CITY OF CHARLOTTE
CITY MANAGER'S OFFICE – INTERNAL AUDIT DIVISION

MEMORANDUM

To: W. Curtis Walton, Jr., City Manager July 22, 2010

From: Greg McDowell, City Auditor

Re: Fiscal Year 2010 Audit Summary

The Internal Audit Division has completed a number of managed-competition and other performance audits during fiscal year 2010. Significant efforts were made to follow up on previous procurement audits, and to support CATS light rail construction. We continue to support the City's efforts to properly report and manage American Recovery and Reinvestment Act (ARRA), or Stimulus Act funds.

MANAGED COMPETITION AUDITS

Internal Audit staff project time was allocated about 30% to competition-related work, including 27 quarterly and semi-annual audits of Solid Waste Services, Water Locates, Vest Water Treatment Plant, Irwin Wastewater Treatment Plant, the Wastewater Optimization Plants (McAlpine, McDowell, Mallard and Sugar Creek) and the final quarter of Wastewater Lift Stations; plus three optimization budget reviews.

- *Solid Waste Services (Optimized North and South Districts; Competed East District):* One semi-annual and three quarterly audits were completed for each of the North and South Districts. Three quarterly audits of the East District were completed. In addition, we reviewed the optimization budgets for the FY10 contracts and have nearly completed our review of the FY11 budget, which reflects SWS' reorganization plans for operations which began in July 2010.

- *Charlotte Mecklenburg Utilities:* Seven semi-annual and four quarterly audits were completed for three separate contracts: Vest, Irwin, and the Wastewater Optimization Plants (combined McAlpine, McDowell, Mallard and Sugar Creek). Four reports related to the new Locates competed contract were issued. The final audit of Lift Stations was also completed. In addition, we reviewed the FY10 budgets at the beginning of the year for the Lift Stations and Wastewater Optimization Plants contracts resulting from optimizations.

PERFORMANCE AUDITS

Seventy percent of Audit staff project time was used to complete fifteen non-competition audits in the following categories:

- 3 Procurement-Related
- 5 CATS-Related

- 1 Stimulus (ARRA)
- 1 Property Tax
- 3 Accounts Receivable Write-offs
- 1 Police Vice
- 1 Annexation

PROCUREMENT FOLLOW-UPS

Procurement Follow-up – Utilities (July 2009): We reviewed transactions from the first eight months of FY09. During this period, CMU processed a significant number of purchases via "direct pay," without using the purchase order (PO) process. The audit questioned the procurement methods or documentation for over $2 million of CMU's transactions for FY09. Contracts and POs protect the City through the use of legal language and budgetary controls, i.e., encumbrances. The failure to initiate POs resulted in non-compliance with approval requirements, including KBE, City Manager and Council. The lack of compliance with city procurement policies creates a weak internal control environment. Also, the lack of competition in some instances may have prevented CMU from obtaining the best prices and may have led to missed opportunities for city-wide procurement efforts to obtain discount pricing.

Auditors noted that two important controls were working properly. First, all POs tested were found to be properly approved. Second, the segregation of duties issue identified in FY07 has been resolved. That is, incompatible requisition and payment duties have been completely eliminated.

We recognize that the City's financial and procurement system limitations make it difficult to ensure that procurement limits are not exceeded and opportunities for joint purchases are not missed. The control weaknesses and lack of compliance have been reviewed with CMU management, who has initiated appropriate and significant actions to address these concerns. For example, the KBE met with each division leader and directed a re-assessment of procurement activities, and CMU has initiated several RFPs in response to concerns raised during the audit. In addition, CMU is working with BSS' Procurement Services Division to conduct workshops for all its employees involved in the procurement process.

> *Update:* While we are satisfied with CMU's response and plans to address the issues raised, we will conduct a follow-up review in early FY11 to ensure that procurement practices comply with existing city policies.

Procurement Follow-up – Engineering & Property Management (December 2009): E&PM maintained adequate documentation of vendor selection or sole source designation for 49 of the 50 FY09 purchase orders tested. However, the audit questioned over $650,000 of FY09 purchases processed via direct payment instead of using the purchase order process. Significant direct payments to several vendors lacked documentation of vendor selection, contracts, or appropriate approval. The purchases from one of these vendors could have been obtained using available city-wide or U.S.

