



September 25, 2003

Hon. Michael T. Garcia, Presiding Judge
Sacramento Superior Court
720 Ninth Street, Department 47
Sacramento, CA 95814

Subject: -2002 2003 Sacramento County Grand Jury Final Report, Issued June 25, 2003

Dear Honorable Judge Garcia,

Fair Oaks Water District (FOWD or the district) appreciated the opportunity to review the 2002 - 2003 Sacramento County Grand Jury Final Report prior to its release on June 27, 2003. Further, we welcome the grand jury requests and appreciated the effort by the grand jury to personally visit FOWD's staff during the investigation. Per the Grand Jury's request, FOWD is providing you a written response to each report recommendation by September 30, 2003.

Background Facts: Fair Oaks Water District

In January 2003, FOWD received a written request for financial information from the Sacramento County Grand Jury. The District provided complete information February 12, 2003. Additionally, the District offered to respond to any inquiry or to clarify any information reviewed. The Grand Jury availed themselves of this opportunity and made a personal visit with the general manager of FOWD on March 11, 2003 to answer further inquiries.

On June 25, 2003, the District received a hand delivered copy of the Sacramento County Grand Jury Final Report ("Grand Jury Report"), citing its release would be on June 27, at 12:00 p.m., 2003. On June 25, 2003, prior to the official release of the report, FOWD phoned the Grand Jury's office to communicate corrections of factual information that were misstated in the grand jury report. Additionally, a letter was faxed to the Grand Jury office on June 25, 2003 outlining errors in factual information presented in the Grand Jury Report. FOWD had requested a correction of these facts prior to the reports final release.

The following information is designed to correct or augment some of the facts as written in the Grand Jury Report.

1. The general manager's annual salary is overstated. The correct figures were supplied with an explanation of taxable fringe benefits which are included as income for income tax purposes, but not ordinarily considered annual salary for comparison purposes.
2. The travel receipts and expense reports are reviewed, not audited by the general manager, accounts payable and the controller. "Audit" implies an independence that is currently not obtained in this level review, since internal employees conduct this review. The travel receipts and expense reports are internally reviewed for compliance

to policies and any proper approvals. Additionally, these documents are available to the external auditors in the annual audit process.

3. As part of FOWD's mission to provide leadership in the community and in regional water activities, board members serve as committee members on various water associations to maintain water industry knowledge. This knowledge serves our customers as the district can employ progressive water practices, instead of reactive water practices. The goal is to serve our customers more effectively which requires training, education and involvement in the community. FOWD believes the investment in knowledge directly benefits FOWD customers.
4. The district Controller reviews all travel expense claim forms, but does not audit them. They are also reviewed by the individual's respective supervisor for appropriateness and authorization. Again, audits can only be conducted by an internal or external audit function. FOWD's organizational size does not warrant an internal audit position. The district is subject to an annual independent audit and all records are made available for audit.
5. District managers are expected to complete all necessary duties and DO regularly work more than 40 hours per week to complete these duties. However, they are not entitled to any overtime pay compensation for these additional hours as they are considered exempt employees.

The remainder of this response will specifically address the Grand Jury's findings and recommendations.

Finding #1: *District directors on the whole do not have financial or accounting backgrounds. They rely on their audit reports to ensure that their district's operation is fiscally sound.*

Response: This statement is generally true, but may be too broadly stated. As exceptions to this statement, FOWD has one board member with finance and accounting education and experience who understands detailed and technical financial issues very well. Further, several FOWD board members are employed at the executive level and thus comprehend fiscal matters quite well. Additionally, there are numerous practices FOWD employs to educate its board on financial matters. The district provides monthly financial statements to its board members for review purposes that provide opportunities for the board to ask questions and raise issues. Other information provided to the board includes a monthly check register detailing the monthly expenses paid and a monthly cash flow overview, providing information regarding cash received and payments made. FOWD staff periodically holds board workshops to review budget versus actual results and provide information on financial practices of the district, including the latest trends and developments. Staff reviews current cash flows as well as future expected cash flows for up to five years so that the board can be apprised of the district's financial position. Lastly, FOWD conducts an extensive public outreach process before adopting its budgets and water rates. This process spells out district needs and invites customer input about priorities, business practices and a host of financial issues.

