

# CALIFORNIA'S INDEPENDENT WATER DISTRICTS

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## ***Reserve Amounts Are Not Always Sufficiently Justified, and Some Expenses and Contract Decisions Are Questionable***

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### *Audit Highlights . . .*

*Our review of independent water districts revealed the following:*

- Five of the eight water districts we visited may have trouble defending to their ratepayers and taxpayers the need for some portion of their accumulated resources.*
- The Office of the Legislative Counsel has opined that the Legislature cannot lawfully enact a statute that would transfer to the State's General Fund money in a special district's reserve fund.*
- Three of the eight water districts paid attendance or similar fees for their directors' participation in events that the districts could not demonstrate were reasonable and necessary.*
- One water district did a much better job than did the others of disclosing reimbursements for individual expenses by directors.*
- A director at one water district made questionable decisions in which she had financial interests in apparent violation of the State's conflict-of-interest laws.*

### REPORT NUMBER 2003-137, JUNE 2004

Eight independent water districts' and the State Controller's Office's responses as of December 2004<sup>1</sup>

The Joint Legislative Audit Committee directed the Bureau of State Audits (bureau) to review three specific areas concerning independent water districts: (1) policies and procedures for accumulating and using cash reserves and for developing and setting rates to determine whether they met relevant statutory requirements; (2) the benefits and compensation packages that water districts offered their directors, and how often boards and their subcommittees met; and (3) policies and procedures that water districts had in place related to conflicts of interest and ethics. We found that:

#### **Finding #1: Many water districts we visited have difficulty supporting the need for some of their unrestricted net assets.**

In analyzing reserves held by water districts, we found that five water districts had weak or nonexistent reserve policies. Consequently, they may have difficulty defending to ratepayers and taxpayers the level of some of their reserves. Most water districts have some type of policy statement about reserves, but some statements are more comprehensive than others. Whether formal policies exist or not, water districts maintain separate accounts or funds to track the revenues and expenses of key activities for budgeting or cash management purposes. We refer to these unrestricted net assets as reserved and any remaining net assets that water districts have not designated for a particular purpose as unreserved.

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<sup>1</sup> The eight independent water districts are: Alameda County Water District (Alameda), Crestline-Lake Arrowhead Water Agency (Crestline), Leucadia Wastewater District (Leucadia), Otay Water District (Otay), San Gabriel Valley Municipal Water District (San Gabriel), Walnut Valley Water District (Walnut Valley), Western Municipal Water District (Western), and Wheeler Ridge-Maricopa Water Storage District (Wheeler Ridge).

Restricted net assets measure the net resources that must be used for particular purposes because of legal, contractual, or other externally imposed requirements. Therefore, although the resources are available, water districts do not have discretion over the purposes for which these net assets must be spent. Unrestricted net assets can be broken down into reserved and unreserved categories.

Regarding weak or nonexistent reserve policies, Crestline has not accounted for a portion of its net assets in a separate fund as required and, despite having needs that could absorb its accumulation of unrestricted net assets, has not established a reserve policy to guide management of its various funds. Also, Crestline has no policy describing what it deems to be an appropriate level for its unreserved net assets. Leucadia's reserve policy has weaknesses in that it does not establish sufficient limits or target levels that match the size of each reserve to its intended purpose. Leucadia also maintains two separate reserves that work in tandem to serve essentially the same purpose.

Neither Walnut Valley nor Wheeler Ridge has a comprehensive reserve policy. According to its general manager, Walnut Valley makes management decisions about the use of reserves through formal and informal discussions with water district staff and board members. Because these discussions and decisions are not formalized in a written, comprehensive policy, it is difficult for an outside observer to fully understand the water district's intentions. Wheeler Ridge on the other hand did not always set upper limits for its reserve funds and did not include written descriptions of the circumstances that would prompt the water district to use its reserve funds. Also Wheeler Ridge has no written policy governing how frequently it reviews its reserves.

Finally, Western has no formal reserve policy. Western maintains various reserve funds, but the water district's board has not established a formal policy for managing them.

To demonstrate that they are using their accumulated public funds to cover reasonable and necessary expenses, water districts should ensure that they have comprehensive reserve policies in place that, at a minimum, do the following:

- Distinguish between restricted and unrestricted net assets.
- Establish distinct purposes for all reserves.
- Set target levels, such as minimums and maximums, for the accumulation of reserves.

