



Mayor Jim Newberry

LEXINGTON-FAYETTE URBAN COUNTY GOVERNMENT
Office of Internal Audit

INTERNAL AUDIT REPORT

DATE: January 8, 2009

TO: Jim Newberry, Mayor

CC: Joe Kelly, Senior Advisor for Management
Mike Webb, Acting Commissioner of Public Works & Development
Marwan Rayan, Director of Engineering
Urban County Council Members
Internal Audit Board Members

FROM: Bruce Sahli, Director of Internal Audit

RE: Division of Engineering Letters of Credit Audit

Background

Within the Division of Engineering, it is the responsibility of the New Development Section (NDS) to monitor infrastructure construction for new subdivisions and commercial development within Lexington and Fayette County. The NDS commonly uses Letters of Credit as a form of bonding to ensure all new development bondable work is completed. A Letter of Credit is a document issued by a bank that essentially acts as an irrevocable guarantee of payment to the LFUCG if a developer does not perform their obligations. If such an incident occurs, the Division of Engineering Bonding Officer submits the Letter of Credit to the bank for the amount secured. Checks are sometimes received from developers in lieu of Letters of Credit, which are deposited into an LFUCG bank account and are held as a form of deposit.

Presently the City has one Bonding Officer in charge of approximately 300 Letters of Credit with a total value of \$18,274,031.59 as of June 23 2008. The Bonding Officer is responsible for ensuring Letters of Credit (or a check from the developer) is on file with the NDS before a plat is accepted and signed by the Urban County Engineer. Occasionally, no plat is required, in which instance a Letter of Credit is required before the Division of Engineering will sign off for either the issuance of a Building Permit or a Certificate of Occupancy. The recording of a plat is required before lots can be sold and construction on those lots, e.g., housing, can begin. The amount of a Letter of Credit depends on the scope and type of bondable work under guarantee. Existing infrastructure (sanitary sewer, storm sewer, roadway base, etc.) is bonded at 10%. Non-existent infrastructure (sidewalks, final surface of

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asphalt, etc.) is bonded at 100%. NDS personnel also have the authority to reduce Letter of Credit amounts based on a Division of Engineering Site Inspector's observation of the amount of work completed. The Site Inspector uses a punch list to document work completed and the re-calculation of Letter of Credit amounts.

If a Letter of Credit expires, LFUCG loses its ability to collect the bonded funds in the event the developer fails to complete the required portions of the development (e.g., paving, sidewalks, curbs, retention basins, etc.). Three primary scenarios may then unfold. In one scenario, LFUCG is successful in obtaining a new Letter of Credit from the developer, a remedy that developers established in the Fayette County area would likely view as being in their own best interest in order to maintain a positive business relationship with the LFUCG. In another scenario, it is subsequently noted that all bondable work has already been completed by the developer and the expired Letter of Credit becomes irrelevant. In a third scenario, the developer has not completed all bondable work and for whatever reason chooses to leave the cost of completing all required development to the LFUCG.

Scope and Objectives

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

- The Division of Engineering complies with all Letters of Credit Policies and Procedures
- Letters of Credit for active projects are renewed before they expire
- The cost to LFUCG for taking over projects left incomplete by developers is reasonable and reflects a practice that is fiscally responsible
- Letters of Credit for completed projects are removed from the active project list in a timely manner

The Office of Internal Audit used Letter of Credit information contained on the Bonding Officer's database as of June 23, 2008. This database contained information on projects dating back to 1958. Testing of objectives one and four included the testing of a sample of all projects included in the database, including those dating back to the 1950's. For objectives two and three, the focus was on projects occurring within the last three years.

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.

SUMMARY OF AUDIT FINDINGS

1. Open Projects with Expired Letters of Credit Need to be Resolved

We noted that the June 23, 2008 Letter of Credit database included 48 projects where the Letter of Credit has expired, 24 of which had expired ten or more years ago. When discussed with the Bonding Officer during fieldwork, he did not know the status of these older projects or if they constituted a financial risk to the LFUCG. The Bonding Officer informed Internal Audit he would work with a Division of Engineering Inspector to examine these sites to determine what work, if any, remains to be completed and any related actual costs. During fieldwork, the Bonding Officer obtained renewed Letters of Credit (or checks from the developer) for Letters of Credit that had expired during 2008.

Due to their age, it is quite possible most if not all of these unbonded projects require little or no remedial action and therefore could have little or no financial impact to the LFUCG. However, until a complete assessment of those properties is completed, the possibility of LFUCG incurring expenses to complete work left over from these unbonded projects cannot be discounted. The open projects per the database with expired Letters of Credit as of June 23, 2008 are provided on an Attachment to this report.

