



John Keel, CPA
State Auditor

A Review of
**The Investigative Report on the
Pedernales Electric Cooperative, Inc.**

February 26, 2009

Members of the Legislative Audit Committee:

The State Auditor's Office has reviewed the *Pedernales Electric Cooperative, Inc. Report of Investigation* (investigative report) prepared by Navigant Consulting (PI) LLC and published on December 15, 2008.

While Navigant Consulting did not conduct an audit, the deficiencies in the Pedernales Electric Cooperative's (PEC) internal controls and organizational structure and the recommendations to remedy the deficiencies detailed in the investigative report rely on some of the same criteria¹ as an audit. Additionally, an auditor would have encountered the same evidentiary limitations (documentation missing or destroyed, witnesses refusing interviews on advice of counsel) that Navigant Consulting encountered while conducting its investigation.

We concur with Navigant Consulting's recommendations for addressing the PEC's governance and management practices that resulted in a lack of effective internal controls. The attachment to this letter includes selected recommendations that the State Auditor's Office noted as significant for improving PEC's internal control structure. In addition, we believe that the following actions, which are primarily based on the Texas Internal Auditing Act, would enhance the recommendation "...that PEC establish an internal audit function...".²

The Legislature should consider requiring by law that:

- A cooperative's board of directors (board) create and maintain a separate audit committee and that an internal auditor be employed who reports to the board. While provisions permitting the internal auditor to communicate and otherwise work with the general manager would be appropriate, the internal auditor should be selected by and report directly to the board or its audit committee. The internal auditor also should be independent in fact and appearance from all responsibilities that may impair the internal auditor's ability to objectively review all aspects of a cooperative's operations.
- A cooperative's internal auditor conduct all audits in accordance with applicable auditing standards.

¹ The Committee of Sponsoring Organizations of the Treadway Commission (COSO), Internal Control – Integrated Framework, 1992.

² See page 70 of the investigative report, which can be found on PEC's Web site at <http://www.pec.coop/CorpProfile/NavigantReport.aspx>.

Background Information

The State Auditor's Office's *Fiscal Year 2009 Audit Plan* includes a provision to review and comment on the investigative report on the Pedernales Electric Cooperative's (PEC) financial and management operations.

This audit plan provision was included in response to numerous legislative inquiries and requests that the State Auditor's Office audit PEC. The State Auditor's Office did not audit PEC for the following reasons:

- At the time of the inquiries and requests, State Auditor's Office resources were fully engaged with other audit work, including a comprehensive audit of financial planning operations of the Department of Transportation.
- Questions existed as to whether the State Auditor's Office had the legal authority to audit PEC.

- A cooperative's internal auditor create an annual audit plan that must be approved by the board or its audit committee. This plan should include:
 - ♦ Individual audits to be conducted that are identified using a risk assessment process.
 - ♦ Periodic audits of the cooperative's major systems and controls.
 - ♦ Audits that assess the cooperative's compliance with any requirements for open meetings, open records, conflicts of interest, and related-party transactions.

Upon completion of each audit, the internal auditor should communicate the results to the board and its audit committee.

- A cooperative's internal auditor prepare an annual public report that includes the internal auditor's findings pertaining to audit work performed pursuant to the audit plan approved by the board or its audit committee. This annual report should be addressed to members of the cooperative, as well as to the board, and be distributed to members in print or electronic form, which may include publication via the cooperative's Web site.

- A cooperative's internal auditor be a certified public accountant or a certified internal auditor.

Employing an internal auditor who reports directly to the board (as indicated in the investigative report) and who is subject to a statutory requirement for public reporting is generally an effective means of policing internal controls and board conduct and preventing management override.

If you have any questions, please contact Lisa Collier, Assistant State Auditor, or me at (512) 936-9500.

Sincerely,

John Keel, CPA
State Auditor

Attachment

cc: Members of the Pedernales Electric Cooperative, Inc. Board of Directors
Mr. Juan Garza, General Manager, Pedernales Electric Cooperative, Inc.
Mr. Todd K. Lester, Director, Navigant Consulting
The Honorable Troy Fraser, Texas Senate
The Honorable Patrick Rose, Texas House of Representatives

Summary of Objective, Scope, and Methodology

The objective was to review and comment on the investigative report on the Pedernales Electric Cooperative's financial and management operations.

This project was a review; therefore, the information in this report was not subjected to all the tests and confirmations that would be performed in an audit. However, the information in this report was subject to certain quality control procedures to help ensure accuracy.

