



Jerry E. Abramson
Mayor

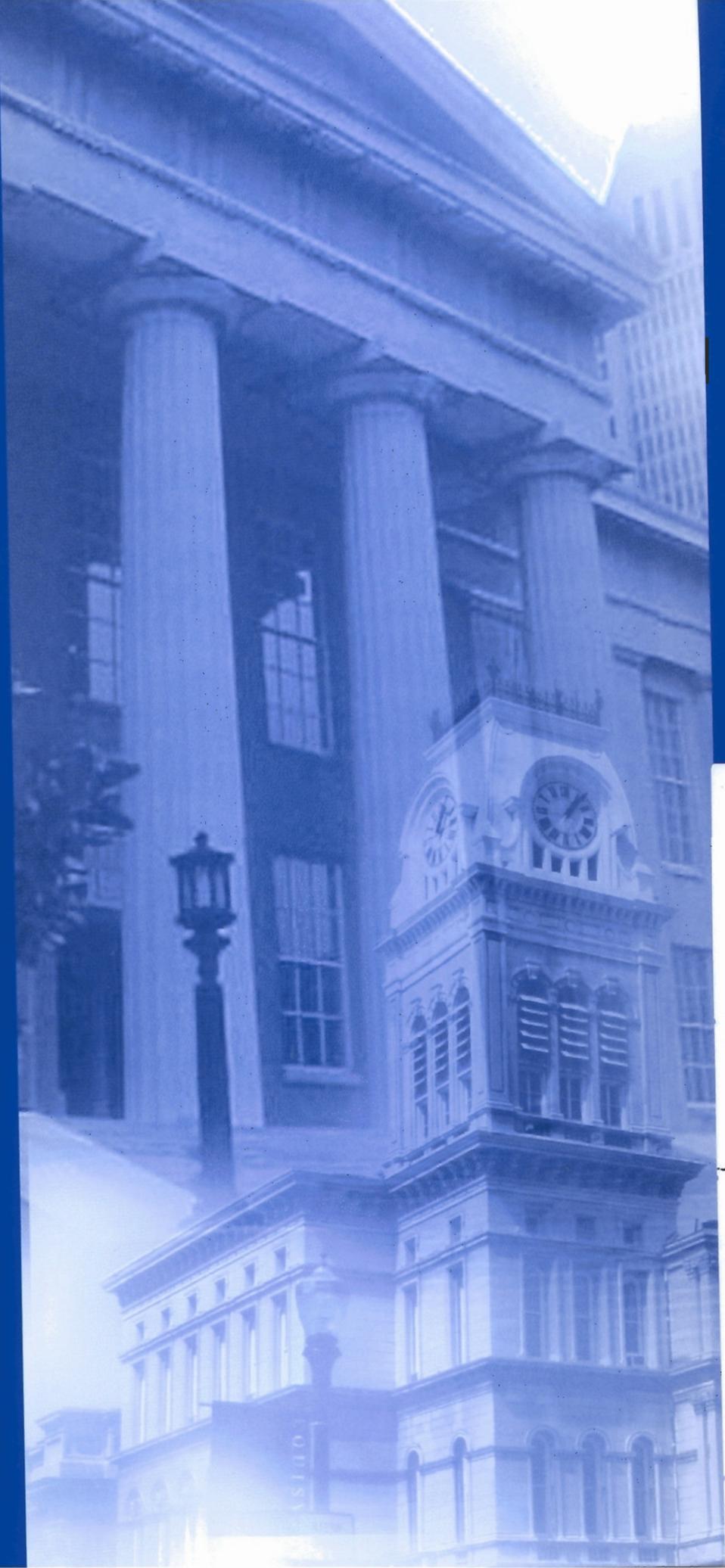
26 Member
Metro Council

The Office of Internal Audit provides independent, objective assurance and consulting services that adds value to and improves Louisville Metro Government.

