

Audit Report

Maryland Environmental Service

April 2016



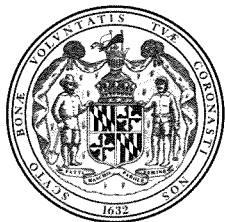
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DEPARTMENT OF LEGISLATIVE SERVICES
MARYLAND GENERAL ASSEMBLY

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DEPARTMENT OF LEGISLATIVE SERVICES
OFFICE OF LEGISLATIVE AUDITS
MARYLAND GENERAL ASSEMBLY

Warren G. Deschenaux
Executive Director

Thomas J. Barnickel III, CPA
Legislative Auditor

April 7, 2016

Senator Guy J. Guzzone, Co-Chair, Joint Audit Committee
Delegate C. William Frick, Co-Chair, Joint Audit Committee
Members of Joint Audit Committee
Annapolis, Maryland

Ladies and Gentlemen:

We have conducted a fiscal compliance audit of the Maryland Environmental Service (MES) for the period beginning December 9, 2011 and ending March 23, 2015. MES provides water supply, wastewater treatment, and waste management services to public and private entities. As of February 2015, MES administered 762 projects, of which 261 projects were operated at State-owned facilities.


Our audit disclosed that MES could not substantiate the need for the full amount of advance payments totaling \$21.4 million received for certain State projects. As a result, the potential exists for some of these funds to be returned to the applicable State agency.

In addition, a 1979 Board of Public Works policy, which addresses the services provided by MES to State agencies for certain projects, may no longer be the appropriate mechanism for establishing the contractual relationship between those parties. Based on the age of the policy and questions about the appropriateness and usefulness of the policy, we believe MES should obtain formal advice regarding the appropriateness of using the existing policy to establish its contractual relationship with these agencies, or if the contractual arrangements should be handled in a different manner. During fiscal year 2014, MES collected approximately \$19 million from State agencies related to 74 projects covered by the policy.

Finally, we noted that MES had not established proper controls over its collections, payroll and personnel transactions, and did not periodically review user access to its financial management system.

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

Respectfully submitted,

A handwritten signature in black ink, appearing to read "TJ Barnickel III". The signature is fluid and cursive, with a small "III" at the end.

Thomas J. Barnickel III, CPA
Legislative Auditor

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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 February 2, 2015, MES administered 762 projects, of which 261 projects were operated at State-owned facilities. According to its fiscal year 2015 audited financial statements, MES's operating expenditures (including salaries, wages, and fringe benefits) totaled approximately \$139.3 million and MES received revenue totaling approximately \$141.1 million, of which approximately \$133.4 million was received from State and local government entities.

MES is governed by a nine-member Board of Directors, including the Director, Deputy Director, Secretary, and Treasurer of MES. The remaining five members are appointed to the Board by the Governor with the advice and consent of the Maryland Senate.

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, 2012, 2013, 2014, and 2015, and the changes in its financial position and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Findings and Recommendations

State Projects

Background

Maryland Environmental Service (MES) performs project services (such as environmental cleanup and recycling program management) for State agencies. Some of the projects are for a short duration, such as scrap tire clean-up. MES enters into a contract with each agency for these projects. During fiscal year 2014, expenditures related to 172 State-related contractual projects totaled approximately \$49.2 million. As provided for in the contracts, MES may require advance payments from agencies to cover project expenditures. Any interest earned on the advances is credited to the individual projects to offset expenditures. According to MES, the necessity and amount of an advance are based on the duration and size of the project. As of June 30, 2014, there were 22 advances outstanding for State contractual projects totaling \$28.8 million.

Other MES projects represent long-term operational commitments by MES, which are administered in accordance with an Executive Order issued in 1971 that directs MES to operate and maintain all State-owned water, wastewater, and solid waste management facilities. The funding for these State reimbursable projects is established through the State budgetary process, during which annual estimates of costs for the projects are submitted by MES to the Department of Budget and Management for inclusion in the annual budget request. MES is reimbursed by State agencies on a monthly basis for a portion of that annual estimate. At year-end, adjustments are made to ensure agencies' payments equal MES's actual costs. During fiscal year 2014, MES collected approximately \$19 million from State agencies related to 74 reimbursable projects.

Finding 1

MES did not maintain documentation to support the need for the full amount of funding advances received for certain State projects.

Analysis

MES did not maintain documentation to support certain outstanding project advances, including the justification for the dollar amount and the duration of the individual advances that were outstanding. Our test of 10 judgmentally-selected advances received from State agencies totaling \$21.8 million as of February 28, 2015, disclosed that MES could not substantiate the need for the full amount of advances received totaling \$21.4 million for 7 projects. Consequently, the potential exists for some of these funds to be returned to the applicable State agency.