Communities contracts. A 2007 audit finding related to the control environment was also noted in this audit, as two E&PM employees (of six previously identified) continued to have the ability to perform incompatible requisition and payment duties. However, E&PM is working toward implementing full segregation of duties. E&PM agreed to seek competition for services when appropriate and provide more procurement training. The KBU will also review purchases at least semi-annually to identify trends concerning spending with vendors on direct pays.

> *Update:* We are satisfied with E&PM's responses to our recommendations. Subsequently, E&PM has resolved its incompatible duties issue.

CMPD Uniforms Procurement (June 2010): At the City Manager's request, we reviewed the circumstances surrounding the City's continued purchasing of uniforms following the expiration of the applicable contract in August 2009. While the dollar limit approved by Council had not been reached, the time period of the authorization had passed. Internal Audit recommended that policies and controls related to direct payments be strengthened. We also recommended that the ownership of procurement and contracting processes be clarified in City Policies. In addition, contract monitoring requirements need further review.

> *Update:* The recommendations were accepted and are under review. We will report progress toward implementation near year-end.

CATS-RELATED

CATS – Vendor Records Review (August 2009): DEW Electric LLC, a subcontractor for the South Corridor Light Rail (SCLR) project, contacted the City regarding a dispute it was involved in with one of the project's primary contractors, MAJV. The inquiry suggested that MAJV improperly billed the City for work performed on the SCLR project. Specifically, DEW claimed that MAJV received payment from the City for certain costs that MAJV deemed unallowable for DEW. In addition, DEW alleged that DEW documents submitted to the City by MAJV to support change order requests were on letterhead that was not DEW's own.

In performing our Agreed-Upon Procedures engagement, which included reviewing documents and inquiring with DEW and MAJV personnel, we found no evidence of billing improprieties. Regarding the letterhead, Internal Audit was satisfied with the explanations provided by MAJV. Further, the differences in the quoted amounts shown on the various documents were immaterial to the total project costs.

CATS – PBS&J Direct Labor, Overhead and Fees through 2006 (September 2009): This audit focused on the direct labor, overhead, and fee charges billed by Post, Buckley, Schuh & Jernigan (PBS&J), one of Parsons Transportation Group's (Parsons) subcontractors for the South and Northeast Corridor Light Rail Transit System projects. The period audited was May 2003 through June 2006.

For the period audited, PBS&J submitted 49 project-related invoices to Parsons totaling $5,194,288. We reviewed direct labor charges of $1,661,799, and overhead and fees of $3,054,387. The audit did not include a review of other direct costs which totaled $478,101. The recommended amount for disallowance is $196,137, or about 4% of direct labor, overhead, and fees.

In June 2006, PBS&J management informed CATS about an embezzlement of $36 million by its former Chief Financial Officer and two other former employees. While PBS&J acknowledged that it had overcharged the City through inflated overhead rates related to the embezzlement, it did not offer to calculate the reimbursement due to the City for the overpayments. Therefore, Internal Audit calculated the overcharges. The entire proposed disallowance is attributable to overstated overhead and fee charges which had been based upon fraudulent financial statements prepared by the former employees to cover their theft.

> *Update:* CATS requested that PBS&J remit $196,137, as detailed in our report. In April 2010, PBS&J remitted $174,145 to CATS. PBS&J also provided documentation supporting its adjusted amount. Internal Audit reviewed the documentation and determined that the amount remitted was materially accurate.

CATS – Bus Imprest Operations (October 2009): We regularly review this account in support of the outside auditors' annual audit. Prior to the conducting the review, we meet with Cherry, Bekaert & Holland to review and update, as needed, our audit plan.

Overall, the system of controls used by TMC for payroll is satisfactory. Further, in response to the audit report for FY08, improvements have been made to policies and procedures. We noted two recommendations for additional steps to improve controls over deposits and payroll distribution. TMC agreed with the recommendations and has developed satisfactory plans to address each issue.

Odell Direct Labor, Overhead and Fees through October 2005 (January 2010): This audit focused on the direct labor, overhead, and fee charges billed by Odell Associates Inc. (Odell), one of Parsons Transportation Group's (Parsons) subcontractors for the South and Northeast Corridor Light Rail Transit System projects. The period audited was May 2003 through October 2005.