Office of Internal Audit

Public Works

Encroachment and
Subdivision Bonds



Audit Report

Office of Internal Audit

Department of Public Works Encroachment and Subdivision Bonds



August 2003

Public Works

Encroachment and
Subdivision Bonds

Table of Contents

Transmittal Letter.....	2
Scope and Opinion.....	2
Internal Control Rating	4
Introduction.....	5
Summary of Audit Results.....	6
Observations and Recommendations.....	7
Bond Management.....	7
Department of Public Works Responses	11



LOUISVILLE, KENTUCKY
OFFICE OF INTERNAL AUDIT

JERRY E. ABRAMSON
MAYOR

RON WESTON
PRESIDENT, METRO COUNCIL

Transmittal Letter

August 27, 2003

The Honorable Jerry E. Abramson
Mayor of Louisville Metro
Louisville Metro Hall

Re: Audit of the Public Works Encroachment and Subdivision Bonds

Scope and Opinion

We have examined the operating records and procedures of the Metro Department of Public Works encroachment and subdivision bonds. The primary focus of the audit was the operational and fiscal administration of the activity.

As a part of our examination, we performed an evaluation of the internal control structure. Our examination was conducted in accordance with Government Auditing Standards issued by the Comptroller General of the United States and with the Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors.

The objective of internal control is to provide reasonable, but not absolute, assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations
- Safeguarding of assets

There are inherent limitations in any system of internal control. Errors may result from misunderstanding of instructions, mistakes of judgment, carelessness, or other personnel factors. Some controls may be circumvented by collusion. Similarly, management may circumvent control procedures by administrative oversight.

The operating procedures of the Public Works Transportation and Engineering Division bond management were reviewed through interviews with key personnel. The operational and fiscal administration of activity was reviewed. The specific topic included the following:

- Bond Management

The scope and methodology of the areas reviewed will be addressed in the Observations and Recommendations section of this report. Our examination would not reveal all weaknesses because it was based on selective review of data.

The internal control rating for each area reviewed is on page 4. These ratings quantify our opinion regarding the internal controls used in managing the activity and identify areas requiring corrective action.

It is our opinion that the overall internal control structure for the administration and processing of encroachment and subdivision bonds is weak. There were some specific problems noted that indicate the internal control structure could be more effective. Examples of the problems include the following.

- Monitoring and reconciliation of bond activity is inadequate. This lack of oversight does not adequately protect the funds and weakens the reliability of the financial statements.
- Files do not contain sufficient documentation to ensure that activity adheres to requirements. The format of files does not provide adequate detail to verify that the procedures were followed. This weakens the reliability of records.
- The bond files are not managed adequately. Files are not secured and information is often incomplete or missing. This hampers the efficiency and effectiveness of information management, as well as, weakens the reliability of records.
- Functional operating policies and procedures are not provided for staff. This may lead to inconsistencies in administration and management of activities.