Recommendation #1(a), *The district should provide to auditors all district policies and procedures before an audit is performed. Auditors should verify that all disbursements made during the year comply with the district's procedures. The audit should include a random sampling of travel expense reports, including credit card usage.*

Response: FOWD concurs with this recommendation generally, with these caveats:

1. FOWD provides all district policies and procedures before an audit is performed. FOWD also answers additional internal control questionnaires provided by the auditors. The auditors review all board meeting minutes since the last annual audit to determine what items affecting the audit, including policies, may have been changed or been adopted during the year under audit.
2. The purpose of an audit is not to verify that all disbursements made during the year comply with the district's procedures. Implementing this recommendation, as explicitly written, is in conflict with current established audit procedures set out by Generally Accepted Audit Standards issued by the American Institute of Certified Public Accountants and Government Auditing Standards issued by the Comptroller General of the United States. Those standards require that auditors plan and perform audits to obtain reasonable assurance about whether financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.
3. The recommendation to verify all disbursements is essentially recreating the financial records independently of the district. The cost to FOWD rate payers would dramatically increase at billing rates that range from \$70 per hour for junior accountants to up to \$225 per hour for partner level accountants for local and regional audit firms and from \$275 to \$550 per hour for larger firms. Rate payers could expect to pay in the hundreds of thousands of dollars annually for this type of service. To understand the magnitude of this recommendation, FOWD has anywhere from 13,000 to 17,250 general ledger entries annually related to disbursements which will result in hundreds if not thousands of hours of audit time if this recommendation were followed.
4. FOWD agrees with the recommendation that the audit could potentially include a random sampling of travel expense reports, including credit card usage. However, Generally Accepted Audit Standards dictate the audit testing and process and does not specify what must be tested. The auditors may select samples, such as travel expense reports, depending upon audit risk assessment, exposure and materiality of these costs to the overall financial results and operations of the district. FOWD has always made its records available to auditors for their audit purposes and will continue to do so in the future.

Recommendation #1b. *The Sacramento County Director of Finance should schedule regular, selective reviews of district audit reports for completeness and financial impact on ratepayers, and report any anomalies to the respective water district board of directors.*

Response: FOWD concurs with this recommendation with the following caveats:

1. FOWD welcomes a review of the Sacramento County Director of Finance of the district audit report for completeness. FOWD currently submits its audited financial statements to the County of Sacramento Department of Finance, Auditor controller on an annual basis. The most recent annual financial statements were submitted on June 19, 2003 for the year ending December 31, 2002.
2. In January 2003, FOWD was recognized by the Government Finance Officers Association of the United States and Canada (GFOA) for its comprehensive annual financial report for the year ending December 31, 2001. FOWD was awarded the Certificate of Achievement for Excellence in Financial Reporting, the highest form of recognition in the area of governmental accounting and financial reporting. FOWD has again applied for this due diligence review for the December 31, 2002 financial statements. Additionally, FOWD implemented Governmental Accounting Standards Board Statement 34, Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments for the year ended December 31, 2002, prior to the required implementation date of December 31, 2004. This accounting standard required new reporting formats and new disclosure information designed to provide enhanced supplementary information to the users of the financial statements.
3. The audit report's management discussion and analysis and letter of transmittal provide some proscribed information regarding the financial impact on ratepayers. More detailed and thoughtful financial impact to ratepayers can be obtained from FOWD's bi-annual budget documents. Both the adopted budget and the audit report are integral components to understanding historical and perspective financial activities and results of the district.

Recommendation #1c. *The California State Government Code Section 2609 should be amended to eliminate Section 2609(f) providing audits to be performed less frequently than once a year. The code should require all districts to perform annual audits.*

Response: We concur with this recommendation as we conduct annual audits routinely.

Recommendation #1d. *The California State Legislature should enact a statute requiring the State Controller to independently verify accuracy and completeness of district audits.*

Response: FOWD does not concur with this recommendation:

1. FOWD welcomes the State Controller's involvement in independently verifying the accuracy and completeness of FOWD's audit. However, we doubt the State Controller has the resources or interest in performing this service for each special district and political jurisdiction in the state. This well intentioned recommendation is simply not

practical. FOWD currently submits financial information in the State Controllers' report, including the audit report and a special districts financial transactions report as required by the State Controllers' office.

2. Essentially, the grand jury is recommending three separate audits of special districts, all of which audit the same financial information and have similar objectives:
 - An independent audit by a private audit firm;
 - A selective audit by the County of Sacramento, and
 - An audit by the State Controller's office.