For the period audited, Odell submitted 69 project-related invoices to Parsons totaling $2,256,550. We reviewed direct labor charges of $524,968 and overhead and fees of $1,209,387. The audit did not include a review of other direct costs which totaled $522,194 and were addressed separately. During its initial review of invoices presented by Parsons, CATS disallowed and deducted direct labor, overhead, and fee charges of $82,503. We agreed with those deductions and propose disallowing an additional $181,819 or about 10% of the direct labor, overhead, and fees. This amount is net of a $101,963 credit which was issued by Odell in September 2005 to reflect a reduction in the provisional overhead rate. It is possible that Odell will supply additional

documentation to support some of these charges after CATS addresses our report findings with them.

> *Update:* CATS addressed the audit results with Odell in February. In April 2010, Odell's CPA requested that Internal Audit provide documentation supporting the proposed disallowances. We are gathering that information and will provide it as requested.

STV FY07 ODC Billings (April 2010): This audit addresses the other direct costs (ODCs) portion of STV North Carolina, Inc.'s (STV) billings related to the South Corridor Light Rail from July 1, 2006 through June 30, 2007.

Auditors reviewed $2.6 million in ODC expenses, or about 34% of STV's approximately $7.5 million in billings. We proposed disallowing $93,067 in questioned costs. The largest category of questioned costs (totaling $71,864) was Charges Without Support. It is possible that STV will supply additional documentation to support some of these charges after CATS addresses our report findings with them. We are also recommending that CATS review an additional $228,271 for propriety. These charges were for administrative support provided by STV, but the documentation supplied was insufficient to determine the specific work completed. It is important for CATS' Finance staff to identify unallowable costs prior to payment and to actively pursue reimbursement of questioned costs identified during the audits.

> *Update:* We will review CATS' resolution attempts in early FY11.

AMERICAN RECOVERY AND REINVESTMENT ACT

Stimulus (ARRA) Reporting Readiness (September 2009): The report addressed one of the primary purposes of Internal Audit's efforts related to the American Recovery and Reinvestment Act (ARRA): to determine the City's Stimulus Reporting Readiness. We focused on stimulus project information collected in the City's Microsoft Stimulus360 (MS360) database system through September 15, 2009.

The City was required to make its first quarterly ARRA ("§1512") report to the federal government by October 10, 2009. Our overall conclusion was:

- The City's Stimulus Fund Project Managers are prepared to accurately report funds expended, and other required data for projects which are in progress as of September 30, 2009.

The following highlights additional results:

- Reporting and auditing controls related to the use of ARRA funds are extensive. As the number of projects grows and existing projects add subrecipients and/or vendors, the effort required by Project Managers to meet ARRA guidelines will increase significantly. KBUs may need to allocate additional resources to ensure compliance with ARRA guidelines over the various grants. Internal Audit

reviewed the City's preparedness and found that adequate controls have been established. Adherence to the controls is the responsibility of each Project Manager and will need to be reviewed regularly. Future audits will revisit these controls.

- One specific control Audit addressed separately is the federal requirement for tracking stimulus funds. While the City's Finance KBU has properly set up the funds in GEAC (the City's financial system), miscommunication among staff resulted in two projects posting expenditures to incorrect accounts. These errors were identified during the audit and are being corrected. A better understanding now exists which should prevent such errors from happening in the future.
- Project Managers were hampered by contract and application issues which caused delays during the limited period available to enter data. In addition, the final reporting template was not available to test during the trial period because the City's contractor had not completed the required coding. Audit staff will work with the Economic Stimulus Team to formulate a process which will allow complete compliance with federal reporting requirements while system issues are being resolved.

Preparing to meet the ARRA reporting guidelines has been challenging, as expected. Each KBU, as represented by the Project Managers and many others, expended the necessary effort to overcome every challenge. We are satisfied with their responsiveness to the requirements, and Internal Audit will continue to provide assistance as requested.

> *Update:* The City met the required reporting deadline for each of the first four quarters. As noted in the "In Progress" section below, a project-specific audit is also underway.

PROPERTY TAXES

Property Taxes Received Via County (December 2009): We reviewed Mecklenburg County's property tax processing control environment, along with the accuracy and timeliness of wire transfers for collections received by the City from the County. In addition, we reviewed the City-County "Restated Consolidated Shared Programs Joint Undertaking Agreement" (Agreement) entered into July 1, 2001, for adherence to key provisions. We reviewed processing before and after the County implemented new property tax software in July 2008. The audit conclusion follows:

> The City relies on the County to collect and transfer the City's share of property taxes. While it is cost-effective and practical to combine City and County property tax collections, the City needs to take additional steps to ensure that its interests are protected. The Consolidated Shared Programs Joint Undertaking Agreement should be amended to address issues identified during this audit. County Finance's responses have addressed most of the concerns raised in our report. However, the City needs to impress upon the County its interests in having a post-implementation review related to the new tax software conducted

promptly, along with a commitment to timely transfer the City's portion of taxes in accordance with the Joint Undertaking Agreement.