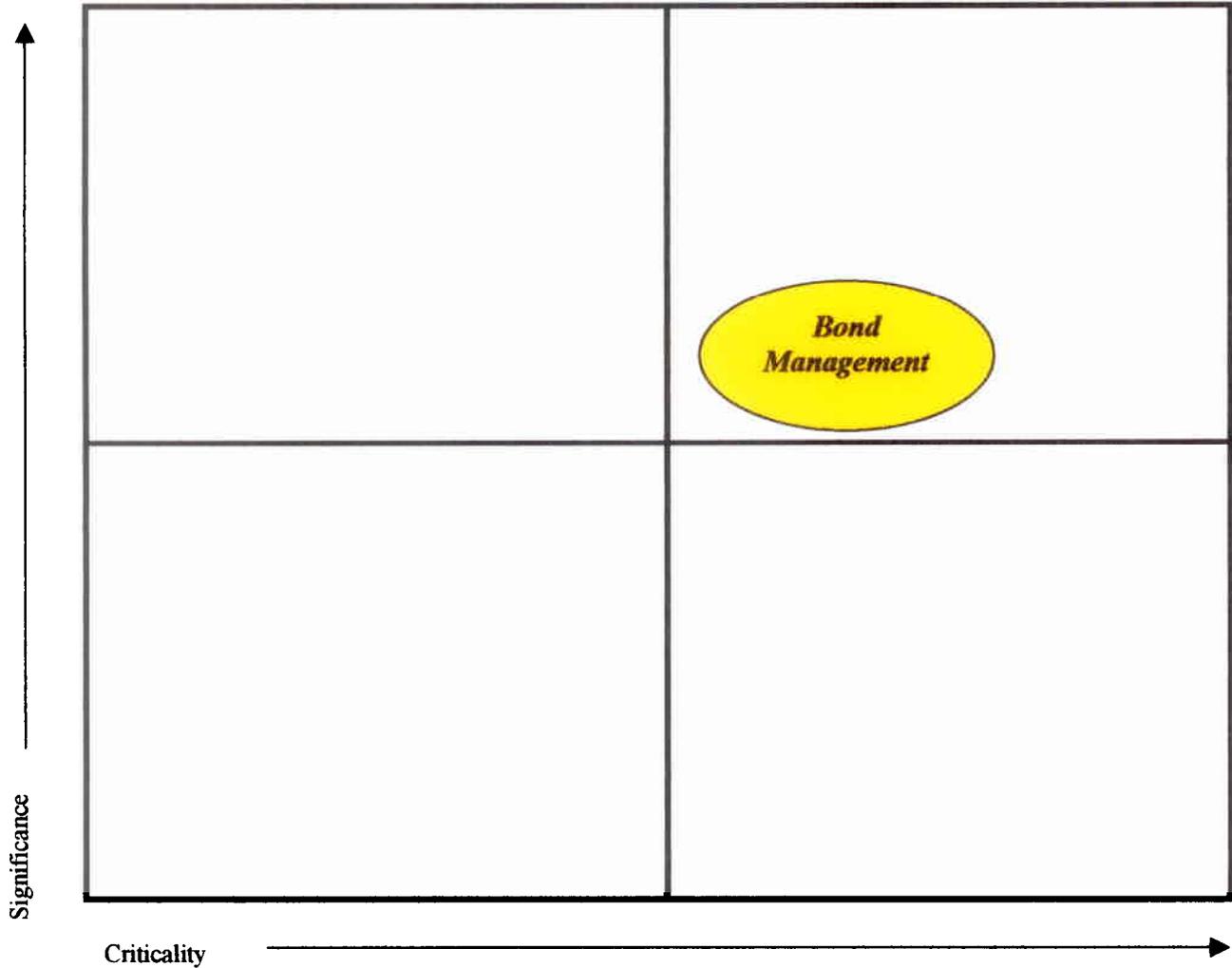
The implementation of the recommendations in this report will help improve the internal control structure and effectiveness of the administration and processing activity for encroachment and subdivision bond management.



Michael S. Norman, CIA
Chief Audit Executive

cc: Louisville Metro Council Audit Committee
Louisville Metro Council Members
Deputy Mayors
Secretary of the Cabinet for Public Works and Services
Director of Public Works

Internal Control Rating



	<i>Legend</i>		
<u>Criteria</u>	<u>Satisfactory</u>	<u>Weak</u>	<u>Inadequate</u>
<i>Issues</i>	Not likely to impact operations.	Impact on operations likely contained.	Impact on operations likely widespread or compounding.
<i>Controls</i>	Effective.	Opportunity exists to improve effectiveness.	Do not exist or are not reliable.
<i>Policy Compliance</i>	Non-compliance issues are minor.	Non-compliance issues may be systemic.	Non-compliance issues are pervasive, significant, or have severe consequences.
<i>Image</i>	No, or low, level of risk.	Potential for damage.	Severe risk of damage.
<i>Corrective Action</i>	May be necessary.	Prompt.	Immediate.

Introduction

The Public Works Transportation and Engineering Division has the administrative responsibility of bond administration. It operates as an agent to the Louisville and Jefferson County Planning and Design Services and the Planning Commission. In order to ensure that land and real estate development projects are performed in accordance with applicable standards (e.g., land development codes, Fire Department requirements, utility regulations, drainage requirements, pollution regulations, etc.), development firms are required to provide financial instruments to serve as collateral. These are required to ensure that work is done correctly and to protect Metro Government from the cost of damages or unfinished work.