At what point does the audit process become redundant and too costly? Do ratepayers receive any greater benefit by triple auditing financial records of the districts? Aside from the direct cost of performing these audits, a significant amount of increased administrative staff will be needed to manage the recommended audits, so the full cost of this recommendation will likely be astronomical, locally and statewide. Perhaps the recommendation should be for the State Controller's office to make selective reviews of audited information.

Recommendation #2. *Auditors should confirm water district's compliance with IRS rules, that all income is being reported, that boards actively oversee payments to management, and that all financial records are maintained for at least five years.*

Response: We concur with portions of this recommendation.

1. Auditors may test for compliance with governmental rules affecting financial transactions, including the IRS for some of the following reasons:
 - If they become aware of compliance issues;
 - The information tested is considered material to the overall financial statements; and/or
 - The transactions or information is considered a high risk as a result of the auditor's risk assessment.

However, it is management's ultimate responsibility to ensure compliance.

2. The generally accepted audit opinion clearly states that the financial statements are the responsibility of the district's management, not the auditors. The responsibility includes compliance with governmental rules affecting financial transactions.
3. Requiring that all income be confirmed by auditors is again in contradiction with auditing standards generally accepted in the United States of America and the Government Auditing Standards. See response to Recommendation #1 a., item 3 for additional discussion. Income transactions subject to audit could range from 13,500 to 81,000 in future years.

4. We concur that boards should actively oversee payments to management.
5. We concur with the recommendation that all financial records should be maintained for at least five years. FOWD maintains its financial records for a period of seven years and payroll records are maintained in accordance with various Federal and State laws. Record retention thus varies from a few years to indefinitely, depending on the type of record.
6. The State of California Business and Professions Code Section 5097 requires audit documentation must be retained for a minimum of seven years and must be retained longer if required by professional standards or during a pending investigation from the State Board of Accountancy. It would seem prudent to recommend public agencies to retain financial records for at least seven years to mirror these rules.

Recommendation #3. *In an effort to obtain a thorough and professional annual audit, auditors should be changed every three years.*

Response: We do not fully concur with this recommendation.

1. We do concur a district should receive a thorough and professional audit annually.
2. Changing auditors every three years does not ensure a thorough and professional annual audit. In fact, it often will take auditors at least two annual audits before they fully understand the operations and financial specifics of an organization. Professionalism of an audit is determined by the quality of the audit firm selected, the depth of experience in the area of audit, the training the audit firm provides to its audit staff, their recognized expertise in particular areas, and the their recognized leadership among their peers.
3. The Sarbanes-Oxley Act of 2002 applies to public companies. Section 203 of this act requires the lead audit or coordinating partner and the reviewing partner must rotate off of the audit every five years, but does not state that the audit firm must be rotated off every five years.
4. The Government Finance Officers Association (GFOA) is the professional association of state and local finance officers in the United States and Canada, and has served the public finance profession since 1906. FOWD's controller is a member of the GFOA. GFOA members are dedicated to the sound management of government financial resources. The GFOA espouses the position that governmental entities should periodically undertake a full-scale competitive process for the selection of independent auditors, consistent with applicable legal requirements. This process should actively seek the participation of all qualified firms, including the current auditors assuming that the past performance of the current auditors has proven satisfactory.
5. Rotating auditors does have some merit as it can minimize a 'too comfortable' relationship between management and the audit team. However, this relationship is often mitigated in practice as new junior auditors are brought annually to the FOWD

audit engagement. Additionally, the auditors could report to an audit committee of the Board, largely independent of financial management in order to have open dialogue regarding any issues they may observe. Auditors then present the audit report and an annual summary and findings to the Board upon completion of the engagement.

6. If rotating auditors is a mandatory recommendation, a seven year rotation would be more reasonable and allow the auditors a few years with the reviewing records in order to understand the operations and financial results. This auditor knowledge will benefit the rate payers by allowing the auditors a more comprehensive understanding of areas of concern or risk to the financial records.

Recommendation #4. *To increase public awareness of district activities and to provide easy access to this information, public water districts should establish and maintain a Web site with links to their audit report, district travel policies and travel expenses.*

Response: We concur with this recommendation.

1. FOWD currently maintains its' annual audit report as well as previous year's audit report on it's website at www.fowd.com, listed under publications.
2. The district is currently planning to add policies to its website, including the travel and travel expense policy. These policies are currently made available to the public whenever requested.

