



Lexington-Fayette Urban County Government
OFFICE OF INTERNAL AUDIT

INTERNAL AUDIT REPORT

DATE: June 17, 2011

TO: Jim Gray, Mayor

CC: Richard Moloney, Chief Administrative Officer
Cheryl Taylor, Commissioner of Environmental Quality & Public Works
Jane Driskell, Commissioner of Finance & Administration
Marwan Rayan, Director of Engineering
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 Letters of Credit Review

Background

On January 8, 2009, the Office of Internal Audit issued an audit report on the Division of Engineering Letters of Credit (LOC) process. The report contained several significant findings related to the use of Letters of Credit by the New Development Section in the Division of Engineering to bond new projects. This follow-up review was conducted to evaluate controls put in place by management to address those specific findings from the January 8, 2009 report as summarized below:

- LOCs expired while projects were still listed as active on the project database
- LOC duties were not properly segregated
- LOC function had no formal written procedures

- LOC cost-based calculations were not validated
- Called LOCs were not evaluated for cost effectiveness

Scope and Objectives

The general control objectives for the audit were to provide reasonable assurance that:

- Expired LOCs were resolved and removed from the database as appropriate
- An appropriate level of segregation of duties exists in the LOC function
- Written procedures for the LOC function have been implemented, including procedures to ensure LOCs are renewed for active projects
- Calculations to determine LOC amounts are reviewed for reasonableness and accuracy
- Projects with called LOCs are evaluated for cost effectiveness.

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 period of review included transactions occurring during July 2008 through February 2011.

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 implemented by the Division of Engineering provided reasonable assurance that the general control objectives were being met. Opportunities to further enhance controls are included in the Summary of 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 AUDIT FINDINGS

Process to Address Forfeited LOC Projects Needs Improvement Priority Rating: High

Condition:

As of February 18, 2011 the Division of Engineering had 21 open projects still pending completion after the related LOCs had been forfeited to LFUCG by the developer or contractor. Funds collected for these open projects totaled \$419,302.45. Six of these projects had LOC funds totaling \$275,769.00 that were forfeited at least two years ago (the oldest forfeiture occurred on February 9, 2006) but were still uncompleted. Overall, the average time elapsed since LOCs for these active projects were forfeited is approximately 18 months.

The Division of Engineering LOC Procedure Manual states that upon collection of forfeited LOC funds a memorandum will be sent by Engineering to the appropriate LFUCG Department or Division (e.g., Division of Water Quality) reporting the remaining project

actionable items and available funds to assist the Department or Division in completing the project. We noted that this memorandum had only been issued by Engineering for three of the open projects reviewed.

Effect:

The cost to complete open projects will typically increase the longer projects exist, thereby having the effect over time of reducing the value of forfeited LOC funds. Failure to communicate to other affected Departments and Divisions the existence of forfeited LOC funds and the related responsibility to complete open projects also contributes to project cost increases by potentially delaying timely construction activity.

Recommendation:

The Division of Engineering should promptly notify other LFUCG Departments and Divisions of the availability of forfeited LOC funds and coordinate with them on timely project completion strategies. We also recommend the Division of Engineering monitor these projects for timely completion and provide a quarterly status report to the Commissioner of Environmental Quality and Public Works.

Director of Engineering Response:

The Division of Engineering will compile a list of all projects for which surety has been forfeited and the appropriate LFUCG divisions will be notified of the need to complete the projects on the list. A quarterly report will be submitted to the Commissioner of Environmental Quality and Public Works. It is important to note that the timeliness of completing these projects depends, to a large degree, on the ability of the responsible division to prioritize these projects.

Commissioner of Environmental Quality & Public Works Response:

I support Director Rayan's comments. The list of projects will be maintained as an on-going and dynamic document and the quarterly report will be regularly shared with all Directors so they have appropriate time to plan for project completion.

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.

2010 Unit Price List Not Implemented Timely

As a result of a recommendation in the January 2009 audit, the Division of Engineering developed an updated 2010 unit price list for calculating new project costs and determining the related LOC amounts to be used as project collateral. However, this new price list had not been implemented as of February 2011, and Engineering had continued to use the 2008 price list to calculate LOC amounts on new projects, resulting in potential underestimations of new project costs and related LOCs.

Engineering management stated that the updated LOC price list had not been implemented in order to obtain “buy-in” from developers and contractors on the new unit prices during a Partnering Workshop to be held this spring. Management stated the Partnering Workshop for Spring 2011 had been cancelled, and therefore agreed to implement the new LOC price list when this matter was brought to their attention.

Director of Engineering Response:

A new price list based on our current Unit Price Contract (effective May 2010) has been prepared. The list will be mailed to those developers, engineers, contractors and other interested individuals who are on the Partnering Workshop mailing list. They will be given opportunity to comment. The new prices will then go into effect.

Commissioner of Environmental Quality & Public Works Response:

I support Director Rayan’s comments and will also require that developers, engineers, and contractors will be given 30 days to comment from the date of the notice. New pricing will be implemented at the end of the 30 day period.