



Lexington-Fayette Urban County Government
OFFICE OF INTERNAL AUDIT

MANAGEMENT ACTION PLAN PROGRESS REPORT

DATE: June 12, 2014

TO: Jim Gray, Mayor

CC: Sally Hamilton, Chief Administrative Officer
Glenn Brown, Deputy Chief Administrative Officer
Aldona Valicenti, Chief Information Officer
David Holmes, Commissioner of Environmental Quality and Public Works
William O'Mara, Commissioner of Finance & Administration
Janet Graham, Commissioner of Law
Charles Martin, Director of Water Quality
Phyllis Cooper, Director of Accounting
Susan Straub, Communications Director
Urban County Council Members
Internal Audit Board Members

FROM: Bruce Sahli, CIA, CFE, Director of Internal Audit
Alicia Boyd, CPA, Internal Auditor

RE: Consent Decree Expenditures Management Action Plan Progress

EXECUTIVE SUMMARY

On September 5, 2013, the Office of Internal Audit issued the Consent Decree Expenditures Audit Report. The 2013 audit report contained three findings and two risk observations addressing consent decree expenditures and contract issues. This follow-up review was conducted to evaluate controls put in place by management to address those specific findings from the September 2013 report.

This review is provided for management information only. It is not an audit and no opinion is given regarding controls or procedures. We sampled Consent Decree expenditures and contracts incurred and entered into from April 1, 2013 through April 18, 2014, when necessary to complete our follow-up procedures.

A summary of the findings and risk observations from the original audit report and a summary of the results of our follow-up are provided in the table below. The original findings and risk observations, management's original responses, and details of the results of this follow-up are contained in the **ORIGINAL AUDIT RESULTS AND FOLLOW-UP DETAILS** section of this report.

| Finding or Risk Observation | Summary of Original Finding | Follow-Up Results |
|------------------------------------|---|--|
| Finding #1 High Priority | Improved Project Cost Tracking & Reconciliation Process Needed | Division has implemented procedures to more closely track project costs and has hired two Administrative Specialists to perform this function. Spreadsheets continue to be used in cost tracking, but spreadsheet information did not reconcile within reason to information contained in PeopleSoft Project Costing Module. Finding is considered resolved. |
| Finding #2 Moderate Priority | Discrepancies Noted in Capitalized Costs | Resolved. Protocols have been developed and are being used. |
| Finding #3 Moderate Priority | RFP Process Not Consistently Followed | Resolved. Additional testing reveals no violations of purchasing policies and procedures. |
| Risk Observation #1 | Comprehensive Knowledge of Consent Decree Resides Solely With Director of Water Quality | Additional personnel continue to be included in the consent decree process, including new hires. Risk Observation is considered resolved. |

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|---------------------|---|---|
| Risk Observation #2 | Right to Audit and Risk Mitigation Language Should be Consistently Included in Consent Decree Contracts | Resolved. Remedial Measures Plan Construction Manager has updated standard contracts used to include right to audit and risk mitigation language. |
|---------------------|---|---|

ORIGINAL AUDIT RESULTS AND FOLLOW-UP DETAILS

Original Finding #1: Improved Project Cost Tracking & Reconciliation Process Needed

Priority Rating: High

Condition:

As noted in Appendix K of the Consent Decree, in lieu of a fine the State of Kentucky established the flooding supplemental environmental project as part of Storm Water control and required LFUCG to spend \$30M within 10 years following the entry date of January 3, 2011. As part of this effort, multiple residential properties have been purchased for demolition to create green space in areas prone to flooding. Initially, the Division of Water Quality provided a spreadsheet with related costs totaling approximately \$5.48 million. During our detail testing we discovered an additional \$640,000 in related costs incurred that the Division subsequently added to this spreadsheet.

We also reconciled individual projects listed on the Division's spreadsheet to actual project costs and Council approved resolutions and ordinances. While all differences noted were eventually explained, the process was difficult given the nature of the audit and the timeframe involved.

Effect:

Appendix K of the Consent Decree states, "The fee component shall be sufficient to generate a minimum of \$30 million over a period of up to ten (10) years, and the stormwater fee ordinance shall specify that said funds shall be expended for work on the projects on the proposed project list". Since the Division of Water Quality is required to demonstrate fees spent of \$30 million over 10 years on this portion of the Consent Decree, all costs needs to be clearly accounted for to demonstrate compliance with requirements and to quickly respond to requests for costs to date on individual projects under the Consent Decree.

