



CITY OF RENO
AUDIT REPORT

SEWER FUND INTERNAL CONTROLS
DECEMBER 2019

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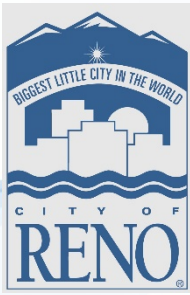
Objectives

The audit objectives include an assessment review designed to assess the probability of a fraudulent event occurring within the organization for key employees managing sewer fund processes and also to test expenditure compliance. Specifically, objectives include:

- To ensure the accounting department is adequately staffed to provide for proper segregation of duties;
- To ensure shared responsibilities have been established and to review whether key employees have taken time off from the workplace;
- To evaluate the process for pre-employment background checks for key employees and determine if policies exist to re-run checks when employees are promoted into a key position or after a predetermined amount of time has elapsed;
- To determine if sewer fund expenditures are reasonable and in compliance with established policies;
- To evaluate the risk of fraud, waste, and abuse relative to the audit objectives.

Internal Audit Mission Statement

To provide the City of Reno with an independent appraisal function designed to assist the Reno City Council, citizens, and City management in establishing accountability, transparency, and a culture of continuous improvement in City operations.



Executive Summary

Sewer Fund Internal Controls Audit

Purpose of Audit

To review management of the Sewer Fund in the following ways: determine if there are adequate internal controls regarding key employees managing the Sewer Fund including appropriate segregation of duties, the vetting and oversight process, and preventative transaction controls. Also, to determine if a sample selection of Sewer Fund expenditures is reasonable and in compliance with state law and established policies.

Audit Recommendations

Recommendations include:

- ✧ A policy determination be made regarding the types of expenditures that are necessary and reasonable expenses from the Sewer Fund Operation and Maintenance account.
- ✧ Consideration of additional oversight procedures regarding key finance employees with managerial duties of the Sewer Fund.
- ✧ Documentation of the agreed-upon capital outlay split percentage for TMWRF in the next iteration of the Reno-Sparks-TMWRF Agreement.

Detailed recommendations are included in the body of the report for each of the five audit findings. Departmental management agrees with four of the five recommendations and departmental actions are being taken for the four findings. The remaining finding requires a determination of City policy moving forward.

KEY FINDINGS

- ✧ Noted three expenditures were not specifically for operations & maintenance (O&M) needs and were approved and expensed from the Sewer Fund O&M account, an Enterprise Fund with restrictions as detailed in NRS 354.517 and City policies.
- ✧ The likelihood of a fraudulent event occurring could be mitigated by the implementation of additional management oversight policies.
- ✧ The ownership split of capital costs at Truckee Meadows Wastewater Reclamation Facility (TMWRF) is not clear as it is not documented in the most current Reno-Sparks-TMWRF Agreement.

BACKGROUND

The Sewer Enterprise Funds include an Operation & Maintenance and a Capital Projects account. An Enterprise Fund, as defined by NRS 354.517, is a proprietary fund reserved for specific purposes. These purposes are further detailed in the Reno Municipal Code and an internal financial policy.

Sewer Funds are managed by Finance staff via the financial software and legacy software termed *Automated Sewer Quote*. The system was unable to produce useful reports for audit testing. A replacement system, *Reno Sewer Quote*, is currently being developed by IT and is planned to have similar functionality and include additional items to assist with modern business practices. These additional functionalities should aid in audit reviews going forward.

BACKGROUND

Sewer Fund

The Sewer Enterprise Funds consist of the Sewer Operations & Maintenance (O&M) Fund and the Sewer Capital Projects Fund. The O&M Fund provides for a system of user charges for the operation and maintenance of the City's wastewater and stormwater collection, treatment, and disposal systems, including the operations of the Reno-Stead wastewater treatment plant and the City's interest in the Truckee Meadows Wastewater Reclamation Facility (TMWRF). The Capital Projects Fund accounts for connection charges to provide for expanded capacity of the wastewater and stormwater systems. The Enterprise Funds also allow for costs connected to implementation and compliance with Reno-Sparks Joint Water Pollution Control Plant's National Pollutant Discharge Elimination System Permit as issued by the Nevada Department of Environmental Protection (NDEP).

An Enterprise Fund is, per NRS 354.517 defined as

“... a fund established to account for operations: ... Which are financed and conducted in a manner similar to the operations of private business enterprises, where the intent of the governing body is to have the expenses ... of providing goods or services on a continuing basis to the general public, financed or recovered primarily through charges to the users ...”

Plainly stated, an Enterprise Fund is reserved for a singular function where the income *into* the account and the purchases *from* the account are for that function only. An Enterprise Fund is a safeguarded, Proprietary Fund with distinct accounting and reporting requirements.

