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October 10, 2008

Audit Committee Members of New York City Municipal Water Finance Authority
75 Park Place
New York, NY 10007

Audit Committee Members of New York City Water Board
59-17 Junction Boulevard, 8th Floor
Flushing, New York 11373-5108

Management of New York City Municipal Water Finance Authority
75 Park Place
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Management of New York City Water Board
59-17 Junction Boulevard, 8th Floor
Flushing, New York 11373-5108

Dear Audit Committee Members and Management:

In planning and performing our audit of the financial statements of New York City Municipal Water Finance Authority and New York City Water Board, which collectively comprise the New York City Water and Sewer System (the "System") as of and for the year ended June 30, 2008 (on which we have issued our report dated October 10, 2008), in accordance with auditing standards generally accepted in the United States of America, we considered the System's internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the System's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the System's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, in connection with our audit, we have identified, and included in the attached Appendix, certain matters involving the System's internal control over financial reporting that we consider to be material weaknesses under standards established by the American Institute of Certified Public Accountants.

We have also identified, and included in the attached Appendix, other control deficiencies involving the System's internal control over financial reporting as of June 30, 2008 that we wish to bring to your attention.

The definitions of a control deficiency, a significant deficiency and a material weakness are also set forth in the attached Appendix.

Although we have included management's written response to our comments in the attached Appendix, such responses have not been subjected to the auditing procedures applied in our audit and, accordingly, we do not express an opinion or provide any form of assurance on the appropriateness of the responses or the effectiveness of any corrective actions described therein.

This report is intended solely for the information and use of management, Audit Committee Members, and others within the organization and is not intended to be, and should not be, used by anyone other than these specified parties.

Yours truly,

Deloitte & Touche LLP

SECTION I — MATERIAL WEAKNESSES

We consider the following deficiencies in the System's internal control over financial reporting to be a material weakness:

1. **Lack of Segregation of Duties Related to Journal Entries**

   Observation

   All journal entries are created and posted at the System's Office of Management and Budget (OMB) office location. We observed that a journal entry can be prepared by the Finance Manager and posted without being reviewed by someone independent of the Finance Manager.

   Impact

   Segregation of duties is a key concept of internal control. Proper implementation of segregation of duties can mitigate the risk of fraud and human error and detect potential misstatements in the financial statements. With no formal review of journal entries, the System is exposed to higher risk of fraud and potential for material errors to occur in the financial statements.

   Recommendation

   We recommend that the System implement the appropriate preparer and reviewer procedures so as to mitigate the risks created by lack of segregation of duties.

   Management's Response

   Journal entries are generally prepared by accounting staff and reviewed by the Finance Manager prior to being entered. Where required, as a result of technical complexity, the Finance Manager has prepared entries herself. Henceforth, any journal entries prepared by the Finance Manager will be reviewed and approved by another accounting manager (Comptroller, Deputy Comptroller or Assistant Comptroller) prior to being entered.

   Moreover, the position of Supervisor of Accounting Services was recently created and the incumbent will begin working with the accounting staff person who is primarily responsible for journal entry preparation for the System, so that more technically complex entries can be prepared for review by the Finance Manager.

2. Prior Period Adjustment- Capital Assets

Observation

The Department of Environmental Protection (DEP) and the System have been working for several years to reconcile the System's fixed assets as reported in its financial statements (both construction work in progress ("CWIP") and utility plant in service ("UPS") with The City's own records of the System's fixed assets (maintained in The City's financial management system ("FMS") and to thereby verify and/or make adjustments necessary to provide for the completeness and accuracy of both sets of records and permit the System to discontinue maintaining its own records and rely on FMS going forward.

A prior period adjustment of $690.7 million was made due to the discrepancy between the general ledger and FMS.

We observed that there were adjustments for prior period interfund agreement (IFA) expenditures made during 2008.

Impact

Capital asset and net asset balances may be misstated.

Recommendation

We recommend that the System rely on the City's FMS system going forward. The System should track all construction projects and accrue for costs related to work performed but not yet invoiced as of the close to ensure FMS records are accurate. Any reconciling items should be investigated and resolved on a timely basis (at least quarterly).

Management's Response

DEP is currently tracking all construction projects. Substantially completed and in service projects are now being moved from CWIP to UPS on a timely basis in the City's accounting system, FMS. Fiscal year 2008 represented a transition year in which adjustments, including to IFA's, were made to eliminate the discrepancy between the general ledger and FMS.

3. Incorrect Capitalization of Filtration Avoidance Costs

Observation

We observed that the filtration avoidance capital expenditures balance used in the reconciliation of capital assets did not agree to underlying documentation.

