful life. During the current year audit, the auditors noted that certain improvements that were above the threshold were being treated as operational expenses, which is not in accordance with the Authority's policy.
- Deficiency 2009-3 – Other Internal Control finding – Procurement Policies were not always followed. Management has taken steps to maintain documentation of written quotations.



- 2) We reviewed the Authority's accounting system and chart of accounts to determine if it is sufficient for the Authority's accounting and reporting needs.
- a) **Finding** – The Authority maintains three separate cash accounts with LAIF (account codes 112) and shows the operating reserve correctly at \$250,000; however, the capital replacement/emergency reserve fund shows \$0.00 balance at June 30, 2009. If the account code is set up to track the balances of the reserves, then the true balance of the capital replacement/emergency reserve should be recorded separately from the other unrestricted investment accounts.
  - b) **Finding** – The capital asset section of the chart of accounts (account numbers 171-191) are comprehensive, exceeding 200 account codes, and include account numbers by year for each asset capitalized starting in 1999. Since the Authority has implemented and purchased a capital asset software module, the chart of accounts is no longer required to be the method of tracking assets. In addition, the capital asset titles in the capital asset software module do not agree to the assets account code listing in the chart of accounts. The Authority should consider reconciling the capital assets listing and reduce the capital asset section of the chart of accounts to major capital asset categories such as land, buildings, improvements, etc. The detail supporting these major categories should be maintained in the subsidiary capital asset software.
  - c) **Finding** – Restricted for Capital Projects (account code 25500) is captured in one account code on the account listing. Per review of the Authority's JPA agreement, it appears that capital projects can be assigned by member agency (not allocated to all parties in accordance with their ownership percentage). For capital projects fund balances that are restricted, reporting would be improved if there was a break down by member agency showing the ownership of these restricted fund balances. The balance as of June 30, 2009 is \$2,379,050.
  - d) **Finding** – Equity classification (account code 26000) is unclear as to the ownership of the equity of the Authority and whether the amounts are designated for use such as reserves.
  - e) **Finding** – Interest revenue (account code 40910) is captured in one account code; however interest earned on reserve balances are treated differently per each reserve balance. It is unclear as to how this revenue is tracked in the account code structure and allocated out to each member agency and reserve balance.
  - f) **Finding** – The expense account codes (50000s) are not easily separated to match the reporting categories in the CAFR. The operating expenses on the CAFR are classified in five categories: treatment, collection system, industrial waste, administration, and depreciation. In reviewing the Chart of Accounts it is not clear which expense codes get classified to each category.
  - g) **Finding** – Collection assessments are generated by use of hours (see #4 for further explanation), however the account code structure in the expense account codes does not allocate the expenses for collections by member agency. It would be more transparent if an expense code was set up for each member agency to record the collection expenses they incurred, accurately.
- 3) We reviewed the Authority's budget document and process.

**Comments** – The budget is prepared by SAM's management team and submitted to the Board for approval. The process for budget preparation and review timeframe is adequate and all line items are agreed upon by the Board. The Authority uses multiple factors of assumptions when preparing the budget and should consider whether these rates are appropriate for their agency. The agency also conducts a mid-year budget review which is a standard practice. When significant increases in the budget are found during the mid-year budget review, SAM will discuss with the board the need to increase the assessments to each of the member agencies. However, if SAM finds that they will be under budget during the mid-year budget review, then they will not decrease the assessment. The extra operating assessment is refunded to the member agencies at the end of the fiscal year. Per the Authority's reserve policy, refunds on operating revenues are to be issued no later than December 31 following the close of the budget year.



4) We compared the budget for the fiscal year ended June 30, 2009 to the actual audited results.

**Comments** – In reviewing the Comprehensive Annual Financial Report for the year ended June 30, 2009, MHM compared the actual audited results to the information board packet provided to the Board for the month ended June 30, 2009.

