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CONFIDENTIAL REPORT OF INDEPENDENT INVESTIGATION OF CERTAIN FINANCIAL ISSUES OF THE DUPAGE WATER COMMISSION

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I. Scope Of Investigation

Jenner & Block LLP was retained as special counsel by the DuPage Water Commission (the "Commission" or "DWC") Board in November 2009 to investigate allegations of accounting irregularities and the exhaustion of the Commission's unrestricted reserves. At the Board's request, Jenner engaged Crowe Horwath to conduct any necessary forensic accounting. The Commission asked Jenner to address the following major questions:

- How was the Commission's unrestricted cash, believed to exceed $100 million in early 2007, exhausted by the fall of 2009?
- Were there accounting errors or irregularities that contributed to the unanticipated depletion of unrestricted cash?
- Who knew that sales taxes were being used to subsidize the operating and maintenance expenses of the Commission and when did they know it?
- Were there shortfalls in restricted reserves?
- Who bears responsibility for the errors and the unanticipated depletion of unrestricted cash?

Our investigation has allowed us to answer each of these questions to a high degree of certainty. Section II of this report explains what we did to investigate these issues. Section III contains a summary of our conclusions. Section IV is a detailed report of our findings and recommendations.

It is important to note that we did not expend the significant additional resources that would be necessary to conduct a full, detailed forensic audit to determine whether any cash was misspent. We saw no evidence of any misappropriation, and the Board's direction to us was that we should not conduct such an audit unless we saw such evidence and received further direction from the Board. Most importantly, the discrepancy between what the Board thought it had in unrestricted cash and what it actually had is accounted for by expenditures on Commission business and declining revenues. In these circumstances, the premise for conducting such an audit – a reasonable suspicion that cash was misappropriated for non-Commission purposes – does not exist.

II. Summary Of Investigative Process

We began our investigation by securing and analyzing the relevant documents. We gathered basic structural and operational documents of the Commission, including by-laws, resolutions, ordinances, meeting minutes, financial reports, monthly Treasurer's Reports, monthly Board packages, and position or office descriptions of the Staff and the Treasurer. We also secured a variety of electronic documents that potentially had relevance to the investigation. In particular, we obtained forensic images of the three computers to which the former Financial Administrator, Max Richter, had access. We also obtained copies of all of the emails sent to or from the General Manager, Financial Administrator, Staff Accountant, and Staff Attorney. We obtained a copy of the computerized accounting server data for the Commission. We also made copies of all of the network drive areas that related to the accounting or administrative function. In addition, at the Board's request, our contractor took custody of all of the Commission's backup tapes going back to 2006.

We then performed comprehensive electronic searches of the gathered data and analyzed the results. We concentrated on reviewing the email communications to and from Richter and General Manager Robert Martin, focusing on emails that reflected communications concerning the financial analysis at issue, accounting errors, personnel problems with Richter, and the discovery of the unanticipated depletion of unrestricted cash. We located and reconstructed electronic versions of the series of spreadsheets that had been included as part of the Five Year Capital Improvement Plans provided to the Commission, as well as a variety of draft spreadsheets. We also reviewed communications to or from the Commission's outside auditors, McGladrey & Pullen. We reviewed the personnel file of Max Richter and contacted the references identified in the resume he submitted to the Commission.

We engaged Crowe Horwath LLP ("Crowe") as forensic accountants to assist in the investigation. Crowe's basic task was to review the financial information of the Commission and determine, from an accounting standpoint, how the Commission's unrestricted cash came to be exhausted by the fall of 2009, and whether there were accounting errors or irregularities that contributed to the depletion of the unrestricted cash. In the process of doing so, at our direction, Crowe performed a number of different procedures which focused on the following:

- An analysis and validation of a theory of the unrestricted cash depletion offered by Rick Skiba;
- An analysis of the unrestricted and restricted funds of the Commission;
- An analysis of the Commission's compliance with the 1987 Revenue Bond Ordinance requirements;
- An analysis of the audited financial statements;
- An analysis of the Forecast Schedules provided to the Board as part of the Capital Improvement Plan ("CIP"), and a reconciliation of those schedules to the audited financial statements;
- An analysis of the cash flow of the Commission from May 2006 through April 2009 to determine the relative effect of various expenditures on the unrestricted cash balances;
- An analysis of water sales accountability schedules in the audited financial statements and annual reports;
- An analysis of the investment schedules included in the Treasurer's Reports for the months of December 2006 through May 2007; and
- A review of the Commission's accounting practices and controls.

After receiving preliminary results from Crowe, we then interviewed the persons believed to be most knowledgeable about the relevant issues. Those interviews included:

- Thomas Bennington, Commissioner
- Elizabeth Chaplin, Commissioner
- Maureen Crowley, Staff Attorney
- Ivin Drew, internal accounting clerk
- Joseph Evans, accountant from McGladrey & Pullen
- Robert Martin, General Manager (multiple interviews)
- Greg Mathews, Chairman of the Finance Committee
- Allan Poole, Commissioner
- S. Louis Rathje, Chairman
- R. Max Richter, former Financial Administrator
- Frank Saverino, Commissioner
- Richard Skiba, acting Financial Administrator (multiple interviews)
- Richard Thorn, Treasurer
- James Zay, Commissioner
- Donald Zeilenga, Commissioner

In addition, we asked each member of the Board who was not selected for an interview if he had information that he believed would be relevant to the investigation and offered to speak to any who did. None of the Board members responded to that invitation. During the course of the investigation, we also had various informal communications with Staff and members of the Commission. The only witness who declined to be interviewed for the investigation was Teresa Chapman, the former internal accounting clerk at the Commission.

Based on the interviews, we asked Crowe to perform additional analysis and procedures, and we conducted necessary follow up interviews.

III. Summary of Conclusions

A. The Depletion Of Unrestricted Cash

The Commission's unrestricted cash was exhausted as a result of the Commission's April 2007 approval of a $40 million rebate to its charter customers, its simultaneous $0.20 water rate reduction, a pre-existing imbalance between water revenues and expenditures, expenditures on new construction projects, and a decline in other revenues.

The Commission made the decisions to pay the rebate and reduce the water rate based on written reports from Staff that overstated the amount of unrestricted cash available. In particular, these decisions were premised on a February 2007 spreadsheet showing that as of April 30, 2007, the Commission would have $109 million in "unrestricted cash and equivalents" (hereafter, "unrestricted cash"). That spreadsheet contained material errors which overstated the amount of unrestricted cash by approximately $40 million. In reality, when the Commission voted to pay the rebate and reduce the water rate, it only had about $69 million in unrestricted cash. The rebate reduced that to $29 million. The rest was fully depleted over the next two and a half years as a result of (i) monthly operating shortfalls caused by selling water for less than it cost to provide, exacerbated by the water rate reduction (which cost the Commission $9 million over two years); (ii) decline in investment income, (iii) a decline in sales tax receipts due to the recession, and (iv) construction expenditures.

B. Accounting Errors

The Commission's unrestricted cash reserves were significantly overstated in financial projections created by the Financial Administrator and submitted to the Board in connection with the five-year plans presented in early 2007, 2008 and 2009. These reports were part of a larger pattern of erroneous and misleading information presented by the Financial Administrator.

C. Knowledge Concerning The Use Of Sales Taxes To Subsidize Operating Expenses

While it was not improper or contrary to law to use sales taxes to subsidize operations and maintenance, the Commission's previous rule of thumb had apparently been to try to match water revenues to operations and maintenance expenses, and to use sales tax receipts (after bond payments) to fund construction. However, it was apparent from the projection in the FY 07[1] Forecast Schedule spreadsheet, submitted to the Board in February 2006, the water sales accountability report provided to the Board in the May 2006 Treasurer's Report, and on the face of the FY 06 audited financial statements released in October 2006 that water revenues were insufficient to pay operating expenses. In addition, in the FY 08 Five Year CIP summary presented to the Board in January 2007, Staff clearly and expressly stated that sales tax revenues would be used to subsidize water rates.

D. Restricted Assets

After the unrestricted cash of the Commission had been fully depleted to cover the monthly operating shortfall, the Commission lacked sufficient funds to satisfy all of its restricted fund obligations under the Revenue Bond Ordinance of 1987. As a result, by December 31, 2009, restricted accounts were underfunded: the O&M Reserve general ledger account was depleted to zero (meaning it was underfunded by approximately $13 million), the Depreciation general ledger account was underfunded by $3 million, and the O&M general ledger account was underfunded by $76,000. All other general ledger accounts restricted by the Revenue Bond

[1] The Commission's fiscal years end April 30 and thus straddle calendar years. To avoid unnecessary confusion, we adopt the naming convention using the end of the period to identify the fiscal year throughout this report. Thus, FY 07 is the fiscal year ending April 30, 2007. The FY 07 Forecast Schedule is the schedule covering May 1, 2006 through April 30, 2007; it was provided to the Board in January 2006; it was to contain actual data from May 1, 2004 through April 30, 2005; and projected data from May 1, 2005 forward.

Ordinance of 1987 were funded in accordance with the Ordinance. The Commission did not miss any payments required by the Ordinance or the bond covenants or debentures.

E. Responsibility

Responsibility for the depletion of the unrestricted cash lies with several parties.

First, the Financial Administrator bears direct and primary responsibility for the numerous and material accounting errors in the information he provided to the Board and which misinformed the Board as to the size of the unrestricted cash reserves. While the accounting errors by the Financial Administrator are consistent with both intentional misconduct and gross negligence, there is no clear and convincing evidence of fraud. We conclude that the Financial Administrator's work was (at least) grossly negligent and his errors were compounded by his reckless failure to clearly and explicitly warn the Board of its diminishing cash reserves.

Second, the General Manager also bears responsibility for the mistakes and the depletion of the unrestricted cash because the General Manager did not meaningfully supervise the Financial Administrator. The General Manager simply accepted the figures presented to him by the Financial Administrator as accurate, even though he had questioned the accuracy of information provided by the Financial Administrator. The General Manager failed in not actively attempting to question or supervise the Financial Administrator or to understand the accounting ledgers. However, there is no factual support for the propositions advanced by some that the General Manager acted with a lack of integrity or that he knew that the financials were misstated. Nor can we conclude that the General Manager unnecessarily delayed notifying the Board about the problem out of any improper motive.

Third, some responsibility lies with the Board of Commissioners.[2] The Board failed to place qualified individuals in the General Manager or Treasurer positions. The Board knew, or should have known, that the General Manager did not have adequate training and experience in financial matters to supervise the Financial Administrator. The Board made critical financial decisions based on Staff projections when it knew that there was essentially no oversight of Staff on financial matters. And the Board allowed the position of the Treasurer to become a ceremonial position with no substantive duties. In addition, the Board failed to raise questions even when monthly reports began to show declining unrestricted cash reserves.

Fourth, we conclude that the Commission's auditors cannot be held responsible for the depletion of the unrestricted cash. Although they made mistakes in the FY 06, FY 07 and FY 08 audited financial statements, the key error occurred after the April 2007 Board decisions that were the principal causes of the shortfall. Moreover, the scope of the audit did not include auditing of the inaccurate spreadsheets prepared by Staff.

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[2] When we refer to the Board, the reference is intended to be collective. However, it is important to note that not all of the current Commissioners were members of the Board at the time of relevant decisions and actions and thus do not bear responsibility for those decisions.

IV. Findings Of Investigation

A. Background

1. The Nature And Structure Of The Commission And Accounting Staff

The Commission is a municipal body created in 1985 under authority of Illinois state statute, 70 ILCS 3720, to help assure a sufficient and economic supply of water to the DuPage County area. The Board consists of a total of 12 Commissioners, each appointed for staggered six-year terms, and a Chairman. Six of the Commissioners are appointed by the Chairman of the DuPage County Board, with the advice and consent of the County Board. Six of the Commissioners are appointed by the municipalities who were the "charter" members of the Commission. Commissioners are paid $600 a year for their service unless they are a member of the governing board or an officer or employee of a unit of local government within DuPage County.

