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Joint Audit Committee Members of
New York City Municipal Water Finance Authority
and New York City Water Board

Management of New York City Municipal Water Finance Authority
75 Park Place
New York, NY 10007

Management of New York City Water Board
59-17 Junction Boulevard, 8th Floor
Flushing, NY 11373-5108

Dear Joint Audit Committee Members and Management:

In planning and performing our audit of the financial statements of the New York City Municipal Water Finance Authority and the 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, 2011, 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 was not designed to 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 Section I of the attached Appendix, a certain matter involving the System's internal control over financial reporting that we consider to be a material weakness under standards established by the American Institute of Certified Public Accountants.

We have previously communicated certain matters noted during our audit of the financial statements of the System for the year ended June 30, 2008 which we considered to be material weaknesses, in our report to management and those charged with governance dated October 10, 2008. As of the date of this report, we believe the System is still in the process of remediating one of these material weaknesses. We have outlined in Section II of the attached Appendix the previously-reported matter which we believe is in the process of being remediated.

We have also identified, and included in Section III of the attached Appendix, a control deficiency involving the System's internal control over financial reporting as of June 30, 2011 that we wish to bring to your attention.

We have also identified, and included in Section IV of the attached Appendix, other matters involving the System's internal control over financial reporting as of June 30, 2010 that we wish to bring to your attention.

The definitions of a deficiency, a material weakness, and a significant deficiency are also set forth in Section V of 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 WEAKNESS

We consider the following deficiency in the System's internal control over financial reporting to be a material weakness as of June 30, 2011:

1. Reconciliation of Construction Work in Progress

Observation

The City of New York ("The City") pays for capital assets on behalf of the System, and the System then reimburses The City. At the end of each fiscal year, The City generates a report showing accruals as of year-end for project expenditures that the System has not yet reimbursed The City. The System tracks all payments made to The City (plus year-end accruals less prior year accruals) as primary evidence of additions to construction work in progress each fiscal year.

The City's Financial Management System (FMS3) tracks capital expenditures via the Available Capital Funds Summary report (Report ID CWA-CFEXPA-001). This report contains a category for year to date expended amounts. There is no reconciliation process between the System's records of cash payments and the FMS3 report or year to date expended amounts.

Furthermore, DEP, with the assistance of a consultant, maintains the construction work in progress information in a master file that is generated from information maintained in FMS3. This master file, however, is a work in progress as it is an informal sub-ledger which continues to be revised and improved upon each year. The ending balance of construction work in progress in this master file does not agree to the ending work in progress balance calculated based off of cash payment records.

Impact

The construction work in progress balance reported in the financial statements may not be accurate.

Recommendation

The System should implement a three-way reconciliation process to reconcile cash payments made to The City, capital expenditures captured in FMS3, and capital expenditures added to the master file monthly.

Furthermore, The City should maintain a record of assets purchased for the System.

Management's Response

We concur that there is a need to improve the records supporting the System's reported capital assets, especially those tracking construction work in progress ("CWIP"), and that additions thereto should be thoroughly reconciled to capital expenditure reimbursement payments made by the Authority to the City.

All capital assets records pertaining to the System are maintained in the City's accounting system, FMS, and are subject to the accounting policies and procedures promulgated by the Office of the City Comptroller. All payments to the City by the Authority to reimburse capital expenditures on System assets, as well as calculations of amounts payable at year end for such expenditures, are calculated by the Comptroller's Office based on FMS reports of unfinanced expenditures made on System projects. The reconciliation between the Authority's payments to the City for eligible capital expenditures and the creation of new System capital assets is not straightforward.

There have been efforts made in recent years to facilitate more accurate capital asset and CWIP records and reconciliations, and improvements have been made, including the development and on-going refinement of the detailed sub-ledger referenced in the auditors' observation.

