

Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards

Independent Auditor's Report

To the Board of Directors
Eastern Municipal Water District
Perris, California

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the business-type activities of Eastern Municipal Water District (the District), as of and for the year ended June 30, 2019, and the related notes to the financial statements, which collectively comprise the District's basic financial statements, and have issued our report thereon dated November 13, 2019.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the District's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the District's internal control. Accordingly, we do not express an opinion on the effectiveness of the District's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. We did identify a deficiency in internal control, described below that we consider to be a significant deficiency.

(1) Construction in Progress

During our audit, we noted two projects classified as construction in progress that should have been removed from that classification as of June 30, 2019. One project was completed in 2018 and placed into service during the fiscal year ended June 30, 2019. The District recorded a material audit adjustment to move this project out of

construction in progress. The other project is unapplied capitalized interest accumulated from prior years. Due to the change in accounting for capitalized interest, the project should be closed and applied to specific projects that incurred those costs in prior periods. Auditing standards require the auditors to include an internal control recommendation when material audit adjustments are detected during the audit process.

Recommendation

We recommend management move completed projects out of construction in progress when they are substantially complete and begin accounting for depreciation.

Management Response

A. Move Completed Projects Out of Construction in Progress

It is the District's practice to move construction projects out of construction in progress into capital assets when they are substantially complete. Depreciation on these assets start in the fiscal year they are capitalized.

The District has three types of constructions projects: Specification Construction Projects, Operations and Maintenance Department Projects and Developer Projects. The process to track and close these projects are different, as summarized below:

1. Developer Projects start in the Development Services Department and are tracked by Service Order (SO), Work Order (WO) or Construction Order (CO), depending on the type of work to be performed. Finance is notified of SO closures electronically by the Development Services Department; WO closures through a Project Closure Form received from various departments; and CO closures through a Project Closure Form received from the Inspection Department. When closure notifications are received, the Finance Department moves the project from construction in progress to capital asset and begins depreciating the asset.
2. Specification Construction Projects (Spec Jobs) are awarded through the bid process and administered by the District. The timeline for completion of these projects can range from several months to several years. To determine if a project is substantially complete, Finance reviews the most recent "Periodic Estimate for Partial Payment" or "Pay Estimate" prepared by the Construction Administration Representatives (CARS). When the Pay Estimate indicates that a project is substantially complete, the Finance Department moves the project from construction in progress to capital asset and begins depreciating the asset.
3. Other Capital Projects include projects not awarded through the bid process. These are closed based on the Quarterly Project Status Report prepared by the Finance Department. These quarterly reports are forwarded to department managers and project engineers with a request to review and notify the Finance Department of completed projects. When closure notifications are received, the Finance Department moves the project from construction in progress to capital asset and begins depreciating the asset.

The material adjustment mentioned above as an audit deficiency, was a category three project noted above. The project was substantially completed as of June 30, 2019, but not capitalized.

At year-end, as a double check for departments that may not have sent in the proper closure forms, the Finance Department generates and distributes the Quarterly Open Project Status Reports to department managers and project engineers. These status reports include all projects that are considered inactive (no costs have been charged to the project in the preceding twelve months). Finance requests that department managers and engineers review the list and advise of projects that are complete and ready to close. The particular project in question was substantially complete but was not included on the status report because there were minimal costs charged in the first month of the preceding twelve months. Since the project was not caught during this review, nor was a closure form submitted, the Finance department was not aware the project was completed and therefore remained in Construction in Progress.

To address these deficiencies, District staff will:

Draft and formalize a uniform, District-wide and enforceable project closure policy and procedure that will require Development, Engineering and Operations & Maintenance Departments to provide the Finance Department timely project closure notifications when projects are substantially complete. The process will include the following:

- a. New staff orientation and regular training updates for current staff.
- b. Developer project tracking and closure notifications led by the Development Services Group.
- c. Regular review and closure of open PARS (this will include the closure of OFA items.)
- d. Require and enforce engineers and project managers to regularly update the Project Plus application.
- e. Require departments to provide Finance a monthly or quarterly report of substantially completed projects.
- f. Adopt a policy of closing work orders that are a year old.
- g. For the long-term, manage projects in a more integrated manner by implementing a Project Module as part of an ERP system whereby one system is utilized by all departments for project reporting.

B. Unapplied Capitalized Interest

The District early implemented GASB Statement No. 89, "Accounting for Interest Cost Incurred Before the End of a Construction Period", in Fiscal Year 2018. The unapplied capitalized interest referred to above, which is immaterial to the Financial Statements, is a result of a change in the method of calculation and application of capitalized interest in fiscal year 2013. The unapplied capitalized interest is not tied to a particular capital project and will be adjusted in fiscal year 2020.

The District's responses were not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the District's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

A handwritten signature in blue ink that reads "Davis Fan" followed by a stylized flourish.

Irvine, California
November 13, 2019