The Commission also has a Treasurer, who need not be a Commissioner. The Treasurer is compensated $50 per meeting for his or her service. According to Article III, Section 5 of the Commission's By-laws, the Treasurer's duties include the following:

> (ii) . . . principal responsibility for the oversight of and advise the Board of Commissioners regarding:
>
> (a) the receipt, deposit and disbursement of monies;
>
> (b) the Commission's investment practices, paying particular attention to safety of principal and compliance with existing bond ordinances;
>
> (c) the Commission's accounting and control systems and whether or not they are consistent with generally accepted accounting principles;
>
> (d) relationships with the local financial community; and
>
> (e) overall treasury and cash management objectives of the Commission.

In addition, the Treasurer is to:

(iii) review financial procedures and practices employed by the Financial Administrator and the General Manager, including the deposit of funds, the making of disbursements, the maintenance of a check register, the reconciliation of bank statements, and the overseeing of the annual audit, and advise the Board of Commissioners on the efficiency of such procedures and practices;

(iv) require such reports or other information from the Financial Administrator or General Manager as may be necessary to perform the duties hereinabove set forth . . .

(Exhibit 1.[3]) In practice, both the current Treasurer and the other Commissioners interviewed described the actual activities of the Treasurer as "ceremonial." The Treasurer is viewed as "sort of an honorary position" that "doesn't do much other than sign the checks."

The Commission has several committees, including the Finance Committee. It is the general practice of the Finance Committee to meet monthly on the same night as the Board meeting, a half hour prior to the Board meeting. Members of the Finance Committee did not receive any financial information that was not also provided to the Board as a whole in monthly board packages. Although some of the Finance Committee members have some finance experience, few of the Finance Committee members during the key time period had a strong financial background. Attendance at the Finance Committee meetings was sporadic.

The Commission's Staff is organized into four departments: Legal, Operations, Administration (headed by the Financial Administrator), and Pipelines. The head of each department reports directly to the General Manager. The personnel primarily responsible for the financial function of the Commission are the General Manager; the Financial Administrator; and an Accounting Clerk (known as the Accountant) who reports to the Financial Administrator.

[3] All exhibits are attached in the separate Appendix to Confidential Report of Independent Investigation of Certain Financial Issues of the DuPage Water Commission.

2. Overview Of The Commission's Finances And Accounting Function

The Commission obtains revenue from two primary sources, water sales and sales tax revenues. The Commission also receives some revenue from investment income. The Commission also has the ability to raise cash through its authority to issue general obligation and revenue bonds. The Commission's primary expenditures are for water distribution, operations and maintenance, debt service, and capital improvements.

The Commission follows Governmental Accounting Standards Board ("GASB") Statement 34, which requires the financial reporting of the Commission to distinguish between Restricted and Unrestricted Funds. In its annual report, the Commission states that it classifies as "Restricted Funds" all "of the restricted cash, investments and other assets in accounts required by the revenue bond ordinance as well as amounts held for paying the debt service on the Commission's general obligation bonds." The Commission further states that "Unrestricted Funds" are cash, investments, and other assets (besides capital investments) that are not Restricted Funds: in other words, everything else. As described below, the Commission's definition of "Restricted Funds" should have included any funds the use of which is restricted by any external law. Contrary to the requirements of GASB 34, the Commission did not classify amounts required to be paid pursuant to Public Act 93-0226 (2003), the $75 million DuPage County grant, as Restricted Funds.

An understanding of the Commission's finances requires an understanding of the distinction between several different accounting concepts: an external bank account, a general ledger account, a restriction, and a designation. An external bank account is an account maintained separately at a financial institution which actually segregates certain funds from others. The Commission maintains a total of five external bank accounts: the "sweep account" at MB Financial into which customer deposits are made; the Illinois Funds Money Market

Account at US Bank, into which all of those funds are subsequently placed; two accounts at the Bank of New York which are under the control of the trustee of the Commission's bonds; and one account at US Bank for the General Obligation Bond requirements.

In contrast to a bank account, a general ledger account on the Commission's accounting books and records does not indicate that the funds in that account are actually segregated from any other funds. Rather, that indicates that for purposes of internal accounting, and for compliance with the 1987 Revenue Bond Ordinance, the Commission's books and records allocate certain funds to that general ledger account.

It is also important to understand the difference between a "restriction" and a "designation." Under GASB Statement 34, funds are restricted only if their uses are constrained by an outside agreement or ordinance, such as the Commission's obligations under its bond indentures or the revenue bond ordinance, or by statute. In contrast, self-imposed announcements of the Commission's intention to use in a particular way funds that are not subject to an external restriction are a "designation," not a restriction, and those funds are not considered to be part of the Commission's Restricted Funds.

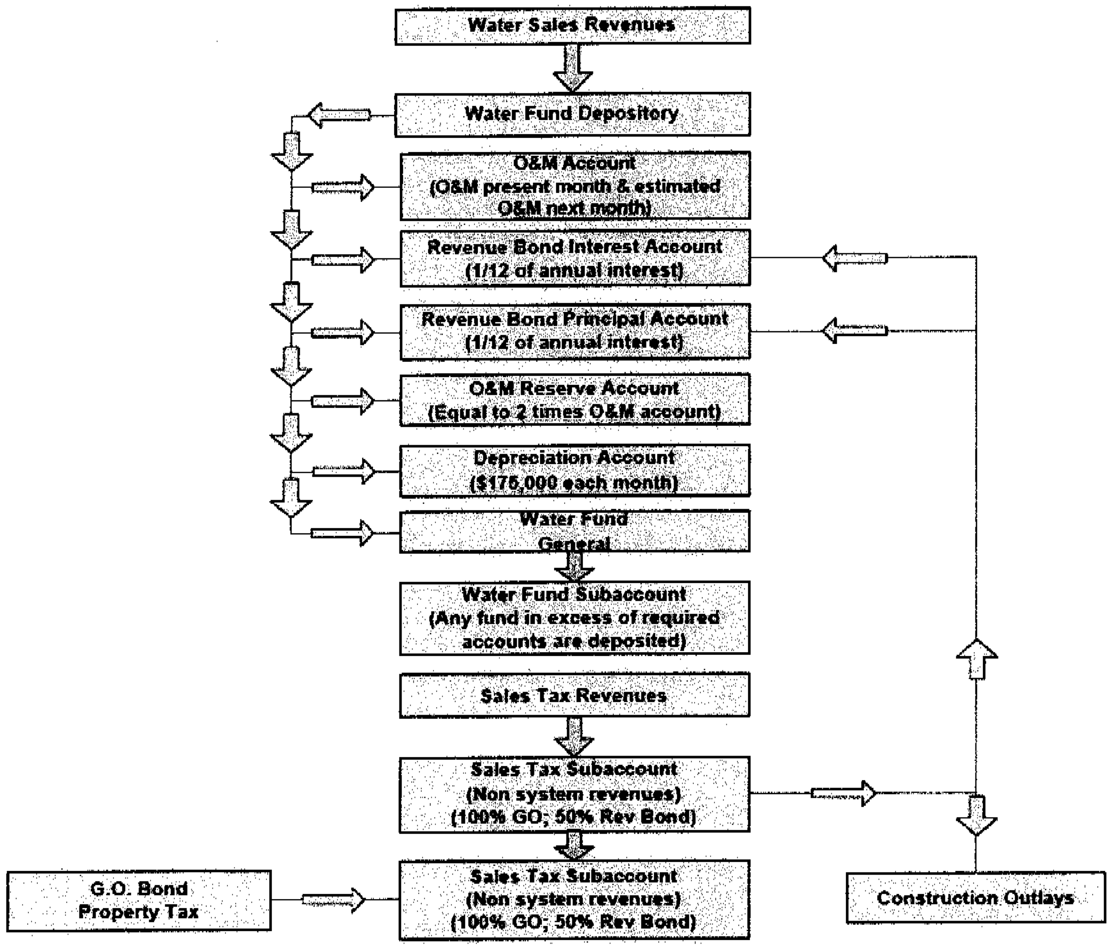
The Commission further makes a designation (not a restriction) of Unrestricted Funds into five subcategories: (1) emergency repairs; (2) water rate stabilization; (3) construction reserve; (4) undistributed water quality loans; and (5) undistributed transfers to DuPage County under the 2003 statute. The Commission has a policy, articulated in Resolution R-28-07, passed on April 12, 2007, of maintaining a target of $20 million in the emergency repairs Unrestricted Funds subaccount.

While the Commission makes these further designations of Unrestricted Funds into subcategories in some of its reports, the Commission does not maintain separate external bank accounts for these various subcategories, nor are there general ledger accounts that correspond to these categories.

The flow of funds through the Commission's accounts was described to us by Skiba and representatives of McGladrey & Pullen, and is prescribed in part by the Bond Ordinance. Receipts from customers are deposited into the MB Financial "sweep" bank account. Each night, all funds in excess of $1,000 are swept into the General Water Fund account, which is an Illinois Funds Money Market Account at US Bank. Sales tax receipts are also deposited directly into the Illinois Funds Money Market Account at US Bank; they are not segregated from the water sales revenues.

In the general ledger, water sales receipts are recorded in the Water Fund Depository account and sales tax receipts are recorded in the Sales Tax Investment account. From there, accounting entries are supposed to be performed which effect the Bond Ordinance requirements. Those entries, which are described below, are graphically shown in the figure below:

Monthly Flow of Funds



Here are the various steps that are supposed to be included in the so-called "waterfall," as described by Article 8 of the 1987 Bond Ordinance:

- A general ledger entry is performed to transfer from the General Water Fund Depository account to the Operations and Maintenance general ledger account sufficient funds to cover operations for the current and next month; in practice, the balance approximates $10 to $13 million each month, depending on the level of expenditures. No money is transferred between bank accounts in connection with this entry.
- A general ledger entry is performed transferring from the General Water Fund Depository account to the Revenue Bond Interest Account an amount equal to 1/6 of the

amount of the next semi-annual revenue bond interest payment. There is also a corresponding transfer of funds from the US Bank external account to a segregated bank account at the Bank of New York, held by the bond trustee, in the same amount.

- A general ledger entry is performed transferring from the General Water Fund Depository account to the Revenue Bond Principal Account an amount equal to 1/12 of the amount of the next annual bond principal payment, as well as a corresponding transfer of funds from the US Bank external account to a segregated bank account at the Bank of New York, held by the bond trustee.
- A general ledger entry is performed transferring from the General Water Fund Depository account to the Operations and Maintenance Reserve general ledger account an amount necessary to cover operations for the current and next month; again, in practice, this balance approximates \$10 to \$13 million each month, depending on the expected level of expenditures. No money is transferred between external bank accounts in connection with this entry.
- If the Depreciation account has less than \$5 million, a general ledger entry is made to transfer \$175,000 from the General Water Fund Depository account to the Depreciation account; no money is transferred between external bank accounts as a result of this entry. It should be noted that the Depreciation Account is not an ***accounting*** "depreciation" account (in which the value of a fixed asset is reduced on the books of an entity to capture the asset's decline in value), but a general ledger account to cover repairs of the system required by the Bond Ordinance.

These are the transactions required by the Bond Ordinance, and they require a total of about \$26 to \$40 million to be on account. Additionally, a portion of sales tax receipts is restricted for General Obligation Bond principal and interest payments and half of the Revenue Bond principal and interest payments. Once these requirements were satisfied, the Commission considered[4] any remaining funds to be unrestricted, and designated them (as described above) for various unrestricted uses. However, it is important to understand that all three types of funds – restricted (other than those that go to the Bank of New York), unrestricted but designated, and undesignated – coexist and are commingled in a single bank account, the Commission's Illinois Money Market account.

It has been the historical practice of the Commission to attempt to match the source of revenue with its use. Thus, historically, operations and maintenance are funded with water sales revenues, and capital improvement projects are funded by sales tax revenues. However, there is no law or ordinance which restricts the use of sales tax revenues to capital improvement projects.

3. Historical Staff And Accounting Information

a. General Manager

The highest Staff position is the position of General Manger. There is a written position description for the General Manager position contained in the Commission's Bylaws. That description includes substantial finance-related duties:

> The General Manager shall be the chief administrative officer of the Commission and shall be responsible for the efficient administration and management of Commission affairs. The duties of the General Manager shall include, but are not necessarily limited to, the following:
>
> * * *
>
> (iii) supervising all Administrative Staff and consultants of the Commission;
>
> * * *
>
> (xi) preparing all checks and maintaining a check register;
> (xii) preparing a monthly statement of receipts and disbursements;
> (xiii) reconciling bank statements on a regular basis;
> (xiv) overseeing the preparation of an annual audit;

[4] While this was the Commission's practice, Crowe concluded that the funds required to be paid to DuPage County pursuant to the 2003 statute, Public Act 92-0226 (2003), should have also been considered restricted, and should have been set aside before any designations were made.