The database is an important monitoring control for ensuring Letters of Credit are updated prior to their expiration date and should be kept current. It is recommended management determine the status of these projects in order to address any unfinished work at their respective sites and update the database accordingly. It is also recommended management establish written procedures to ensure Letters of Credit for projects still outstanding are renewed prior to their expiration date. Once projects are completed, this should be so noted on the Letter of Credit database.

Director of Engineering Response: We agree with the recommendation of the audit that open projects with expired letter of credits should be closed. The number of such projects is smaller since the date the list was originally compiled. Several projects have been closed and we are continuing to work on the list until it is brought up to date. LFUCG has incurred no construction costs related to the projects on the list. The recommendation for written procedures for renewal of letters of credit will be incorporated in the written procedure document referenced in Item No. 3 of the summary of audit findings.

Acting Commissioner of Public Works Management Response:

I have instructed the Director of Engineering to complete the necessary inspections to determine the status of open projects in the data base with expired letters of credit by January 31, 2009. The date base will be updated as the inspections are completed. Where necessary, immediate action will be taken to reestablish a letter of credit.

Please see Item # 3 for Commissioners response to the need for written procedures.

2. Lack of Segregation of Duties

The Bonding Officer is solely responsible for the Letter of Credit database used to track the existence and status of Letters of Credit, has physical possession of and custodianship duties for the Letters of Credit, is responsible for insuring their timely renewal or removal from the database once projects are completed, and is the central contact for the banks when a Letter of Credit is called. In addition, there is insufficient review of the Bonding Officer's function. This practice does not properly segregate the recordkeeping, custodianship, and renewal duties of the Letters of Credit function.

It is recommended that Division of Engineering management assign recordkeeping and custodianship duties to separate individuals to improve controls over this function. It is also recommended that management perform a comparison of actual Letters of Credit to the related database and promptly resolve any discrepancies noted during that review.

Director of Engineering Response: We agree with the need to segregate the responsibilities of the Bonding Officer in regards to recordkeeping and custodianship of letters of credit. The actual letters of credit will become the responsibility of the NDS Section Manager and the Engineering Bonds Officer will continue to manage and update the database. A comparison of the letters of credit to the database will be made on a monthly basis and reported to the Director of the Division of Engineering.

Acting Commissioner of Public Works Management Response:

I agree with the need to segregate the responsibilities of the Bonding Officer in regards to recordkeeping and custodianship of letters of credit. I have instructed the Director of Engineering to transfer custodianship of the Letters of Credit to the NDS Section Manager and to identify a back up for custodial duties no later than January 15, 2009.

3. Written Procedures Needed

There are no written procedures addressing the Letter of Credit responsibilities of the Bonding Officer. Written procedures are an important control that provides process instruction, performance standards, and a basis for measuring compliance with management expectations. A complete set of written procedures should therefore be developed for the Bonding Officer's Letter of Credit process. This is particularly important as the Bonding Officer's function is only administered by one employee within the Division of Engineering, and there does not appear to be any cross training to ensure continuity of the process.

Director of Engineering Response: Letters of credit are currently addressed in the Subdivision Regulations and the Procedures Manual. There is also a written procedure for using and managing the database. However, we agree that a complete written procedure that incorporates requirements from the Subdivision Regs, the Procedures Manual and the instructions for managing and using the

database is needed. We are also looking at retraining 2 former Bonds Officers in the Division of Engineering.

Acting Commissioner of Public Works Management Response:

I have reviewed the Subdivision Regs, Engineering Procedure Manuals and internal Engineering procedures that deal with Letters of Credit processes and database information and information updating. I agree that an update of the procedures is needed. I have instructed the Director of Engineering to review and update the existing internal procedures to address the current process that are required to manage the Letters of Credit. The update and review of the internal procedure will commence January 15, 2009 and be completed March 31, 2009. I have also instructed the Director of Engineering to identify a back up for the Bonding Officer no later than January 15, and to commence cross training no later than February 1, 2009. Training is to be completed by March 1, 2009.

4. Letter of Credit Cost-Based Calculations not Validated

As stated in the Background section of this report, the amount of a Letter of Credit depends on the type and scope of work under guarantee. Sewers and roads are bonded at 10% of total cost, while infrastructure items such as sidewalks and curbs are bonded at 100% of total cost. The Division of Engineering provides a list of unit prices to local Engineering firms who use this list to assign costs to their construction or development projects. We were informed by Division of Engineering personnel that they examine project documentation and verify that correct unit prices are used, but the external engineering firms' calculations are not verified.

