

## Memorandum

To: Board of Water Commissioners Finance Committee, Detroit Water and Sewer Department

From: Joe Heffernan and Tim St. Andrew

Subject: Summary of audit observations and comments

Date: July 11, 2017

CC: Gary Brown and Marcus Hudson

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We have recently completed our audit of the City of Detroit, which included the Water Fund and Sewer Fund as Enterprise funds of the City. As part of that audit, we have communicated relevant matters to those charged with governance of the City. With the issuance of the separate Water Fund and Sewer Fund financial statements, we felt it appropriate to summarize the information contained in those communications that are relevant to the Detroit Water and Sewer Department.

Below is a summarized discussion of the observations and comments that are contained in our formal communications to the City of Detroit (note that the finding numbers refer to the more comprehensive discussion to be found in the City's Report on Internal Control and Compliance). For a more complete understanding, we would refer you to those original documents. However, the two of us are available to discuss these concepts with the Board of Water Commissioners at its convenience.

It is important to understand that due to the financial environment in place, DWSD is reliant on certain accounting procedures and controls of the City, as well as GLWA. We include all such matters here, because we feel that in your oversight role, it is important to focus on all internal control issues that impact DWSD.

## Internal Control Matters

<b>Finding No.</b>	2016-001
<b>Finding Type</b>	Material Weakness
<b>Finding</b>	DWSD should have a process in place to ensure proper recording and reconciling of general ledger activity throughout the year as well as identification and recording of all year-end closing entries in accordance with generally accepted accounting principles (GAAP) prior to the commencement of the audit. DWSD's general ledger and underlying financial records were not reconciled and closed in a timely manner.

<b>Finding No.</b>	2016-002
<b>Finding Type</b>	Material Weakness
<b>Finding</b>	There should be a procedure in place to reconcile bank activity on a timely basis and to ensure cash balances are properly stated as of the end of the year. In addition, the City should ensure its listing of accounts with financial institutions is updated timely and access rights related to online banking are reviewed and updated as employee status changes are made. DWSD did not have procedures in place to ensure all bank accounts were fully reconciled to the general ledger on a timely basis.
<b>Finding No.</b>	2016-003
<b>Finding Type</b>	Material Weakness
<b>Finding</b>	There should be a documented process in place to ensure that the City has proper segregation of duties and approval processes in place related to certain employee-related cash disbursements. During our audit, we noted that there was a lack of adequately documented, segregated and implemented controls over processes related to wage changes and approvals, and employee termination payments.
<b>Finding No.</b>	2016-005
<b>Finding Type</b>	Material Weakness
<b>Finding</b>	The City of Detroit/DWSD relies on multiple third party service providers to process transactions, including workers compensation, IT hosting services, payroll processing, and self-insurance claims processes. When an entity outsources tasks or functions to a third party service organization, the user organization, in this case the City, needs to monitor risks associated with outsourcing, particularly risks related to how the service organization performs the tasks or functions and how that may affect the user entity's compliance with requirements. The City did not have processes in place to assess and validate controls in place at third party service providers.
<b>Finding No.</b>	2016-007
<b>Finding Type</b>	Material Weakness
<b>Finding</b>	The City should ensure general controls related to user access of information technology are operating effectively. The City did not have processes in place to ensure user access to the financial application systems was reviewed to ensure appropriate access rights were granted and limited to user needs and changes in access were made as user roles changed.
<b>Finding No.</b>	2016-008
<b>Finding Type</b>	Significant Deficiency
<b>Finding</b>	The City should have controls in place to ensure that adjustments to individual customer accounts in the utility billing system are appropriate and documented as reviewed by a second person. We identified two customers whose drainage charges were modified in the utility billing system, and we did not observe any documented procedure for a second person to review and approve these changes. In one of the instances, we did not note any documentation supporting the change or explaining why the change was being made.



## Audit Observations

### ***Qualitative Aspects of Accounting Practices***

#### *Bifurcation Uncertainties*

On January 1, 2016, the City of Detroit effectuated a lease agreement with the Great Lakes Water Authority for the regional water and sewer system for the term of 40 years, to be extended automatically to coincide with the final maturity of any bonds issued to finance improvements to the regional or local water and sewer systems. The agreement and a corresponding lease of the regional water and sewer system collectively provide for an annual lease payment of \$50 million in exchange for a leasehold interest in certain assets of the Systems' held by the Funds as of December 31, 2015, assignment of all revenue of the regional and local water and sewer systems and the assumption of all DWSD bonded debt and certain liabilities.

DWSD has been in negotiations with the Great Lakes Water Authority since February 2016 regarding a multitude of open items related to the January 1, 2016 bifurcation of DWSD. These items include the following:

- Establishment of responsibility for certain assets and impaired assets
- Allocation of debt service responsibilities and initial cash balances
- Clarification and interpretation of certain aspects of the lease
- Allocation of certain other liabilities (e.g., pensions, OPEB, etc.)

In concert with the bifurcation, DWSD finance has made certain assumptions regarding the above items. Due to the current status of negotiations, all of these items could cause DWSD to make an adjustment to the accounting currently being used in the June 30, 2016 financial statements.

#### *Other Accounting Estimates*

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected.

Estimate	Basis for Estimate
Accrued claims and judgments	The estimated probable loss that will result from ongoing litigation involving general and automobile claims
Accrued workers' compensation	An actuarial report prepared by an independent third party. The report was based on certain assumptions pertaining to actual loss development patterns which are augmented with industry benchmark loss development patterns.
Allowance for doubtful accounts	Management's analysis of accounts receivable for water and sewer billings that are unlikely to be collected by DWSD

Net pension liability, deferred inflows and outflows, and pension expense	Independent third-party actuary services. These valuations are based on certain assumptions pertaining to mortality, expected returns on plan assets, and future contributions from the City/DWSD.
ARC to the pension plans	Independent third-party actuary services. These valuations are based on certain assumptions pertaining to mortality, expected returns on plan assets, funding methodologies, and other assumptions.

We evaluated the key factors and assumptions used to develop the estimates above in determining that they are reasonable in relation to the financial statements taken as a whole.

Certain financial statement disclosures are particularly sensitive because of their significance to financial statement users. The most sensitive disclosures affecting the financial statements were the long-term obligation disclosures included in Note 6, Note 7, and Note 8, the risk management disclosures in Note 9, the pension disclosures in Note 10, the bifurcation uncertainties disclosures in Note 15, and the subsequent event disclosures in Note 16.

We would like to take this opportunity to thank DWSD's staff for the cooperation and courtesy extended to us during our audit. Their assistance and professionalism are invaluable. We welcome any questions you may have regarding the following communications and we would be willing to discuss any of these or other questions that you might have at your convenience.