(xv) preparing an annual budget;

* * *

(xx) assigning such duties as may properly be delegated to the Financial Administrator or Secretary.

(Exhibit 1.) The current General Manager was hired as part of a search process utilizing a professional recruiter. The search profile stated that a successful candidate must have "strong financial management and budgeting experience and the ability to comprehend complex financial matters and to present clear information and financial policy alternatives to the Board." (Exhibit 2.)

Since the Commission's establishment in 1985, the General Manager position has been held by two persons. James Holzwart, who is now deceased, was the first General Manager and held the position until 2004, when he retired. Holzwart, who held an M.B.A. from the University of Chicago, had a substantial financial background and, according to Skiba, played an active role in monitoring the Commission's finances. Robert Martin is the second person to hold the position. Martin has an engineering education and background but has essentially no financial or accounting experience. Martin was hired as an assistant to the General Manager in 1987 and became the General Manager in 2005.

The Board was responsible for selecting Martin as the replacement General Manager in 2005. The Board conducted a national search, and Martin was hired by a divided vote from among approximately five candidates. In general terms, the members of the Board who were appointed by municipalities supported Martin's candidacy, and the members appointed by the County did not.[5] The Board was aware that Martin had no financial background or expertise when it hired him. Martin stated in an interview that he advised the Board of this deficiency and said he would handle it by hiring a competent Financial Administrator to report to him. Martin

[5] We heard from virtually everyone we interviewed about the division on the Board between County and municipal factions and observed it ourselves during Board meetings.

also stated that he had told then-Chairman Vondra that Martin did not intend to stay with the Commission if he was passed over.

Martin regarded his job as mostly "putting out fires." Martin said that he focused on the business of the Commission, delivering water to its constituents, and did not focus on financial issues.

b. Financial Administrator

The position of Financial Administrator is responsible, under the direction of the General Manager, for the finances of the Commission. Relevant portions of the written position description (Exhibit 3) include:

> Under the direction of the General Manager, the Financial Administrator is responsible for the accounting and financial activities of the Commission which include, but are not limited to, financials, insurance, investments, budgeting, and human resources.
>
> Have principal responsibility for and advise the General Manager as to policies concerning: the receipt, deposit, and disbursement of Commission funds; the investment practices of the Commission, paying particular attention to safeguarding principal and complying with bond ordinances; the Commission's accounting and control systems; and the overall treasury and cash management objectives of the Commission.
>
> Comprehend complex financial matters and present clear information and financial policy alternatives to the General Manager.
>
> * * *
>
> Be thoroughly knowledgeable about the Commission's financial condition at all times.
>
> Prepare the annual management budget and budget and appropriation ordinance.
>
> * * *
>
> Oversee the preparation of the annual audit.
>
> Serve as an impartial financial management resource and advisor to the General Manager, presenting information and reports clearly, completely, and on a timely basis.

> Assist and work with the General Manager in initiating and considering policy-related issues and in assisting the General Manager in determination of policy recommendations to the Commission.

The position of Financial Administrator has been held by three different persons since 1987: Rick Skiba, Cheryl Patelli, and Max Richter. Skiba served from the inception in 1987 until 2004. Skiba was well-qualified: he had a B.S. in accounting, passed the examination for certified public accountants (although he is not currently registered), and had substantial experience in high-level accounting positions. During Skiba's tenure, Skiba implemented a "spreadsheet-based" accounting system. That is, all of the Commission's finances were maintained on electronic spreadsheets (ultimately using the off-the-shelf Microsoft Excel program). All of the spreadsheets had been custom-designed from scratch by Skiba; the Commission did not have any standardized accounting program or "double-entry" general ledger system. Skiba was reluctant to convert the Commission from the spreadsheet system to a standardized electronic accounting program.

Skiba retired in 2004, at the same time as Holzwart. Both accepted retirement packages. Skiba said that he was an opponent of the $75 million DuPage County grant. He believed that he angered County operatives by insisting that the entire $75 million should be booked as a liability in the first year of the grant, rather than booking it as a $15 million annual expense over five years.

When Skiba left, the Commission engaged a professional search firm, the Par Group, to find a replacement Financial Administrator. (Exhibit 4.) In the summer of 2004, Cheryl Patelli was hired to replace him, and Skiba worked part time to help train Patelli and smooth the transition. Patelli was the Financial Administrator until approximately March 2005, when she announced she was leaving because the commute from her home was too long for her.

During Patelli's tenure, at the recommendation of the Illinois Auditor General,[6] the Commission began a transition from the spreadsheet-based accounting created by Skiba to a standard accounting software package, known as InCode. Beginning in March 2005, the Commission's main accounting function was maintained on InCode. However, Unrestricted Fund designations were still made on stand-alone spreadsheets, outside the InCode system. Indeed, at least the following reports are still prepared on spreadsheets and without using InCode:

- All budgeting, including the Forecast Schedules submitted with the annual Five Year Capital Improvement Plan;
- The monthly Treasurer's Report; and
- The monthly "INV" or "Investments" report.

While InCode may not have been able to perform all of these functions in the same form as the spreadsheets, the Staff's failure to use InCode for these functions to the maximum extent possible fell short of best practices for two reasons. First, the use of stand-alone spreadsheets increased the chances of errors. Those errors could be (and, as described below, in fact were) introduced in two ways: in manually copying numbers output from the InCode general ledger system into the spreadsheets, and in the hidden and sometimes complex formulas on which the spreadsheets rely but which are not visible to the ultimate paper-copy recipients. Second, the use of the stand-alone spreadsheets created an opportunity for intentional misconduct, because data on the stand-alone spreadsheets could differ from data in the InCode general ledger system, and only the latter was subject to auditing.

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[6] In addition to requiring the $75 million transfer of funds, the 2003 DuPage County grant legislation also required that the Illinois Auditor General conduct the yearly audit of the Commission for the duration of the grant. The Auditor General contracted with McGladrey & Pullen, who performed the audits for the fiscal years ended April 30, 2003, 2004, 2005, 2006, and 2007. Previously, the Commission had engaged McGladrey &Pullen directly.

Upon Patelli's departure, the Par Group was required to repeat the executive search for the Commission at no additional charge. The Par Group found several candidates, including Max Richter. Based on his resume, Richter appeared qualified. Richter had a bachelor of science in business administration degree, and had more than 30 years of finance-related experience. Richter also had substantial bond-related experience. As part of our investigation, we checked Richter's references and determined that they were all bona fide. Richter held the Financial Administrator position from 2005 through October 2009. The post is currently not occupied, although, as explained below, Skiba has returned to the Commission and is currently performing the Financial Administrator functions.

4. Financial Reporting To The Board

The Board was provided with four basic sources of information regarding the financial condition of the Commission: (1) financial reports and a Treasurer's Report provided to members of the Finance Committee and the Board on a monthly basis in advance of the Board's meeting; (2) Forecast Schedules as part of the Five Year Plan packages provided to the full Board early in each calendar year; (3) the Finance Department section of the Commission's public Annual Report; and (4) the audited annual financial statements prepared by the Commission's auditors, McGladrey & Pullen, which were completed roughly six months after the end of each fiscal year.

a. Monthly Financial Reports

The Staff prepared and provided members of the Finance Committee and Board monthly financial reports. An example report, for May 2009, is attached as Exhibit 5. We reviewed these financial reports as well as the minutes of the Finance Committee meetings. These reports provided information on water sales, sales tax collections, revenues and expenses and investments, and included a balance sheet, but did not provide any breakdown between restricted and unrestricted cash and equivalents. However, beginning with the May 2009 Financial Report, provided to the Board in June 2009, and through the discovery of the shortfall, the reports showed a negative balance for cash. *See* Exhibit 5. To anyone with a financial background, that would indicate that the reports were in error, as cash cannot be negative.[7]

The Finance Committee and the full Board also received a monthly Treasurer's Report. This report was distributed to the Board, read at the Board meeting, and approved by the Board. From December 31, 2006 through November 30, 2007, there was no breakdown between unrestricted and restricted funds in the Treasurer's reports. However, from December 31, 2007 through August 31, 2009 (with the exception of June 2009, when there was no report at all), the Treasurer's reports did contain a breakdown of unrestricted and restricted cash and equivalents.

Those reports (attached as Exhibit 6) provided the following information:

- As of December 31, 2007, the Commission had $39 million in unrestricted cash.
- In March 2008, after $13 million was paid on the Commission's General Obligation bonds, the unrestricted cash in the Treasurer's report decreased to $25 million.
- Between April 2008 and January 2009, the Treasurer's report showed a gradual decrease in funds.
- In February 2009, after another $12 million was paid on the Commission's General Obligation Bonds, the Treasurer's report showed a $10 million balance.
- Between February and July 2009, the balance reported to the Board fluctuated between $10 and $15 million.

[7] While a cash account can be overdrawn, in a formal double-entry accounting system, being overdrawn would be properly accounted for in ways other than showing a negative cash balance. For example, if hypothetically the bank advances funds to the Commission to cover a check that would otherwise overdraw the cash account, that is properly accounted for by reducing the cash account to zero (not negative) and showing the amount advanced by the bank as a liability of the Commission.

While these figures were not necessarily accurate, they furnished good reason to believe that the Commission was exhausting its unrestricted funds.

b. Forecast Schedules

The Staff prepares and presents to the Board a Five Year Capital Improvement Plan in January or February of each calendar year. As part of the plan, the Staff includes a Microsoft Excel spreadsheet titled "Summary of Revenues, Expenditures & Fund Balances," which we refer to as the "Forecast Schedule." The basic purpose of the Forecast Schedule was to aid the Board in making budgeting decisions. The Forecast Schedule did this by projecting Unrestricted Net Assets[8] balances into the future given current actual fund balances and certain assumptions about revenues and expenditures. The Forecast Schedule was designed to start with the prior fiscal year's actual balances, show projected inflows (revenues) and outflows (expenses) for each fiscal year, and show the projected Unrestricted Net Assets balance at the end of each fiscal year.

While certain aspects of the Forecast Schedule changed over time, its basic operation remained constant, as shown in the figure and Exhibit 7:

[8] Unrestricted Net Assets include both cash and non-liquid assets such as accounts receivable.

Start of calculated, projected columns; continues for 14 years.

DU PAGE WATER COMMISSION - 5 YEAR PROJECTION
SUMMARY OF REVENUES, EXPENDITURES AND FUND BALANCES
MAY 1, 2003 TO APRIL 30, 2008

Start for projections; should match actual results reported for fiscal year most recently ended.