- MES could not justify why it needed advances totaling \$20.9 million for five Maryland Port Administration (MPA) projects with original budgeted costs of approximately \$196.3 million, of which \$80.3 million was unexpended as of February 28, 2015. From May 2013 through October 2014, MES requested and received significant project advances, which according to the contracts were supposed to be based on the project tasks authorized and that efforts would be made to ensure that advances were to be outstanding no more than three months. However, a correlation between the cost of tasks and the advances was not always documented, and the advances received by MES have exceeded what has been needed to fund the projects for three months.

For example, in May 2013, MES received \$5.5 million from MPA that increased the advance for one of the aforementioned projects to \$16.7 million. However, during the period from May 2013 to April 2015, the monthly billed expenditures for this project averaged \$442,000 and ranged from approximately \$80,000 to \$1.2 million. Therefore, the advance amount was well beyond the amount actually needed to fund expenditures for any three-month period; at the most, only \$3.6 million was needed as an advance during that two-year period. MES could not provide documentation to justify the advance amount or to justify the extended period of time the advance remained outstanding. We were advised that the advance was needed to fund upcoming large projects and project delays had been experienced for various reasons.

- MES did not provide adequate documentation to support the continuing need for advances totaling approximately \$356,000 and \$98,000 for two MPA projects, respectively. These advances were paid to MES prior to 1993 for expenditures related to a groundwater treatment facility and a hazardous waste landfill, which are no longer active. When questioned about whether these advances had been approved to be outstanding for this amount of time, MPA management stated it was unaware that MES was retaining funds related to these projects.

Recommendation 1

We recommend that MES

- a. prepare and retain documentation supporting the need for advance amounts and duration; and**
- b. periodically evaluate advances received and return to State agencies funds in excess of the needs established in the contracts, including the appropriate portion of the advances for the aforementioned seven projects.**

Finding 2 (Policy Issue)

A 1979 Board of Public Works (BPW) policy, which addresses the services provided by MES to State agencies for reimbursable projects, may no longer be the appropriate mechanism for establishing the contractual relationships between those parties.

Analysis

MES did not establish separate contractual agreements with State agencies for the operation of each reimbursable project; rather, MES officials advised that its relationship with State agencies for such projects is primarily reliant on the aforementioned 1971 Executive Order. Subsequently, a policy statement was approved by the BPW in 1979 to provide more clarity for those contractual arrangements. Although there is no indication the policy has been rescinded, when we contacted a BPW official, the official questioned whether the policy is an appropriate mechanism for establishing the contractual relationship between MES and State agencies. Furthermore, we noted that MES was not adhering to certain provisions of the policy statement.

Specifically, when we inquired about the policy statement, the BPW official was unaware of its existence and opined that current members of BPW were similarly unacquainted with the statement. Consequently, the official had no knowledge that the policy statement had been rescinded. However, the BPW official questioned if such a policy statement is the appropriate mechanism for establishing the current relationship between MES and State agencies. The official indicated that, subsequent to the issuance of this policy statement, the General Assembly directed that such policies be handled through the regulatory process. The official also was uncertain whether BPW now has jurisdiction over this matter. Therefore, the official believes the appropriate course of action would be to consult with the Office of the Attorney General to resolve the matter.

We also noted that MES was routinely not adhering to a provision in the policy which may, in part, suggest that the policy statement is outdated. We were advised by MES that the required detailed working agreement and description pertaining to the scope of responsibility assigned to each party is not included in any documentation prepared by either MES or the State agency. Furthermore, MES does not consistently prepare intergovernmental agreements or similar contractual documents to describe processes for various aspects of the facility management, such as emergency repairs and sub-contractors. Although we were advised that comprehensive intergovernmental agreements are prepared for county agencies receiving similar services, MES stated that it believed the agreements are unnecessary for State projects, but would prepare them if requested by a State agency.

In view of the age of the policy statement, and current questions about the appropriateness of the policy and usefulness in its current form, we believe legal advice should be sought to determine if such a policy is the appropriate mechanism for establishing the contractual relationship between MES and State agencies. In addition, existing contractual requirements should be reassessed and updated as appropriate to sufficiently define responsibilities and protect the interests of each party.