- Identify the triggering events or conditions that prompt the use of reserves.
- Conform with plans to acquire or build capital assets.
- Receive board approval and be in writing.
- Require periodic review of reserve balances and the rationale for maintaining them.

Also, the Legislature should consider amending the California Water Code to require all water districts to develop and implement comprehensive reserve policies that include the key elements discussed in this report and outlined in our recommendation to the water districts.

***Water District Actions: Partial corrective action taken.***

Four of the five water districts are considering the adoption of reserve policies. The fifth, Crestline, implemented policies in August 2004 and September 2004 to address our recommendations.

***Legislative Action: Unknown.***

We are unaware of any legislation that addresses our recommendation.

**Finding #2: Changes in standards now require water districts to report equity in terms of net assets.**

We focused on the net assets of the water districts for two reasons. First, recent changes in governmental accounting standards now require all governments, including water districts, to report equity—assets minus liabilities—in terms of net assets. Second, the Milton Marks “Little Hoover” Commission on California State Government Organization and Economy (Little Hoover Commission) reported concerns in 2000 about the size of special district reserves, including those of water districts. At the time the Little Hoover Commission was reviewing special district equity, accounting standards required governments to include a significant amount of what they had already spent on fixed (capital) assets for their enterprise activities as retained earnings, the term used to measure the equity of enterprise activities at that time. This parallels the way the State Controller’s Office (controller) still gathers information from all special districts that report enterprise activities to compile

its Special Districts Annual Report. However, we found that more than half the accumulated equity possessed by the water districts we visited represented amounts that they had already spent for their capital assets, even after reducing these figures by any outstanding debts they incurred to build or acquire them. Because water districts typically would not choose to sell off the capital assets that allow them to deliver their goods and services, their net investment in capital assets should not be viewed as available to fund future activities, as may have been presumed when they were included in retained earnings. In addition, the new governmental accounting standards require governments, including water districts, to separately report the portion of their net assets over which they have less control because of externally imposed requirements such as laws, contract terms, or bond covenants. This helps to highlight the remaining unrestricted net assets over which governments have complete discretion.

To ensure that special districts report information on their enterprise activities in a manner that is consistent with current governmental accounting standards, the controller should amend its instructions to special districts and the format of its Special Districts Annual Report for reporting special district equity. Specifically, the instructions and reporting format should reflect special district equity in terms of net assets for all of their enterprise activities. In addition, to ensure that anyone reading the Special Districts Annual Report understands clearly how special districts intend to use the unrestricted net assets from their enterprise activities, the controller should continue to ask special districts to separately identify the portion of their unrestricted net assets that their boards have reserved for specific purposes.

***State Controller's Office Action: Pending.***

According to the controller, implementing the recommendation will depend on the actions taken by its Advisory Committee on Financial Transactions (committee) and working through the regulatory process. The controller stated that the government code authorizes it to prescribe accounting and reporting procedures only after consultation with and approval by majority vote of the committee. The controller also stated that it is coordinating staff activities and initiated discussion with the Department of Finance to prepare for a committee meeting tentatively scheduled for February 2005. The procedures must then be adopted under the regulatory process administered by the Office of Administrative Law.

**Finding #3: Using weak policies and inadequate guidance, water districts have reimbursed directors for unreasonable and unnecessary expenses.**

Our review of information on expenditure amounts for the 30-month period from July 1, 2001, through December 31, 2003, revealed that three of the eight water districts we visited paid a total of about \$47,000 in expenses that did not seem reasonable and necessary. While these questionable expenses are relatively small compared with the districts' total spending, they are nonetheless troubling because of their apparent lack of a substantial relationship to the water districts' purposes. Directors' expenses that are not reasonable and necessary can undermine public confidence in the water districts' stewardship of their public funds.

Policies and guidance that control water districts' spending of public funds should be sufficiently specific and provide enough constraints to ensure that directors' expenses are reasonable and necessary for achieving the water districts' purposes. However, state statutes covering directors' expenses provide only general direction, and some water districts' policies appear to be overly generous about the types of expenses considered appropriate.

