



Lexington-Fayette Urban County Government  
OFFICE OF INTERNAL AUDIT

## **INTERNAL AUDIT REPORT**

DATE: June 3, 2011

TO: Jim Gray, Mayor

CC: Richard Moloney, CAO  
Cheryl Taylor, Commissioner of Environmental Quality & Public Works  
Jane Driskell, Commissioner of Finance & Administration  
Marwan A. Rayan, Director of Engineering  
William O'Mara, Director of Revenue  
Phyllis Cooper, Director of Accounting  
Susan Straub, Communications Director  
Urban County Council Members  
Internal Audit Board Members

FROM: Bruce Sahli, Director of Internal Audit

RE: Division of Engineering Permit Collections Process Audit

### **Background**

The Division of Engineering is responsible for significant cash collection activity, including fees for sewer tap-on permits and Right of Way permits (ROW). Prior to connecting residences or businesses to the sanitary sewer system owned by the Lexington-Fayette Urban County Government (referred to as a tap-on), fees must be calculated and collected for the service being offered. The Division of Engineering is responsible for calculating the required tap-on fees and for collecting the fees prior to issuing tap-on permits. In addition, utilities and/or contractors applying for surface cut or installation permits necessary to perform work in the public rights-of-way must obtain and pay for an ROW permit. The Division of Engineering is also responsible for calculating and collecting ROW permit fees. The combined sewer tap-on fees and ROW fees collected during FY 2010 total \$1,401,664.

## **Scope and Objectives**

The general control objectives of the audit were to determine that:

- Fees are charged in compliance with applicable Ordinances
- Collections are properly recorded, deposited, and reconciled on a timely basis
- Written procedures exist for the audited collection processes
- Prior audit recommendations have been implemented

Audit results are based on observations, inquiries, transaction examinations, and the examination of other audit evidence and provide reasonable, but not absolute, assurance controls are in place and are effective. In addition, effective controls in place during an audit may subsequently become ineffective as a result of technology changes or reduced standards of performance on the part of management.

The scope of our audit included permit collection activity from July 1, 2008 through June 30, 2010.

## **Statement of Auditing Standards**

We conducted our audit in accordance with the International Standards for the Professional Practice of Internal Auditing. Those standards require that we plan and perform the audit to afford a reasonable basis for our judgments and conclusions regarding the organization, program, activity, or function under audit. An audit also includes assessments of applicable internal controls and compliance with requirements of laws and regulations when necessary to satisfy the audit objectives. We believe that our audit provides a reasonable basis for our conclusions.

## **Audit Opinion**

In our opinion, the controls and procedures did not provide reasonable assurance that the general control objectives were being met. Opportunities to enhance controls are included in the Summary of Audit Findings.

## **Priority Rating Process**

To assist management in its evaluation, the findings have been assigned a qualitative assessment of the need for corrective action. Each item is assessed a high, moderate, or low priority as follows:

High - Represents a finding requiring immediate action by management to mitigate risks associated with the process being audited.

Moderate – Represents a finding requiring timely action by management to mitigate risks associated with the process being audited.

Low - Represents a finding for consideration by management for correction or implementation associated with the process being audited.

## **SUMMARY OF FINDINGS**

### **Finding #1: Tap-On Fee Receipt Process Needs Improvement**

**Priority Rating: High**

#### **Condition:**

During Fiscal Year 2010, 866 tap-on permits were issued using a highly manual receipt process. As a result of this manual process, our test work identified several issues with tap-on receipts, including (1) payments for multiple properties on one receipt, (2) the type of property (i.e. apartment or single residence) not identified, (3) individual property fees not evident, (4) absence of payee names on receipts, (5) absence of identifiers within PeopleSoft with which to match reported collections to related manual receipts, (6) receipts not consistently issued in sequential order, (7) duplication of effort in the production of manual receipts, and (8) the efficient reconciliation of permits issued to related collections is problematic, largely due to the other issues noted above.

In addition, two manual permit receipts examined during the audit did not agree with the amount collected per related entries into PeopleSoft, highlighting the necessity for automated receipts to be generated directly from the mainframe whenever payments are received.

#### **Effect:**

The weaknesses and limitations of the manual receipt process identified above create multiple internal control issues in the collection process, resulting in increased risk of undetected collection errors and irregularities.

**Recommendation:**

An automated receipting process should be implemented that requires the entry of each property location and the type of property receiving a permit, the individual property fee, payee information, the automated issuance of payment receipts in sequential order, and reports for management review that provide a detailed accounting of collection activity. When related deposits are entered into PeopleSoft, a unique identifier should be established that will enable management to readily associate specific permit collections to the related deposit. If implemented, these controls will significantly improve management's ability to detect and correct errors and irregularities that could occur at various points in the collection process.

**Director of Engineering Response:**

The Division of Engineering will work with the Divisions of Computer Services and Revenue to implement the recommendations for automating the tap-on fee receipts. We will also work with Internal Audit during this process to keep them informed of the schedule for implementation and any limitations encountered in implementing the recommendations.

