



Lexington-Fayette Urban County Government

Division of Internal Audit

INTERNAL AUDIT REPORT

DATE August 16, 2004

TO: Teresa Ann Isaac, Mayor

CC: Milton Dohoney, Chief Administrative Officer
Wayne Waddell, Commissioner of Public Works
Michael Robinson, Director of Solid Waste

FROM: Bruce Sahli, Director of Internal Audit

RE: Material Recovery Facility Internal Audit

Background

The Material Recovery Facility (MRF) is a recycling facility that operates a “one sort plus glass” recycling program. The MRF recycles steel cans, aluminum cans, PET plastics (two liter bottles), newspaper, office paper, glass, corrugated boxboard, and package boxboard. The MRF employs the services of the Bluegrass Regional Recycling Center (BRRC) to act as a broker for the recycled products produced by the MRF. With the exception of aluminum cans, MRF recycled products are sold to various mills through BRRC’s brokerage service, for which BRRC receives a \$7 per ton broker fee. The MRF sells aluminum cans directly to an Anheuser-Busch mill. Revenue is generated via proceeds from the sale of all recycled products with the exception of glass, for which no effective market exists. BRRC removes and processes glass for a fee of \$21.25 per ton. During FY 2004, the MRF generated \$742,572 in revenue, while operating costs totaled \$815,908.

Scope and Objectives

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

- Resalable inventory produced by the MRF is properly safeguarded and accounted for
- Payments to LFUCG for product sold are accurately calculated and properly supported
- Collections are properly recorded and reported
- Collections are accurately deposited on a timely basis

- MRF operation costs are reasonable and properly allocated

Statement of Auditing Standards

We conducted our audit in accordance with generally accepted government auditing standards. 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 provided reasonable assurance that the general control objectives were being met. Opportunities to enhance existing controls are included in the Summary of Audit Findings.

SUMMARY OF AUDIT FINDINGS

Incorrect Cost Allocation

During our review of FY 2004 MRF expenditures, we noted three Labor Works invoices totaling \$25,000 originally charged to the MRF that were later reclassified to the Yard Waste Collection Program (which appears to be the correct cost center). We also noted a \$33,203 payment to Grot Incorporated for MRF electrical system upgrades that were charged to MRF Land Improvements. We discussed these issues with MRF management who stated it was their understanding it was acceptable to expense items to any program having budgeted funds available as long as the expenditures remained under Solid Waste operations.

The misclassification of expenditures by program or accounts within a program circumvents the budget control process. Council appropriates funding for specific programs by specific General Ledger accounts, which are then monitored by the Division of Budgeting for adherence to budgeted spending limits. Expenditures should be properly classified and expensed to the correct program and related account. If additional funds are needed then budget amendments should be processed to re-appropriate the funds to the proper program and/or account, thus maintaining a proper matching of expenditures to related budgeted programs.

Division of Solid Waste Management Response: Quarterly expenditure reports have been requested from the Division of Budgeting to monitor the adherence to cost accounting procedures and make reporting adjustments as needed. We will move all LFUCG workers at the Recycling Center to the 355 Budget line.

Late Deposit of Collections

We examined all MRF collection activity completed during Fiscal Year 2004 through May 2004. While there was no indication of failure to deposit funds, we noted significant late deposit activity. Checks received from the sale of recycled products to Anheuser-Busch were deposited an average of eight days late, while checks from BRRC were deposited an average of seven days late. The total amount deposited from July 2003 through May 2004 was \$671,709, with individual check amounts ranging from \$23,000 to \$78,000. Details of the late deposits have been provided to MRF management. It is important that all deposits be made in a timely manner to provide appropriate safeguarding of assets and to ensure all collections are made available to LFUCG on a timely basis. It is recommended daily deposit procedures be developed and adhered to on a consistent basis.

Division of Solid Waste Management Response: We have notified all end users and commodity marketers to send checks directly to the LFUCG Division of Revenue and to send a photocopy with the supporting documentation to our office.