Absent sufficient direction from either state statutes or their own policies, three of the eight water districts we reviewed paid directors' expenses that do not appear reasonable and necessary. These three water districts—Otay, Walnut Valley, and Western—used public funds during our 30-month review period to pay attendance or similar fees for their directors' participation in events such as social mixers, retirement parties, anniversary celebrations, and chambers of commerce functions. In the 30 months, payments from the three water districts for 103 such events totaled about \$4,400. Further, Otay and Walnut Valley used public funds to pay their directors daily stipends totaling \$14,500 for attending these types of events. Moreover, we found that in a handful of instances, Western paid for the directors' spouses to attend certain events. We also have concerns about a \$10,000 contribution by Western to a foundation and about Walnut Valley's spending of almost \$18,000 for 15 meals.

To ensure that all payments to or on behalf of water district directors are reasonable and necessary, water districts should adopt and implement policies that identify the types of events that they believe serve their statutory purposes as water districts and that explain how these events serve their statutory purposes.

***Water District Actions: Partial corrective action taken.***

Two of the three water districts stated that they have implemented this recommendation. The third—Western—stated in its November 2004 response to us that it would review the ordinance establishing the rules and procedures for the payment of fees and reimbursement of expenses and would revise the ordinance by December 2004 if changes were warranted.

**Finding #4: Some water districts disclose directors' reimbursements more effectively than do others.**

One of the eight water districts we visited—Crestline—did not provide disclosure reports to us, telling us that its directors incurred no individual administrative expenses exceeding \$100. Each of the remaining seven water districts had some method of disclosing its directors' reimbursements. However, the method adopted by one water district—San Gabriel—enables ratepayers and taxpayers to see the nature and amount of each incurred expense more effectively than do the practices used by the other water districts.

San Gabriel periodically issues a document that describes a particular cost (for example, the name of a conference attended or the destination of a flight taken), the date the district incurred the cost, and the name of the director who incurred it. Directors for San Gabriel review this document and approve it during a board meeting open to the public. Further, San Gabriel discloses on this document when it prepays expenses for a director (for example, when it purchases an airline ticket for a director rather than reimbursing the director who purchases a ticket personally), and the water district discloses all reimbursements it makes to its directors as required by law. We believe that the disclosure methods adopted by San Gabriel enable it to more clearly demonstrate to ratepayers and taxpayers the types of expenses it pays for its directors.

Six of the other water districts we visited took less obvious steps in their attempts to comply with the State's disclosure law. Alameda provides its board with a quarterly report detailing the expenses directors incurred for items like conference registration fees, lodging, and air travel. Although it does not discuss this report in an open meeting, Alameda makes the internal report available to those who request it. Otay produces an annual report that summarizes the expenses each director incurred by

month, and Otay's directors vote on the report in an open board meeting. Further, rather than limiting its report to just expenses of \$100 or more, Otay discloses expenses as low as \$5. However, Otay does not disclose individual reimbursements as state law requires; it simply provides the monthly totals for each director for items like mileage, seminars and conferences, and travel. As noted earlier, the law requires special districts to disclose individual charges.

Leucadia, Walnut Valley, and Western indicated that they disclose director expenses simply as part of their periodic lists of warrants paid or to be paid that they bring before the board. Also, Wheeler Ridge told us that its directors incurred no disclosable expenses during our 30-month review period. It added, however, that if its directors did incur any disclosable expenses, it would include them in the overall list of accounts payable distributed monthly to directors at board meetings. None of the four water districts produces a distinct report that separately identifies administrative expenses for their directors. Therefore, if concerned ratepayers or taxpayers wish to identify the directors' expenses, they must hunt for them among all the other warrants or payables listed. Further, Walnut Valley does not disclose individual reimbursements as state law requires. We believe that the practices used by these four water districts to disclose directors' expenses through warrant registers or payables lists are clearly weaker than if they had produced a separate document for consideration during board meetings.

To clearly inform ratepayers and taxpayers about the nature and amounts of reimbursements paid to directors, water districts should adopt and implement policies to periodically report in public board meetings the specific amounts paid to or on behalf of directors and the specific purposes of those payments.

***Water District Actions: Partial corrective action taken.***

Four of the six water districts have adopted and implemented procedures to enhance the reporting of director expenses to address this recommendation, while one other district—Leucadia—is developing a report to accommodate our recommendation. Although the last water district—Wheeler Ridge—did not produce a separate report that identified directors' expenses, it believes that its current practice of listing directors' expenses at the beginning of its list of payables complies with the spirit and intent of California law and that further action is not required.