Legacy Software

Sewer users are billed quarterly for use of the sewer system. Billings and payments are managed by the Finance department via a legacy application. (A legacy application is a software program that is outdated or obsolete.) This legacy system, Automated Sewer Quote (ASQ) system was built in-house by the IT department many years ago. Quarterly billings are processed using this system in conjunction with the financial software and third-party billing companies. A replacement system, Reno Sewer Quote (RSQ), is currently being developed by IT. RSQ is planned to have similar functionality and will include additional items to assist with modern business practices. The new system's design includes a built-in audit trail and IT intends to issue unique passwords to City of Reno users for the system. These additional functionalities should aid in audit reviews going forward.

AUDIT RESULTS

Expenditures

We reviewed expenditures from the Sewer Fund for proper supporting documentation, approval, reasonableness, and compliance with established policies. Guidelines for purchasing procedures are documented in Management Policies and Procedures (MPP) #303 - Purchasing and also the *City of Reno Purchasing Card Program Cardholder Manual*. Additional guiding principles for the Sewer Fund, an Enterprise Fund, are documented in the Reno Municipal Code, the City of Reno Financial Policy *Sanitary Sewer Enterprise Funds Fund Policy*, and Nevada Revised Statutes (NRS). Sample audit testing included 54 expenditures to obtain a mid-range sample as is an industry standard for audit testing of populations over 250. The following five exceptions were noted, an error rate of 9.3%.

Expenditures From the Sewer Fund Were Not Solely for O&M

1. On three occasions, the expenditure was assigned as an expense from the Enterprise Sewer Fund for Operations & Maintenance (O&M), although it was not specifically for an O&M function. The sampled expenditures include catering costs for a departmental meeting, financial assistance to a research group, and renovations to office space in City Hall. Full revenues collected by users and maintained in the Enterprise Fund may not be available for future needs of facilities if they are depleted unnecessarily for purchases that are not solely for operations and maintenance.

The criteria for this audit finding is found in state law, Reno Municipal Code, and the City's Financial Policy. Specifically:

NRS 354.517

“Enterprise Fund’ means a fund established to account for operations ... Which are financed and conducted in a manner similar to the operations of private business enterprises, where the intent of the governing body is to have the expenses ... of providing goods or services on a continuing basis to the general public, financed or recovered primarily through charges to the users ...”

Reno Municipal Code Section 12.16.160

“The proceeds from the sewer charges shall be used solely for the operation, maintenance and replacement of the wastewater facilities and stormwater facilities...”

City of Reno Financial Policy - Sanitary Sewer Enterprise Funds Fund Policy

“The Operations Fund provides for a system of user charges for the operation and maintenance of the City’s wastewater and storm water collection, treatment, and disposal systems ...”

NRS includes broad language regarding Enterprise Funds. City policies contain additional verbiage on the use of the Sewer Funds. Departmental management considers the three expenditures sampled in this audit as appropriate for the fund. Audit flagged the expenses as tangentially related to the operation and maintenance of stormwater and wastewater facilities as detailed in the criteria and not in agreement with the use for which the fund was established.

The City’s Financial Advisory Board currently functions as the Audit Committee to provide expertise and review draft audit reports. The Board discussed this audit finding and use of the Enterprise Fund and suggested Audit seek guidance on the use of Enterprise Funds from a state-based oversight body for best practices and past determinations or opinions. Queries were submitted to multiple local oversight groups for input. Little clarification was obtained through these requests as documentation was not available of a previous vetting process for determining the types of allowable expenditures from an Enterprise Fund as established by NRS 354.517.

Recommendation:

We recommend a policy determination be made regarding the types of expenditures that are necessary and reasonable expenses from the Sewer Fund Operations and Maintenance Enterprise Fund. In addition, we recommend the internal City of Reno Financial Policy be updated to reflect the policy direction and clarify appropriate expenditures.

Expense Assigned to an Inaccurate Account

2. On two occasions, the expense was applied to an inaccurate account. Two were identified as *Supplies* while they were *Machinery & Equipment*. Improper classification of expenses degrades the value of financial reports, equipment tracking, and the ensuing analysis and decision-making.

Recommendation:

We recommend greater care be taken when assigning accounts to expenditures during the purchasing process for more accurate financial reporting and equipment tracking.

Key Employee Review

The Association of Certified Fraud Examiners (ACFE) offers a Fraud Risk Assessment for key employees that was used during audit fieldwork. The assessment questions are designed to assess the probability of a fraudulent event occurring within the organization based on: internal controls, the internal control environment, and the resources available to prevent, detect, and deter fraud. A sample of key employees processing sewer fund transactions within the Finance department were considered during the assessment. Two recommendations result.