Recommendation 2

We recommend that MES

- a. consult with legal counsel and obtain formal advice regarding the appropriateness of the existing BPW policy statement or whether the contractual arrangements between MES and state agencies should be handled in a different manner, such as through regulation; and**
- b. reassess existing contractual requirements with State agencies and ensure they are sufficient.**

Cash Receipts and Accounts Receivable

Finding 3

Internal controls over collections were not adequate and cash receipts and account receivable duties were not adequately separated.

Analysis

Controls over collections processed using the remote deposit system, a process that scans the images of checks and electronically transmits those images to the bank for deposit, were not adequate. In addition, duties related to cash receipts and accounts receivable were not properly segregated. Checks received in February 2015 totaled \$3.8 million, and as of February 28, 2015, the outstanding accounts receivable balance was \$21.3 million.

- MES did not record and restrictively endorse checks prior to scanning the checks in the remote deposit system, which electronically endorses the scanned image of the checks. Also, two employees shared one username and password to routinely access the bank's remote deposit system. Finally, deposited checks appeared to be retained for an excessive period. We were advised by MES management that the checks were retained for approximately three months (or two months longer than required) prior to being destroyed.

- MES did not adequately separate the cash receipts and accounts receivable functions. Two employees responsible for handling and scanning checks in the remote deposit system were also assigned access capabilities in the automated financial management system to adjust the related accounts receivable records. Furthermore, the supervisor responsible for reviewing and approving the adjustments to the accounts receivable records also had access capabilities that allowed the supervisor to initiate adjustments. In addition, two employees (one of whom also had access to checks) could initiate and approve non-cash credits in the accounts receivable records without independent supervisory approval. Non-cash credit transactions totaled approximately \$3.4 million in fiscal year 2014.

As a result of the above conditions, checks could be misappropriated without detection. The Office of the State Treasurer's *Policy on the Use of Remote Deposit Services by Maryland State Agencies* requires that checks be restrictively endorsed and logged in upon receipt, remote deposit system users be assigned individual user IDs, passwords not be shared among users, and scanned and transmitted checks should be stored no longer than 30 days before they are destroyed. The Comptroller of Maryland's *Accounting Procedures Manual* requires the establishment of sufficient internal controls over collections, including adequate separation of cash receipt processing duties, independent verification of collections to deposit, and initial accountability over collections received.

Recommendation 3

We recommend that MES

- a. restrictively endorse and record all checks immediately upon receipt,**
- b. assign unique usernames and passwords to employees with access to the bank's remote deposit system,**
- c. ensure proper segregation of duties over cash receipts and accounts receivable functions,**
- d. ensure that checks processed through the bank's remote deposit system are destroyed in a timely manner, and**
- e. ensure that accounting adjustments and non-cash credits are approved by independent supervisory personnel.**

We advised MES on accomplishing the necessary separation of duties using existing personnel.

Human Resources and Payroll

Finding 4

Human resources and payroll system user capabilities were not adequately restricted. In addition, independent documented reviews of personnel and payroll transactions were not performed.

Analysis

MES had not established adequate controls over its personnel and payroll processing. According to State records, MES employed approximately 700 employees as of June 30, 2014, and payroll expenditures totaled approximately \$42 million.

- Critical human resources (HR) and payroll system access capabilities, such as those allowing the changing of employee salary and direct deposit information and the recordation, review, and approval of payroll-related information, were not adequately restricted. Our review of the five individuals with HR and payroll responsibilities disclosed that the duties that could be performed by three of these employees were not adequately segregated as the employees could unilaterally perform all critical personnel and payroll transactions in MES's HR and payroll system. As a result, these employees could process improper payroll payments without detection.
- There was no independent review to ensure that processed employee personnel and payroll transactions were correct and appropriate. Transactions, such as adding or deleting employees and editing the bi-weekly time and payroll reports, were manually approved prior to being recorded in the system, but there was no independent verification performed to ensure that the information actually posted in the system was proper. As a result, there is an increased risk of improper transactions being processed.

Recommendation 4

We recommend that MES

- a. establish a proper separation of duties over human resources and payroll duties; and**
- b. perform a documented independent supervisory review of critical personnel and payroll transactions processed, at least on a test basis.**

We advised MES on accomplishing the necessary separation of duties using existing personnel.

Financial Management System Access

Finding 5

MES had not established adequate controls to ensure the propriety of access capabilities assigned to users of its automated financial management system.