**Commissioner of Environmental Quality & Public Works Response:**

I agree that the tap on process must be automated. I plan to have this program work through DWQ (Division of Water Quality) to assure proper rates and changes are incorporated and that the payments are recorded, tracked, and allocated to the appropriate funds.

**Finding #2: Sewer Tap-On Rates not Adjusted Timely**

**Priority Rating: High**

**Condition:**

Per Ordinance 34-2008, the Urban County Council approved a rate fee increase for tap-on fees effective May 1, 2008, with a second rate increase effective July 1, 2009. However, through September 2010 these rate increases were not applied by Division of Engineering personnel responsible for tap-on fee collections, resulting in substantial tap-on fees being collected at lower rates. Division of Engineering personnel indicated that they were not aware of the increase in fees and therefore did not adjust for the new fees. A conservative estimate of lost revenue during this period totals \$369,678. Engineering management became aware of this loss in revenue prior to commencement of our audit fieldwork.

**Effect:**

Failure to adjust authorized fee increases in a timely manner will result in lost revenue for LFUCG.

**Recommendation:**

LFUCG should develop a formal process to immediately notify appropriate Commissioners and Directors whenever the Council authorizes fee rate changes affecting collection activities under their management.

**Commissioner of Finance & Administration Response:**

The appropriate Finance staff will discuss this issue with the Council Administrator and the Council Clerk to arrive at a feasible solution to ensure rate changes are clearly communicated to Directors responsible for their implementation.

**Finding #3: Late Deposit Activity**

**Priority Rating: High**

**Condition:**

During fieldwork the employee responsible for tap-on fee collections stated he was depositing collections about once per week. Our detail testing of a sample of tap-on fee collections occurring between July 2009 and June 2010 noted 11 of 16 deposits were from three to six business days late, thereby verifying this statement by the employee. Late deposit activity was also noted in the July 2004 audit of this function.

**Effect:**

Funds may be lost or misappropriated if not deposited in a timely manner. In addition, timely deposit activity results in funds being available for LFUCG use as expeditiously as possible.

**Recommendation:**

All funds received by Departments and Divisions making deposits via the Revenue collection counter should be immediately endorsed and presented to the collection counter within one business day of receipt for locations in the downtown campus, and within two business days for the outlying locations as stipulated by CAO Policy #40 Check and Cash Handling Procedures.

**Director of Engineering Response:**

Currently all funds are being deposited at the Revenue collection counter daily or within 24 hours of receipt. This procedure has been in place since August 23, 2010.

**Commissioner of Environmental Quality & Public Works Response:**

I support the plan for all funds to be deposited on a daily basis.

**Finding #4: ROW Franchise Fees not Allocated to ROW Fund**  
**Priority Rating: High**

**Condition:**

Kentucky American Water Company (KAWC) has a franchise agreement with LFUCG that stipulates a portion of the franchise fee (.289%) shall be allocated to the ROW fund for installation and surface cut permits issued to KAWC. This fee is collected by the Division of Revenue, which is responsible for its allocation to the ROW Fund. However, we found no evidence that the ROW fee for the quarter ending June 2008 was posted to the ROW Fund. It appears that funds were submitted by KAWC but the ROW portion was never allocated to the ROW Fund, thereby remaining in the General Fund. In addition, a review of the ROW fees for Quarters Ended June 2008 through September 2010 indicated that an incorrect allocation percentage of .288% was used by Revenue in calculating the ROW portion of the franchise fee. The combined effect is \$36,109 of additional funds that should be transferred from the General Fund to the ROW Fund.

**Effect:**

Without the correct and timely transfer of the ROW portion of the KAWC franchise fee, the ROW Fund will be understated.

**Recommendation:**

The Division of Revenue should develop procedures to transfer the correct allocation of KAWC's ROW fee to the ROW Fund on a timely basis.

**Director of Revenue Response:**

The Division of Revenue was requested to allocate a portion of Kentucky American Water Company's franchise fee to Right of Way by Bob Starkweather, the LFUCG franchise fee officer at the time. The request was given to a staff person in the Director's office. The manual allocation was overlooked and the duties were permanently reassigned to the processing area of Revenue. At the time of the transition, the .288% allocation was used. A journal entry was prepared to allocate dollars to Right of Way for all past periods. This correcting entry included all of fiscal 2008. It failed to allocate the quarter ending June 30, 2008.

**Commissioner of Finance & Administration Response:**

I concur with the Director of Revenue's response.

### **Finding #5: Mainframe to PeopleSoft Reconciliation Needed**

**Priority Rating: High**

#### **Condition:**

The Division of Revenue is responsible for reconciling collections received at its counter collections office to permit collections posted in PeopleSoft. However, the reconciliation of permit collections per the mainframe (used to process fees and issue tap-on and ROW permits) to collections posted to PeopleSoft is performed in the Division of Engineering by employees who are also responsible for generating permits and collecting the related fees.