The scope covered the *Pedernales Electric Cooperative, Inc. Report of Investigation* (investigative report), which was prepared by Navigant Consulting and published on December 15, 2008.

The methodology included reviewing the investigative report and identifying and commenting on certain recommendations related to internal controls.

The following staff of the State Auditor's Office worked on this project:

- Brad Reynolds, Senior Economist
- Leslie P. Ashton, CPA (Quality Control Reviewer)
- Linda Lansdowne, CPA (Quality Control Reviewer)
- Lisa R. Collier, CPA (Assistant State Auditor)



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Attachment

Selected Recommendations from Navigant Consulting's Investigative Report

Navigant Consulting (PI) LLC was retained to (1) perform an independent investigation into alleged abuses at the Pedernales Electric Cooperative, Inc. (PEC) and (2) provide business process improvement consulting services to PEC. Navigant Consulting investigated the financial management and operations of PEC for the period from January 1, 1998, through December 31, 2007, with emphasis on the most recent five years. Navigant Consulting's Pedernales Electric Cooperative, Inc. Report of Investigation (investigative report) included more than 140 recommendations, many of which address the business operations and processes specific to PEC, such as other affiliate ventures. The investigative report also included recommendations that address numerous internal control weaknesses associated with PEC's governance and management practices.

The State Auditor's Office reviewed the investigative report, including all recommendations. Table 1 includes the recommendations that auditors noted as significant for improving PEC's internal control structure.

Table 1

| Selected Navigant Consulting Recommendations from <i>Pedernales Electric Cooperative, Inc. Report of Investigation</i> | | | |
|---|-------------------------|----------------|--|
| Report Section | Topic | Page Number(s) | Recommendation |
| IV. Former Management/Management Practices | Internal Audit Function | 70-71 | PEC's system of internal controls needs to be strengthened through additional resources, adoption of best practices and retention of personnel with substantial experience in the financial and internal audit areas. It is recommended that PEC establish an internal audit function either as a separate Department, or a separate function of the Finance Department, and vest the position with the authority to establish procedural and policy reviews of various financial reporting related activities across the Cooperative. |
| IV. Former Management/Management Practices | Internal Audit Function | 71 | It is recommended that the established position have access and the ability to report to the Board's Audit Committee on matters deemed appropriate for their consideration, and that the Board Audit Committee have input into the planning of the scope and areas for review throughout the year. |
| IV. Former Management/Management Practices | Policies and Procedures | 71 | PEC's current policies and procedures consist of various standardized polices [sic], Board resolutions, internal memoranda, and informal "buckslips" created over the years. However, they do not appear to have been consolidated into a comprehensive policy and procedures manual, nor do they appear to have been evaluated for relevance and consistency. It is recommended that PEC undertake to compile and consolidate the Cooperative's various formal and informal policies and procedures into an electronic manual with ready access by the employees of the Cooperative. During this process, it is also recommended that PEC undertake a systematic review of the current applicability of the identified policies and procedures and their effectiveness as control activities. |

