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October 10, 2012

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
255 Greenwich Street, 7th Floor
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, 2012 (on which we have issued our report dated October 10, 2012), 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 and therefore, material weaknesses or significant deficiencies may exist that were not identified..

We have previously communicated certain matters noted during our audits of the financial statements of the System for the years ended June 30, 2011 and June 30, 2008 which we considered to be material weaknesses, in our reports to management and those charged with governance dated October 7, 2011 and October 10, 2008, respectively. As of the date of this report, we believe the System is still in the process of remediating these material weaknesses. We have outlined in Section I of the attached Appendix the previously-reported matters which we believe are in the process of being remediated.

We have also identified, and included in Section II of the attached Appendix, other matters involving the System's internal control over financial reporting as of June 30, 2011 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 III 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

APPENDIX

SECTION I — MATERIAL WEAKNESSES IDENTIFIED IN A PREVIOUS AUDIT THAT ARE IN THE PROCESS OF BEING REMEDIATED

We identified and previously communicated the following deficiency that was 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, 2011. As of the date of this report, we believe this deficiency has not yet been remediated by the System**:**

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 ("CWIP") 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, the New York City Department of Environmental Protection ("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.

2012 Update

We observed that The City is able to provide detailed support for expenditures made that have been coded as Water-Funded. Water-Funded is defined as having a capital bond status relating to the System. We further observed that the payments made by the System to The City for reimbursement of capital assets agreed to The City's expenditure detail. This provides assurance that the assets being capitalized as CWIP do represent assets of the System.

However, the System is still unable to reconcile from these cash records to a CWIP subledger. This is due to the fact that the subledger is maintained manually at DEP rather than on The City's FMS system.

Recommendation

We recommend that new additions to CWIP be maintained in detail within The City's FMS system. This would require DEP to follow the same procedures as The City for recording and tracking CWIP assets via the automated creation of FA documents so that there is a linkage between capital spending and capital assets. The System should also define and implement review procedures to ensure that CWIP subledger details are accurate based on bond status and reconciling items such as pollution remediation projects, expenditures for land that do not represent assets of the System, and other similar items.

Management's Response

The System recognizes the importance of CWIP and other fixed asset records maintained by DEP and their ability to be reconciled to capital disbursements funded by the Authority. The concerns raised by the auditors notwithstanding, we are confident that only eligible System-related capital projects are financed by Authority bond proceeds, due to the capital expenditure eligibility review process that is in place and the Authority's bond financing program tax compliance procedures.

Currently DEP, in consultation with the Authority's accounting staff and other City offices, is exploring the implications of, and options for, maintaining CWIP detail in FMS for new capital projects going forward. The procedures used by other City agencies may not be readily transferable to DEP, because DEP's operations require the maintenance of fixed asset records at a greater level of detail and involve information entry by numerous people in several bureaus throughout the agency. We expect to complete this analysis early in calendar 2013 and shortly thereafter determine the best course of action, with the tentative goal of implementation for the start of fiscal 2014.

We identified and previously communicated the following deficiency that was 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**

<u>Observation Communicated in Letter Dated October 10, 2008</u>

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.

<u>Management's Response Communicated in Letter Dated October 10, 2008</u>

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.

<u>2009 Update</u>

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.

2012 Update

Enhancements to the existing CIS system are still in progress and have not yet become operational.

Management's Response

The vendor has just completed the system testing of all enhanced functions. DEP started user acceptance testing on November 14, including regression testing, scalability performance and generation of annual reports. Depending on the volume of defects and corrective measures required as a result of the testing, the enhancements may be implemented in the first quarter of calendar year 2013.

SECTION II — OTHER MATTERS

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

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.

2012 Status Update

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

SECTION III — DEFINITIONS

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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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