

Audit Report

Maryland Environmental Service

October 2009



OFFICE OF LEGISLATIVE AUDITS
DEPARTMENT OF LEGISLATIVE SERVICES
MARYLAND GENERAL ASSEMBLY

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Karl S. Aro
Executive Director

DEPARTMENT OF LEGISLATIVE SERVICES
OFFICE OF LEGISLATIVE AUDITS
MARYLAND GENERAL ASSEMBLY

Bruce A. Myers, CPA
Legislative Auditor

October 14, 2009

Delegate Steven J. DeBoy Sr., Co-Chair, Joint Audit Committee
Senator Verna L. Jones, Co-Chair, Joint Audit Committee
Members of Joint Audit Committee
Annapolis, Maryland

Ladies and Gentlemen:

We have audited the Maryland Environmental Service (MES) for the period beginning February 1, 2006 and ending May 5, 2009. MES provides water supply, wastewater treatment, and waste management services to public and private entities.

Our audit disclosed that MES did not adequately document the basis for a contract settlement, which resulted in a payment of \$1.85 million to the vendor. In addition, MES did not properly restrict computer system access. For example, we found that certain employees with access to cash receipts could also initiate and approve non-cash adjustments in the accounts receivable records on its automated accounting system.

MES' response to this audit is included as an appendix to this report. We wish to acknowledge the cooperation extended to us by MES during the course of this audit.

Respectfully submitted,

Bruce A. Myers, CPA
Legislative Auditor

Background Information

Agency Responsibilities

The Maryland Environmental Service (MES) was created as an instrumentality of the State and a public corporation to provide water supply, wastewater treatment, and waste management services to public and private entities. MES constructs, operates, and maintains various water, sewer, and solid waste plant facilities under contracts with the State of Maryland, its political subdivisions, and private enterprises. Additional services offered include sludge and dredged materials management. As of June 30, 2009, MES operated and maintained 593 projects, of which approximately 300 were State-related projects. According to the State's records, MES' operating expenditures for fiscal year 2009 totaled approximately \$101.2 million.

Financial Statement Audits

In accordance with the Natural Resources Article, Section 3-126 of the Annotated Code of Maryland, MES engaged an independent accounting firm to audit its financial statements annually. In the related audit reports, the firm stated that the financial statements presented fairly, in all material respects, the financial position of MES as of June 30, 2006, 2007, and 2008, and the respective changes in financial position and, where applicable, cash flows thereof for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Status of Findings From Preceding Audit Report

We reviewed the status of the two findings included in our preceding audit report dated July 5, 2006. We determined that MES satisfactorily addressed both of these findings.

Findings and Recommendations

Settlement Agreement

Finding 1

MES lacked adequate documentation indicating the basis for a contract settlement with a vendor.

Analysis

MES did not document the basis for a contract settlement with a vendor totaling \$1.85 million. MES, as contract manager for another State agency, awarded a contract to a vendor to perform dredging and associated activities at a total contract price (including change orders) of \$42.6 million. The other State agency reimbursed MES for all contractual expenditures. After the completion of the work, the vendor filed two claims, totaling \$4.6 million, against MES, requesting additional compensation for work performed under the contract. In a letter dated May 19, 2008, the responsible procurement officer indicated that MES did not believe the claim was valid. The contractor filed an appeal with MES management who decided to settle the claim. According to the January 7, 2009 settlement agreement, which was approved by the Office of the Attorney General, MES was to pay \$960,000 in liquidated damages, which were previously withheld because of the vendor's failure to complete the project on time, and \$890,000 in additional compensation. These amounts were ultimately paid by the other State agency. While MES officials advised us that the settlement was entered into because it was not cost-beneficial to pursue litigation, MES could not produce documentation to support that assertion, nor could it substantiate how the settlement amount was determined.

Recommendation 1

We recommend that, in the future, MES fully document the basis for contract settlements with vendors.

System Access

Finding 2

MES did not adequately restrict user access to certain critical processes on its automated accounting system.

Analysis

MES did not adequately restrict user access to certain critical processes on its automated accounting system. Our review of the nine employees with the ability to process non-cash credits related to accounts receivable disclosed that six employees could both initiate and approve non-cash credits, without being subject to independent approval. Of the six employees, two also had routine access to cash receipts and three others did not require such access based upon their job responsibilities. This situation occurred because employees could access the automated system using previous versions of system menus, on which there were no security restrictions; such restrictions had been established for current menus.

The lack of controls over non-cash credits increased the risk of error and misappropriation. According to MES records, as of April 30, 2009, the outstanding account receivable balance totaled \$27.9 million.

Recommendation 2

We recommend that MES

- a. ensure that employees do not have the capability to both initiate and approve non-cash credits,**
- b. ensure that employees with access to cash receipts do not have access to the related accounts receivable records, and**
- c. periodically ensure that access to critical menus is appropriately restricted and is only granted to those employees who require such access to perform their assigned job duties.**

Audit Scope, Objectives, and Methodology

We have audited the Maryland Environmental Service (MES) for the period beginning February 1, 2006 and ending May 5, 2009. The audit was conducted in accordance with generally accepted government auditing standards. Those 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.