ACCOUNT TITLE	ALL FUNDS FY 02-03 ACTUAL	ALL FUNDS FY 03-04 FORECAST	ASSUMPTION OR % CHGE FY 02-07	ALL FUNDS FY 04-05 FORECAST
REVENUES				
O & M PAYMENTS	42,819,534	42,809,836	CALCULATED	46,335,940
SALES TAXES USED FOR O & M COSTS	0	0	CALCULATED	0
FIXED COST PAYMENTS (% PAID BY SALES TAX)	10,164,758	8,916,329	50.0%	7,143,969
SUBSEQUENT CUSTOMER DIFFERENTIAL/EMERGENCY SUPPLY	974,590	853,150	1.0%	861,682
SALES TAXES USED FOR CONSTRUCTION AND BOND PAYMENTS	30,704,457	31,580,715	2.0%	32,212,329
INTEREST INCOME	5,808,624	2,707,302	EXTRAPOLATED	2,758,921
OTHER INCOME	589,493	63,689	0.0%	0
TOTAL REVENUE	91,061,456	88,931,021		89,912,941
OPERATING EXPENDITURES				
WATER PURCHASES (3% ANNUAL RATE INCREASES)	39,037,396	39,427,165	CALCULATED	42,966,596
20% CREDIT THRU OCTOBER 200[illegible]	(7,807,479)	(7,885,433)	CALCULATED	(4,528,814)
5 YEAR CAPITAL PLAN MAJOR RE[illegible]	2,041,455	4,810,523	CALCULATED	790,000
OTHER OPERATING EXPENSES ([illegible]	9,038,873	10,914,451	5.0%	11,460,174
REVENUE BOND PRINCIPAL AND [illegible]	17,832,908	21,147,964	CALCULATED	14,287,938
G.O. BOND PRINCIPAL AND INTE[illegible]	13,122,650	13,[illegible]	[illegible]	[illegible]122,150
CAPITAL EQUIPMENT	98,581	[illegible]	[illegible]	58,657
TOTAL OPERATING EXPENDITURES	73,364,393	81,[illegible]	[illegible]	[illegible]156,701
5 YEAR CAPITAL PLAN NEW CONSTRUCTION	5,448,543	3,[illegible]	[illegible]	[illegible]105,000
5 YEAR CONSTRUCTION PLAN (DELAY)-CATCH-UP	0	0	[illegible]	0
OTHER MINOR RELATED OUTLAYS	333,799	0	4.0%	250,000
DU PAGE COUNTY SALES TAX GRANT	0	75,000,000	PA03-0226	0
PRIOR SERVICE PENSION COSTS	3,805,524	0	BOARD POLICY	0
WATER QUALITY LOANS	10,000,000	0	BOARD POLICY	0
TOTAL CASH OUTLAYS AND COMMITMENTS	92,952,259	160,053,369		97,511,701
NET TRANSACTIONS	(1,890,803)	(73,122,348)		(7,598,860)
UNRESTRICTED NET ASSETS - BEGINNING	127,243,034	122,716,067	CALCULATED	69,458,112
CONVERTED (TO) - FROM RESTRICTED OR CAPITAL NET ASSETS	(2,636,164)	19,864,393		0
UNRESTRICTED OPERATING NET ASSETS - ENDING	122,716,067	69,458,112		61,859,252
HELD FOR EMERGENCY REPAIRS-TARGET (1)	28,100,000	[illegible]400,000		
O&M RATE STABILIZATION RESERVE	45,005,162	40,369,[illegible]		
CONSTRUCTION RESERVE	49,512,314	17,688,135		
UNRESTRICTED NET ASSETS - ENDING	122,617,476	69,458,112		
O & M RATE	1.34	1.38		
FIXED COST RATE	0.32	0.29		
TOTAL RATE	1.66	1.67		1.85

Beginning balance should by definition match last year's ending balance.

Ending balance must equal the total designations.

Ending balance is the beginning balance summed with the net transactions. Carried over to each projection.

The first column of numbers is supposed to reflect the actual results from the fiscal year ended immediately prior to the preparation of the Forecast Schedule; that is, copied verbatim from the results. Each subsequent column was a projected column based on the ending balance in the prior column, the Unrestricted Net Assets. The items above the red box show inflows and outflows, revenues and expenses, and culminate in the ending balance as the result of those, Unrestricted Net Assets. The items in the red box, in contrast, are the various designations of the

Unrestricted Net Assets. By construction, the amount in the calculated ending Unrestricted Net Assets balance should equal the total of the designation at the end of the year.

Our investigation focused on six Forecast Schedules:

- The FY 07 Forecast Schedule presented to the Board on February 9, 2006. (Exhibit 8.) This Forecast Schedule was prepared by Max Richter.
- Three versions of the FY 08 Forecast Schedule, the first of which was presented to the Board on January 11, 2007, and the second and third of which were presented on February 8, 2007. (Exhibits 9-11.) These Forecast Schedules were prepared by Max Richter, although it appears that Richter asked for Skiba's review of at least the first version. (Exhibits 12 and 13.)
- The FY 09 Forecast Schedule presented to the Board on January 10, 2008. (Exhibit 14.) This Forecast Schedule was prepared by Max Richter.
- The FY 10 Forecast Schedule presented to the Board on January 8, 2009. (Exhibit 15.) This Forecast Schedule was prepared by Max Richter.

As described in more detail below, we conclude that errors in the Forecast Schedules were the root cause of the Commission's incorrect belief in the adequacy of the unrestricted reserves, which in turn led to the expenditures that drew down unrestricted cash. The Forecast Schedules overstated both the current and future projected balances of unrestricted cash over a period of several years.

c. Annual Reports

The Board also received the annual reports of the Commission, which were completed approximately six months after the end of the fiscal year. The FY 08 Report is attached as Exhibit 16. The Commission's annual reports did not contain any projections, although it did include a Net Assets Analysis, which presented the breakdown of Net Assets into Unrestricted Operating Funds, Unrestricted Funds, Restricted Funds, and Capital Investment for the prior ten fiscal years. While we refer to certain aspects of the annual reports below in our investigation, and while Crowe concluded that they contain some inconsistent data, they were not the cause of the Commission's incorrect belief in the adequacy of the unrestricted cash.

d. Audited Financial Statements

The Board also received annual audited financial statements of the Commission, which were prepared by the Commission's auditors, McGladrey & Pullen. The audit was typically concluded and distributed to the Board six months after the end of the fiscal year. The most recent final audited financial statement is attached as Exhibit 17. McGladrey audited the Commission's statements in accordance with auditing standards generally accepted in the United States. McGladrey issued opinions through April 30, 2008 that the Commission's financial statements were fairly presented in all material respects.

As explained in Section IV.E.4 below, there were errors in the audited financials, but those errors did not contribute to the 2007 spending decisions.

5. The 2007 Rebate And Water Rate Reduction

Between its revenues from water sales and the sales tax, by 2003 the Commission had accumulated substantial unrestricted cash assets. In 2003, the Illinois legislature passed a law that provided for the Commission to grant a total of $75 million to DuPage County over a period of five years, or $15 million a year; the payout concluded in 2008. *See* Public Act 93-0226 (2003).

Even with that grant, by the end of 2006, the Commission continued to accumulate substantial unrestricted cash. The apparent magnitude of the unrestricted reserves led to concern about a second "raid" by the County on Commission funds. During the annual budgeting process in early 2007, the Board considered a number of possibilities for reducing the amount of accumulating cash. Among those options was a $40 million rebate to its customers and a reduction of the water rate charged to its customers from $1.45 to $1.25 per 1,000 gallons.

In considering those options, Staff presented the Board with several different Forecast Schedules showing the forecasted results under the various proposals. On February 8, 2007, the Board voted to adopt the proposal for the $40 million rebate with a $0.20 water rate reduction. Before the Board at the time of the vote was a Forecast Schedule that showed existing "Unrestricted Cash and Equivalents"[9] (as of April 30, 2007) of $109 million. That Schedule also projected that, even with the proposed changes, total unrestricted cash would be more than $20 million through the end of FY 10, although the projection shows a $14 million balance at the end of FY 11. (Exhibit 11.) The Board formally approved Resolution R-28-07, granting the $40 million rebate, and Ordinances O-4-07 and O-5-07, enacting the $1.25 water rate, on April 12, 2007.

The $40 million rebate was made to charter customers on May 1, 2007. The water rate was reduced the same day.

6. Max Richter's Personnel Problems And Discovery Of The Accounting Problems

Max Richter's performance declined during his tenure. Richter's first two reviews by General Manager Martin were generally good, and he received favorable comments. (Exhibits 18 and 19.) Martin gave Richter less favorable reviews on his third performance review, on May 6, 2008, and his fourth performance review, on April 29, 2009, including comments that Richter needed to make fewer errors in financial reporting. (Exhibits 20 and 21.) Martin explained to us

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[9] The early 2005 budgeting process was the first time that the Forecast Schedule used the term "Ending Five Year Cash and Equivalents" instead of "Unrestricted Net Assets." As explained below, this change was in itself a significant error because Net Assets include *non-cash* assets, such as accounts receivable. Characterizing "net assets" as being "cash and equivalents" overstated the amount of cash available.

that he found mathematical errors in the monthly financial reports, and said that he found errors in other memoranda as well. These errors led him to be concerned about Richter's attention to detail. Martin could not recall any triggering event that led to that concern, but said that it was a concern toward the end of Richter's tenure.

Several Commissioners told us that they had doubts about Richter as well, and that he often was not able to answer questions which should have been within his area of expertise. Commissioner Poole specifically pointed us to several errors that Richter made in various reports and presentations.

The accounting clerk, Teresa Chapman, was the person directly responsible for reconciling bank statements, making the monthly general ledger entries necessary to effect the flow of funds (the "waterfall") through the Commission's general ledger accounts and unrestricted account designations, and reconciling investment lists and collateral lists to bank statements. Before Chapman went on leave in April 2009, she trained a temporary clerk, Ivin Drew, on how to make the necessary ledger entries. Chapman was subsequently fired and replaced by Drew. Drew told us in her interview that when she questioned the purpose of the waterfall entries, Richter said he did not know what they were for, and Richter told Drew that she did not need to perform them in Chapman's absence. They were not performed from the time Chapman left until Skiba returned to the Commission. In our view, Richter's statements to Drew evidence a serious decline in his mental condition and functioning.

During the late summer of 2009, Richter's mental state declined further. On the Friday before Labor Day, Maureen Crowley, the Commission Staff Attorney, and Carolyn Johnson, an administrative assistant, approached Martin and stated they thought that Richter was drinking at work. Richter had been keeping his door closed, and several employees had reported smelling alcohol on Richter's breath. Some employees had reported that Richter had made unintelligible remarks.

On September 4, 2009, Martin and Crowley met with Richter to ask him about these allegations. [redacted] Richter denied drinking while at work and claimed that the smell was an alcohol-based mouthwash. When interviewed, Martin said that he did not think Richter was drinking on the job and did not observe erratic behavior, [redacted]

Following the meeting with Martin and Crowley, Richter was placed on a four-week medical leave. During that time, DWC shut off Richter's access to DWC's computer network and building. Richter had his computer with him when he left, and Martin met him at a restaurant close to the DWC facilities to retrieve it. At the time Richter was placed on leave, there had been no sign of financial difficulties and Martin fully expected that Richter would return to full time employment [redacted]

After Richter was put on medical leave, Martin timely advised the Board on September 10, 2009, during a meeting in executive session, about Richter's performance issues and paid leave. Skiba returned to the Commission to fill the Financial Administrator role in an interim capacity. Martin stated that he asked Skiba to return because, while the Staff could handle the accounts payable and checks, Martin was concerned about the bond requirements. Martin stated he wanted to ensure that there would be no defaults and that all bond payments and requirements would be met.

During September, Skiba began to discover problems with the financials. Skiba first discovered that the monthly financial reports showed a negative cash balance, which (as noted above) is not possible in a double-entry system. Skiba began to trace the issue backwards, and discovered that Richter had not been performing the monthly general ledger entries necessary to effect the flow of funds through the Commission's general ledger accounts or the designations of the unrestricted funds for various uses.

Skiba concluded by early October that certain accounts were not fully funded and that the Commission's unrestricted cash had been fully depleted. He communicated these facts to Martin, but the timing of this communication is not entirely clear. On October 8, 2009, at the Board's executive session, Martin revealed to the Board that they were in the process of "investigating certain accounting anomalies recently discovered" and would report back. Martin advised us that he did not want to say more at that time because he did not know the scope of the problem and was not sure whether Skiba's initial assessment of the issue was accurate or not. While we do not agree with his judgment in not reporting the potential scope of the problem, we believe that Martin's explanation for why he did not apprise the Board of the potential magnitude of the issue is credible based on our observations of his personality and his methodical approach. The delay was of little consequence because four days later members of the Board were involved in discussions concerning the accounting issues.

On October 12, 2009 at 2:00 p.m., Martin was scheduled to meet with Joe Evans of McGladrey to discuss Skiba's concerns about the audit and that the restricted reserves were not satisfied. In advance of that meeting, Martin called Finance Committee Chairman Greg

Mathews and Commission Chairman Louis Rathje and apprised them of the situation. Both Mathews and Rathje attended the meeting, along with Treasurer Thorn, Martin, Skiba, Crowley, and Evans and Sean Hickey from McGladrey. (Exhibit 22.) Restricted reserves and the audit were the principal focus of the meeting. However, there was also a discussion about unrestricted reserves. None of the participants has a good recollection of what was discussed in that regard.