Analysis

MES did not perform periodic reviews of user access capabilities for its automated financial management system, which is used for all aspects of the agency's operations, including payroll and human resources, cash receipts and accounts receivable, and disbursements and procurement functions. As of April 2015, MES had granted 327 users access to this system. While access to the system is originally requested and approved by an employee's direct supervisor, no subsequent reviews are performed to ensure access assigned continues to be appropriate. During the course of the audit, we noted instances where individuals had incompatible or inappropriate system capabilities, such as access to both cash receipt and accounts receivable records (Finding 3) and the ability to perform critical personnel and payroll transactions without supervisory review and approval (Finding 4).

Furthermore, our review disclosed 10 unnecessary active system administrator profiles assigned to certain third parties that allowed unrestricted access to the system, such as editing system settings, establishing system user accounts and security. We were advised by MES management that these profiles were assigned to former consultants and were not required, and MES subsequently deactivated the profiles.

The State of Maryland's *Information Security Policy*, requires agencies to monitor the security controls over its information systems at least annually and states that each agency must establish an authorization process which specifically grants access to information ensuring that access is strictly controlled, audited, and that it supports the concepts of "least possible privileges" and "need-to-know."

Recommendation 5

We recommend that MES

- a. perform a periodic documented review of user access capabilities for the financial management system and ensure users are assigned only those capabilities needed to perform job duties, and**
- b. restrict users' capabilities to eliminate the ability of users to perform incompatible duties.**

Audit Scope, Objectives, and Methodology

We have conducted a fiscal compliance audit of the Maryland Environmental Service (MES) for the period beginning December 9, 2011 and ending March 23, 2015. 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's financial transactions, records and internal control, and to evaluate its compliance with applicable State laws, rules, and regulations.

In planning and conducting our audit, we focused on the major financial-related areas of operations based on assessments of significance and risk. The areas addressed by the audit included accounts receivable, cash receipts, procurements and disbursements, payment advances from project participants, and project cost accounting.

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, 2012, 2013, 2014, and 2015, 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. We have relied on the work of the independent accounting firm to provide audit coverage of certain aspects of MES's operations (such as, internal controls and testing for debt financing and certain accounts receivable activities). Our audit procedures in these areas were generally limited, therefore, to obtaining a sufficient basis for that reliance.

To accomplish our audit objectives, our audit procedures included inquiries of appropriate personnel, inspections of documents and records, observations of MES operations, and tests of transactions. Generally, transactions were selected for testing based on auditor judgment, which primarily considers risk. Unless otherwise specifically indicated, neither statistical nor non-statistical audit sampling was used to select the transactions tested. Therefore, the results of the tests cannot be used to project those results to the entire population from which the test items were selected.

We also performed various data extracts of pertinent information from the MES's financial management system (such as revenue and expenditure data). We determined that the data extracted from these various sources were sufficiently reliable for the purposes the data were used during this audit. Finally, we performed other auditing procedures that we considered necessary to achieve our objectives. The reliability of data used in this report for background or informational purposes was not assessed.

MES's 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 relating to conditions that we consider to be significant deficiencies in the design or operation of internal control that could adversely affect MES's ability to maintain reliable financial records, operate effectively and efficiently, and/or comply with applicable laws, rules, and regulations. Our report also includes findings regarding 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.

The response from MES 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



Larry Hogan, Governor

John J. O'Neill, Jr., Deputy Director

April 5, 2015

Mr. Thomas J. Barnickel, III, CPA
Legislative Auditor
Department of Legislative Services
Office of Legislative Audits
301 West Preston Street Room 1202
Baltimore, MD 21201

Dear Mr. Barnickel,

Enclosed please find the responses for the Maryland Environmental Service audit. It was a pleasure working with your staff.

Sincerely,

A handwritten signature in black ink, appearing to read "John J. O'Neill". The signature is fluid and cursive, with the first and last names being more prominent.

John J. O'Neill
Deputy Director

Cc: Janet Irvin, CPFO

Finding 1

MES did not maintain documentation to support the need for the full amount of funding advances received for certain State projects.

Recommendation 1

We recommend that MES

- a. prepare and retain documentation supporting the need for advance amounts and duration; and**
- b. periodically evaluate advances received and return to State agencies funds in excess of the needs established in the contracts, including the appropriate portion of the advances for the aforementioned seven projects.**

MES concurs with the auditors' recommendation and has implemented steps to respond accordingly:

- a) As of August 24, 2015, MES is preparing and retaining increased documentation to support how each advance amount is determined. This includes calculations, client discussions and direction or other appropriate documentation that substantiate advance funding requests.**
- b) As of August 24, 2015 MES has been working with State agency clients to identify and execute the best methods to resolve excess advance funding balances that may exist. Methods thus far include reducing planned project funding to draw down advance funding balances, amendments to current contracts that update contractual language regarding advances, and an increase in project activities that had been previously delayed.**

Finding 2 (Policy Issue)

A 1979 Board of Public Works (BPW) policy, which addresses the services provided by MES to State agencies for reimbursable projects, may no longer be the appropriate mechanism for establishing the contractual relationships between those parties.

Recommendation 2

We recommend that MES

- a. consult with legal counsel and obtain formal advice regarding the appropriateness of the existing BPW policy statement or whether the contractual arrangements between MES and state agencies should be handled in a different manner, such as through regulation; and**
- b. reassess existing contractual requirements with State agencies and ensure they are sufficient.**

MES utilizes the Governor's Executive Order, the BPW Policy Statement, the MES Act, and permits issued by MDE to define the administration, operations and maintenance of

State-owned water, wastewater, and solid waste management facilities. MES believes these documents have proven to be more than adequate to define the relationship between MES and other State agencies, and are the basis for the successful approach to properly and consistently managing these facilities and ensures environmental protection is a priority.

MES also believes that certain documents prepared by MES, such as detailed budget plans and Annual Reports, fulfill the requirements for documentation in the Policy.

MES agrees to:

- a) By May 31, 2016 consult with legal counsel and obtain formal advice regarding the appropriateness of the existing BPW policy statement or whether the contractual arrangements between MES and State agencies should be handled in a different manner,
- b) By June 30, 2016 reassess existing contractual requirements with State agencies and ensure they are sufficient.

Finding 3

Internal controls over collections were not adequate and cash receipts and account receivable duties were not adequately separated.

Recommendation 3

We recommend that MES

- a. restrictively endorse and record all checks immediately upon receipt,
- b. assign unique usernames and passwords to employees with access to the bank's remote deposit system,
- c. ensure proper segregation of duties over cash receipts and accounts receivable functions,
- d. ensure that checks processed through the bank's remote deposit system are destroyed in a timely manner, and
- e. ensure that accounting adjustments and non-cash credits are approved by independent supervisory personnel.

We advised MES on accomplishing the necessary separation of duties using existing personnel.

MES concurs with the auditors' recommendation and has implemented steps to respond accordingly:

- a. Effective July 19, 2015 checks are restrictively endorsed immediately on receipt.
- b. As of July 21, 2015 staff members are utilizing unique user names and passwords for the bank's remote deposit system.

- c. On August 3, 2015 MES implemented changes to the E1 security for the three positions noted with inappropriate adjustment authority.
- d. Effective July 22, 2015 scanned checks are destroyed in a rolling 30 days period.
- e. On August 3, 2015 MES implemented changes to the E1 security for the two positions noted, who are now unable to initiate non-cash credits, and will perform the posting and review functions.

Finding 4

Human resources and payroll system user capabilities were not adequately restricted. In addition, independent documented reviews of personnel and payroll transactions were not performed.

Recommendation 4

We recommend that MES

- a. establish a proper separation of duties over human resources and payroll duties; and
- b. perform a documented independent supervisory review of critical personnel and payroll transactions processed, at least on a test basis.

We advised MES on accomplishing the necessary separation of duties using existing personnel.

MES concurs with the auditors' recommendation and has implemented steps to respond accordingly:

- a) On May 18, 2015 the security for the Basic Compensation application was changed for the 3 named positions to prohibit them from entering changes. The security for the Payroll supervisor, who will be confirming payroll changes made by the Payroll Specialist, has been changed in E1 effective August 3, 2015 prohibiting her from making PDBA History changes.
- b) For HR transactions, effective August 3, 2015 an HR Generalist verifies the transactions entered by the HRIS Specialist. Effective July 22, 2015 the Deputy CFO verifies the Time and Pay Exception Report, and the payroll register both before and after the payroll is processed.

Finding 5

MES had not established adequate controls to ensure the propriety of access capabilities assigned to users of its automated financial management system.

Recommendation 5

We recommend that MES

- a. perform a periodic documented review of user access capabilities for the financial management system and ensure users are assigned only those capabilities needed to perform job duties, and**
- b. restrict users' capabilities to eliminate the ability of users to perform incompatible duties.**

MES concurs with the auditors' recommendation and has implemented steps to respond accordingly:

- a. On April 15, 2015, MES IT prepared and distributed documentation of the user access capabilities for review and approval by management. All grids were reviewed and all approvals and/or requests for changes were completed by August 3, 2015. The review will be done annually.**
- b. Role responsibilities will be reviewed by management in the same cycle as user access capabilities.**

AUDIT TEAM

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