**Findings** – The audit detected \$1,185,952 in audit adjustments during the year.

**Findings** – Amounts presented in the June 30, 2009 budget to actual schedule (which are unaudited) have the following large variances, with comparison to the audited results, as follows:

<u>Description</u>	<u>Amounts per Board Packet</u>	<u>Amounts per Audited Financial Statements</u>	<u>Difference</u>
Operating revenues	\$3,896,400	\$3,658,926	\$237,474
Capital assessments	\$527,880	\$306,812	*\$221,068
Due to member agencies	\$0.00	\$518,153	\$518,153
Depreciation expense	\$0.00	\$1,545,549	\$1,545,549
Net income (loss)	\$833,508	(\$889,906)	\$1,723,414

\* Amount is added to “due to member agencies” per an audit adjustment for the year; however, per policy capital assessments that are not spent are currently being accumulated in the capital reserve.

**Finding** – In review of the budget to actual, the amount assessed for continuing assets was approximately \$400,000 to the member agencies. Approximately \$32,000 was spent from this account with the remaining balance going to the capital reserves.

5) We reviewed and evaluated the Authority's capital and operating assessment methodology and assumptions for reasonableness. For capital assessments related to future replacement projects, we evaluated the rationale for collecting monies in advance. We compared the rationale to standard practices used by other Sewer Authorities and recommend a methodology that is more consistent with industry standards.

**Background** – The Authority receives revenues through assessments to the three member agencies it provides services to which are the City of Half Moon Bay, Granada Sanitary District, and Montara Water and Sanitary District. Assessments are determined by the budgeting process and have different inputs for calculating the required amounts. The budget for Operating and Capital is approved by the Board each spring and the assessments are allocated to each entity as follows:

- City of Half Moon Bay – 50.5%
- Granada Sanitary District – 29.5%
- Montara Water and Sanitary District – 20%

Invoices to the member agencies are broken out into six categories which make up their assessment each month.

**Administration** – administrative expenses for normal operations, allocated based on percentages above.

**Administration Capital** – administrative expenses for office areas, allocated based on percentages above.

**Treatment** – expenses for maintenance and operation of the treatment plant, allocated based on percentages above.



**Treatment Capital** – includes expenses for improvements and replacements, allocated based on percentages above. This category also includes “continuing capital cost” which is made up of expenses for future replacements and improvements.

**Collection** – assessments are based on both fixed costs (only insurance cost) and variable costs and the allocation differs each year based on the percentage of hours spent in the member agency’s collection system.

**Collection Capital** – these are specific to each district and are allocated accordingly.

**Additional Billings** – In addition to the standard assessments outlined above, the Authority bills the member agencies additional amounts for special projects during the year which included the Wet Weather Flow Management Project and allocations of the Intertie Pipeline System (IPS)/Pumpstation in 2009.

- **Findings** – The method of charging for “continuing capital assets,” which are included in the assessment for Treatment Capital assessment, does not always accurately estimate the replacement costs for assets. The continuing capital assets is determined by management to be capital assets that are included on a listing maintained by management for items to be replaced in the future. This list was established in 2005. Management has determined the amounts charged to the member agencies by a formula of current cost times a Construction Cost Index divided by the estimated useful life of the asset.

Example = Truck cost in 2009 = \$20,000 X 1.05 for 7 years - estimate useful life (index) = \$21,000. Cost allocated to assessment = \$21,000/7 = \$3,000 x % of assessment (50.5%) = \$1,515/per year

Assets that have been purchased since 2005 are included on this list and each member agency is charged for the replacement cost. If an asset is not replaced at the end of the calculated useful life, then the Authority continues to charge the rate of replacement until it is replaced. In these cases, the asset is charging more than the amount it would cost to replace it since it lasted past its original estimated useful life. Management feels that continuing to charge for these assets increases the reserves for future costs that are not included in the replacement list or expected.

The Board should be provided the support for continuing capital asset listing during the budgeting process to determine if the list is reasonable. In addition, there is no break out from the reserve as to the balances per member agency or per type of capital reserve (e.g. continuing capital assets or other capital reserves).