Recommendation:

The Division of Water Quality should adopt a thorough process for tracking all Consent Decree costs, including a process for periodic updates and reviews of tracked costs. This

should include spreadsheets designed to compare actual costs to estimated costs (i.e., Council approved amounts through resolutions, ordinances, and the budget process) and amounts remaining to be spent. Since the Division worked closely with the Office of Internal Audit during the audit, and now appears to have an accurate list of projects and related costs through March 31, 2013, this recommendation should not be difficult to implement going forward.

Director of Water Quality Response:

The division agrees that an improved process for tracking and verifying cumulative cost totals, such as the Appendix K requirement, is necessary. In the near-term, the division will look to implement a reconciliation protocol to track costs logged on the spreadsheets in contrast with PeopleSoft records. The division is requesting assistance with development of this protocol due to limited skill within the division in regards to navigating PeopleSoft logged transactions.

Maintenance of a separate log or spreadsheet of project costs outside the PeopleSoft environment has considerable accuracy risks because multiple purchase orders are often associated with a specific project. At the same time, a project may have multiple staff members (within and outside the division) working on a single project, each associated with a different project component. Continuity and accuracy are also compromised as staff leaves LFUCG employment or transfers within the government.

The division will work to improve its tracking and reconciliation protocols but recommends implementation of a PeopleSoft solution to eliminate the redundancy of data, improve accuracy and improve the overall efficiency of staff.

Commissioner of Environmental Quality & Public Works Response:

There are expenses related to the consent decree that fall outside DWQ's budgets/control. Tracking systems and reporting out of PeopleSoft will involve other departments and divisions including Enterprise Solutions, Accounting, Budgeting, et al.

Follow-Up Detail Results:

We interviewed the Director of Division of Water Quality and other applicable staff. The Director indicated no formal discussion has occurred with other LFUCG management to eliminate the need for spreadsheets outside PeopleSoft.

The Division has implemented procedures to more closely track project costs and has hired two Administrative Specialists to perform this function. A third Administrative Specialist is expected to be hired in August. We examined the spreadsheets maintained by the Division, and in particular the spreadsheets

maintained for the \$600M Remedial Measures Plan (RMP) projects. We attempted to reconcile spreadsheets maintained for three recent RMP projects (Fund 4003) to the Project Costing Module in PeopleSoft. We were able to fully reconcile one project's spreadsheets with the PeopleSoft Project Costing Module, while the other two we examined reconciled to within \$1,176 (0.16%) and \$1,736 (0.44%), respectively. The Project Costing Module is used to track projects included in Funds 4003 and 4052, both of which are Division of Water Quality funds, as well as any projects that may be funded with state or federal dollars and included in Funds 3XXX and debt service proceeds included in Funds 2XXX.

No management response required.

Original Finding #2: Discrepancies Noted in Capitalized Costs

Priority rating: Moderate

Condition:

We tested the purchase of fourteen properties receiving Federal Emergency Management Agency (FEMA) reimbursements and noted that in three of the fourteen land purchases the relocation fee of \$1,700 was expensed. This fee should have been capitalized as part of the land purchase price.

Effect:

Failure to properly capitalize applicable asset purchase costs results in the understatement of capital assets and the overstatement of expenses.

Recommendation:

The Division of Water Quality should coordinate with the Division of Accounting to ensure all assets are properly capitalized, particularly since the Consent Decree will result in multiple capitalized projects totaling several hundred million dollars.

Director of Water Quality Response:

The Division of Accounting has already implemented protocols to ensure the capitalization of all expenses associated with a capital project. Accounting proposed the protocol in March 2013 and began implementation in May 2013.

Commissioner of Environmental Quality & Public Works Response:

The department concurs with the division's response.

Follow-Up Detail Results:

We interviewed the Accountant Senior in the Division of Accounting. Protocols have been implemented for proper capitalization of all capital projects, including Consent Decree. In addition, Accountant Senior and staff of the Division of Water Quality have been coordinating efforts to assure all Consent Decree capital projects are properly capitalized.

No management response required.