Richter was out of town from October 15 to 20. On Friday, October 23, 2009, Martin, Crowley, and Skiba met with Richter to discuss the accounting problems. (Exhibit 23.) Skiba had prepared a memorandum outlining the problems that he had discovered. (Exhibit 24.) This memo was used at the meeting to ask Richter questions, and Crowley took notes. Martin described Richter's demeanor during the meeting as "sheepish." Richter was asked if he had ensured that the bond ordinance requirements were met each month. Richter said that he relied on Chapman to do that. Richter admitted he had not been reviewing the Commission's financial situation on a monthly basis to ensure that it was correct; he had not performed any account-by-account analysis to ensure compliance with the Bond Ordinance; and the reconciliations of bank accounts and subsidiary schedules to the general ledger had not been done. Richter admitted that he knew that the sales tax subaccount had been greatly reduced, and when Martin asked Richter if he had any idea what position he had put the Commission in, Richter did not say anything. Richter said he knew there was almost nothing left in the water fund subaccount as early as April 2008, and that the account had a zero balance as of April 2009.[10] Richter was also asked in the meeting why he did not tell Martin that the reserves were being depleted, and Richter said that he

[10] These admissions are significant because all unrestricted cash is necessarily reflected in either the water fund subaccount or the sales tax subaccount.

did not say anything because he thought that the sales tax revenue would pick up. At the conclusion of the meeting, Martin terminated Richter's employment.[11]

Following the October 23 meeting, Martin sent an email to the Board announcing the firing. Martin called Rathje and Mathews around noon and told them that there were no unrestricted reserves.

Martin told us that he did not want to just present the entire Board with the problem, but also with a solution. He had Speer Financial, a financial consulting firm, put together a plan for a short-term loan and a bond deal.

In early November, Commissioner Zay called Martin on an unrelated issue and Martin revealed that the Commission had "big financial problems" and a "hole" of $20 to $25 million. On November 10, 2009, Martin met with Commissioner Zay, Sheryl Markay, assistant to DuPage County Chairman Robert Schillerstrom, and Tom Cuculich, Schillerstrom's chief of staff. (Exhibit 25.) Martin also had a meeting that day with Crowley, Skiba, Rathje, and Mathews. (Exhibit 26.) These meetings were to discuss the financial problems. At the Board meeting on November 12, Martin disclosed the extent of the problem to the full Board.

B. The Cause Of The Depletion Of The Unrestricted Cash

The basic cause of the depletion of unrestricted cash were the decisions to issue a rebate and to reduce water rates based on inaccurate accounting information provided to the Board. The Commission voted in February 2007 to rebate $40 million to its charter customers and to reduce the water rate by $0.20, which amounted to $9 million over the following two years. The Commission based its decisions to make the rebate and to reduce the water rate on the amount of unrestricted cash and equivalents reflected on the Forecast Schedule spreadsheet submitted to the

[11] In our interview with Richter, he substantially repeated the admissions regarding the depletion of reserves.

Board on February 8, 2007. That spreadsheet reflected a forecast that as of April 30, 2007, the Commission would have $109 million in unrestricted cash.

1. The Errors In The FY 08 Forecast Schedules Submitted in Early 2007

The Commission did not have $109 million in unrestricted cash as of April 30, 2007. Rather, it had only $69 million in unrestricted cash. The FY 08 Forecast Schedule before the Commission at the time of the rebate/reduction decision contained three basic errors.

First, the FY 08 Forecast Schedule used an inaccurate starting balance. (Exhibits 9-11.) As we described, the first column of each FY 08 Forecast Schedule contained the actual results from the year most recently ended (in this case, FY 06). The beginning balance for the year in progress (FY 07) should have been copied, verbatim, from the ending balance for the prior year's actual results. In prior years the Staff had properly carried the actual balance from one spreadsheet to the next: the actual beginning balance of unrestricted cash in the first forecast year matched the ending balance from the prior year's actual results. For example, as shown in Exhibit 27, and excerpted in the following figure, the FY 04 Forecast Schedule submitted in early 2003, which contained actual results for FY 02, reflected an ending balance of $127,243,034:

NET TRANSACTIONS	16,256,794
UNRESTRICTED NET ASSETS - BEGINNING	113,148,022
CONVERTED (TO) - FROM RESTRICTED OR CAPITAL NET ASSETS	(2,161,782)
UNRESTRICTED NET ASSETS - ENDING	127,243,034
HELD FOR EMERGENCY REPAIR	27,300,000
O&M RATE STABILIZATION RESE	46,471,406
CONSTRUCTION RESERVE	53,471,628
UNRESTRICTED NET ASSETS - ENDING	127,243,034

FY 01-02 Ending balance: $127,243,034

On the same spreadsheet, the $127,243.034 was also properly shown as the projected unrestricted net assets beginning balance for FY 03. It was then properly carried over to the FY

05 Forecast Schedule and used as the beginning balance for the FY 03 actual results, as shown in the figure below and Exhibit 7:[12]

TOTAL OPERATING EXPENDITURES	73,364,393
5 YEAR CAPITAL PLAN NEW CONSTRUCTION	5,448,543
5 YEAR CONSTRUCTION PLAN (DELAY)-CATCH-UP	0
OTHER MINOR RELATED OUTLAYS	333,799
DU PAGE COUNTY SALES TAX GRANT	0
PRIOR SERVICE PENSION COSTS	3,805,524
WATER QUALITY LOANS	10,000,000
TOTAL CASH OUTLAYS AND COMMITMENTS	92,952,259
NET TRANSACTIONS	(1,890,803)
UNRESTRICTED NET ASSETS - BEGINNING	127,243,034
CONVERTED (TO) - FROM RESTRICTED OR CAPITAL NET ASSETS	(2,636,164)
UNRESTRICTED OPERATING NET ASSETS - ENDING	122,716,067

FY 02-03 Beginning balance: $127,243,034

However, in the FY 08 Forecast Schedules submitted to the Board in January and February 2007, Staff did not simply carry over the actual FY 05 ending balance as the FY 06 beginning balance. Instead, the FY 08 spreadsheets added approximately $15 million to what should have been the beginning FY 06 balance. That error had the effect of adding $15 million to the projected ending balance for every subsequent year.

As shown in Exhibit 8 and the figure, the actual FY 05 ending balance in the prior year's Forecast Schedule was $119,903,780.

WATER QUALITY LOANS	2,103,547
TOTAL CASH OUTLAYS AND COMMITMENTS	107,260,236
NET TRANSACTIONS	(18,613,198)
BEGINNING FIVE YEAR PLAN CASH AND EQUIVALENTS	138,776,328
CONVERTED (TO) - FROM RESTRICTED OR CAPITAL NET ASSETS	(259,350)
ENDING FIVE YEAR PLAN CASH AND EQUIVALENTS	119,903,780

FY 04-05 Ending balance: $119,903,780

[12] In some years, an adjustment was necessary to square cash with accrual accounting, but that was not the case for the FY 08 and subsequent Forecast Schedules.

That same number should have been used as the beginning balance for the actual FY 06 column in the FY 08 Forecast Schedules submitted to the Board in early 2007. Indeed, the correct number was used in a December 7, 2006 draft of the FY 08 spreadsheet that was reviewed by Commissioner Poole. Specifically, in that draft, Richter had gotten the FY 06 beginning balance correct (that is, $119,903,780), but had made a different error: carrying out the $15 million grants to DuPage County until FY 09 when they in fact ended in FY 08.

DuPAGE WATER COMMISSION
SUMMARY OF REVENUES, EXPENDITURES & FUND BALANCES
50% REVENUE BOND SUBSIDY - $1.30 RATE

	ACTUAL FY 05-06	PROJECTED FY 06-07	ASSUMPTIONS OR % CHANGE	FORECAST FY 07-08	FORECAST FY 08-09
REVENUES:					
FIXED RATE	7,144,469	7,145,094	50.0%	7,145,344	7,144,719
O & M REVENUE	40,848,001	41,593,077	CALCULATED	36,691,444	37,193,021
SALES TAX	34,894,007	35,677,398	2.0%	36,390,944	37,118,763
INVESTMENT INCOME	5,429,133	5,237,712	CALCULATED	5,050,376	4,446,791
SUBSEQUENT CUSTOMER	572,790	714,437	1.0%	721,581	728,797
EMERGENCY SUPPLY	9,854	10,051	2.0%	10,252	10,457
OTHER INCOME	1,236	2,500	0.0%	2,500	2,500
TOTAL REVENUES	88,899,490	90,380,267		86,012,443	86,645,048
EXPENDITURES:					
WATER PURCHASE	46,058,449	45,127,728	3.0%	46,920,176	48,706,252
CREDIT FORM CHICAGO		(268,166)		(2,790,000)	(6,116,000)
OPERATING EXPENSES	9,346,198	9,813,508	5.0%	10,304,183	10,819,392
MINOR CAPITAL	397,058	200,000	[illegible]	[illegible]	210,000
MAJOR REPAIRS		2,938,000	[illegible]	-	-
REV BOND P& I	14,288,937	14,290,188	[illegible]	[illegible]	14,269,438
GO BOND P & I	13,124,150	13,117,900	[illegible]	[illegible]	13,116,900
TOTAL EXPENDITURES	83,214,790	84,679,156		[illegible]	81,024,012
5 YEAR CONSTRUCTION PLAN	5,356,901	1,902,000	[illegible]	[illegible]	16,623,000
DuPAGE COUNTY PAYMENT	15,000,000	15,000,000	PA 93-0226	15,000,000	15,000,000
RECLASSIFICATION OF RESTRICTED TO UNRESTRICTED			CALCULATED	-	
QUALITY LOAN REPAYMENT			BOARD POLICY		
NET TRANSACTIONS	(14,672,201)	(11,200,889)		(22,603,254)	(26,001,964)
BEGINNING BALANCE	119,903,780	120,160,126		108,959,237	86,355,983

FY 05 ending balance of $119,903,780 properly used as FY 06 beginning balance

$15mm rebate payment improperly extended to FY 08-09

Commissioner Poole sent an email to General Manager Martin on December 11, 2006, advising him of Richter's mistake and instructing Martin to correct it. (Exhibit 28.) This email is reproduced below:

From: Allan Poole [mailto:PooleA@naperville.il.us]
Sent: Monday, December 11, 2006 8:43 AM
To: Robert Martin
Cc: mayorwdg@aol.com; Peter Burchard; Doug Krieger
Subject: Major Error in DWC Long Term Financial Plan

Another major snafu on the spreadsheets for the Long Term Financial Plan has been made. The ending balance for FY 08-09 and thereafter is understated by $15,000,000 as a major error has been made in extending the annual $15 Million payment to DuPage County by a 6th year.

Be advised that the 5th and final year for the $15 Million payment is in FY 07-08 not FY 08-09. You need to correct both your December 8, 2006 memo spreadsheets as well as the Summary of Revenues, Expenditures and Fund Balances.

In the next version of the FY 08 spreadsheet, dated December 11, 2006, Richter made two changes: one was to delete the $15 million grant from expenditures in the FY 09 forecast as Commissioner Poole had correctly suggested; the other was to add $15 million to the FY 06 beginning balance. The latter change was incorrect and, since FY 06 had closed months earlier, bizarre.

Every version of the FY 08 Forecast Schedule prepared thereafter, including the final February 8, 2007 version of the FY 08 spreadsheet before the Board at the time of the vote, showed an FY 06 beginning balance of $134,832,327, roughly $15 million too high, as seen in the figure below and Exhibit 11:

GO BOND P & I	13,124,150
TOTAL EXPENDITURES	83,214,790
5 YEAR CONSTRUCTION PLAN	5,356,901
DuPAGE COUNTY PAYMENT	15,000,000
REBATE	
RECLASSIFICATION OF RESTRICTED TO UNRESTRICTED	-
QUALITY LOAN REPAYMENT	-
NET TRANSACTIONS	(14,672,201)
BEGINNING BALANCE	134,832,327
ENDING BALANCE	120,160,126
UNRESTRICTED	
HELD FOR EMERGENCY REPAIRS	12,900,000
O&M RATE STABILIZATION	31,052,607
CONSTRUCTION RESERVE	42,417,219
RECLASSIFICATION OF RESTRICTED TO UNRESTRICTED	-

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In an attempt to understand this error, we reviewed the electronic versions of the FY 08 spreadsheets from the Commission's server. Our review revealed that both versions of the FY 08 spreadsheet presented on February 8, 2007, as well as the version presented on January 11, 2007, contained the following formula in cell C31, the FY 06 beginning balance:

=119903780+15000000-71453

The first number in this sequence, $119,903,780, was the correct beginning balance because it was the ending balance for the prior year. However, Richter added $15 million to that number, and subtracted $71,453. Richter could not recall why he would have made these changes. He offered to look at the electronic version of the FY 08 spreadsheet, but when we emailed it to him, he initially ignored our communication and later said that he had not received the spreadsheet.[13] We have not found any explanation for the $71,453 subtraction. We believe that the addition of the $15 million was a badly misguided effort to correct the error that Commissioner Poole had identified in the December 7, 2006 version of the FY 08 spreadsheet.