- 6) We obtained an understanding of how capital and operating assessments are billed and collected. We reviewed the timing between billing member agencies and spending the money. We reviewed the Authority’s procedures for tracking unspent monies.

**Comment** – The Authority bills each member agency monthly for each portion of their assessment in accordance with the budget for each year equally divided over 12 months. Monies are spent in accordance with the budget for the year. The Authority is in the process of reviewing the prior years for unspent monies and there was an audit adjustment for the year ended June 30, 2009.

- 7) We obtained an understanding of the Authority’s interest income allocation methodology and assessed whether interest is allocated to unspent capital and operating assessments from member agencies.

**Finding** – Currently, the Authority does not have an allocation policy for interest earnings; all interest, regardless of source, is defaulted to the Capital reserve fund. Management stated that Parsons Accounting has been working on reserves allocations for several months. They are now working on the analysis of interest income. The methodology they are using involves analyzing the cash balance in the Sewer Authority’s bank account since June 30, 2001 and allocating the earned interest on a



monthly basis to the member agencies in proportion to their contribution based on the excess of assessments over actual expenses. Parsons Accounting's analysis results determined interest earned over the eight year period was \$541,586 and is due to the member agencies.

- 8) We reviewed the types of reporting, adequacy of information and timing of reporting provided to the member agencies regarding monies collected, monies spent, reserves, and annual financial statements.

**Finding** – Board packets currently include the following financial information: trial balance for year to date, trial balance summary compared to budget, and a capital projects analysis. Additional information as to the reserve balances, replacement of capital listing, transactions by vendor printed from QuickBooks, and accounts payable from for the month printed from QuickBooks, could be additional beneficial information provided to the Board for their meetings.

- 9) We evaluated the Authority's capital asset records to determine how capital assets are recorded, depreciated, removed and inventoried.

a) **Finding** – The fixed asset listing does not uniquely identify a capital asset. Asset numbers were given to items, but they are not used to tie back to the asset on the trial balance or the physical asset. Multiple numbers also may be given for one asset as additions or replacements have been added with new numbers.

b) **Finding** – There are multiple assets recorded on the listing that do not meet the set capital asset thresholds per the Authority's Accounting & Financial Policies and Procedures Manual. In addition, the useful life for some assets do not agree to the Authority's policy manual (e.g. there are assets being depreciated over 75 years when the maximum for that area is 50 years). Management should review each useful life used in the calculation of depreciation expense to determine if correct. In addition, the useful life figure is also being used to determine the assessment to member agencies for continuing capital assets.

c) **Finding** – Descriptions for assets listed on the capital assets listing indicate that there are multiple assets which have been replaced or updated but are not referenced to one specific asset. When recording an asset disposal, it would be hard to determine which asset numbers to delete.

d) **Finding** – Capital Asset Listing – Asset categories do not agree to the financial statements. There is no description for easements and construction in progress on the asset detailed fixed asset listing, yet there are account numbers that are separated out in the trial balance.

e) **Finding** – Inventory – Management indicated that a full inventory was performed in the fall of 2008 when the Authority implemented the new capital asset program. Per review of the listing and discussion with the Chief Engineer, the capital assets are not tagged to identify the assets individually back to the listing. If disposal or replacement costs are incurred, the change to the asset can not be accurately identified due to similar asset descriptions and types in some cases. Management has given each asset on the list a number and should accurately tag or add identifying attributes to each asset.

f) **Finding** – Capitalization of fixed assets – Per discussion with management, past expenses have been missed when capitalizing assets. Management has changed their purchasing procedures to include a box to check at the invoice level when an expense is determined to be a capital asset. The Authority's Manager is now reviewing invoices to ensure that items are properly capitalized and included on the new listing.

g) **Finding** – The replacement reserve or "Continuing Assets" log should be included as an item to the Board; in addition, the listing should be reconciled and tied back to the capital asset listing to verify the cost of replacement and years in service are accurately recorded and the assessment to the member agencies is correct. Monies received in excess are added to the reserve for capital.