Written Agreement Needed Between LFUCG and BRRC

BRRC provides brokerage services for all products sold by the MRF with the exception of aluminum cans, and also removes glass from the MRF for offsite processing. BRRC has several processing fees and freight charges associated with these services, as well as responsibility for obtaining the highest sale price attainable for MRF recycled products. No written agreement exists between LFUCG and BRRC to provide standards or guidelines regarding fees and other charges, or to establish specific expectations regarding market prices and other services BRRC provides in its broker function.

It is recommended a written agreement be established between LFUCG and BRRC addressing all legal requirements and service expectations of the brokerage service.

Division of Solid Waste Management Response: Initial discussions have occurred between LFUCG and BRRC representatives to address the basic tenants of a new agreement. Since the management personnel at the recycling center are not in place we are still in transition in terms of management and operational needs.

Steel Can Prices Substantially Below Market

BRRC provides brokerage services for recycled product the MRF wishes to sell on the open market. In order to evaluate BRRC's effectiveness in obtaining reasonable market prices on behalf of the MRF, we selected a sample of sale transactions completed by BRRC and compared the unit selling price to a marketplace price guide provided by the Kentucky Division of Waste Management. Our review determined that prices for steel cans obtained by BRRC were significantly lower than the marketplace guide in four of the six steel can transactions we tested. In these exceptions, the price per ton per the guide ranged from \$34.01 to \$45.99 higher than that obtained by BRRC, an overall average of 26.6% less than market as quoted in the guide.

The MRF sorts steel cans via an electromagnet, which results in very little waste being introduced into the steel can bales produced for sale. These variances are therefore particularly significant when the steel can sorting method is considered. It is recommended MRF management review steel can price strategies with BRRC to determine the cause of the discrepancies and improve the market price obtained.

Division of Solid Waste Management Response: See response to Direct Negotiation of Mill Contracts Recommended.

Direct Negotiation of Mill Contracts Recommended

The MRF currently pays BRRC an annual affiliation fee of \$36,472, and for FY 2004 through May 2004 has paid BRRC \$74,457 in broker fees. In addition, as mentioned in the finding Steel Can Prices Substantially Below Market, it does not appear that BRRC has been consistently effective in obtaining reasonable market rates for recycled steel cans.

Solid Waste has been budgeted to fill Plant Manager and Operations Supervisor positions at MRF for at least two years but has not been able to do so for various reasons. It is recommended Solid Waste make the filling of these positions a priority. By doing so, this may provide the MRF with personnel sufficient to research and negotiate purchase contracts directly with the mills, thereby eliminating some of the costs associated with the current reliance on BRRC brokerage services.

Division of Solid Waste Management Response: The LFUCG will certainly be capable of managing direct contracts with the recycling mills when we are fully staffed at the recycling center. Ultimately, the level of services that the BRRC's provides to the LFUCG is a decision to be made by the Mayor and Urban County Council.

It does appear that the Steel Can prices that we have been receiving in the past two months have caught up to market averages.

Inventory Verification System Needs Enhancement

There are no procedures in place to report monthly MRF inventory balances to Accounting or to identify variances between book and physical inventory. Daily inventory counts were initiated at the MRF in June 2004 but these are used primarily to track baled product internally in order to determine when shipments to the mills need to be scheduled.

It is recommended monthly inventories be completed with a proper cutoff procedure in order to account for inventory values and variances on a monthly basis. The results of these inventories should be provided to Accounting for financial reporting purposes.

Division of Solid Waste Management Response: Daily inventory balances of both unprocessed and processed commodities will continue to be recorded. An end-of-the month inventory report will be included with the regular monthly report.

BRRC Billing & Payment Reconciliation Recommended

BRRC generates a monthly report providing detail information regarding the calculation of fees charged and revenue earned from the sale of recycled products. MRF management had been attempting to compare this report with related MRF documents to ensure its accuracy when a system crash destroyed the necessary data. There was no file backup. Since that time MRF management has been reviewing the BRRC report transactions on a sample basis.

It is recommended a complete reconciliation of the BRRC report to related MRF documents be conducted on a monthly basis to ensure the accuracy of fees charged and payments received. The reconciliation should be performed by an individual with no responsibility for receiving and depositing BRRC payments.

Division of Solid Waste Management Response: Recycling Center staff has initiated an ongoing reconciliation system using the program provided by the Internal Audit staff. Monthly reconciliations will be completed in a timely manner.