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|--|---|----------------|--|
| IV. Former Management/Management Practices | Budgets/Forecasts | 72 | The Cooperative currently makes no use of budgets, and only limited use of financial forecasts, especially in relation to variance reporting where actual results differ from budgeted or forecasted expectations. At a minimum, it is recommended that the Cooperative create variance reporting in various controllable expense areas, especially where expenses are significantly discretionary in nature or where significant ongoing expenditures are expected (e.g., line maintenance, technology costs, consulting fees, etc.). |
| IV. Former Management/Management Practices | Capital Expenditure Forecasting/Prioritization/Allocation | 72 | The Cooperative currently uses no process to determine the level of capital expenditures that current rates and revenues can support, and has no formal process for establishing targets of capital investment, nor a process for prioritization of projects considered to be necessary. It is recommended that the Cooperative adopt a rigorous financial forecasting process to determine the level of capital expenditure targets that should be adopted and a basis for allocation of available capital expenditure dollars to necessary projects. |
| V. Board of Directors - Governance Structure | Level of Board Expertise | 85 | We recommend that the Cooperative and its members endeavor to include some individuals with financial literacy on its Board, in order to ensure the proper implementation of financial controls, as well as the effectiveness of the Board's Audit Committee and its fundamental responsibilities. Some progress has been made in this respect since PEC's 2008 Board election. |
| V. Board of Directors - Governance Structure | Financial Review | 85 | We recommend that the Board receive and review timely reports of the Cooperative's financial activities, including the review and approval of the Cooperative's annual budgets and/or forecasts, and monitoring of actual performance against those forecasts. |
| V. Board of Directors - Governance Structure | Travel and Expense Reimbursement | 86 | It is recommended that the Board establish clear, written policies for paying or reimbursing expenses incurred by anyone conducting business or traveling on behalf of the organization. |
| V. Board of Directors - Governance Structure | Travel and Expense Reimbursement | 86 | It is also recommended that the Board adopt clear guidance on the Cooperative's travel rules, including the types of expenses that can be reimbursed and the documentation required to receive reimbursement. Such a policy should require that travel on the Cooperative's behalf be undertaken in an efficient and cost-effective manner. The travel policy should be provided and adhered to by anyone traveling on behalf of the Cooperative, including Senior Management and the Board. In addition, the Board's policy should also state that it will not pay for nor reimburse travel expenditures for a spouse, dependents, or others who are accompanying an individual conducting business for the Cooperative unless the additional person is also conducting business for the Cooperative. |
| V. Board of Directors - Governance Structure | Clarification of Board Roles and Fiduciary Responsibilities | 87 | <p>The role of the Board relative to Senior Management should be clarified. This assessment can be accomplished through a well-defined, and documented, delegation of authority outlining the respective responsibilities and associated authority delegated to Senior Management, as well as the authority reserved by the Board.</p> <p>The Board policy relating to Authority and Responsibilities adopted by the Pedernales Electric Cooperative, Inc. Board on November 17, 2008 largely achieves this objective. This policy should be re-examined at appropriate intervals to ensure that it optimally meets the Cooperative's goals.</p> |
| V. Board of Directors - Governance Structure | Conflict of Interest Policy | 87-88 | As a matter of recommended practice, the Board should adopt and enforce a conflict-of-interest policy consistent with the Cooperative's needs and the underlying laws of the State of Texas, as well as adopt and implement policies to ensure that all conflicts of interest, or the appearance of any such conflicts, including relationships with potentially related parties, within the Cooperative and the Board are appropriately managed through proper disclosure and necessary actions in relation to voting on items before the Board. |

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|--|--|----------------|--|
| V. Board of Directors - Governance Structure | Conflict of Interest Policy | 88 | Board members should certify on a periodic basis that they have disclosed any relationships with related parties and that they are in compliance with the conflict of interest policy. |
| V. Board of Directors - Governance Structure | Conflict of Interest Policy | 88 | The Board needs to establish a policy and procedures for certain members to be recused who may have a potential or perceived conflict of interest. |
| V. Board of Directors - Governance Structure | Code of Ethics and Code of Conduct | 88 | It is recommended that the Board develop and adopt a formal written code of ethics with which all of its Directors are familiar and to which they adhere, as well as a formal code of conduct outlining the specific conduct anticipated in adherence to the code of ethics. The policy should be applicable to all Directors and require annual compliance certificates. |
| V. Board of Directors - Governance Structure | Code of Ethics and Code of Conduct | 88 | It is recommended that a separate code of ethics and code of conduct be developed for all PEC employees, including requesting certification, as well as periodic renewal of such certifications. |
| V. Board of Directors - Governance Structure | Whistleblower Policy | 88 | The Board should also adopt policies and procedures that encourage and protect individuals who come forward with credible information on illegal practices or violations of adopted policies of the organization, as well as efforts to address possible conflicts of interest and the reporting of suspected malfeasance and misconduct by the Cooperative's managers. |
| V. Board of Directors - Governance Structure | Greater Transparency | 88 | It is recommended that PEC adopt policies to promote openness and transparency for the benefit of the Cooperative's members. While PEC is not subject to the referenced Sarbanes-Oxley legislation and SEC disclosure requirements, those standards provide useful benchmarks for companies seeking to follow industry best practices. |
| VI. Operational Review and Evaluation/VII. Financial Review and Evaluation | Prepare a Long-Term (5 years or greater) Strategic Plan with Associated Long-Term Financial Plan | 101 and 113 | It is recommended that senior management and the Board develop a Strategic Plan and Long-Term Financial Plan with input from members and PEC staff. These long-term plans will identify strategic objectives that can guide the investment decisions and operational activities of the organization. Key decision-making throughout the year will be based on impacts on the ongoing goals and objectives contained within the long-term plans. PEC should revisit, reassess, and reprioritize these directives annually. |
| XI. Texland Electric Cooperative, Inc. | Accounting Treatment for the Texland Investment | 167 | To the extent it is eventually determined that PEC has ownership of any portion of the remaining funds, PEC will need to evaluate the relative impact to its financial statements, and whether the Texland investment should have been reported on PEC's financial statements in the past. |
| XI. Texland Electric Cooperative, Inc. | Policy Regarding Related Party Transactions | 167 | In relation to Texland, as well as various related and affiliated party issues described throughout the Report, it recommended that the Board adopt a policy establishing specific authorization guidelines and disclosure requirements involving Cooperative transactions in which a related or affiliated party of either the Board, senior management or other PEC employee is involved. In addition, it is recommended that the Board consider establishing certain limits and/restrictions on related and affiliated party transactions going forward. |
| XI. Texland Electric Cooperative, Inc. | Internal Control Environment | 167-168 | A significant concern arising from the Texland history is the apparent lack of inquiry from PEC officers, managers and financial department staff over the years in relation to why PEC was receiving a bank statement each month for Texland, and why the Cooperative was continuing to file required state franchise tax forms and maintain the Texland entities as active corporations when their apparent purpose had been concluded. It is recommended that PEC undertake to develop and implement control processes regarding the completion and submission of information related to filings with the Texas Secretary of State, including verification of the accuracy of such information, as well as establishing limits on the requisite level of authority and disclosures required for management and the Board. |