Original Finding #3: RFP Process Not Consistently Followed **Priority Rating: Moderate**

Condition:

We noted one project conducted early in the Consent Decree process that was not completed properly and was subsequently completed by a second firm. Actual costs charged by the second engineering firm for the project in question totaled \$27,650 (included invoices dated May 11, 2011 through August 4, 2011). The second engineering firm selected without the use of the RFP process had replaced the first firm (hired using RFP process) that was fired after failure to adequately complete a self assessment for LFUCG as part of the Consent Decree. Although the Purchasing Procedures Manual requires the selection of professional services in excess of \$25,000 to follow the RFP process, discussions with management and related e-mails indicate the decision to forego the RFP process was made to avoid a lengthy hiring process in order to avoid potential EPA non-compliance penalties. The project has since been completed, and we are not aware of any other Consent Decree project where purchasing requirements were not met.

Effect:

If professional services are not properly vetted, the selection process is compromised and additional costs may be unnecessarily incurred.

Recommendation:

The Division of Water Quality should seek to consistently comply with all LFUCG purchasing policies and procedures.

Director of Water Quality Response:

The division concurs with the recommendation and believed at the time that sufficient emergency conditions existed, and appropriate approval from upper level management was received in this instance to waive LFUCG purchasing policies and procedures.

The original, competitive bid contract was for the completion and delivery of a document – the CMOM Self Assessment. This document was subject to EPA review and approval. The preparation or response to EPA comments received on the submittal was not in the scope of the original contract because the consultant providing the services employed the former EPA employee credited with developing the original CMOM guidance documents used by EPA to evaluate self assessments.

Comments received from EPA in December 2010 stated that the entire original CMOM submittal was deficient because the format did not meet current EPA guidance. The overall deficiency of the CMOM Self Assessment document along with the overall changes implemented by the division since the original 2007 submission made a complete re-write of the document unavoidable.

The due date for the re-submittal was July 3, 2011 and failure to meet that deadline exposed LFUCG to stipulated penalties of \$3,000.00 plus \$500.00 - \$1,000.00 per day. The firm responsible for the original submission no longer employed the persons involved with the preparation of the original submittal.

There were two options to complete the re-submittal, each with a perceived risk.

| Option | Action | Perceived Risk |
|--------|--|---|
| 1 | Rebid the CMOM Self Assessment deliverable | Miss the deadline and incur stipulated penalties. |
| 2 | Directly contract with a firm with demonstrated experience in successful preparation, submission and approval of CMOM Self Assessment documents. | Expose the division to criticism for not following standard procurement protocol. |

With the concurrence of both the then Director of Central Purchasing and Commissioner of Environmental Quality, option 2 was implemented successfully with approval of the CMOM Self Assessment occurring in August 2012.

Commissioner of Environmental Quality & Public Works Response:

The department concurs with the division's response. The procurement process is imperfect, especially when we have a vendor failure and deadline looming.

Follow-Up Detail Results:

We interviewed the Director of Water Quality. He stated to his knowledge the professional service contract mentioned in the original comment was the only instance in which this occurred. We also reviewed more recent professional service contracts entered into since the release of the original audit and found them to be in compliance with purchasing policies and procedures.

No management response required.

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 exist. The following observations identified risks associated with the Consent Decree program but do not represent a violation of statutes, policies, or procedures. Both are considered to be of sufficient importance to deserve mention in this report to ensure senior management's awareness.

Original Risk Observation #1: Comprehensive Knowledge of Consent Decree Resides Solely With Director of Water Quality

The Division of Water Quality has several knowledgeable staff able to discuss their assigned responsibilities of Consent Decree day-to-day operations. However, only the Division Director has a comprehensive working knowledge of the Consent Decree and its related projects since its inception in March 2008. Such extensive knowledge residing with one individual would create a significant management risk if this individual left the LFUCG. To at least partly mitigate this risk, the Division Director should develop a process to further educate select members of his staff on the comprehensive details and requirements of the Consent Decree.

Director of Water Quality Response:

The division concurs with this observation and is working to abate this risk. Two examples are provided:

1. Susan Plueger's role as Municipal Separate Storm Sewer System (MS4) coordinator. Susan became employed by LFUCG after the Consent Decree was negotiated and Lodged. The continued implementation of all 41 Consent Decree Performance Standards is her responsibility. Her knowledge, beginning

with her employment start date, makes her a redundant “subject matter expert” in a large component of the Consent Decree deliverables.