The addition of $15 million to the FY 06 balance directly inflated the projected balance for FY 07 and the succeeding forecast years on the FY 08 spreadsheets.

Second, all versions of the FY 08 spreadsheet distributed on January 11, 2007 and February 8, 2007 inappropriately included the undistributed $15 million in the DuPage County grant in the category of unrestricted cash. As shown in Exhibit 11 and the figure, included in the category of Unrestricted Cash was the $15 million amount that had to be paid to DuPage County in FY 07:

[13] Richter returned our email messages following up on his offer to review the electronic version of the spreadsheet during the last week in February. By that time, he had moved out of state.

REV BOND P& I	14,288,937	14,290,188
GO BOND P & I	13,124,150	13,117,900
TOTAL EXPENDITURES	83,214,790	84,579,156
5 YEAR CONSTRUCTION PLAN	5,356,901	1,902,000
DuPAGE COUNTY PAYMENT	15,000,000	15,000,000
REBATE		
RECLASSIFICATION OF RESTRICTED TO UNRESTRICTED	-	-
QUALITY LOAN REPAYMENT	-	-
NET TRANSACTIONS	(14,672,201)	(11,001,625)
BEGINNING BALANCE	134,832,327	120,160,126
ENDING BALANCE	120,160,126	109,158,501
UNRESTRICTED		
HELD FOR EMERGENCY REPAIRS	12,800,000	13,300,000
O&M RATE STABILIZATION	34,052,607	22,281,709
CONSTRUCTION RESERVE	42,417,219	55,550,492
RECLASSIFICATION OF RESTRICTED TO UNRESTRICTED	-	-
UNDISTRIBUTED PA93-0226	30,000,000	15,000,000
UNDISTRIBUTED QUALITY LOANS	3,790,300	3,026,300

This amount is restricted by the DuPage Co. Grant Legislation.

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Because the use of that money was restricted by an external law, it should not have been shown as unrestricted. This error inflated the actual amount of expected unrestricted cash for the close of FY 07 by an additional $15 million.

Third, the January 11, 2007 and February 8, 2007 spreadsheets also included non-liquid assets, such as accounts receivable, in the row for "Total Unrestricted Cash & Equivalents." Non-liquid assets are not unrestricted cash or equivalents. By including non-liquid assets of $14 million, net of $2 million of liabilities in the projected FY 07 results, the spreadsheet inflated actual cash and equivalents by roughly $12 million.

These errors, which overstated unrestricted cash by $42 million, were partially offset by a $2 million understatement in undistributed water quality loans.

In summary, when the Board voted to rebate $40 million and to reduce the water rate, the figures presented to it in the FY 08 spreadsheets showed that there was $109 million in unrestricted assets. As a result of the three errors described, that number was inflated by $40 million. Once the rebate was paid on May 1, 2007, actual unrestricted cash was down to $29 million.

2. Continued Inflation Of Unrestricted Reserves In FY 09 And FY 10 Forecast Schedules

The beginning balance error in the FY 08 Forecast Schedule was repeated in the next two years. In the FY 09 Forecast Schedule (submitted to the Board on January 10, 2008), instead of using the FY 06 actual ending balance as the starting balance for FY 07 Unrestricted Funds, the spreadsheet uses the same mistaken beginning number used in the FY 08 spreadsheet. (*See* Exhibit 14.) In other words, the beginning balance for FY 06 (which was already wrong by $15 million) was copied from the February 8, 2007 spreadsheet to the cell for the beginning balance for FY 07 in the January 10, 2008 spreadsheet. As a result, the $15 million error was effectively doubled in the latter spreadsheet, showing anticipated unrestricted cash that was inflated by $30 million.

There were two errors in the FY 10 spreadsheet presented to the Board on January 8, 2009. First, unrestricted cash projected for the end of FY 09 was overstated by $17.4 million, principally as a result of the $15 million beginning balance error that began with the FY 08 Forecast Schedules. (*See* Exhibit 15.)

Second, the January 8, 2009 FY 10 spreadsheet failed to deduct the amount of the May 1, 2007 $40 million rebate from the ending actual balance for FY 08. As shown in Exhibit 15 and the figure, while the $40 million rebate itself is shown on the face of the January 8, 2009 spreadsheet, the formula that totals up the expenditures for that year does not include the cell in which the $40 million rebate was placed. Thus, the bottom line is overstated by $40 million.

TOTAL REVENUES	78,336,219
EXPENDITURES:	
WATER PURCHASE	46,071,475
CREDIT FROM CHICAGO	(980,408)
OPERATING EXPENSES	9,763,347
REV BOND P&I	14,290,187
GO BOND P & I	13,117,650
TOTAL EXPENDITURES	82,243,161
FIVE YEAR CONSTRUCTION PLAN	3,033,313
DUPAGE COUNTY PAYMENT	15,000,000
WEST CHICAGO PAYMENT	1,014,943
REBATE	40,000,000
RECLASSIFICATION OF RESTRICTED TO UNRESTRICTED	-
QUALITY LOAN REPAYMENT	-
NET TRANSACTIONS	(20,950,255)
BEGINNING BALANCE	112,467,014
ENDING BALANCE	91,516,759
UNRESTRICTED	
HELD FOR EMERGENCY REPAIRS	18,864,117
O&M RATE STABILIZAT	5,061,887
CONSTRUCTION RESE	28,725,741
RECLASSIFICATION O … TED	-
UNDISTRIBUTED PAVG	-
UNDISTRIBUTED QUAL	3,152,730
TOTAL UNRESTRICTE	56,794,475
RESTRICTED	
DEPRECIATION	5,000,000
O & M	9,930,859
O & M RESERVE	12,592,764
TOTAL RESTRICTED CASH & EQUIVALENTS	27,523,423
TOTAL CASH & EQUIVALENTS	84,317,898

Rebate is shown on face of spreadsheet.

But math formula in cell subtracting expenses from revenues does not include rebate; mathematically obvious that revenues less all expenditures left bigger deficit than $21 million.

Together with the $17.4 million starting balance error, this caused an overstatement of $57.4 million in unrestricted cash balances in the information provided to the Board in January 2009.

In the summer of 2009, Commissioner Chaplin sent Richter a series of emails asking when the imbalance between water revenues and water expenditures would result in a loss that would overwhelm the Commission's sales tax revenues and investment income. On June 24, 2009, Richter responded with a memorandum that again included the erroneous January 8, 2009 spreadsheet which overstated unrestricted cash by $57.4 million.

3. Other Accounting Errors

Our investigation showed that the accounting errors in the Forecast Schedules were part of a pattern of errors in documents prepared by Richter. Above, we highlighted those that directly contributed to the Board's misimpression regarding the amount of unrestricted cash in 2007. General Manager Martin also reported various unspecified errors, both in his interview with us and in contemporaneous evaluations of Richter's performance. We also identified the following errors.

a. Construction Reserve In The FY 08 Forecast Schedules

As previously discussed, the spreadsheet broke down unrestricted funds into subcategories. Richter failed to independently calculate or verify each of the components of unrestricted cash. Instead of obtaining each of the designation balances of each of the categories of unrestricted cash from an external source that could be checked, such as the audited financial statements, the FY 08 spreadsheets presented to the Board in early 2007 used a formula that calculated the Construction Reserve by starting with the total unrestricted cash – calculated by the income statement presentation – and subtracting out the other accounts that were part of unrestricted cash.

For example, as shown in Exhibit 9 and the figure, the January 11, 2007 version of the FY 08 spreadsheet, the Construction Reserve was reflected as $42,417,219:

NET TRANSACTIONS		(14,672,201)
BEGINNING BALANCE		134,832,327
ENDING BALANCE	(A)	120,160,126
UNRESTRICTED		
HELD FOR EMERGENCY REPAIRS	(B)	12,900,000
O&M RATE STABILIZATION	(C)	31,052,607
CONSTRUCTION RESERVE		42,417,219
RECLASSIFICATION OF RESTRICTED TO UNRESTRICTED		-
UNDISTRIBUTED PA93-0226	(D)	30,000,000
UNDISTRIBUTED QUALITY LOANS	(E)	3,790,300
TOTAL UNRESTRICTED CASH & EQUIVALENTS		120,160,126
RESTRICTED		
DEPRECIATION		5,000,000
O & M		11,112,075
O & M RESERVE		11,532,818
TOTAL RESTRICTED CASH & EQUIVALENTS		27,644,893
TOTAL CASH & EQUIVALENTS		147,805,019
O & M RATE		1 22
FIXED COST RATE		0.21

Not supplied from/checked against external source; calculated as (A) Ending balance minus (B) through (E); i.e. residual or leftover amount of (A) put in Construction Reserve.

This is not an appropriate accounting methodology. The presentation of unrestricted cash balances should be checked against, or tied to, external sources.

Richter also used the wrong "plug" number. Rather than including the residual of the unrestricted reserves in the construction reserve, the construction reserve should have been calculated as sales tax less approximately $7 million. This also shows that Richter failed to consult the audited financial statements or the Net Assets Analysis, because the construction reserve number should have agreed to the presentation in the audited financials, which it did not.

b. FY 07 Water Sales Accountability Schedule

Included in the Commission's Annual Report is a schedule which lists the purchases of water and sales of water to customers, in dollars and gallons, for each month in the just-closed fiscal year. The Water Sales Accountability schedule in the FY 07 Annual Report contained two significant errors. First, the schedule incorrectly showed that water revenues exceeded the cost of purchasing water by $2,516,921. (Exhibit 29 at page 39.) That entry was clearly incorrect. Unlike prior and subsequent years, the FY 07 schedule included revenues from the fixed-cost charges to customers, which inflated the overall water revenues and gave the reader the false impression that water revenues exceeded water costs in FY 07. Second, that schedule contained an inflated amount of water purchased from Chicago: the amount was inflated by nearly $1.5 million. (Exhibit 30.)

4. Depletion Of Funds After April 30, 2007

Crowe's analysis shows that, by April 30, 2008, unrestricted cash had been reduced to $19.5 million, a figure which agrees with unrestricted cash in the FY 08 audited financial statement. Crowe's analysis shows that, by April 30, 2009, unrestricted cash had been reduced to $3.2 million. (Exhibit 31.) Five principal factors caused this reduction.

First, the $40 million rebate payment directly reduced unrestricted cash.

Second, ongoing operating shortfalls, exacerbated by the water rate reduction, ate up unrestricted cash at a rate of roughly $2 million per month. In order to cover the shortfalls, between May 2007 and April 2009, almost $50 million was transferred from unrestricted cash accounts to the Operating and Maintenance (O&M) account. Ninety percent of that amount was transferred from the Sales Tax account.

Third, the Commission approved and began funding several new construction projects. In particular, according to General Manager Martin, from April 2007 through December 21, 2009, the Commission spent approximately $17 million on construction and engineering related to capital improvements that were approved after the rebate vote. The Commission's approval of these projects was made in reliance on the Forecast Schedules the Staff provided to the Commission in January 2008 and January 2009 which, as described above, contained substantial overstatements of the remaining unrestricted cash.

Fourth, because the Commission had less cash invested, there was a substantial decline in investment income.

Fifth, sales tax receipts declined due to the recession.

By September 2009, the balance of unrestricted cash was at zero.

C. Use Of Sales Tax Revenues To Subsidize Operating Expenses

We investigated and analyzed the assertion that there was some impropriety in the Commission's use of sales tax revenues to subsidize water operations during the relevant period. We were told variously that it was a "surprise" that sales tax revenues were being used to cover the shortfall in operating revenues, and then that it was a "surprise" to what extent they were being used. We concluded that there was nothing improper about the use of those revenues, and that it was, or should have been apparent, to the Board and the Staff that sales tax revenues were used in that fashion.

Both Skiba and Martin told us that historically, the Commission attempted to fund water operations with water revenues and construction operations with sales taxes. Both Skiba and Martin suggested at first that no sales tax revenues should have been used to cover water expenses. They also suggested that, if some sales tax revenues were being used, they should not have been used to the extent they were. We also heard from some Commissioners that they were surprised to learn that sales tax revenues were used to fund water operations.