> *Update:* County Finance has not responded to our request for an update to the recommendations; however, we are aware that a selection of a consultant to conduct the recommended Post-Implementation Review has been made.

WRITE-OFFS

Animal Control Citation Write-offs (August 2009): Internal Audit reviewed the Fiscal Year 2009 write-off request made by the City Finance Department which relates to unpaid animal control citations issued during the period July 1, 2003 through June 30, 2005. The purpose of the audit was to determine if the accounts should be written off the City's accounts receivable ledger maintained by the Finance Department. We also reviewed related transactions and internal controls.

Due to the age of the citations being requested for write-off, we concurred that uncollected citations of $386,170 for FY04 and FY05 should be written-off the City's accounts receivable ledger. We noted that a collection rate of 39% was obtained for the two-year period covered by the audit. We also determined that the current collection rate for FY09 through April 2009 was 33%. We recommended that Finance staff work with CMPD's Animal Control staff to begin utilizing the North Carolina Debt Set-off Program. This state program attaches our claims to citizens' income tax refunds, and therefore can increase the City's revenues. Finance and Animal Control staffs have agreed. We also made minor recommendations to Animal Control staff which can improve their process controls.

> *Update:* Animal Care and Control (ACC) began utilizing the NC Debt Setoff Program in April 2010. ACC will continue utilizing a collection agency for the first 90 days a citation is overdue.

Accounts Receivable Write-Off for Aviation (February 2010): We issued a final report relating to our review of past due Aviation accounts receivable totaling $251,794. The total includes $151,507 related to companies that filed for bankruptcy, plus other accounts that have become delinquent in paying facility rents or advertising charges. The past due invoices date from February 23, 2000 through January 14, 2008. The purpose of the audit was to determine if the accounts should be written off the accounts receivable subsidiary (detail) ledger, maintained by the Aviation Department, as well as the City's general ledger, maintained by the Finance Department. Of the total $251,794.20 requested for write-off, we concur that the uncollected invoices totaling $202,675.28 that have passed the three-year statute of limitations should be written off the City's accounts receivable ledgers. This total is net of $3,601.92 for recent payments received and other adjustments. Accounts totaling $45,517 have not reached the three-year statute of limitations, and Aviation is to consider sending most of those accounts to a collection

agency. Aviation will also determine whether utilizing the North Carolina Debt Setoff Program would be beneficial.

> *Update:* Aviation has addressed the accounts totaling $45,517 noted in the audit, placing about $23,000 with a collection agency. Of the remainder, approximately half was sent to the NC Debt Setoff Program, while half was written off.

Accounts Receivable Write-Off of Code Enforcement Citations (Health and Zoning Violations) (February 2010): We issued a final report concerning our review of this FY09 write-off request by the Finance KBU relating to unpaid citations issued during FY05 and FY06. The purpose of the audit was to determine if the accounts should be written off the City's accounts receivable ledger maintained by Finance. We also reviewed related transactions and internal controls. Due to the age of the citations being requested for write-off, i.e., all are past the three-year statute of limitations, we agree that uncollected FY05 and FY06 citations totaling $86,460 for Zoning and $28,695 for Health should be written off the City's accounts receivable ledger. We noted that a collection rate of approximately 20 percent for health citations and approximately 25 percent for zoning citations was obtained for the period covered by the audit. We also observed a low collection rate for more recent periods, e.g., for FY09. Accordingly, we included recommendations in the report aimed to increase the rate of collections, as follows:

- Current high-dollar citations should be subjected to collection attempts now, rather than waiting for new software.
- Finance staff and N&BS Code Enforcement staff should work together to begin utilizing additional collection options.

  Update: Finance activated new accounts receivable software in April 2010 that when fully customized will interface with a collection agency and NC Debt Setoff.