2. Vernon Azevedo’s role as Remedial Measures Plan (RMP) Construction Manager. Vernon became employed by LFUCG after the Consent Decree was entered. Responsibility for the design and construction of the 82 RMP capital projects lies entirely within Vernon’s staff, with the DWQ director playing an advisory role (RMP Construction Manager reports directly to the Commissioner of Environmental Quality and Public Works).

A perception that all Consent Decree knowledge resides with the DWQ division director is unavoidable in the context of this audit because it is a “look back” at what has transpired since 2007. The director is the only current LFUCG employee who has been directly involved in both the negotiation and the early implementation of Consent Decree deliverables. Unanswered questions to what we’ve done and why we did it are best answered by the person who was there for both parts.

The DWQ director’s management style is to be intimately involved with the development and start up of a program, then find a capable and qualified person to run the program so the director can then move on to other programs he perceives to be in need of improved management. Susan and Vernon are two examples of that management style and future audit inquiries will necessitate their active involvement since the director has reduced his role to advisory.

Commissioner of Environmental Quality & Public Works Response:

Loss of institutional knowledge is a great concern in any large organization. To DWQ’s credit, there is a very thorough record of all legal documents and reports submitted as part of the consent decree that are freely-accessible online. Also, approximately 20 people from many divisions of LFUCG and our outside contractors attend a monthly consent decree meeting that has been occurring on the third Wednesday of every month for many months. DWQ does a great job in disseminating information to other organizational units in the LFUCG and briefing the Urban County Council and outside groups.

Follow-Up Detail Results:

We interviewed the Director of Division of Water Quality and other applicable staff of the Division. The Director stated that since he's been acting Commissioner of Environmental Quality and Public Works for the last six months, he's not been as involved in the day to day operations of the Division, including consent decree. This has, in turn, encouraged more staff involvement. We noted that some additional hires have occurred as stated in Auditor Follow-up

to Finding #1, and a temporary position was created for the Capacity, Management, Operation and Maintenance (CMOM) portion of Consent Decree.

No management response required.

Original Risk Observation #2: Right to Audit and Risk Mitigation Language Should be Consistently Included in Consent Decree Contracts

While reviewing engineering firm agreements and contracts for Consent Decree projects with construction companies, we noted that the standard right to audit clause was not included in three of the newer construction contracts for projects listed on the remedial measures plan. These three contracts also had insufficient or non-existent transfer of financial risk clauses. While two of these contracts imposed fines of \$600 or \$1,200 per day for contractor actions leading to non-performance or failure to meet project deadlines, the third contract did not impose any fines at all. The Department of Law should coordinate with the Division of Water Quality to ensure the right to audit clause and the sufficient mitigation of financial penalties risk is included in all Consent Decree project contracts.

Director of Water Quality Response:

The Division of Water Quality defers to the Department of Law and the Division of Central Purchasing in regards to the inclusion of standard right to audit clauses in construction contracts.

The division concurs that appropriate transfer of risk clauses should be included in all construction contracts. The division recommends that all construction contract bid recommendations be signed off on by the requesting division director—as is done with blue sheets, so that they can be reviewed prior to placement on the docket. Because that is not the current practice, upper level division management seldom sees a construction contract prior to execution.

Commissioner of Environmental Quality & Public Works Response:

The department concurs with the division's response.

Commissioner of Law Response:

The Department of Law regularly meets and coordinates with the Division of Water Quality regarding a variety of issues including the agreements it utilizes. The Department has previously worked with the division on standardizing many of its agreements, including those related to the Consent Decree, and the standardized agreements include provisions to mitigate the risk associated with these projects. The Department will meet

with the Division of Water Quality and any other necessary LFUCG personnel to specifically discuss the results of this audit and what steps may need to be taken to ensure that the interests of the LFUCG are reasonably protected under the provisions of any future contracts.

Follow-Up Detail Results:

We interviewed the RMP Construction Manager about the right to audit and risk mitigation language issue. For the \$600M in RMP projects, excluding the three projects noted in the original risk observation, the construction manager has worked with others at LFUCG to create standard contract language. The RMP Construction Manager stated the right to audit language was originally only included in Kentucky Infrastructure Authority documents that accompany contracts of projects funded by KIA. We examined the three most recent RMP project contracts entered into since the original audit was released, all funded by KIA, and noted that right to audit and risk mitigation language was included in those contracts.

Subsequent to our interview, the construction manager updated the standard contract language to include the right to audit provision in all contracts, regardless of funding. The risk mitigation language was already included in the standard contract language.

No management response required.