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| XIV. Director Compensation and Benefits | Board Roles and Responsibilities | 215 | Navigant Consulting also recommends that the Board consider defining, in written form, the following: (1) expectations, roles and obligations of the individual Directors and their expected participation in Board committees, training and other Cooperative sponsored events; and (2) Board duties to provide effective oversight to Senior Management and the Cooperative, and provide policy-making advice and guidance to Senior Management in connection with key operating decisions, regulatory compliance, and corporate governance. |
| XV. Director Expenses/Expense Reimbursement, XVII. Former Senior Management Expenses/Expense Reimbursement | Travel Expense Reimbursement Policy | 229 and 281 | Pursuant to allegations and concerns raised regarding former Senior Management and Board expenditures, at the direction of the new PEC General Manager, PEC instituted a <i>Travel Expense Reimbursement Policy</i> applicable to both PEC employees and the Board. The expense policy was specifically targeted at travel involving an overnight stay and/or airline travel, with the remaining expense reimbursement procedures for mileage, meals and other incidentals handled through a reimbursement of actual expenses incurred. Navigant Consulting considers the new PEC policy to be appropriate. |
| XV. Director Expenses/Expense Reimbursement | Travel Expense Reimbursement Policy | 229 | In addition, PEC's new <i>Travel Expense Reimbursement Policy</i> specifically excludes reimbursement of expenses for spouse, family or others accompanying the business traveler. |
| XV. Director Expenses/Expense Reimbursement | Audit Committee Review Process | 230 | The new expense reimbursement policy requires the Board Expense Audit Committee to review and approve Board-related expenditures, including responsibility for verifying that the stated purpose of travel is valid and related to official Cooperative business, that expenditures are in accordance with the newly established policy, and that required backup support documentation has been provided and that it is accurate and complete. It is recommended that the Board's Expense Audit Committee, through appropriate delegation to the Cooperative's CFO, establish specific guidelines for the review, identification and verification of expense items submitted for reimbursement. |
| XVII. Former Senior Management Expenses/Expense Reimbursement | Board Expense Audit and Review Process | 280 | Navigant Consulting recommends that the Expense Audit Committee also be tasked with the periodic review of Senior Management expenses, at least periodically, to ensure that Senior Management is complying with the travel expense reimbursement policy. |
| XVI. Former Senior Management Compensation and Benefits | Compensation Committee | 252-253 | The key elements of an effective Compensation Committee should include the following: <ul style="list-style-type: none"> - The Compensation Committee should be independent, both in fact and appearance, from the Cooperative's senior management. - The Compensation Committee should formally review all elements of compensation for PEC senior management positions at least annually. - Any changes to the General Manager's compensation and benefits should be reviewed and approved by the full Board, not just the Compensation Committee or Executive Committee. - Any compensation consultant hired to evaluate management compensation should be retained by the full Board. - Every few years, an independent qualified compensation expert should be asked to provide an opinion as to the reasonableness of the General Manager's total compensation package. - Transparency should be a guiding principle. |
| XVII. Former Senior Management Expenses/Expense Reimbursement | Finance Department Expense Audit and Review Process | 280-281 | It is recommended that Cooperative, as well as all Senior Management and employee expenses, be subject to review, evaluation and audit by the Finance Department. This review should entail ensuring that all expenses are properly approved, coded and supported by underlying invoices and receipts as required by the Cooperative's policies and procedures. The designated reviewers should have the authority to deny reimbursement of |