We concluded that there was nothing inherently wrong or contrary to law in using sales tax revenues to subsidize operations and maintenance. Our investigation did not locate any external law or ordinance that placed any such restriction on sales tax revenues. None of the interviewees was able to specify any source of such a restriction. Consequently, we concluded that the Commission's use of sales tax revenues for a Commission purpose, to provide water to its customers, was not improper or contrary to law.

We also concluded that the fact that sales tax revenues were being used to subsidize the provision of water was clearly known, or should have been clearly known, to both the Staff and the Board, and to any member of the public who desired to review public Commission records. There were at least three sources of information that made this obvious.

First, the Five Year Plans presented to the Board for approval expressly stated that sales tax revenues would be used to pay for deficits in water expenses. For example, from January 2005 to January 2007, the cover memoranda for the Capital Improvement Plan included a statement that "To maintain this lower water rate, it is necessary to use sales tax beginning in fiscal year 2008-09 to supplement operation and maintenance costs." (Exhibits 32-34.) The January 2008 CIP cover memorandum noted that "sales tax revenue will be utilized in fiscal year 2008-2009 to supplement operation and maintenance revenues." (Exhibit 35.) A February 1, 2006 memorandum from Martin to the Board regarding an alternative CIP stated that "Operation and Maintenance rates are subsidized by current sales tax collections in FY 2008-09 through FY 2013-14." (Exhibit 36.)

Second, it was apparent from the face of the audited financial statements that revenue from water sales was insufficient to pay for operating expenses. For example, as shown in the figure and Exhibit 17 at page 7, the FY 08 audited financial statements, provided to the Board in October 2008, showed total Operating Revenues of approximately $40 million, but total operating expenses of approximately $62 million:

COMPARATIVE SUMMARY OF REVENUES AND EXPENSES
For Fiscal Years Ending April 30

		2008		2007	IN (D
Revenues					
Operating:					
Water sales - all categories	$	40,185,989	$	45,036,990	$
Other		1,319		63,690	
Nonoperating:					
Sales tax		34,308,874		36,422,562	
Investment income		3,958,431		7,350,036	
Gain on the sale of capital assets		46,624		-	
Total revenues		78,501,237		88,873,278	
Expenses					
Operating:					
Water supply costs		50,234,652		48,591,776	
Depreciation		6,503,779		6,695,222	
Personnel services		3,765,227		4,879,217	
All other expenses		1,886,996		1,939,158	
Nonoperating:					
Bond interest		7,514,478		8,180,506	
Total expenses		69,905,132		70,285,879	

The prior year showed a similar deficit, of $45 million in operating revenues but approximately $62 million in operating expenses.

Third, questions asked by Commissioner Chaplin reflected that the Board was aware that sales tax revenues were being used to subsidize water operations. On June 7, 2009, Commissioner Chaplin sent an email to Richter indicating that the "loss from regular operations has been steadily climbing and at some point ***it will overwhelm the sales tax*** and investment income." (Exhibit 37 (emphasis supplied).) Commissioner Chaplin requested an answer from Richter about the timing of when the sales tax would be insufficient. Commissioner Chaplin sent a follow up email on June 15, 2009, acknowledging that water was sold for less than it costs, and asked whether the operating loss was "an indication that if there were no sales tax nor investment income [then] the DWC would have to report a loss because the income is less than the expenses?" (Exhibit 38.) After several more email exchanges, Richter, in a memo that was reviewed by McGladrey and other Staff members, stated: "The Commission has been subsidizing the water rate via the sales tax revenues." This memorandum was provided to the entire Board on June 19, 2009. (Exhibit 39.)

Consequently, we concluded that there was no basis for the assertion that it was either improper, or a surprise to the Board or the Staff, that sales tax revenues were being used to subsidize water operations.

D. The Status Of Restricted Assets

Crowe analyzed the status of restricted funds to determine whether the Commission had at all times complied with the Bond Ordinance. Crowe reached the following conclusions:

- By April 30, 2009, the O&M Reserve general ledger account was underfunded by $2 million. (Exhibit 40.)
- By September 30, 2009, the O&M Reserve general ledger account was underfunded by $6 million. (*Id.*)

- By December 31, 2009, the O&M Reserve general ledger account was depleted to zero (underfunded by $13 million), the Depreciation general ledger account was underfunded by $3 million, and the O&M general ledger account was underfunded by $76,000. (Exhibit 41.)
- All other accounts restricted by the Revenue Bond Ordinance of 1987 were funded in accordance with the Ordinance.
- The Commission has not missed any payments of interest or principal due the bondholders.

The deficiency in the O&M Reserve general ledger account was caused by transfers from the O&M Reserve general ledger account to the O&M general ledger account. In other words, as the unrestricted cash was depleted, in order to fund the ongoing monthly shortfall in operations requirements, Richter began transferring money from the restricted O&M Reserve general ledger account into the O&M general ledger account.

E. Responsibility For The Depletion Of Unrestricted Cash

1. The Financial Administrator

Direct and primary responsibility for the accounting errors, the Board's misunderstanding of the size of the unrestricted cash reserves, and thus the depletion of unrestricted cash lies with the Financial Administrator who prepared inaccurate financials. Richter was responsible for preparing the Forecast Schedules and the monthly reports provided to the Finance Committee and the Board. The reports, as described above, contained serious, unjustifiable and material errors.

Worse, Richter has admitted knowing that the Commission's unrestricted cash was running out but not identifying the problem to the Board. Richter gave us two explanations for his failure to raise the issue directly. First, he said that although the unrestricted reserves were down because water sales and sales taxes were down, he thought that the Commission could recoup the money through sales taxes and cutting expenses. Second, he said that he believed that it was sufficient that he was providing a monthly Treasurer's Report to Martin and to the Board that reflected the steep decline in unrestricted cash reserves. These explanations are not only inadequate, but irrational.

We investigated and analyzed whether the errors made by Richter were intentional or the product of extreme negligence. The errors were consistent with both explanations, but we conclude on balance that the best explanation is that his conduct was grossly negligent, not intentionally fraudulent.[14]

We cannot discern any motive Richter would have had to make the most important errors – those that occurred in the January and February 2007 spreadsheets before the Commission made its decisions on the rebate and the water rate. Richter would have had no interest in inflating the unrestricted cash balance in those spreadsheets. Doing so paved the way for the $40 million rebate, but we have found no evidence that Richter favored the rebate nor can we conceive of any benefit to him if the rebate were made. In addition, at the time these errors were made, Richter could not have known whether any rebate would be paid, whether the excess funds would be used to pay down the Commission's debt, or whether the funds would be spent on some other purpose or held in reserve. Moreover, the sequence of events in December 2006, in which Commissioner Poole's catching a different $15 million error (in the FY 09 column) appears to have somehow led to Richter's "correction" of adding $15 million to the beginning balance for FY 06, supports the conclusion that the key error was made negligently, not intentionally.

[14] Under Illinois law, fraud must be established by "clear and convincing" evidence. *Avery v. State Farm Mut. Auto Ins. Co.*, 216 Ill. 2d 100, 191-92, 835 N.E.2d 801, 856 (2005).

Nor is there any apparent financial motive for Richter to have made these initial errors. While no exhaustive forensic audit has been performed, we are satisfied, based on the investigation that has been performed, that the depletion of the unrestricted reserves can be traced to the legitimate Commission operations, including the rebate, the reduction of the water rate, and the other factors identified above.

The later errors – carrying forward the incorrect balance in the FY 09 Forecast Schedule and omitting the subtraction of the $40 million rebate payment from unrestricted cash in the FY 10 Forecast Schedule – could conceivably have been part of a cover up attempt. Specifically, it is possible that having learned that his erroneous FY 08 Forecast Schedule resulted in Board action that depleted the unrestricted reserves, Richter sought to conceal the earlier error by falsifying the FY 09 and FY 10 Forecast Schedules. While this is certainly a plausible reconstruction of events, we have found no hard evidence to support it. Given the breadth of Richter's mistakes over a period of years, and the fact that at the same time as he created the inaccurate January 10, 2008 and January 8, 2009 spreadsheets he was also providing close-to-accurate information on unrestricted cash in the Treasurer's Reports, the subsequent accounting errors were more likely the product of gross negligence.

During the course of our investigation, we were told that the FY 10 Forecast Schedule, which had been submitted to the Board on January 8, 2009, could not be found on the Commission's server, and the question was raised whether it was deleted as part of a cover up. We exhaustively analyzed all versions of this spreadsheet on the server and could not locate one that was identical to the printed version used at the January 8, 2009 meeting. However, there were a number of versions on the server that contained precisely the same mistakes, indicating that it was very unlikely that the failure to retain this version was an intentional deletion designed to hide the errors.

[redacted]

[redacted]

2. **The General Manager**

The General Manager also bears significant responsibility for the mistakes and the unexpected depletion of the unrestricted reserves. The General Manager simply accepted the figures presented to him by the Financial Administrator as accurate. Even given his lack of financial expertise, the General Manager failed in not actively attempting to question or supervise the Financial Administrator or to understand the accounting ledgers. Finally, the General Manager should have learned of the substantial depletion of the unrestricted cash by no later than March 2009 by simply reading the Treasurer's Reports.

We interviewed Martin on three occasions, and had numerous informal contacts with him.[15] Martin said that, if he had time, he would look through the monthly financial reporting, but that he would not do so every month. Martin told us that although he had reprimanded Richter for providing inaccurate information to the Board, Martin did not provide any checks and balances with respect to Richter's performance, and he hoped that Chapman, who reported ***to*** Richter, did so. Martin also said that he hoped that Maureen Crowley (who in fact had no financial responsibilities) would catch errors, as she sometimes did. If Martin was in fact relying on Richter's subordinate – who was not an accountant and whose job description clearly provides that she serves "under the direction of the Financial Administrator" – and an attorney to provide checks on Richter's work, that reliance was reckless. (Exhibit 42.) More likely, this is an after-the-fact rationalization by Martin.

Martin said he did not consider reviewing the financial statements and asking Richter questions to be a "key" part of his job but that, in light of recent events, "it probably should have been." Martin said that his job mostly concerned "putting out fires." Martin said that he probably looked at the financial information more in the early years that Richter was at the Commission because Richter was a new employee. Martin said that, as Richter was around longer, toward the end, Martin probably was not looking at them "in any depth" because of the other issues Martin had to address. Martin said he had other priorities, and that his biggest priority was the reliability of the system and making sure it was working properly. Martin said "obviously now in 20/20 hindsight" he "probably should have looked at them more carefully," but he did not when other things were going on. Martin said his biggest concern all of the time

[15] Throughout the investigation, Martin was cooperative, answered questions, and provided requested materials to the investigators. Like a number of witnesses interviewed for this investigation, however, Martin at times sought to deflect a portion of the blame to others.

was the reliability of the system and making sure that water was pumping to three quarters of a million people.

Based on the nature of his prescribed duties, and his admitted failure to perform them, we conclude that the General Manager bears significant, if secondary, responsibility for the errors, and was negligent in failing to catch them. We do not find any evidence that Martin acted intentionally, or that he failed to properly advise the Board when the errors were discovered. The suggestion advanced by some parties that Martin acted with a lack of integrity, in that he supposedly knew, but did not disclose, that the financials were misstated, is unsupported. We also believe that there was nothing sinister in the timing of Martin's reporting the problems to the Board. While he clearly could have (and should have) made more complete and swifter disclosures as he learned of new developments, doing so might have caused him to be criticized for "jumping the gun" without being sure of the facts if Skiba had been incorrect. Rather than immediately report Skiba's opinion to the Board, he waited until he could confirm it by interviewing Richter. When Richter admitted the substantial depletion, Martin promptly advised Chairman Rathje and Commissioner Mathews of the problem. Although Martin should have told the entire Board what he knew no later than October 23, the fact that he did inform two Board members at that time weighs against any conclusion that he was trying to delay disclosure of the magnitude of the problem.

3. The Board

The Board of Commissioners as a whole also bears some responsibility for the depletion of unrestricted cash. It is important to note, however, that not all current Board members were on the Board at the time of the relevant decisions or omissions. The Board bears responsibility in the following four respects.