As prescribed by the State Government Article, Section 2-1221 of the Annotated Code of Maryland, the objectives of this audit were to examine MES' financial transactions, records and internal control, and to evaluate its compliance with applicable State laws, rules, and regulations. The areas addressed by the audit included accounts receivable, cash receipts, and procurements and disbursements. We also determined the status of the findings contained in our preceding audit report.

In planning and conducting our audit, we focused on the major financial-related areas of operations based on assessments of materiality and risk. Our audit procedures included inquiries of appropriate personnel, inspections of documents and records, and observations of MES operations. We also tested transactions and performed other auditing procedures that we considered necessary to achieve our objectives. Data provided in this report for background or informational purposes were deemed reasonable, but were not independently verified.

MES' management is responsible for establishing and maintaining effective internal control. Internal control is a process designed to provide reasonable assurance that objectives pertaining to the reliability of financial records, effectiveness and efficiency of operations including safeguarding of assets, and compliance with applicable laws, rules, and regulations are achieved.

Because of inherent limitations in internal control, errors or fraud may nevertheless occur and not be detected. Also, projections of any evaluation of internal control to future periods are subject to the risk that conditions may change or compliance with policies and procedures may deteriorate.

Our reports are designed to assist the Maryland General Assembly in exercising its legislative oversight function and to provide constructive recommendations for improving State operations. As a result, our reports generally do not address activities we reviewed that are functioning properly.

This report includes findings that we consider to be significant deficiencies in the design or operation of internal control that could adversely affect MES' ability to maintain reliable financial records, operate effectively and efficiently, and/or comply with applicable laws, rules, and regulations. Our audit did not disclose any significant instances of noncompliance with applicable laws, rules, or regulations. Other less significant findings were communicated to MES that did not warrant inclusion in this report.

MES' response to our findings and recommendations is included as an appendix to this report. As prescribed in the State Government Article, Section 2-1224 of the Annotated Code of Maryland, we will advise MES regarding the results of our review of its response.

APPENDIX



Martin O'Malley, Governor

James M. Harkins, Director

October 8, 2009

Bruce A. Myers, CPA
Legislative Auditor
Department of Legislative Services
301 W. Preston St. Room 1202
Baltimore, Maryland 21201

Dear Mr. Myers:

Director Harkins has requested that I reply to your letter of September 18, 2009.

Responses to the draft Legislative Audit Report for the Maryland Environmental Service are provided as an attachment to this letter. An electronic version has also been submitted as you requested.

Please let me know if further information is needed.

Sincerely,



Joseph C. Zimmerman, CPA
Director of Finance/Treasurer

CC: Jim Harkins
Henry Cook

Settlement Agreement

Finding 1

MES lacked adequate documentation indicating the basis for a contract settlement with a vendor.

Response

Following the receipt of the Auditor's Finding we again reviewed the documentation related to the contract settlement. The settlement amount consisted of two components. The first was the release of \$960,000.00 retained under the contract. This amount could have been assessed as liquidated damages. At the time of the settlement the Procurement officer had not made a decision to impose liquidated damages for the delay in completing the project. After analysis it was decided that because of delays in obtaining the permit for the project there might not be justification to impose the liquidated damages. The retainage of \$960,000 was released as part of the settlement.

The remaining amount of the settlement was based on analysis by the Office of Attorney General, agency staff, and the agency's consultant of the relative strengths and weaknesses of the contractor's case and the cost to litigate the action. Under MES procurement regulations the contractor would have been able to file a de novo breach of contract action in circuit court if it was not satisfied with the Director's decision in the appeal. The contractor would have been able to assert a new theories of liability, including that it was delayed in the performance of the contract because a permit had not been issued as early as the parties intended, thereby limiting the time period when the contractor could perform the work.

Based on the hourly rates of the individuals who would become involved in the litigation, including preparation, discovery, depositions, trial of three weeks or more and appeal it was determined that MES employee time of between \$250,000 to \$300,000 (including the office of Attorney General) and expert time of \$300,000 to \$350,000 would be incurred to fully litigate this matter. An analysis of the uncertainty of litigation was also made. Given the strengths and weaknesses of the contractor's claim it was determined that an additional \$890,000 should be paid on the contractor's \$4.6 million dollar claim to resolve this matter.

The above analysis was given orally to the Auditors in the last meeting with the executive staff of MES. It was acknowledged by the auditors that the uncertainty of the result of litigation is a legitimate component in any settlement.

In the future MES will fully document the settlement of any claim.

System Access

Finding 2

MES did not adequately restrict user access to certain critical processes on its automated accounting system.

Response

MES has been using JD Edwards accounting software since 1992. JD Edwards provides numerous updates to the software on an ongoing basis. MES reviewed and updated employees' security status based on the latest version. However, some of the employees retained access to the older version. When notified by the auditors, MES immediately removed access to the older version for the A/R specialist, the Accounting Assistant and the Fiscal Associate II.

As a result, employees with access to cash receipts or the accounts receivable records do not have ability to approve and post any transactions to the accounts receivable records.

MES will also limit access by the Financial Accountant, the Senior budget Analyst and the Financial Accounting Manager to the functions required to perform their assigned job duties.

AUDIT TEAM

Edward L. Shulder, CPA
Audit Manager

James M. Fowler
Senior Auditor

LaTeasa R. Robertson
Staff Auditor