Recommendation #5. *Notices of public hearings for rate increases should be clear and concise enabling customers to understand easily the reasons and justifications for such increases.*

Response: We concur with this recommendation and have done so since 1998.

1. FOWD has provided notices to its customer base in the form of a "President's Letter" for its public hearings for rate increases for November 17, 1998, November 4, 1999, and November 7, 2001. The rate hearings for 1999 and 2001 represented two complete budget years, encompassing calendar year 2000 and 2001 and then calendar years 2002 and 2003. FOWD is currently in the process of notifying its customer base for the budget calendar years 2004 and 2005.
2. FOWD also provides workshops for the public to review the budget details, understand the reasons behind rate adjustments, and to ask questions and offer suggestions. This workshop information is included in the public hearing notices.
3. Additionally, FOWD has included additional mailing stuffers in water bills and information in the semi-annual newsletter regarding the rate increases and reasons for them.

Finding #2: *The Grand Jury finds that an electorate, kept unaware by a district that fails to "give light" to its actions, cannot properly evaluate the performance of district personnel. These voters elect boards to oversee the operation of the district. The board in turn hires a general manager to manage the district. It is the close*

relationship between the board and the general manager that has potential for misuse of district funds. We find that the use of district credit cards may enable the misuse of district funds; however, it is the culture within the district that permits the abuse. District managers and board members should be aware of what is and what is not proper. Golf at district expense is not proper. Expensive restaurant meals charged to the district is not proper. Increasing the retirement benefits to a level primarily give to public safety personnel to benefit a retiring general manager is not proper.

Response: This statement is generally true for some districts. There are specific actions and processes FOWD implements on a routine basis to mitigate some of the effects of the above statement.

...an electorate kept unaware: FOWD has always conducted its business openly and publicly. FOWD has made its financial records available publicly. Additionally, FOWD's budget practices and rate increase process have been an open and public process, providing substantial detail to customers who seek to avail themselves of this information. FOWD notifies customers about these processes using several communications methods (website, direct letters, mailing stuffers, brochures). FOWD has always given light to its actions at its monthly board meetings.

...It is the close relationship between the board and the general manager that has potential for misuse of district funds: We agree that close relationships between the board and the general manager or other individuals has the "potential" for misuse of district funds. However, close board/management relationships do not automatically create a "potential" for misuse of district funds. Board members take an oath of office to serve the district's interests and management has a similar charge which is not changed by virtue of a close relationship. Properly designed internal control procedures and well designed policies and practices help create a deterrent for misuse of district funds. FOWD employs numerous internal control procedures designed to ensure proper use of district funds. Segregation of duties exists for purchasing, approving, signing of checks, and reconciling accounting information. Expense and budget policies established by the board also provide for review opportunities by the board for expenditures. Additionally, the FOWD board is provided with financial reports on a monthly basis in the board agenda package for their review or the public's review.

...We find that the use of district credit cards may enable the misuse of district funds; however, it is the culture within the district that permits the abuse: We concur that organizational culture can permit abuse. We do not believe the use of credit cards is the "problem". In fact, the use of district issued credit cards within defined credit card policies and procedures allow an entity to operate much more effectively and efficiently in certain circumstances. FOWD uses credit cards as a payment method for district related expenses. To minimize cost and maximize internal controls, FOWD uses the California State sponsored Cal-Card program.

The authority to make purchases or expenses comes from the adopted budget documents and from established policies. The use of credit cards still must follow the districts expense policy and budget plan. A credit card facilitates some of the following benefits to the FOWD rate payers:

- Allows the district to delay cash payments by up to 60 days versus typical 30 day payment cycle;

- Avoids construction crew work stoppage due to part or supply shortages with no timely access to funds to pay for the necessary supplies;
- Allows coordination of travel and training at more favorable rates since reservation booking these can be centrally coordinated versus relying on individuals booking their own reservations because they have to use their personal credit cards; and
- Reduces the number of checks to pay for invoices.

...District managers and board members should be aware of what is and what is not proper. Golf at district expense is not proper. Expensive restaurant meals charged to the district is not proper. Increasing the retirement benefits to a level primarily given to public safety personnel to benefit a retiring general manager is not proper: Since 1996, FOWD has been on a plan to increase productivity, provide superior customer service, thoughtfully plan financial resources over five to fifteen year time horizons, to reach out to customers using progressive communication ideas, use incentive based pay systems, and employ non-bureaucratic techniques and processes to get more work done more effectively. The district has invested heavily in training its employees and board members and reinvented its culture so that it may serve the customer base more effectively and efficiently. FOWD's productivity statistics and customer satisfaction have increased dramatically, accomplishing more work with the same or fewer resources.