The City (through the Office of Management and Budget), in a cost-sharing arrangement with the Authority, has engaged KPMG to serve as consultants to assist us in resolving these issues. The first phase of this consulting work has begun and is expected to be completed before the end of calendar 2011. The work includes: (1) assessing and improving the processes in place for reconciling and tracking Construction in Process (CIP) for water and sewer capital assets; (2) helping to identify root causes for differences identified in the reconciliation process; and (3) assessing the accuracy of the detailed records of the components of CIP. Based on the findings and recommendations that result from this phase, we will determine what if any additional assistance is necessary for the City and the Authority to establish on-going procedures to maintain accurate and reliable capital asset and CWIP records for the System and to fully reconcile with the Authority's payments to the City. It is our expectation that prior to the preparation and audit of System financial statements for fiscal 2012, new procedures will be in place that will help to ensure the accuracy of the reported CWIP.

SECTION II — MATERIAL WEAKNESS IDENTIFIED IN A PREVIOUS AUDIT THAT IS IN THE PROCESS OF BEING REMEDIATED

We identified and previously communicated the following deficiency that were considered to be a material weakness in the System's internal control over financial reporting during our audit of the financial statements of the System for the year ended June 30, 2008. As of the date of this report, we believe this deficiency has not yet been remediated by the System**:**

1. **Accounts Receivable – Customer Information System**

Observation Communicated in Letter Dated October 10, 2008

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 the 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.

Management's Response Communicated in Letter Dated October 10, 2008

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.

2009 Update

The current configuration of the system still 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. However, we observed that management has created a report that calculates a reserve for each customer account based on a computer-designed logic. During our testing, we did not note any material differences between our expectation of the reserve for selected customer accounts and the reserve assigned to that customer account by the report.

Management has begun the procurement process for a new billing and customer information tracking system. Because of this and the aforementioned improvement of management's ability to assess customer account reserves, we have not identified this as a material weakness in the current year.

Management's Response

Management is continuing to pursue the procurement process for a replacement customer billing and tracking system. The inclusion of appropriate controls and measures to effectively age and report on Accounts Receivables is of the highest importance and is a requirement.

2010 Update

The current configuration of the system still requires many adjustments that potentially result in the inclusion of incorrect information within the system.

Management has awarded a contract for the development, testing and installation of a new customer information system ("New CIS"), and design work has begun. Management continues to work with the vendor to ensure the system has appropriate controls and measures to age and report on accounts receivable effectively. Additionally, DEP has plans to hire a Director of Accounting, part of whose duties will include working on the system design and implementation to help assure that the New CIS will meet the System's accounting and financial reporting needs and provide an adequate audit trail.

Management's Response

Management has awarded a contract for the development, testing and installation of a new customer information system. Management continues to work with the vendor to ensure the system has appropriate controls and measures to age and report on accounts receivable effectively.

2011 Update

The New CIS was unable to be completed as planned. The vendor is now working to enhance the current CIS system rather than implement the New CIS system.

Management's Response

On September 30, 2011, the vendor and DEP agreed to a new project scope that includes necessary enhancements to address the material control weakness in the existing CIS, including the proper aging of accounts receivable. The vendor projects that the enhancements will be operational in June 2012.

SECTION III — OTHER DEFICIENCY

We identified the following other deficiency involving the System's internal control over financial reporting as of June 30, 2011 that we wish to bring to your attention:

1. **Management Review**

   Observation

   A formal management policy requires timely review by management of schedules that support the balances recorded in the general ledger. However, we observed that there is not a process in place to ensure that these procedures are performed on a timely and consistent basis. As a result, we identified an error in the accrued interest expense schedule that was not detected by the system of internal controls.

   Impact

   Financial statement balances may not be accurate. Furthermore, if one person is creating a schedule and there is no one reviewing it, there is lack of segregation of duties.

   Recommendation

   When a process is performed within a department, there should always be another level of review and approval performed by a knowledgeable individual independent of the process. The reviewer should be able to identify errors and omissions. The approval should be documented to verify that a review has been done. Review and approval help to reduce uncorrected errors, irregularities and inaccurate or incomplete information in accounts and reports.

   Management's Response

   We will ensure that all schedules that support the balances recorded in the general ledger are consistently reviewed by someone other than the preparer. Additionally, the Authority has begun the implementation of a new database management system which will help to eliminate the type of error identified in the accrued interest expense schedule that was not detected by the current system of internal controls.