10) We reviewed the Authority's reserve policies and determine the amounts collected from member agencies for reserves.

**Background** – The Authority currently maintains three reserve funds:

- i) Operating Reserve: \$250,000 – Interest earnings on this balance are transferred to the Capital Replacement/Emergency Reserve.
  - ii) Capital Replacement/Emergency Reserve: no min/max level of reserve – Interest earned is added to this reserve.
  - iii) Connection Fee Fund: no min/max level of reserve – Interest earned is added to this reserve.
- a) **Finding** – The Board of Directors has not established a minimum or maximum reserve amount for the Capital reserves. A balance of \$2,379,050 exists as of November 2009.
  - b) **Finding** – The reserve policy is silent as to whether the agencies or the Authority should maintain the reserve balances. Since all interest is currently going to the Capital Reserve or Connection Fee Reserve, it appears to be sufficient to have the Authority maintain the reserve. However, the Authority should track these reserves my member agency and regularly report these amounts to the Board of Directors.

11) We reviewed internal controls over cash receipting, cash disbursement, payroll, capital asset accounting, and investments.

**Background** – The Authority adopted an "Accounting and Financial Policies and Procedures Manual" in November 2005. The Authority should review the procedures and determine if they are still current.

- a) Cash receipts – We reviewed the cash receipts process and determined the majority of cash receipts received by the Authority were from the member agencies. We have no recommendations in the area of cash receipting.
- b) Cash disbursements – In addition to the area noted in step one for findings by the prior auditor and the expenditures reviewed for capital assets, MHM reviewed the disbursement procedures and noted that the Authority's policies states that a detailed check report is reviewed approved for all disbursements and there is a second signature on all checks. We have no additional recommendations in the area of cash disbursements.
- c) Investments – In reviewing the procedures for wire transfers, the Supervisor has the ability to request and approve transfers from the Authority's bank accounts. It is noted that the wire request should have the SAM Manager's signature, but the ability to do both is not a proper segregation of duties.

We were not engaged to, and did not, conduct an audit, the objective of which would be the expression of an opinion, on the accounting records. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of City of Half Moon Bay and the Sewer Authority Mid-Coastside and is not intended to be and should not be used by anyone other than those specified parties.

*Mayer Hoffman McLennan P.C.*

[Responsible Party's Letterhead]

April 21, 2010

Mayer Hoffman McCann PC  
84 South First Street, 3<sup>rd</sup> Floor  
San Jose, CA 95113

In connection with your engagement to apply agreed-upon auditing procedures to the Sewer Authority Mid-Coastside (Authority) as of the month of December 2009, we confirm, to the best of our knowledge and belief, the following representations made to you during your engagement.

- 1) We are responsible for the presentation of the internal controls and fiscal policies in accordance with attestation standards established by the American Institute of Certified Public Accountants.
- 2) As of April 21, 2010, the items listed in the agreed-upon procedures report is presented in accordance with the attestation standards established by the American Institute of Certified Public Accountants.
- 3) We are responsible for selecting the criteria and for determining that such criteria are appropriate for our purposes.
- 4) We have disclosed to you all known matters contradicting the internal control and fiscal policies.
- 5) There have been no communications from regulatory agencies, internal auditors, and other independent practitioners or consultants relating to internal controls and fiscal policies described in the engagement letter, including communications received between September 16, 2009 and April 21, 2010.
- 6) We have made available to you all information that we believe is relevant to the agreed upon procedures internal control and fiscal policies.
- 7) We have responded fully to all inquiries made to us by you during the engagement.
- 8) No events have occurred subsequent to April 21, 2010 that would require adjustment to or modification of the agreed-upon procedures report.
- 9) Your report is intended solely for the information and use of Sewer Authority Mid-Coastside management and its member agencies and is not intended to be and should not be used by anyone other than those specified parties.

Signature:

Title: