



Metro

Metropolitan Transportation Authority

One Gateway Plaza
Los Angeles, CA 90012-2952

213.922.2000 Tel
metro.net

24

**EXECUTIVE MANAGEMENT & AUDIT COMMITTEE
APRIL 19, 2007**

**SUBJECT: PRICEWATERHOUSECOOPER'S REPORT TO
MANAGEMENT**

ACTION: RECEIVE AND FILE

RECOMMENDATION

Receive and file Report to Management from PricewaterhouseCoopers, "PWC", regarding Metro's internal control. (Attachment A)

ISSUE

As part of their independent audit of our financial statements for fiscal year ended June 30, 2006, PWC issued the attached report, commonly known as a "management letter", describing four suggestions to help improve our system of internal control and achieve operating efficiencies. Significantly, the auditors noted no "material weaknesses" or "reportable conditions."

DISCUSSION

The responsibility of Metro's system of internal control rests with management and the Board of Directors. A strong system of internal control is indicated by organizational goals being met, management directives being followed in a timely and efficient manner and assets of Metro being properly safeguarded.

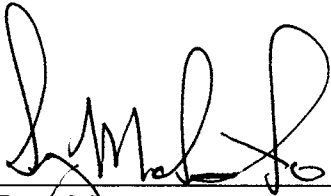
NEXT STEPS

Implement the agreed upon actions to improve internal controls.

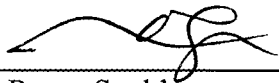
ATTACHMENT

PricewaterhouseCoopers Report to Management

Prepared by: Josie V. Nicasio
Controller



Terry Matsumoto
Chief Financial Services Officer and Treasurer



Roger Snoble
Chief Executive Officer

**Los Angeles County Metropolitan
Transportation Authority**

**Report to Management
For the Year Ended June 30, 2006**

January 10, 2007

Mr. Terry Matsumoto
Chief Financial Services Officer and Treasurer
Los Angeles County Metropolitan Transportation Authority
One Gateway Plaza
Los Angeles, CA 90012-2952

Dear Mr. Matsumoto:

We have completed the audit of the financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the Los Angeles County Metropolitan Transportation Authority (the "LACMTA") which collectively comprise the LACMTA's basic financial statements for the year ended June 30, 2006. In planning and performing our audit of the basic financial statements of the LACMTA, we considered the internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the basic financial statements and not to provide assurance on the effectiveness of internal control. Our consideration of internal control would not necessarily disclose all matters in internal control that might be reportable conditions or material weaknesses, as defined in AU 325, *Communication of Internal Control Related Matters Notes in an Audit (AU 325)*, of the *AICPA Professional Standards* and shown below:

Reportable condition – a condition which could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of the management in the financial statements.

Material weakness – a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

We noted certain matters involving the system of internal control and its operation, and are submitting these matters for your consideration to help LACMTA improve the system of internal control and achieve operating efficiencies. Our comments reflect our desire to be of continuing assistance to the LACMTA.

This letter is intended solely for the information and use of the executive management and audit committee, board of directors, management, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties.

If you would like further information or would like to discuss any of the issues raised, please contact Nancy Shelmon, Engagement Partner, at (213) 217-3146.

Very truly yours,

PricewaterhouseCoopers LLP

Los Angeles County Metropolitan Transportation Authority
Index
For the Year Ended June 30, 2006

Page

CURRENT YEAR COMMENTS

1.	Monitor direct changes to financially significant production databases and remove network domain administrator access by certain personnel	1
2.	Develop a more consistent approach to support the reserve for self-insurance claims	3
3.	Update the assumptions used for other post-employment benefits	4
4.	Prepare for upcoming changes to communication of internal control related matters identified in an audit	5

STATUS OF PRIOR YEAR COMMENTS

No prior year comments were noted.

Los Angeles County Metropolitan Transportation Authority
Report to Management
For the Year Ended June 30, 2006

CURRENT YEAR COMMENTS

- 1. Monitor direct changes to financially significant production databases and remove network domain administrator access by certain personnel**

Observations

We performed a review of Information Technology General Controls in support of the Oracle Financial Information System (FIS) and Payroll system. This includes reviewing the IT entity level controls, Access to Programs and Data, Computer Operations, Program Changes, and Program Development.

Following are the observations noted in the areas of data security and network security:

Data Security

The activities of those with direct database access are not monitored to confirm that any changes made to financially significant production data are authorized.

While we observed that access has been appropriately restricted to the six employees within the Database and Storage Administration group, there is currently no detective control to monitor their activities.

While we also observed that LACMTA has a change management framework to which every data change should adhere, there is currently no detective control to ensure that all data changes made comply with the framework.

Network Security

Three of the nine people with network domain access no longer require this level of access as they have moved to other responsibilities within the unit.

Recommendations

Regarding data security, regular monitoring of direct changes to financially significant production databases (and/or tables) should be performed by a responsible and independent IT official. This detective control will strengthen the overall security of data in conjunction with the preventive controls already in existence.

Regarding network security, the network domain administrator access level should be removed for these three employees.

Los Angeles County Metropolitan Transportation Authority
Report to Management
For the Year Ended June 30, 2006

Management's Response

Network Security

The recommended changes were made on September 13, 2006 as noted in the PwC report.

Data Security

ITS does not agree that there is no monitoring of database changes as ITS uses several methods to track and monitor the activities of the Database and Storage Administration employees as well as the integrity of the production data as follows:

- 1) Requests for database changes or upgrades are reviewed for approval by the Database Administration Manager. The request(s) is logged into an electronic tracking file and assigned to a database administrator. Upon completion of the work, the Software Support Group is notified that the upgrade has been completed and to test the results.
- 2) For system patches and upgrades, in addition to step 1) above, the Database Administration Manager reviews the work before it is placed into production status.
- 3) For the Financial Information System (FIS) and Payroll System, ITS generates exception reporting that is utilized by the Finance Department to check for data anomalies.

To address the audit recommendation of detective control, the Director of System Integration will periodically select requests from the database tracking log for review to ascertain that there were no unauthorized changes.

**Los Angeles County Metropolitan Transportation Authority
Report to Management
For the Year Ended June 30, 2006**

2. Develop a more consistent approach to support the reserve for self-insurance claims

Observation

As of June 30, 2006, LACMTA has recorded a claims reserve in the aggregate amount of approximately \$270 million.

Management uses the actuarial report of Milliman in the determination of self-insurance claims. Based on the Milliman report and assuming a discount rate of 3%, the actuarial valuation as of June 30, 2006 was estimated to be approximately \$246 million.

The recorded claims reserve is 9.6% or \$24 million over the Milliman's valuation. Specific reasons provided by LACMTA's Risk Management Group for this deviation include the "inherent uncertainty in reserve estimates, the history of adverse reserve development in the 1990's and early 2000's, and the possibility that projected investment returns will not match projections".

We observed that management appears to have taken a more conservative approach in selecting a management's best estimate this fiscal year ("FY"), as the amount is on the higher end of the range acceptable by the auditors. We recognize the inherent uncertainties associated with self-insurance claims. However, such uncertainties do not, by itself, justify taking a more conservative approach in selecting management's best estimate. While LACMTA experienced adverse reserve development in FY2003 and FY2004, more recent experiences have reflected a more favorable claims reserve development.

Recommendation

We recommend that management should develop a more consistent and rigorous approach to support its claim reserve estimate.

Management's Response

We agree that management should have consistent and rigorous approach to support its claim reserve estimate. Based on industry experience as presented by Metro's actuary, Milliman, reserve balances in sum should be between the 50% and 80% "confidence levels," the probability that the ultimate costs will fall within this range. Annually, management will assess the inherent uncertainty in reserve estimates, the recent history of adverse/favorable reserve developments and the possibility that projected investment returns will not match projections to determine where in this range to set the year end liability.

Los Angeles County Metropolitan Transportation Authority
Report to Management
For the Year Ended June 30, 2006

3. Update the assumptions used for other post-employment benefits

Observation

LACMTA used the following assumptions in calculating its liability for other post-employment benefits:

Medical inflation rate:	static 5%, and 0% for certain union groups
Discount rate:	7.5%
Mortality table:	1983 GAM

The above assumptions do not reflect current industry standards, which typically are as follows:

Medical inflation rate:	graded down rate from 10% to 5% in a span of several years
Discount rate:	5.75%
Mortality table:	RP2000 Blue Collar Mortality Table

Recommendation

Management should review and update their assumptions annually, and record its liability for other post-employment benefits based on assumptions more reflective of actual expectations.

Management's Response

We agree that management should review and update our assumptions on a regular basis and record the liability for other post-employment benefits based on assumptions that are reflective of actual expectations. We will be implementing this effective March 31, 2007.

Los Angeles County Metropolitan Transportation Authority
Report to Management
For the Year Ended June 30, 2006

4. Prepare for upcoming changes to communication of internal control related matters identified in an audit

Observation

In May 2006, the Auditing Standards Board issued Statement of Auditing Standards (SAS) No. 112, *Communicating Internal Control Related Matters Identified in an Audit*. This SAS, which will be effective for the fiscal year ending June 30, 2007:

- Defines and requires the use of the terms significant deficiency and material weakness, incorporating the definitions already in use for public companies and prescribed by the Public Company Accounting Oversight Board ("PCAOB");
- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements; and
- Requires the auditor to communicate, in writing, to management and those charged with governance (e.g., Board of Trustees), significant deficiencies and material weaknesses identified in an audit.

While this new standard does not change audit procedures, it does change the process for evaluating deficiencies that come to our attention and brings the thresholds for reporting control deficiencies in line with the thresholds required for public organizations. As these revised thresholds effectively lower the bar, it is expected that the reporting of what are now defined as either significant deficiencies or material weaknesses will become increasingly more prevalent. There is a possibility that items not previously identified as control deficiencies could rise to what has now been defined by the Auditing Standards Board as a significant deficiency or a material weakness simply as a result of imposing a new definition on the auditor, not as a result of any deterioration in the LACMTA's system of internal control. Common areas of potential weakness that we have found in our other clients include controls in place over the financial statement closing process, information technology (IT) controls over significant systems, segregation of duties, complex spreadsheets, and consideration of the use of third party service providers.

For entities that receive federal funding, such as the LACMTA, any identified material weaknesses in internal controls would be specified in the *Report of Independent Auditors on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards*, which is part of the A-133 report that is filed with the Federal Audit Clearinghouse.

Los Angeles County Metropolitan Transportation Authority
Report to Management
For the Year Ended June 30, 2006

Recommendation

Management should prepare for the implementation of SAS 112 in the next fiscal year.

Suggested action plans include the following:

- Debrief on key controls identified and relied upon during the audit process, including controls installation on key spreadsheets which have direct linkages to the financial reporting process.
- Strengthening key detective controls such as management performance of analytical reviews at a lower threshold level to minimize the likelihood of material misstatements.
- Focusing on the consistent implementation of key controls such as the performance and reviews of reconciliations to minimize the likelihood of material misstatements.

Management's Response

Management is now reviewing the key controls in the preparation of the financial reports. Also, LACMTA implemented a software called "PwC TeamMate" to document, monitor, control and strengthen the analytical reviews being performed by staff to minimize material misstatements in financial reporting.

Los Angeles County Metropolitan Transportation Authority
Report to Management
For the Year Ended June 30, 2006

STATUS OF PRIOR YEAR COMMENTS

No prior year comments were noted.