Impact

The filtration avoidance costs schedule is used during the reconciliation process to arrive at the ending capital assets balance. Filtration avoidance costs are expensed rather than capitalized. If the filtration avoidance costs schedule does not reflect the proper balance, amounts may be reported as capital assets that should have been expensed.

Recommendation

We recommend that the System reconcile the filtration avoidance costs schedule used during the fixed asset reconciliation to underlying supporting documentation.

Management's Response

DEP will be more diligent in the tracking and recording of filtration avoidance expenditures during the course of the fiscal year. At fiscal year end, final filtration avoidance cost reconciliation will be completed.

4. Accounts Receivable- Customer Information System

Observation

The accounts receivable system currently utilized by the Authority does not provide sufficient, reliable real-time information to allow management to determine an accurate accounting of customer accounts receivables. It was noted that the current configuration of the system requires many adjustments that potentially result in the inclusion of incorrect information within the system, and also, does not produce a reliable aging of accounts receivable. For example, in many circumstances balances are adjusted by crediting the entire balance and establishing the receivable with a totally new entry. As a result, the system ages the balance based upon the date of the new entry instead of the date which the receivable was originally created resulting in an inaccurate aging. In order to determine an accurate aging, management is required to perform an extensive analysis of each account which results in inefficiencies and is subject to error. This also results in the inability to produce current, reliable information due to the time requirements necessary to undertake this effort. Therefore, given the current work load demands, aging is performed only on a sporadic basis, generally annually. In addition, adjustments are made to accounts receivable without documentation of an independent review. Therefore, it is difficult to determine if appropriate segregation of duties over the adjustment process is being exercised. This situation could result in inappropriate adjustments, inaccuracies and abuse.

We have also observed that the system does not have the in-house capabilities to review the current accounts receivable required to make accurate judgments concerning the collectability of receivables; thus creating the potential for a material misstatement of accounts receivable amounts in the financial statements.

Recommendation

We recommend that the System undertake an effort to determine the feasibility of replacing the current accounts receivable system. The System should perform a detailed analysis of the requirements of the system which should include assessing the needs of the day-to-day operations of the System, information which is needed to produce timely, accurate financial reports, and the real-time information necessary to allow management to appropriately manage the accounts receivable process. It is also recommended that the System establish procedures for providing an independent review of all adjustments made to the accounts receivable with documentation support, appropriate review and approval. Additionally, we recommend that the System institute procedures to review the collectability of accounts receivable on a more current basis, at least quarterly.

Management's Response

Management understands that the accounts' receivable reporting has been an ongoing issue for the System. In FY 2008, it began the procurement process for a new billing and customer information tracking system.

Such a new system will address the recommendations noted above. Management will also examine the technical and resource requirements required to address the recommendations that DEP establish procedures to provide for an independent review of receivable adjustments and review the collectability of receivables at least quarterly.

SECTION II — OTHER MATTERS

Our observations concerning other matters related to operations and best practices involving internal control over financial reporting that we wish to bring to your attention are as follows:

1. **Transfers from Department of Finance (DOF)**

Observation

DOF transferred receivable balances related to pre-1994 charges to foreign countries to DEP's books.

Impact

The balances were entered into CIS as receivables, however they have been deemed non-transactions for the System.

Recommendation

Management should perform an analysis on all amounts transferred from DOF to assess the appropriateness of the amounts.

Management's Response

In FY 2009, DEP initiated a project to examine open credit balances transferred from DOF and will consider the review of receivable debit balances transferred from DOF when this project is complete.

2. Fixed Asset Disposals

Observation

The project engineers submit a summary listing of capital assets being disposed of during construction. These assets are the identified in the inventory library based on location and description of the asset provided by the project engineer. Afterward, the fixed asset disposal is created for the capital asset in the FMS system. Documentation is not included in the fixed asset disposal summary referencing the underlying documentation. As such, we were unable to verify amounts in summary listing provided by the contract engineer to appropriate supporting documentation.

Impact

Incorrect capital assets may be disposed of by error. Additionally, capital asset disposal balances may be misstated.

Recommendation

We recommend that DEP enter an identifier during the fixed asset disposal made in the FMS system so there is a way to identify the summary listing used to prepare the fixed asset disposal.

Management's Response

As information is furnished by the project managers, DEP will maintain records on file of the engineers' reports on retirements and the corresponding FMS fixed asset disposal documents. This information will be used to identify inventory for fixed asset disposal.