POLICE VICE

Police Vice Imprest (February 2010): It has been the CMPD's practice for many years to request an audit of its Vice Imprest Fund prior to obtaining replenishment. During calendar year 2009, Internal Audit conducted seven such reviews. Overall, we are satisfied with the level of controls in place related to the Police Department's Vice Imprest Fund. We recommended that Vice continue to monitor advances closely. The procedures instituted by the Vice and Narcotics Division have helped to ensure that most advances are returned within the time limits, and we are satisfied that the open cash advances are adequately controlled. The Police Chief and staff reviewed the report and had opportunity to provide comments. We are satisfied with the responses to our recommendations.

ANNEXATION

Private SWS Companies' Economic Loss – Amended for K&S Sanitation (August 2009): Internal Audit completed an audit of the addresses re-submitted by K&S Sanitation Service, Inc. The addresses are within the Providence/I-485 Area annexed by the City June 30, 2009. In its original May 2008 submittal, K&S incorrectly labeled some of its customers' dwelling types. We examined K&S' re-submittal and agreed with the corrections. The purpose of this audit was to determine the amount of economic loss to K&S, since K&S no longer services these customers.

The report, originally issued October 28, 2008, has been amended to include our audit and computation of the amount of the loss related to the K&S addresses. The impact of the corrections resulted in a payout due to K&S of $10,732.50.

FOLLOW-UP (Selected audits from FY09 are summarized in this section.)

PROCUREMENT

Procurement Audits – Interim Update to 2008 Reports (December 2009): We are conducting a follow up to the City-wide audit and consultant's study (Matrix) which we reported to Council in May 2008. Since that time, we have completed six KBU-specific audits and reviewed issues raised in the procurement audits completed in 2005 and 2007.

Our interim update noted that the City's procurement processes have improved measurably. The City continues to build upon its strengths, while also addressing important opportunities for improvement. Specific concerns raised included excessive reliance upon direct pays, and the avoidance of contracts for services.

> *Update:* A final report had been scheduled for FY10, but was delayed until FY11 as we focused on other priorities. We also will revisit two of the six KBUs noted, to ensure significant issues raised have been addressed. We will issue a report related to our BSS review in early FY11 and are planning to complete a review of Utilities later in FY11.

CATS CONSTRUCTION

FWA Direct Labor, Overhead and Fees (January 2009): This audit focused on the direct labor, overhead, and fee charges billed by The FWA Group (FWA), one of Parsons Transportation Group's (Parsons) subcontractors for the South and Northeast Corridor Light Rail Transit System projects.

For the audit period May 2004 through October 2005, FWA submitted 24 project-related invoices to Parsons totaling $1,318,899. We reviewed direct labor charges of $422,543 and overhead and fees of $271,253. We proposed disallowing $50,676 in questioned costs, or 7% of direct labor, overhead, and fee charges reviewed. We discussed our findings with FWA management, who did not agree with our conclusions. It is possible

that FWA will supply additional documentation to support some of these charges after CATS addresses our report findings with them.

Update: CATS met with FWA, and we await a report of negotiation status.

SIGNIFICANT AUDITS IN PROGRESS @ June 30, 2010

CATS Construction

- Following a meeting with CATS and Internal Audit, Neighboring Concepts has provided additional documentation which may result in adjustments to the disallowed amount originally cited in our draft report. We will continue to work with Neighboring Concepts to finalize this review.

- Other Direct Costs (ODCs) – We have initiated a review of the ODCs portion of STV North Carolina Inc.'s (STV) billings from July 1, 2007 through June 30, 2008 related to the South Corridor Light Rail Line and will continue to review those invoices.

Other Audits in Progress

- Prepared Foods Tax – The County collects this tax for the City, retains 3% for administration, and forwards the remainder to the City each month. We are reviewing the results of recent taxpayer audits performed by an independent auditing firm under contract to the County. Based on that review, we will determine what additional audit procedures are necessary by Internal Audit for this revenue source.

- Annexation Audits – Audits required for the proposed June 30, 2011 annexation are in progress or being completed for five private solid waste hauling companies and three volunteer fire departments.

- Stimulus Audit Work – Audit has reviewed ARRA reporting for the most recent quarter and all projects met the Federal deadline. The number of projects has almost doubled with the addition of the energy grant. Our quarterly reviews will continue until the ARRA projects are finalized. In addition, as part of our overall plan, we are in process of a more specific audit on the Muddy Creek project.

- Utilities Billing Review – Audit has been reviewing data and City actions related to the high usage spikes. A report will be issued in late July.

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