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Pedernales Electric Cooperative, Inc. Report of Investigation

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|---|---|----------------|--|
| XXVI. Analysis of Other Accounts/Expenses | Expense Audit and Review Process | 386 | certain expenses unless they are satisfied that the established policies and procedures are met. An expense limit should also be established for expense items exceeding a certain dollar amount, with higher-level approval being required, including approval by the CFO or General Manager. |
| XVII. Former Senior Management Expenses/Expense Reimbursement | Finance Department Expense Audit and Review Process | 281 | Navigant Consulting also recommends that certain types of expenditures should not be permissible through the Cooperative-issued credit cards or expense voucher process, unless otherwise approved by senior management. These defined types of expenditures should be specified as subject to processing only through the Cooperative's purchasing and procurement procedure. |
| XXVI. Analysis of Other Accounts/Expenses | Expense Audit and Review Process | 386 | |
| XXIII. Third Party Service Providers | Adopt New Board Policy | 350-351 | Pursuant to allegations and concerns raised regarding the retention of Third Party Service Providers, at the direction of the new PEC General Manager, PEC has adopted a new <i>Authority and Responsibilities Policy</i> applicable to both PEC employees and the Board. The policy establishes specific guidelines as to when, and for whom, prior authorization is required for entering into a consulting contract with Third Party Service Providers. The policy requires the General Manager to receive Board approval in advance for consulting contracts in excess of \$1 million or for a term greater than two years. Navigant Consulting considers the new PEC policy to be appropriate. |
| XXIII. Third Party Service Providers | Formalize Contract and Agreement Process and Reporting Function | 351 | PEC's ad hoc process lacked the rigor and objectivity of having an established internal policy and procedure regarding Third Party Service Provider retention selection, retention requirements, authorization requirements, and compensation guidelines, as well as a mechanism for periodic performance evaluation for longer-term agreements. In addition, PEC failed, in many cases, to require contracts or agreements setting out the terms, conditions, and anticipated services to be provided. Also noteworthy is the lack of invoices or any kind of documentation to support the payments PEC made to a number of the Third Party Service Providers. It is recommended that PEC establish clear policies and procedures regarding the retention of various outside consultants and Third Party Service Providers including minimum requirements for contracts and agreements, invoicing and periodic, or at least annual, disclosure of agreements to the Board. At a minimum, it is recommended that the Board have an opportunity to periodically evaluate whether such agreements are in the best interest of the Cooperative and its members. |
| XXIII. Third Party Service Providers | Establish Audit and Review Process | 351 | PEC lacked a formal audit and review process of the arrangements with the Third Party Service providers. The Finance department was not provided with sufficient information and supporting documentation to evaluate the arrangements and was relegated by Mr. Fuelberg [PEC's prior general manager] to essentially a payment processing function. It is recommended that PEC establish policies and procedures for contracts to be audited and reviewed by the Finance and Legal Services Departments to ensure that fees incurred are appropriate and that invoices include appropriate level of detail to verify the services provided and to justify payment. |
| XXIV. Construction Contractor and Material Supplier Contracts | New Policies and Procedures | 363 | It is recommended that PEC establish more formalized policies and procedures for the Cooperative's purchasing function specifically related to the construction contractor and material supplier contracting process. The new policy should be evaluated in conjunction with certain business process improvement recommendations regarding the centralization of the contracting/purchasing function into one Department, with specific guidelines to ensure that proper controls are followed and that reasonable and consistent prices are obtained for the items acquired/services received. |

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|----------------------------------|------------------------------|----------------|--|
| XXV. Land and Building Purchases | Formal Policy and Procedures | 371 | PEC purchased land and buildings from individuals who were related parties of the Cooperative. It is recommended that PEC adopt policies and procedures that outline when and to whom disclosures are to be made when business transactions are conducted with related parties in which a potential conflict of interest may exist and what action should be taken by Directors or others affected by the transaction. |