#### **Effect:**

This creates an incompatible series of duties regarding the collection process that should be segregated to reduce risk of asset misappropriation.

#### **Recommendation:**

A reconciliation between permit fees charged per the mainframe and permit fees collected per PeopleSoft should be performed by an Engineering employee who has no permit fee collection or recording duties. Included in this reconciliation process should also be a review of Engineering's receipt log for comparison to the related deposit.

#### **Director of Engineering Response:**

An Engineering employee who has no permit fee collection duties will be assigned to reconcile between permit fees charged per the mainframe and permit fees collected per PeopleSoft.

#### **Commissioner of Environmental Quality & Public Works Response:**

The process of collecting and reconciling permit fees between the mainframe and PeopleSoft should be eliminated in a properly designed automated collection system. This will be worked in partnership with DWQ (Division of Water Quality).

### **Finding #6: Jessamine County Collections Segregation of Duties Issue**

**Priority Rating: High**

#### **Condition:**

Certain properties located in Jessamine County use the LFUCG sanitary sewer system and must therefore pay the related tap-on fees. One employee in the Division of Revenue has the responsibility of invoicing Jessamine County for these tap-on fees, receiving the related payments, and processing the payments, the most recent payment posting occurring on May 10, 2011.

**Effect:**

This creates an incompatible series of duties regarding the collection process that should be segregated to reduce risk of asset misappropriation.

**Recommendation:**

The Division of Revenue should separate the processes so that one person is not responsible for the billing, collection, and payment processing duties for the Jessamine County tap-on fees.

**Director of Revenue Response:**

The billing and collection of tap-on fees related to the Jessamine County Water District is currently handled in the Division of Revenue in the sewer/landfill section, a three person work group. Prior to the issuance of the government wide Cash Handling Procedure in June of 2010, the administrative assistant in the sewer/landfill section issued bills based on information received from the tap-on desk and processed the payments. The process was changed after the Cash Handling Procedures were issued to have the one person issue the invoice and another person process the payment. A review of the procedure since June 2010 identified two instances where, due to absences in the work group, the same person issuing the invoice has also processed the payment. The emphasis was to protect government assets and deposit payments as soon as received. Additional remedial steps during staff absences will be implemented to ensure separation of duties between invoicing and payment application.

**Commissioner of Finance & Administration Response:**

I concur with the Director of Revenue's response that demonstrates a separation of duties does exist and that additional procedures will be implemented to ensure that in the event of absences in the work group that separation is maintained.

**Finding #7: AGP Fee not Paid by Utility**

**Priority Rating: Moderate**

**Condition:**

In addition to permit fees, Section 17C-22(b) of the Code of Ordinances assesses an annual general permit fee (AGP) of either \$3,000 or \$15,000 to certain registrants performing work in the ROW, based on the amount of acreage the registrant's facilities occupies within Fayette County. On an annual basis, utility companies are therefore sent a registration packet for the AGP fee. We were informed that AT&T is the only utility that does not pay the registration fee, on the premise that their franchise agreement with the state of Kentucky is sufficient to dig within the Fayette County ROW.



**Effect:**

AT&T's non-payment of the AGP fee represents potential lost revenue for the LFUCG.

**Recommendation:**

This matter should be referred to the Department of Law to determine if AT&T is exempt from complying with Section 17C-22(b) of the Code of Ordinances regarding the AGP fee.

**Director of Engineering Response:**

The Division of Engineering will request from the Department of Law, through the Commissioner of Public Works and Environmental Quality, to determine if AT&T is, in fact, exempt from paying the AGP fee. AT&T claims that this exemption is based on its franchise agreement with the State of Kentucky.

**Commissioner of Environmental Quality & Public Works Response:**

I support the recommendation of the Director of Engineering

**RISK OBSERVATION**

Standards for the professional practice of internal audit stipulate that it is the Office of Internal Audit's responsibility to inform management of areas where risk to the organization or those it serves exist. The following observation identifies a risk associated with the Division of Engineering Permit Collection process that is not a violation of statutes or policies, but that is considered to be of sufficient importance to deserve mention in this report to ensure senior management's awareness.

**Written Procedures not Implemented Timely**

The July 2004 audit of this collection function noted the absence of written collection procedures and recommended such procedures be developed. Management concurred with this recommendation. It should be noted that the July 2004 report was issued to the previous Director of Engineering.

Written procedures are an important control that provides process instruction, performance standards, and a basis for measuring compliance with management expectations. In our initial meetings conducted during this audit with Division of Engineering personnel responsible for these collection processes, it was determined that no written collection procedures existed. Such procedures were subsequently developed by Engineering management during the early stages of audit fieldwork.

**Director of Engineering Response:**

I agree with the recommendation of the audit report. A written procedure for the collection and deposition of permit fees for the Tap-on and Right-of-Way permits was prepared and put into effect in August 2010.

**Commissioner of Environmental Quality & Public Works Response:**

The procedures implemented in August 2010 need to be revisited to assure they meet the recommendations of this audit. This needs to occur in conjunction with the automation of the collection process.