It should be noted that testing key employees' actual transactions (adjustments, voids, etc.) in the sewer accounting system was not possible due to the ASQ legacy software in use. Useful reports could not be generated from the system for audit testing. As such, we did not test key employee transactions within the sewer system and have no opinion on the appropriateness of transactions conducted during the audit scope.

Segregation of Duties Could be Improved With Policy Implementation

3. We examined payroll system reports for five key employees to determine if they have taken leave from the workplace, and we analyzed for patterns in leave times. Requiring key employees to take vacation time that spans consecutive dates can aid in detecting an ongoing fraud scheme because the employer is more likely to discover such a scheme when the perpetrator is removed from the scene. We noted four of the five employees tested took vacation time that spanned at least four days in a row. One of the five key employees tested did not have any documented consecutive vacation leave days during the audit scope, although 23 vacation days were used. The employee's responsibilities included processing unusual sewer transactions that, per inquiry, were frequently left idle when the employee was out of the office, as those duties were not assigned to remaining staff.

Recommendation:

We recommend management determine the feasibility of implementing a policy to require key employees to be removed from their area of work for consecutive days to allow for possible discoveries of fraudulent schemes.

A Systematic Screening Procedure for Key Finance Employees Is Not in Place

4. Key employees entrusted with financial management do not undergo any additional screening once they have been hired and processed with a standard pre-employment background check. Key employees who have bankruptcies on record represent a potential fraud risk to the organization and additional monitoring by management may be appropriate. We noted three of the five employees tested have not had an employer-initiated

background check in over 13 years. Without an ongoing and systematic screening procedure for these key positions, it is unknowable if additional monitoring is prudent.

Recommendation:

We recommend management determine the feasibility of implementing a policy to run background checks for employees promoted into a key financial position or after a predetermined time has elapsed.

Agreement Documentation

Ownership Split of Capital Costs at TMWRF Documentation

5. Joint ownership of the Truckee Meadows Water Reclamation Facility (TMWRF) is shared between the City of Reno and the City of Sparks and is detailed in the Reno-Sparks-TMWRF Agreement (“the agreement”). Capital costs at TMWRF are based on the agreed-upon ownership split and are directly tied to the facility’s total capacity. The billings issued to the City of Reno tested during the audit include an ownership split calculation that is greater than the split documented in the agreement, resulting in apparent overpayments by the City of Reno by 2.38%.

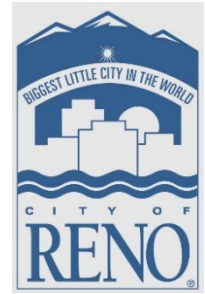
An adjustment to the “Division of Capacity Ownership” was last documented in the second addendum to the agreement dated February 14, 1983 and was to be applied upon the completion of the 40 MGD Master Project documented therein. Upon completion, however, the MGD Master Project resulted in a larger total capacity of 46.48 MGD. The Agreement was not updated to reflect the increased capacity and resulting ownership split.

While the ownership split percentage is not documented in the agreement or its four addendums, a separate agreement referred to as *Reno, Sparks and Washoe Phase III Wastewater Facilities* dated November 8, 1999 does detail the capacity ownership split that agrees to the monthly billing calculations for capital costs issued to the City of Reno. The separate agreement’s ownership split and the processing of billings after phase three completion appear to conform and be the agreed-upon split percentage.

Recommendation:

We recommend the capacity ownership split (capital cost split) be documented in the next iteration of the Reno-Sparks-TMWRF Agreement.

**SEWER FUND INTERNAL CONTROLS AUDIT – Management Responses
– City Manager’s Office**



Findings’ Conditions (condensed), Recommendations, and Management Responses
(Numbering Convention: Sequence corresponds to the Audit Results as listed in the report.)

Expenditures From the Sewer Fund Were Not Solely for Operation & Maintenance

1. On three occasions, the expenditure was assigned as an expense from the Enterprise Sewer Fund for Operations & Maintenance (O&M), although it was not specifically for an O&M function.

We recommend a policy determination be made regarding the types of expenditures that are necessary and reasonable expenses from the Sewer Fund Operations and Maintenance Enterprise Fund.

What measures are planned to address this finding?

A policy determination will be made regarding the types of expenditures that are necessary and reasonable expenses from the Sewer Fund Operations and Maintenance Enterprise Fund.

When will the measures be taken?

January 2020.

In addition, we recommend the internal City of Reno Financial Policy be updated to reflect the policy direction and clarify appropriate expenditures.

What measures are planned to address this finding?

If determined necessary, the internal City of Reno Financial Policy will be updated to reflect the policy direction and clarify appropriate expenditures.