It is recommended that Division of Engineering personnel verify external firms' project calculations, as they are the basis for Letter of Credit amounts. This verification process will provide greater assurance that Letter of Credit amounts provide sufficient surety if LFUCG assumes responsibility for uncompleted projects.

Director of Engineering Response: The engineering firms' calculations are checked for significant discrepancies. The design engineer is bound by our local regulations as well as by professional licensing obligations to present accurate data in all aspects of his work and we feel that the current practice of checking significant discrepancies is sufficient. We currently add a 20% contingency to the letter of credit amount that might in part be used to offset discrepancies in quantity estimates.

An example of checking for a significant discrepancy is presented as follows. If one knows the length of street is 500 linear feet along the centerline and the street cross section calls for 27 feet of pavement and sidewalks on either side of the street, the reported quantities should be in the neighborhood of 1500 square yards of pavement, 1000 linear feet of sidewalk simply based upon the geometry of the street. One might expect some variation from these quantities based on horizontal and vertical curvature of the street, the position of the sidewalk relative to the centerline and unique geometric features of the street such as an intersection with another street, the presence of a median, etc. If the design engineers reported quantities were less than the simplified calculation presented above, then that would be cause to suspect a significant discrepancy and he would be asked to recheck the calculation and explain the figures.

Checking storm and sanitary sewer quantities are somewhat more easily quantified whereby the length of pipe and number of manholes or storm structures is simply measured or counted from the record drawings. The engineers' quantities for the surety calculation should correlate directly to that information. Otherwise, that discrepancy would be questioned.

Acting Commissioner of Public Works Management Response:

I agree with the recommendation to do verification of quantities to be covered by the Letter of Credit. I have instructed the Director of Engineering to include this verification step in the determination of the Letter of Credit amount, and develop a tracking mechanism that verification has been completed. This step in the Letter of Credit process will be documented in the updated Procedures.

5. Called Letters of Credit are not Evaluated for Cost Effectiveness

When it becomes necessary to call a Letter of Credit, the Division of Engineering does not compare the actual cost of project completion incurred by LFUCG to the amount of funding obtained by the call. Without such a comparison, the costs effectiveness of the Letter of Credit process cannot be effectively quantified.

It is recommend the Bonding Officer compare called Letters of Credit to related project costs borne by LFUCG to evaluate the cost effectiveness of that process and report the results to management. Performed over a period of time, this comparison would provide a trend analysis of bonded versus actual costs incurred that would be an effective performance metric in evaluating the accuracy of the Site Inspector's recommended Letter of Credit reductions. If a pattern emerged whereby reduced Letters of Credit subsequently resulted in insufficient bonding for LFUCG to complete unfinished projects, this would be an indicator the Site Inspection process needs improvement. This process would also enable management to identify escalating project costs due to delays in completing projects taken over by LFUCG.

Director of Engineering Response: We agree with the audit recommendation. A comparison of the called letters of credit with actual cost to complete the work would be helpful in making letters of credit reflect actual costs at time of construction.

Acting Commissioner of Public Works Management Response:

I agree with the recommendation and have instructed the Director of Engineering to develop a tracking mechanism for called Letters of Credit estimated cost versus actual cost to construct. The process for tracking and annual review will be incorporated in the Letters of Credit updated procedures. The verification process and tracking mechanism are to be in place by January 31, 2009.

RISK OBSERVATIONS

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 exists. The following observations identify risks associated with the Letters of Credit process not considered audit findings, but which are considered to be of sufficient importance to deserve mention in this report to ensure senior management's awareness.

1. Renewed Letters of Credit Should Reflect Current Year Prices

Each year the Division of Engineering coordinates with the Division of Purchasing to develop unit costs related to bondable sewer, road, and other infrastructure items. However, renewed Letters of Credit do not reflect changes in unit costs even in those circumstances where the bonded project may be several years old. For example, if a developer signs an initial Letter of Credit in 2000 for items having a combined bondable unit cost of \$100,000, a renewed Letter of Credit for 2008 would still reflect the 2000 unit costs rather than being adjusted for inflation. It is recommended the Division of Engineering confer with the Department of Law to determine if current year unit costs can be used in renewed Letters of Credit, and if not, determine whether an index for inflation can be included in Letters of Credit contractual language to provide coverage against the rising costs of development and construction.