Despite our work productivity success, the success we have had in building regional alliances and in obtaining millions of dollars in external funding, we have re-evaluated the appropriateness of golf and have discontinued this as a business practice. Though golf is an expected and understood part of business relationship building, the practice seems to suggest fiscal irresponsibility in public agencies, especially in light of recent events in the Sacramento region. Golf related expenses have been voluntarily reimbursed by the directors and managers for the last two years.

FOWD agrees that excessively expensive meals are not proper. FOWD is in the process of reviewing the reasonableness of its travel and expense policies through a citizen's advisory committee. The current travel and expense policy allows for daily federal per diem rates or actual expenses, not both. Most likely this policy will be modified to a daily per diem rate or dollar limit, but the actual policy development is still in progress.

FOWD did not change its staff retirement benefits to a level primarily given to public safety officers. Additionally, FOWD board members do not receive retirement benefits.

Recommendation #2a. *These practices should stop immediately.*

Response: We concur with this recommendation.

Recommendation #2b. *Expenses submitted for reimbursement or charges on district credit cards that exceed California State per diem allowances or that do not fall within permitted district expense policies should be disallowed, published on the district's Web site and discussed at the next board meeting.*

Response: We concur with this recommendation with caveats:

1. As previously stated, FOWD is currently in a committee process to review and recommend changes to our travel and expense policy. We are committed to customer input on 'reasonableness' in this area. As part of its current travel and expense policy, the district has used Federal per diem allowances published by the Internal Revenue Service. These rates are more reflective of the true current costs of restaurant meals while traveling.
2. Expenses that do not fall within permitted district expense policies have historically and are currently disallowed. We agree that publishing the district expense policies on the website is a good idea and plan on implementing this suggestion by December 31, 2003, depending upon the committee results.

Finding #3. *Some written practices and policies, which vary from district to district, may be outdated.*

Response: We generally concur with this finding.

1. FOWD is in continual review of its policies and practices. In fact, many policies have been modified numerous times since 1996 as noted by the Grand Jury Report.
2. Staffing and resources are often the only real challenge in accomplishing this goal. Currently, the district has about 60 policies. Additionally, there are several new policy ideas that have been identified and will be developed over the next twelve to eighteen months.
3. FOWD believes an every three year review of policies may be a more realistic working solution.
4. There are policies within FOWD that need current revisions and are slated for review over the next three years.
5. District practices are derived from policy. These practices are modified on an as needed basis when situations or regulations change. District staff is responsible for establishing and carrying out practices which fulfill policy objectives.

Recommendation #3. *Each district general manager and board of directors should review and update bi-annually practices and policies.*

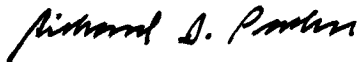
Response: We concur with this recommendation.

1. Staffing and resources are often the only real challenge in accomplishing this goal. Currently, FOWD has about 60 documented policies. Additionally, there are several new policy ideas that have been identified and will be developed over the next twelve to eighteen months. FOWD believes an every three year review of policies may be a more realistic working solution.
2. FOWD is in continual review of its policy and practices through out the last six years. In fact, many policies have been modified numerous times since 1996 as noted by the Grand Jury Report.

3. There are policies within FOWD that need current revisions and are slated for review over the next three years. District practices are derived from policy. These practices are modified on an as needed basis when situations or regulations change. District staff is responsible for establishing and carrying out practices which fulfill policy objectives.

Again, we welcome the oversight of the Grand Jury and appreciate the opportunity to respond to your report and recommendations. If you have any questions, or concerns regarding the information we provided, we welcome your feedback and dialogue. We would be happy to meet with you to discuss some of the ideas and recommendations in more detail.

Sincerely,
FAIR OAKS WATER DISTRICT



Richard D. Plecker, PE
General Manager
by Direction of the Board of Directors

RDP:NK:dg

cc: Mark Norris, Director of Finance for the County-Clerk Recorder Division;
Sacramento County Grand Jury, Attention: Michelle Park;
Honorable Debra Ortiz, California State Senator
Fair Oaks Water District Board of Directors; Fair Oaks Water District Controller