**Finding #5: Training can increase directors' awareness that they must disclose and avoid conflicts of interest.**

Among the eight water districts we visited, some offered directors comparatively comprehensive training in the State's conflict-of-interest requirements, and others could not provide evidence that their training pertained to conflicts of interest. An example of some directors' lack of awareness of state conflict-of-interest laws occurred at Leucadia, where a director appears to have participated in making decisions in which she had financial interests. Additionally, water districts do not always ensure that directors appropriately disclose their economic interests.

One method that water districts can use to help ensure that their directors comply with the State's conflict-of-interest requirements is to provide them with training. All eight of the water districts we visited claimed to provide some level of training on conflicts of interest. However, although some water districts give their directors fairly comprehensive training, other districts could not show us evidence that their training pertains to conflicts of interest. Even when water districts make training available to their directors, the extent to which directors participate in the training varies significantly among water districts.

As part of Crestline's orientation for new directors, the water district's legal counsel gives a presentation that contains a summary of conflict-of-interest laws. Also, four of the five current directors at Alameda have attended the training seminar put on by the California Special District Association. Staff at Alameda told us that the fifth director is a former city councilman who had previously participated in seminars for new council members conducted by the League of California Cities and had additional orientation in conflict-of-interest laws through his former employment. Also, Walnut Valley sent letters to its directors recommending and encouraging their attendance at training sessions related to conflicts of interest and ethics.

On the other hand, the general counsel for San Gabriel told us he offered to provide training to San Gabriel's directors but, as of April 2004, the directors had not yet taken advantage of his offer. Although the water district has recommended various training courses to its directors, none has attended any course. San Gabriel's general manager told us that directors are well informed about conflicts of interest and ethics and the district's legal counsel frequently discusses these issues at board meetings. He also indicated that four directors are professional engineers and follow ethics codes of the profession, which are not too different from



political ethics codes. Additionally, Leucadia makes training available to its directors, but not all directors attend the training courses consistently. Also, Western does not appear to offer consistent training, relying heavily on on-the-job experience to build directors' knowledge of ethics and conflict of interest.

Of the 49 current and former directors at the eight water districts we visited, we identified one director who may have violated state conflict-of-interest laws when participating in the approval of various contracts. A director at Leucadia is the sole owner and manager of a private consulting firm that offers public relations services. For one of its clients, an engineering company, the director's firm contracted in August 2002 to produce a monthly newsletter. The director's consulting firm receives \$2,740 per month to produce the newsletter. In February 2003, six months after the director's consulting firm formed this business relationship with the engineering firm, the director voted to approve at least two agreements between Leucadia and the engineering firm for design services: an amendment to an existing contract worth \$67,000 and a new contract for \$35,900. We believe that this director's participation in the approval of these agreements may have violated both Section 1090 et seq. of the Government Code and the Political Reform Act.

In reviewing records from eight water districts, we found that three water district directors did not include information related to business positions they held or income they earned in their economic disclosure statements as required by state law, state regulation, and district policy. Despite having owned her consulting firm for at least 10 years, the Leucadia director previously mentioned did not disclose on her statements covering 2000 through 2002 either her income from or her business position with her consulting firm. We saw another instance of this type of omission on an economic disclosure statement for one director at Walnut Valley and one at Otay. When describing why they omitted their business positions from their economic interest statements, the directors told us either that they believed such disclosure was not required or that they simply did not think to include their positions or incomes.

Though regular training on conflicts of interest and ethics cannot prevent directors from making willful departures from statutory requirements, it can serve to keep such requirements at the forefront of directors' minds and help directors hold one another accountable for fulfilling their responsibilities as public officials.

To ensure that their directors are fully aware of their responsibilities regarding conflicts-of-interest requirements, water districts should do the following:

- Provide periodic training related to conflicts of interest.
- Guide directors in completing economic disclosure forms and stress the importance of disclosing all economic interests as required by law.

***Water District Actions: Partial corrective action taken.***

Regarding the provision of periodic training related to conflicts of interest, one water district—Western—provided training to its directors in October 2004. Four other water districts are considering the adoption of policies.

Regarding the provision of guidance in completing economic disclosure forms and stressing the importance of disclosing all required economic interests, all three water districts at which we observed deficiencies are considering the adoption of applicable procedures.