Director of Engineering Response: We agree with the recommendation of the audit. We are considering making changes to the L.O.C. amount calculation. Using an inflationary index at renewal time is one way to adjust L.O.C. amounts to current construction costs. Rules in the Engineering Manuals and Subdivision Regulations will have to be revised.

Acting Commissioner of Public Works Management Response:

I agree with the recommendation and have instructed the Director of Engineering to meet with the Department of Law on renewing Letters of Credit with annual updated costs for units of work uncompleted. If the change is possible Engineering will draft the necessary changes in the Engineering manuals and Subdivisions Regulations that accommodate the process. The changes will be submitted for approval.

2. Called Letters of Credit Administrative Fee Should be Considered

On those occasions when Letters of Credit are called and their funds are used to complete projects, the current practice of the Division of Engineering is to return all unused funds to the responsible developer. It is recommended Engineering ask the Department of Law to evaluate whether LFUCG can assess an administrative fee for completing projects left unfinished by developers. If so, this would need to be incorporated into the language of LFUCG's Letter of Credit agreements.

Director of Engineering Response: We agree with the recommendation of the audit. The Law Department has looked at the legality of charging a fee for managing the construction of items in the letter of credit and found that there is nothing prohibiting it.

Acting Commissioner of Public Works Management Response: I agree with the recommendation and have instructed the Director of Engineering to meet with the Law Department to determine if there is any tracking of administrative time necessary prior to charging these overhead rates.

DIVISION OF ENGINEERING LETTERS OF CREDIT AUDIT
Open Projects per Database with Expired Letters of Credit as of June 23, 2008

<u>Plat</u>	<u>Letter of Credit Expiration Date</u>
Northland Sub Unit 1-A	12/11/1960
Elkhorn Park, Amd.	5/29/1963
Eastland Block C	9/24/1965
Johnson Heights Unit 1-B	11/4/1967
Viley Heights Unit 2-A	6/1/1969
Parkway Plaza	5/12/1971
Viley Heights Unit 5-B	2/4/1972
Chenault Unit 1	3/1/1972
Eastland Block C	5/22/1974
Viley Heights Unit 5-C	11/21/1974
Lexington Industrial Foundation	9/4/1975
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Professional Park, Burt Road	11/1/1979
Chinoe Village	1/31/1983
Chinoe Village	1/31/1983
Harrods Hills East Unit 1	10/29/1988
Hillenmeyer Industrial Unit 2, Lot 3	12/10/1988
Summerhill Unit 5-B	8/16/1989
Todds Station Unit 1	9/4/1991
Todds Station Unit 2	1/15/1992
Brighton Place Unit 3	12/3/1993
Winburn Estates Unit 1-E	2/1/1995
Lancaster Woods Unit 3, Sec. 4	3/2/1996
Plaza East Office Park	4/3/1996
Mapleleaf Subdivision Unit 3	5/29/1999
Country Hills Unit 1-A & 1-B	12/9/2003
Covey Ridge 3 Ed. Amd.	7/13/2005
Wellington Unit 1, parcel C, lot 5A	6/5/2006
Richardson Property, Unit 3, Sec 1	3/3/2007
Richardson Property, Unit 6	3/4/2007
Richardson Property, Unit 3, Sec. 2	3/18/2007
Richardson Property, Unit 3, Sec. 3	4/14/2007
Wellington, Unit 1 (Parcel "C") Lot 4	5/20/2007
Richardson Property, Unit 7	10/11/2007
Richardson Property, Unit 4, Sect 3 & 4	12/7/2007
Richardson Property, Unit 5 Sect 1	12/8/2007
Denton Farms, Unit 3, Sect A, Townhomes	1/26/2008
Richardson Property, Unit 1, Sec. 2	2/26/2008
Richardson Property, Unit 2, Sec. 1	4/8/2008
Tucker, Unit 1, Sections 2 & 3	5/11/2008
Denton Farms, Unit 4A, 4B & 1G & 3B, Sect 2	5/17/2008
Sharkey Property, Unit 1, Lot 2 (Walgreens)	5/27/2008
Sunny Slope Farm, Unit 1A, Sec. 1	6/3/2008
Sunningdale (Gleneagles Unit 4)	6/6/2008
Gleneagles, Phase V, Sec. 2	6/6/2008
Glen Creek Unit 3A	6/12/2008
Woodward-Lander (Pump Sta. Fence & Pavement)	6/14/2008
Henry Clay Subdivision, Unit 11, Sec. 3	6/19/2008