When will the measures be taken?

June 2020.

Segregation of Duties Could be Improved With Policy Implementation

3. We examined payroll system reports for five key employees to determine if they have taken leave from the workplace, and we analyzed for patterns in leave times. We noted four of the five employees tested took vacation time that spanned at least four days in a row. One of the five key employees tested did not have any documented consecutive vacation leave days during the audit scope, although 23 vacation days were used.

We recommend management determine the feasibility of implementing a policy to require key employees to be removed from their area of work for consecutive days to allow for possible discoveries of fraudulent schemes.

What measures are planned to address this finding?

CMO will determine the feasibility of implementing a policy to require key employees to be removed from their area-of-work for consecutive days to allow for possible discoveries of fraudulent schemes.

When will the measures be taken?

January 2020.

A Systematic Screening Procedure for Key Finance Employees Is Not in Place

4. Key employees entrusted with financial management do not undergo any additional screening once they have been hired and processed with a standard pre-employment background check. Noted three of the five employees tested have not had an employer-initiated background check in over 13 years.

We recommend management determine the feasibility of implementing a policy to run background checks for employees promoted into a key financial position or after a predetermined time has elapsed.

What measures are planned to address this finding?

CMO will determine the feasibility of implementing a policy to run background checks for employees promoted into a key financial position or after a predetermined time has elapsed.

When will the measures be taken?

January 2020.

Ownership Split of Capital Costs at TMWRF is Not Clear

5. Capital contributions to Truckee Meadows Water Reclamation Facility (TMWRF) are shared between the City of Reno and the City of Sparks. The ownership split is based on the capacity assigned for each city and is a function of the facility's total capacity. Monthly billings are issued from the City of Sparks or TMWRF detailing the operations and maintenance costs (based on actual flow data) and capital outlay for the month.

An adjustment to the "Division of Capacity Ownership" was last documented in the second addendum to the Reno-Sparks-TMWRF Agreement dated February 14, 1983 upon the completion of the 40 MGD Master Project. Upon completion, however, the MGD Master Project resulted in a larger total capacity of 46.48 MGD. The Agreement was not updated to reflect the ownership amount of this increased capacity. However, a separate agreement referred to as *Reno, Sparks and Washoe Phase III Wastewater Facilities* dated November 8, 1999 does detail the capacity ownership split that agrees to the monthly billing calculations for capital costs issued to the City of Reno. The intent of the separate agreement and the processing of billings since phase three completion appear to conform.

We recommend the capacity ownership split (capital cost split) be documented in the next iteration of the Reno-Sparks-TMWRF Agreement.

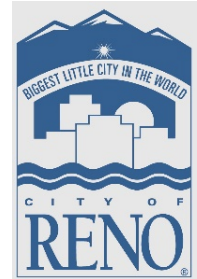
What measures are planned to address this finding?

CMO will oversee that the capacity ownership split (capital cost split) be documented in the next iteration of the Reno-Sparks-TMWRF Agreement.

When will the measures be taken?

June 2020.

**SEWER FUND INTERNAL CONTROLS AUDIT – Management Responses
– Public Works Department**



Findings' Conditions (condensed), Recommendations, and Management Responses

Expenditures Assigned to an Inaccurate Account

2. On two occasions, the expense was applied to an inaccurate account. Improper classification of expenses degrades the value of financial reports, equipment tracking, and the ensuing analysis and decision-making.

We recommend greater care be taken when assigning accounts to expenditures during the purchasing process for more accurate financial reporting and equipment tracking.

What measures are planned to address this finding?

The two expenditures were charged to supplies where they should have been charged to Equipment due to the amount of the purchase (> \$10,000). A training for Supervisors, Managers, and Administrative staff will take place at the next All Staff meeting planned for late October.

When will the measures be taken?

Training to occur at All Staff meeting in late October 2019.

Scope

The audit scope included a review current procedures and Sewer Fund expenditures from January 1, 2017 through April 30, 2019. Audit fieldwork began April 18, 2019 and concluded July 23, 2019.

Methodology

The audit review included tests of the accounting records, inquiries with key personnel, and other auditing procedures as was considered necessary. Conclusions were reached by:

- Conducting a key employee review including segregation of duties, time-off testing, and background checks for agreement with best practices;
- Testing a sample of expenditures for reasonableness, supporting documentation, and compliance with documented policies; and
- Evaluating the risk of fraud, waste, and abuse relative to the audit objectives.

Audit Standards

We conducted this audit in accordance with standards of The Institute of Internal Auditors, sans Standards 1310-1 through 1321. Standards require that we plan and perform the audit to obtain sufficient, 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.