Bond amounts are based on estimated project costs. The current bond inventory includes amounts ranging from \$500 to \$853,000. Metro Government administers bonds for two types of activity.

- **Encroachment Bonds.** An encroachment bond must be secured before developers can perform work on any designated Metro “*through-roads*” and others as determined. Public works staff described “through-roads” as a strip of street that has a definite beginning point and ending point. “Through-roads” are networks of county roads that connect major arteries and are designated by the County Engineer. A release of a developer’s bond is contingent upon the satisfactory inspection results of completed work. Encroachment bond instruments and documentation are retained by the Department of Public Works.
- **Subdivision Bonds.** Subdivision bonds guarantee that work will be performed properly in accordance with approved construction plans. These instruments serve as leverage in order for Metro Government to ensure that the developer completes work and complies with requirements when performing work on the “public right of way.” According to Public Works staff, the “public right of way” is the dedication of property to the County for public use. For the purpose of this review, the public right of way is granted when a developer receives a record plat by Louisville Planning and Design Services as approval for subdivision development. The bond instruments are held by a financial institution, with the Department of Public Works responsible for maintaining the associated records and monitoring the bond activity.

Upon successful completion of the project, the bond instruments are returned to the developer. If a developer defaults in completing work according to requirements, funds from the bond instruments may be forfeited to Metro government. The forfeited funds are used to complete the project for which they are associated with. After the project is completed, any surplus funds are returned to the developer.

For the period examined, there were approximately 750 active bond instruments having a value of approximately \$30,300,000. The balance of forfeitures to Public Works totaled approximately \$300,000 as of March 31, 2003.

This audit was requested by the Director of the Metro Department of Public Works.

Summary of Audit Results

I. Current Audit Results

See Observations and Recommendations section of this report.

II. Prior Audit Issues

The Office of Internal Audit has not conducted any reviews of the former Jefferson County encroachment and subdivision bonds.

III. Statement of Auditing Standards

Our audit was performed in accordance with Government Auditing Standards issued by the Comptroller General of the United States and with the Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors.

IV. Statement of Internal Control

We conducted a formal study of the internal control structure in order to obtain a sufficient understanding to support our final opinion.

V. Statement of Irregularities, Illegal Acts, and Other Noncompliance

Our examination did not disclose any instances of irregularities, any indications of illegal acts, and nothing came to our attention during the examination that would indicate evidence of such. Any significant instances of noncompliance with laws and regulations are reported in the Observations and Recommendations section of this report.

VI. Views of Responsible Officials

An exit conference was held at the Metro Department of Public Works on July 28, 2003. Attending were James Adkins, Rick Storm and Paula Osborne-Wahl representing the Metro Department of Public Works; Mike Norman and Mark Doran representing Internal Audit. Final audit results were discussed.

The views of the Metro Department of Public Works officials are included as responses in the Observations and Recommendations section of the report.

Observations and Recommendations

Bond Management

Scope

Key personnel were interviewed in order to review the operational and fiscal administration of encroachment and subdivision bond activity. This included the processing, records management, and monitoring of bond activity. As of March 2003, there were approximately 750 active bond instruments, totaling approximately \$30,300,000. Though some bond instruments are in Public Work's possession, the majority is held at a banking institution.

Fifteen encroachment and subdivision bond files were judgmentally selected for review from a March 2003 listing of bonds. The files were reviewed for completeness and accuracy of support documentation. In addition, all bond forfeitures posted to the financial system as of March 2003 were reviewed for accuracy of the forfeiture amount and appropriateness of payment activity. There were twenty bond forfeiture accounts, valued at approximately \$300,000. The following concerns were noted.

Observations

There were some weaknesses noted with the management of bond activity. As a result, the internal control structure is weakened and its effectiveness impaired. Examples of weaknesses include the following.