3. Office of Management and Budget (OMB)– Windows 2003 Security & Password Policies

Observation

Areas of security configuration improvements (i.e. enforcement of password policies and domain default account settings) were identified.

Impact

Although Water and Sewer has enabled a number of Windows 2003 security features, the following areas in which security parameters could be further strengthened for the NYC Water and Sewer Windows 2003 environment:

- There are fifteen user accounts that have not changed passwords in over 180 days, of which two of the user accounts have administrative privileges.
- There are six user accounts whose passwords were set to never expire; of which two of the user accounts have administrative privileges.
- The default administrator account has not been renamed.

Recommendation

Management should consider implementing the following security configurations to further strengthen security within the Windows 2003 environment:

- All users should be required to have a password to access the system and to change that password on a regular basis (typically, every 30-60 days). Passwords that are not changed on a frequent basis increases the risk over time of it being compromised.
- Only service accounts have business justification for having passwords that do not expire. If users are not required to change their passwords on a frequent basis, their passwords are likely to become known to other employees and potential intruders. The user profile could then be used to gain unauthorized access to systems and data until the real user changes the password to a new one.
- The built-in administrator account should be renamed. This will minimize the risks of intruders trying to use this well-known account when attempting to log on to the domain.

Corrective Action Taken

- Management has disabled 8 user accounts for passwords greater than 180 days. One user account has been deleted. Please refer to the next bullet point for the corrective action taken on the remaining 6 user accounts.
- Management will change 5 of the 6 user accounts with password setting to the standard 90 expiration period. The remaining user ID is one that the Director of Management and Budget has requested be set not to expire.

Management Response:

All OMB user accounts now have been placed under the policy that requires a password change after 90 days, which is in line with the DoITT citywide policy on password expiration. As the corrective action notes above indicate, 8 IDs with passwords that had not been changed for over 180 days were disabled, since they had not been used at all for that period of time, and a ninth ID was deleted. The 8 IDs have not been deleted yet because there is a possibility they may still be needed. If they are re-enabled, the password policy will apply and the user will be required to update the expired password.

Of the 6 IDs that had been set to never expire, 5 have now been set to conform to the 90 day expiration policy, including the two administrative level IDs.

The single remaining ID was granted an exception by the Director of the Office of Management and Budget. He has requested that this password not expire, so we have not applied the 90 password change policy to this ID.

No non-administrative ID has the permission to log on to an OMB server including the OMBGP01 server that hosts the Dynamics GP application. OMBGP01 does allow members of the DynamicsGP security group to use resources on the server, but the exception ID is not a member of that group.

We have chosen not to rename the built-in network administrator account and do not believe that it exposes the organization to any risk. Our decision is based on the following considerations:

Our network directory was originally created in Windows NT and has been upgraded through Windows 2000 through to Windows 2003, so the Administrator ID has been carried forward throughout all those upgrades. (As Microsoft Technet article 757208 notes, the Administrator account exists on all Windows systems since Windows 2000, and renaming that account does not alter the security identifier (SID) for "Administrator".)

OMB's internal network is strongly protected from external access and to us, the small security benefit renaming provides does not appear worth any potential system malfunctions that may be caused by renaming the Administrator account.

The built-in local Administrator account on OMBGP01 itself is disabled, so that eliminates any possibility of exploiting that ID on the Dynamics GP server.

4. Department of Environmental Protection (DEP)- RACF Data Sets Not Found

Observation

An assessment of the NYC Water and Sewer mainframe environment identified eight datasets that were indicated as "not found."

Impact

A review of the DSMON Selected Data Sets Report identified eight datasets with a selection criteria of APF that were "not found" on the specified volume. This may indicate a security exposure that should be investigated and corrected.

Recommendation

To maintain the integrity of the system, management should review the datasets indicated as "not found" and delete them.

Corrective Action Taken

The eight datasets indicated as N.F. (Not Found) with selection criterion of APF have been deleted after the testing results were sent to DoITT by the Deloitte & Touche audit team. These entries were deleted from the system as of August 25, 2008.

DoITT Management's Response

These entries were deleted from the system as of August 25, 2008, and no further action is required.

SECTION III — DEFINITIONS

The definitions of a control deficiency, a significant deficiency and a material weakness that are established in AU 325, *Communicating Internal Control Related Matters Identified in an Audit*, are as follows:

A *control deficiency* 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 misstatements on a timely basis. A deficiency in *design* exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that even if the control operates as designed, the control objective is not always met. A deficiency in *operation* exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.

A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control over financial reporting.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control over financial reporting.

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