First, in 2005 the Board hired a General Manager who it knew, or should have known, did not have adequate training and experience in financial matters to supervise the Financial Administrator. The fact that Martin lacked the requisite financial experience was plain from his resume, and the contrast between his financial credentials and those of his predecessor was stark. Moreover, several Commissioners who were on the Board at the time of Martin's hiring acknowledged that Martin's lack of a finance background was known to the Board.

Second, in 2007 the Board made critical financial decisions based on Staff projections when it knew that there was essentially no oversight of the Staff on financial matters. Specifically, Commissioners told us that the Board voted to make the $40 million rebate, and the rate reductions, and continue with capital construction projects, based on information provided by the Staff. However, the Board knew that Martin was not qualified to supervise the financial Staff, and (as described below) that the Treasurer provided no additional meaningful review of Staff-provided financial information. Some Commissioners even advised us that they did not rely on the Forecast Schedules, but rather on the impression created by Staff that there were substantial reserves.

Third, the Board's failure to insist that the Treasurer post be meaningfully filled contributed to the depletion of unrestricted cash. Although the Treasurer was assigned significant oversight responsibilities under the by-laws, and the Commission paid for significant bond commensurate with those responsibilities, the Board allowed the position of the Treasurer to become a ceremonial position with no substantive duties. The Board knew or should have known that (at least) the past two Treasurers did not have the background and experience necessary to fulfill the duties required of them by the by-laws and that active oversight was needed. The Board also created a situation in which its committees were essentially meaningless. The Finance Committee had no greater access to information than other Board members and did not exercise significant oversight of financial statements or projections.

Fourth, the Board should have learned from the Treasurer's Reports that unrestricted cash had been largely depleted by no later than March 2009. The Board as a whole was provided with monthly Treasurer's Reports that, during 2008 and 2009, expressly showed the amount of unrestricted cash. The February 2009 report indicated (circulated in March) indicated that the amount of unrestricted cash was only $10 million. (Exhibit 43.) (In reality, the unrestricted cash was even less by that point.)

In interviews, some Commissioners suggested variously that they did not have the expertise necessary to interpret the financial data provided to them, that they did not have the time to do so, or that that they were not responsible for reviewing the information, and that it was the responsibility of Staff to call to their attention any problems. There is a degree of truth to all of these explanations. Most of the Board's members are lawyers or public officials; only one has a significant background in financial matters. The Board members are paid either nothing or a nominal sum, and it is hardly surprising that they devote most of their attention to their jobs rather than their essentially volunteer service on the Board. Staff should have caught the errors and brought problems to the Board's attention. But if the Board had no separate responsibility to review the information provided, it would be hard to understand why a Board was needed. In short, these reasons do not fully explain why no one on the Board knew of the exhaustion of the unrestricted reserves, and they do not warrant a conclusion that the Board was blameless.

4. The Commission's Auditors, McGladrey & Pullen

The Commission's auditors cannot be held responsible for the depletion of unrestricted cash. Although they too made mistakes, described below, in the 2006, 2007 and 2008 audited financial statements, the key error occurred in the FY 07 financials, which came out long after the April 2007 Board decisions regarding the rebate and reduction in water rate. Consequently, the Board was not relying on those financial statements at the time of the critical decision.

Moreover, and more importantly, the Commission's auditors were not responsible for verifying all of the financial information at the Commission. An audit engagement is typically focused on the accuracy of specific financial statements, and the auditor's assurance that those financial statements fairly present in all material respects the financial condition of the Commission (or any other entity) is limited to those statements that are the subject of the audit. Here, the Forecast Schedules and much of the monthly reporting to the Board were taken from the legacy, spreadsheet-based accounting system. That accounting system was not used to prepare the audited financial statements, and auditing the spreadsheets used for internal Commission planning was beyond the scope of the audit engagement.

We have seen no evidence that the Financial Administrator or the General Manager consulted the auditors on the accuracy of the figures in the Forecast Schedules or the monthly reporting provided to the Board. We interviewed McGladrey representatives on February 4, 2010, and they confirmed that review of the internal Commission planning spreadsheets was not part of their engagement.

Crowe read the audited financial statements for the fiscal years 2004 through 2008 and made the following observations.

a. FY 06 Audit

Footnote 9, on page 36 of the 2006 audited financial statements (Exhibit 44) fails to match up with the Unrestricted Net Asset balance shown on the face of the Statement of Net Assets on pages 19-20. In addition, the amounts designated in the three unrestricted reserve areas in Footnote 9 do not agree with the designations made in the Net Asset Analysis Schedule at page 32 of the Annual Report for that time period. (Exhibit 45.) The total amount designated in the three unrestricted reserve areas in Footnote 9 is $62,932,585, about $7.5 million less than the total amount ($70,508,726) designated in the Net Asset Analysis schedule. However, the presentation issues in footnote 9 appear to be limited to the footnote itself, and did not affect the designations of the unrestricted cash in the Forecast Schedules subsequently prepared by Staff (and which were not themselves subject to audit).

b. FY 07 Audit

The 2007 audited financial statements (Exhibit 46) contained a similar error, in that the Statement of Net Assets on page 19-20 does not match footnote 9, Unrestricted Net Assets, on page 36. There is about a $5.2 million discrepancy, apparently caused by an incorrect amount designated to O&M rate stabilization in the footnote. In addition, the designations of Unrestricted Assets do not agree with the designations in the FY 07 Annual Report at page 32. (Exhibit 29.)

More importantly, a restatement of the results for FY 07 resulted in an understatement of Restricted Net Assets and overstatement of Unrestricted Net Assets of approximately $20 million.[16] (Exhibit 17 at 5.) We interviewed Skiba about this issue. Skiba said there are three categories of net assets: (1) restricted assets, (2) unrestricted assets, and (3) fixed assets (such as property, plant and equipment) net of current related debt. Skiba said that, at the effective date of audits (April 30 of each year), a revenue bond principal payment of about $20 million was due on May 1 of each year following the audit. Skiba said that because the amount to pay the principal coming due was in the Restricted Funds, and therefore fully defeased, Skiba had historically taken the position with McGladrey that it did not need to be netted from the fixed

[16]The restated results for 2007 appeared in the 2008 comparative statement of net assets, which was part of the Management's Discussion and Analysis included in the 2008 audited annual financial report.

assets. Skiba said that McGladrey had historically accepted that position and the audits reflected that position.

However, Skiba said that the quality review partner retired, and during the FY 08 audit cycle, McGladrey provided a new reviewer. Skiba said that the new reviewer took a different position and deducted the amount of principal due, about $20 million, from Capital Assets. The $20 million liability, which was previously netted against restricted assets, should have been reclassified from Restricted Net Assets, but it was not performed correctly. Instead of reclassifying it from Restricted Net Assets, the liability was deducted from Unrestricted Net Assets. The result of this was an overstatement of Unrestricted Net Assets by $20 million.

c. FY 08 Audit

The 2008 audit contained the same error as the restatement of the 2007 audited financials, and for the same reason: an overstatement of unrestricted cash of approximately $20 million. (Exhibit 17 at 10-11.)

It is critical to note that the $20 million overstatement in the FY 07 and FY 08 audits was not a factor in the Board's April 2007 decisions to make a $40 million rebate or to reduce the water rate. The FY 07 audit was not released until October 2007, about six months after the Board's action. In addition, no Commissioner we interviewed stated that he or she relied on the audited financial statements as a basis for making budgeting decisions. Instead, the Board relied on Staff's representations, the figures in the Forecast Schedules, or both.

F. Structural And Procedural Recommendations To Avoid Future Accounting Issues

Municipal bodies spending public funds, whether from taxes or other sources, must be accountable to the public for the control of those funds. The Commission, unlike a city council or county board, is not an elected body and is not directly accountable to the public. Neither, of course, is the Commission's Staff. Thus, it is all the more necessary that there be careful oversight of Staff to ensure accountability of public funds. In consultation with Crowe, including members of its public sector group, we make the following recommendations to avoid future issues like the one that is the subject of our investigation:

1. Control And Oversight

We recommend that the following changes in oversight be made:

a. The Board should clearly define the responsibilities of the Board and its Committees, as well as the responsibilities of management.

b. In particular, the Finance Committee should actively supervise Staff's handling of financial matters and budgeting. The Finance Committee should hold regular meetings that are not time-limited by the necessity to begin the full Board meeting.

c. The Board and the appointing authorities should recruit professionals with finance experience to serve on the Board and its Finance Committee.

d. The Board should establish the position of Treasurer as a paid, non-staff position, responsible directly to the Board, to perform the treasury functions outlined in the By-laws. In addition, this Treasurer could be charged with acting as a watchdog or inspector general to report to the Board any improper or unnecessary expenditures,[17] budgetary errors, or accounting irregularities. The position should be filled with a person with the necessary financial background and experience.

[17] We were not asked to investigate whether Staff made or recommended unnecessary expenditures, and reach no conclusion on this point, but based on Commissioners' questions about certain expenditures and the lack of transparency regarding those items, it would be prudent to have a non-staff member serve this function. We were surprised and concerned to learn that a Commissioner was once forced to file a Freedom of Information Act request to obtain information concerning the Staff's dealings with vendors.

e. The Board and Staff should document and comply with accounting policies, procedures, and controls in accounting. Any deviation from the procedures and controls should be reported to the Finance Committee and the reason for the deviation should be fully explained.

2. Monthly Financial Reporting To The Board

We recommend that monthly reporting to the Board include at least the following elements:

a. Detailed information regarding the Commission's cash and investment position, including whether the Commission has sufficient cash and investments to pay its debt service, operating expenses, and capital expenditures, as well as maintain the required reserve levels. The schedule should show the required funding levels for restricted funds, and unrestricted cash and investment balances should be shown with comparisons to the unrestricted reserves.

b. Detailed information concerning the Commission's operating performance, including the budgeted and actual monthly amounts for water sales, water costs, and other operating expenses.

c. Detailed information regarding the type and performance of the Commission's investments, including whether they are made and reported in compliance with the Commission's policy.

d. Detailed information regarding the progress of capital projects, including whether the percentages of completion and costs incurred are on track.

3. Accounting And Reporting

We recommend that the following policies or procedures, or accounting controls, be implemented:

a. The Staff Accountant should perform Bank reconciliation and General Ledger account reconciliations on a monthly basis. The Financial Administrator should review these reconciliations, and they should be provided to the Treasurer and the Finance Committee.

b. The Commission should establish a proper segregation of duties between, on the one hand, the individual who processes wire transfer and check disbursements, and, on the other hand, the individual who prepares bank reconciliations. This will provide a further check against any intentional misappropriations.

c. The Commission should ensure that there is a proper segregation of duties between the individual recording revenue and the individual preparing bank reconciliations, which will provide further insulation against intentional misconduct.

d. The Commission should restrict access to the InCode accounting system and General Ledger system, and provide for adequate segregation of duties.

e. The Commission should have an independent person, *i.e.*, someone not on the Staff, review any annual changes in the InCode Payroll module, such as pay rates and deductions.

f. The Commission should make better use of InCode subsidiary ledgers, like the Accounts Receivable Module and the Fixed Asset module, to reduce the number of manual journal entries (currently, there are approximately 1,250 of these entries each year). Maximizing use of InCode will reduce the Commission's reliance on spreadsheet-based reports, which are more susceptible to human errors.

g. The Commission should segregate the duties of journal entry input and posting.

h. The Financial Administrator should review and approve all manual journal entries and supporting documentation. Any entries made by the Financial Administrator should be reviewed and approved by the Treasurer.

i. The Commission should obtain an adequate monitoring control to compensate for areas lacking segregation of duties. For example, the Staff Accountant's duties include maintaining the vendor master file, and she performs accounts payable detail input. Therefore, changes to the vendor master file should be independently reviewed.

j. When Staff reviews any reports, such as payroll validations, check runs, bank reconciliations, or wire transfer forms, the reviewer should indicate in a log that the task was completed.

k. The Financial Administrator should closely review the Construction in Progress worksheet to monitor the progress of construction projects to ensure timely reclassification to the appropriate asset categories for depreciation purposes.

l. The Financial Administrator should carefully document any GAAP analysis or communications with GASB and provide a full report to the Finance Committee.

Respectfully submitted,
JENNER & BLOCK LLP

By: ______________________
Chris C. Gair

Dated: March 2, 2010