- Due to the nature of subdivision bond activity (e.g., length of project, etc.), a banking institution serves as the custodian for bond instruments. A periodic report is provided for the Department of Public Works that details the inventory of items held in a lockbox, along with any other activity (interest on investments). The following problem was noted with this account.
 - While this account is intended to be used for lockbox purposes, the bank statement includes cash equivalents with an original value of approximately \$8,650 and a current value of approximately \$8,100. Metro Government personnel could not identify with certainty the source of funds or associate them with specific projects. It is believed that these may be associated with historical activity that may be closed out.
- If a developer fails to meet the requirements associated with a project, the bond funds may be forfeited to Metro Government. These forfeited funds are used to complete the project for which they are associated. Public Works submits forfeited bond funds to the Finance Department where they are recorded on the financial system. There were some weaknesses noted regarding bond forfeitures.
 - Public Works personnel do not adequately monitor or reconcile activity.
 - One bond forfeiture account on the (former) County financial system reflected a negative balance of approximately \$8,000. It appears that the total of payments made from the account exceeded the original bond amount. This negative balance has been carried for a couple of years. As a result of this

review, Public Works personnel plan to correct the account by transferring the balance to another bonded phase of the project.

- Public Works personnel are not aware of the financial system accounts established for bond forfeitures. In order to process activity using these funds (e.g., contractor payments, etc.), the Finance Department must be contacted.
- The banking institution requires developers to pay a fee (\$50) in order to establish a subdivision bond. Though it has been discussed in the past, Metro Government does not charge a fee for holding developers encroachment bonds. This could be a potential source of revenue for Public Works that could help to offset administrative costs.
- Public Works personnel stated that there have been defaults in the past from insurance companies issuing surety bonds. These are not secured by actual assets or credit and have resulted in the inability to collect funds when requested. Though the entire bond instrument cannot be in the form of a surety (\$3,000 must be the form of a Certificate of Deposit or Savings Account), there is a potential risk associated with collection of forfeitures.
- Public Works staff is responsible for administering all bond information. This includes instruments held by the banking institution, along with those maintained internally. There were several problems noted with the management of bond files.
 - Bond files are not managed efficiently and effectively. Two separate electronic bond files are maintained, both containing similar information. Additionally, project files are maintained and index cards are used to record similar development project information.
 - Encroachment bond instruments are stored in an accordion file folder, in an unsecured file cabinet.
 - The archives retention schedule does not specifically address the maintenance period for these files. Files are maintained indefinitely, unnecessarily using storage space and administrative resources.
 - There were several instances where bond file documentation was inaccurate or missing.
 - In one case, the bond inventory listing recorded outdated information for a development. According to the bond file support documentation, it appears the original bond instrument had been exchanged for another type. Public Works personnel corrected this file as a result of the audit inquiry.
 - In one case, an Inspection Release form was missing. This document serves as evidence that work has been satisfactorily completed and an inspector has properly authorized the release of a bond instrument.
 - In another case, an Encroachment Permit Bond Requirement Letter was missing. The file noted that the requirements had been communicated to the developer via telephone. This does not adhere to described procedures. In addition, the established documentation helps to ensure that consistent and complete information is provided.
 - One bond file was missing numerous documents (MSD Approval Response Letter, Work Order Letter, index card documentation).

- Public Works does not maintain detailed policies and procedures for the bond management process. As a result, employees do not have readily available guides to assist in processing, recording and monitoring the activity. There are practiced guidelines followed to assist in the case-by-case determination as to whether an encroachment bond should be required, but the criteria is not documented. This could lead to inconsistencies in administering funds, insufficient monitoring and noncompliance with requirements.
- The original bond setup and any corresponding bond activity are not recorded on the (former) County financial system. Bond activity is only recorded in the system when forfeited and is reflected as a liability to the Metro Government. Finance staff are not aware of any accounting standards or principles that require activity to be recorded on the financial statements, but it may be beneficial for tracking and control purposes.
- Some forms being used for bond administration have not been updated to reflect the new Metro Government. One example is the encroachment bond permit request that states that application is being made to Fiscal Court of Jefferson County, Kentucky.

Recommendations

Appropriate personnel should take corrective action to address the concerns noted. Specific recommendations include the following.