SECTION IV — OTHER MATTERS

We identified and previously communicated the following matter that we wish to bring to your attention at this time:

1. **Communication Between the System and The City of New York**

Observation

The System is required to meet The City of New York's ("The City") early October deadline for submission of the audited financial statements. The City runs its capital accrual report after this deadline. The capital accrual report identifies accruals related to the Department of Environmental Protection ("DEP") which are to be booked as capital assets for the New York City Water Board and a payable from the New York City Water Board to The City.

Impact

There is potential for a material adjustment to be identified after the financial statements have been issued.

Recommendation

The System should have a deadline that coincides with the timing of the capital accrual report so that all necessary adjustments are identified and recorded in the financial statements.

Management's Response

The City's early October deadline for its component units ("CU"), including the System, to submit their audited financial statements is in place in order to permit the City and its auditors adequate time to review and incorporate the CUs' financial statements into the City's CAFR. In prior years, especially when the System's financial statement audit has been conducted by a firm other than the firm which conducted the City's financial statement audit, difficulties have arisen when the System's audit was not completed in a timely way. This and similar issues with other CUs have threatened the timely issuance of the City's CAFR in accordance with City Charter imposed deadlines.

The Municipal Water Finance Authority management will work with the Office of the Comptroller to try to adjust the timing of the capital accrual report, the financial statement submission time line, or both, in order to minimize the risk that material adjustments might be identified by the City after the System's statements have been issued.

2011 Status Update

This issue has been resolved and is considered to be closed.

2. DEP – RACF Data Sets Not Found: Password Change Interval

Observation

DEP's RACF (Mainframe system that supports the Customer Information System application) password policy states that users are required to change their passwords every 90 days. It was noted that for nineteen out of the twenty-five employees selected for testing, the "password change interval" was set to N/A.

Impact

The risk of having weak or no password parameters may result in inadequate security mechanisms being configured, and implemented inconsistently across the entity, to prevent unauthorized access to sensitive information resources and financial information underlying automated controls and computer generated information.

Recommendation

Management should consider establishing a process to ensure the password interval is set in accordance with the DEP policy when a new account is set up.

Management's Response

On December 8, 2006, the New York City Department of Information Technology and Telecommunications ("DoITT") published Security Policy Memorandum 2006-2, which required enforced password changes every 90 days. With the exception of two user profiles, all user profiles cited above were created prior to the issuance date of this Security Policy Memorandum. In compliance with the City-wide security standards, all password intervals, belonging to profiles created both before and after issuance of the memorandum, will be set to the 90-day standard for all users no later than January 15, 2011.

2011 Status Update

This issue has been resolved and is considered to be closed.

3. DEP –RACF Data Sets Not Found

Observation

A review of the Data Security Monitor ("DSMON") Selected Data Sets Report identified the following results:

- Two datasets were indicated as N.M. (Not Mounted)
- Seven datasets were indicated as N.C (Not Catalogued) and were not RACF protected

Impact

This may indicate a security exposure.

Recommendation

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

Management's Response

The nine datasets indicated above with selection criterion of Authorized Program Facility ("APF") have been deleted after the testing results were sent to DoITT by the Deloitte and Touche audit team. These entries were deleted from the system as of September 22, 2010.

As part of the normal maintenance of the operating system, data sets are added and removed from the system. The security exposure of the deficiency described is minimal to non-existent due to the fact that only members of the MVS systems programming group -- MVS is the operating system for the RACF mainframe server -- have update rights to the APF list and datasets in question.

2011 Status Update

This issue has been resolved and is considered to be closed.

SECTION V — DEFINITIONS

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

A *deficiency* in internal control over financial reporting 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 and correct 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 would not be met. A deficiency in operation exists when (a) a properly designed control does not operate as designed, or (b) the person performing the control does not possess the necessary authority or competence to perform the control effectively.

A *material weakness* is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

A *significant deficiency* is a deficiency, or combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

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