- ✓ Public Works staff should determine the nature of cash equivalent items held in the bond fund maintained by the banking institution. A determination should be made as to the appropriate disposition of these funds. The Metro Department of Finance should be consulted for assistance as necessary.
- ✓ It is imperative that Public Works personnel monitor and reconcile bond forfeiture accounts.
 - Public Works personnel should monitor and reconcile financial reports to ensure bond forfeitures are being properly administered. This should include reviewing financial reports for appropriateness of deposits, payment activity, and the closing of accounts when activity is completed.
 - All activity regarding bond forfeitures (deposits, payments, etc.) should be thoroughly documented and procedures should be in place to address additional funding issues (e.g. when payments to developers cost more than the original bond amount).
- ✓ The feasibility of charging a fee for administering bonds should be considered. The revenue generated could help offset the costs associated with managing bond activity.
- ✓ Public Works personnel should evaluate the number of defaults and uncollected funds from using Surety / Insurance companies. It may be beneficial to not accept bond instruments from these types of companies, or at least those with a poor credit history. Another option might be to increase the \$3,000 minimum for more secure instruments (e.g., CD / Savings Account bond instrument) required in addition to surety bonds.
- ✓ Care should be taken to ensure that bond files are properly managed.

- Bond files should be stored in a physically secure location. Ideally, access to files should be limited to staff directly responsible for processing and administration.
 - Since archive schedules do not address bond files, appropriate Public Works personnel should consult with the Metro Archives Division and the County Attorney to determine the appropriate retention period. This would allow for files to eventually be destroyed instead of remaining in storage indefinitely.
 - Electronic bond files should be combined into one file to provide a single activity report of all activity. One file is much more efficient to maintain and would provide a single source to obtain bond activity information. Care should be taken to ensure that the bond inventory listing contains complete and accurate information.
 - While supporting documentation should be retained in the bond file, the practice of recording information on index cards should be discontinued.
- ✓ Care should be taken to ensure that all necessary documentation is appropriately maintained in each bond file. A checklist could be posted in the left inside front cover of the each file folder to assist Public Works personnel in making sure the appropriate documentation is obtained and procedures are adhered to. Notations, checkmarks, and / or initials should be made to the list to verify that each procedure requiring documentation was appropriately performed. This will also provide evidence that work has been appropriately reviewed and closing actions taken (e.g. release of bond).
 - ✓ Written policies and procedures for bond administration should be developed. These should be distributed to all applicable personnel. This manual should include sufficient detail for each job duty performed, copies of forms used and policies followed in the processing of bond activity. These should include guidelines that state the criteria requiring a bond, so as to avoid the perception of favoritism. In addition, the valuation and determination of bond amounts should be detailed. Training of key personnel will help ensure consistent adherence to the requirements.
 - ✓ It may be beneficial to record all bond instruments on the Metro Government's financial system. Though they are not a true liability until they are actually forfeited, this would allow for easier tracking and document potential liabilities. Metro Finance personnel should be contacted regarding the feasibility of recording such transactions on the financial system.
 - ✓ With regards to development work being completed properly, the entire inspection process should be evaluated and a determination made as to who should be involved in the final inspection process. There should be documented criteria by which decisions are based. Policies and procedures should address these criteria and determinations should be properly documented and stored in bond files.
 - ✓ All forms used in the administration of bond activity should be reflective of the newly merged government entity. This will ensure accurate documentation and legal claim to the bond instruments.

Department of Public Works Responses

Public Works has reviewed the Encroachment and Subdivision Bonds Audit Report. The department is in concurrence with the recommendations of the report to improve the internal control structure, effectiveness of the administration, and processing activity. Several initiatives are currently underway that will address the findings and recommendations. These include:

- A Fee Study is being conducted within the department. The potential for charging a fee to developers for holding bonds will be included as part of that study.
- Public Works is working with the County Attorney's office to evaluate the elimination of accepting surety bonds.
- A plan review manual will be developed within a year that will include bonding procedures and requirements. An inspection manual is planned to be included in the future.
- A bond file checklist is now being used to improve documentation practices.
- Security practices are being evaluated. A safe is to be provided to secure bond instruments.
- Future plans include using the MIDAS system for development review and bond management.

The Transportation Engineering Division will continue to monitor and evaluate bond management activities and work towards implementation of the report recommendations.



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