

**Examination of Allegations of Potential Fraud and Other  
Related Issues Regarding Procurement Practices of  
Lexington-Fayette Urban County Government**



**CRIT LUALLEN**  
**AUDITOR OF PUBLIC ACCOUNTS**  
[www.auditor.ky.gov](http://www.auditor.ky.gov)

**209 ST. CLAIR STREET**  
**FRANKFORT, KY 40601-1817**  
**TELEPHONE (502) 564-5841**  
**FACSIMILE (502) 564-2912**



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**List of abbreviations/acronyms used in this report**

<b>ACFE</b>	Association of Certified Fraud Examiners
<b>APA</b>	Auditor of Public Accounts
<b>CAO</b>	Chief Administrative Officer
<b>CDBG</b>	Community Development Block Grant
<b>Central Purchasing Council</b>	Division of Central Purchasing Urban County Council
<b>DOI</b>	Kentucky Department of Insurance
<b>FRA</b>	Fraud Risk Assessment
<b>KLC</b>	Kentucky League of Cities
<b>KLCIS</b>	KLC's Insurance Services
<b>LFUCG</b>	Lexington-Fayette Urban County Government
<b>LLRMI</b>	Legal Liability Risk Management Institute
<b>PEPIP</b>	Public Entity Property Insurance Program
<b>RFP</b>	Request for Proposal
<b>SIR</b>	Self Insured Retention
<b>TPA</b>	Third Party Administrator
<b>US&amp;C</b>	Underwriter's Safety and Claims







CRIT LUALLEN  
AUDITOR OF PUBLIC ACCOUNTS

October 4, 2010

The Honorable Jim Newberry, Mayor  
Lexington-Fayette Urban County Government  
200 East Main Street  
Lexington, Kentucky 40507

RE: Examination of Allegations of Potential Fraud and Other Related Issues Regarding Procurement Practices of Lexington-Fayette Urban County Government (LFUCG)

Dear Mayor Newberry:

The enclosed report, *Examination of Allegations of Potential Fraud and Other Related Issues Regarding Procurement Practices of Lexington-Fayette Urban County Government*, contains our observations, analysis, findings, and recommendations related to the fraud allegations made public in May 2010. The report offers specific recommendations to improve and strengthen: the communication of allegations of fraud to the Internal Audit Board, LFUCG, and the Council; the processes to maintain confidential complaints; the oversight, bylaws, and structure of the Internal Audit Board; and the consistency and transparency of procurement policies.

This examination included procedures to determine whether: evidence of fraud or improper activities existed related to the procurement of LFUCG insurance; the review by the external and internal auditors of allegations was appropriate; and the insurance procurement process complied with required policies. Our examination procedures included interviews of over 40 individuals and reviews of thousands of documents including emails, policies, auditing standards, board minutes, and state law.

The Auditor of Public Accounts requests a response from LFUCG on the implementation of audit recommendations within 60 days of the issuance of the final report. If you wish to discuss this report further, please contact Brian Lykins, Executive Director of the Office of Technology and Special Audits, or me.

We greatly appreciate the courtesies and cooperation extended to our staff during the audit.

Respectfully submitted,

A handwritten signature in black ink that reads "Crit Luallen".

Crit Luallen  
Auditor of Public Accounts







## **Examination of Allegations of Potential Fraud and Other Related Issues Regarding Procurement Practices of Lexington-Fayette Urban County Government**

### **Examination Objectives**

On June 3, 2010, the Auditor of Public Accounts (APA) announced that based on information received by this office and requests by the Director of Internal Audit and the Mayor for the Lexington-Fayette Urban County Government (LFUCG), we would conduct an independent examination of questions raised by a city employee's allegation concerning procurement issues. The State Auditor also spoke with the LFUCG Vice-Mayor regarding the Urban County Council's (Council) plan to create a Special Investigative Committee to look into these issues. The APA initiated an examination of the allegations, the process used by the external and internal auditors to review those allegations, and the procurement process for insurance services. To accomplish this examination, the APA developed the following objectives:

- Examine the allegations presented and questions raised regarding the fiscal year (FY) FY 2008 and FY 2009 external audit along with any supporting documentation or information, to determine if there is any evidence of fraud or improper activities.
- Examine the LFUCG external and internal auditors' review of the allegations to determine if the process used was appropriate and followed all required procedures and standards.
- Examine the LFUCG procurement process related to excess insurance services, including contracts with insurance brokers and agents, insurance carriers, and third party administrators (TPA). Determine if the procurement process complied with any required policies and if improvements to the procedures could be made.

To address these objectives, the APA interviewed over 40 individuals, including: the LFUCG Mayor and management, current and former employees, current and former Council members, Internal Audit staff and Board members, LFUCG external auditors, Kentucky League of Cities (KLC) employees, LFUCG vendors, and others. Thousands of documents, including emails and policies, were supplied by the LFUCG staff and the employee making the allegations. These and other

documents were reviewed and analyzed to address the issues raised by the employee and to respond to other questions presented to this office during the course of the examination. The time period of most documents and correspondence reviewed was from July 1, 2007 to the present date; however, certain documents and various issues discussed with those interviewed are from an earlier time period.

### **Background**

LFUCG is an urban county form of local government as authorized by KRS Chapter 67A, operating with the powers and responsibilities of both a county and a city of the second class. The Mayor administers the executive functions of government and is elected to serve a four-year term. The Council serves as the legislative body and is comprised of 15 members that includes the Vice-Mayor. Twelve Council members are elected by district and serve two-year terms, while three at-large members are elected by the entire county and serve four-year terms.

The Mayor is currently assisted in administering the executive branch by three senior advisors and seven department commissioners, each of whom is appointed by the Mayor. The seven departments are each divided into divisions, which are managed by directors. These directors are civil service employees and not subject to political appointment or removal.

### **LFUCG's Division of Risk Management**

The Office of Risk Management was originally created in 1983 by Ordinance No. 145-83 and placed in the Department of Finance to manage its self-insurance programs. In 1985, it became the Division of Risk Management. From 1986 to 1996, the Division of Risk Management was placed in various departments, ranging from Administrative Services, Department of Personnel, Department of Insurance and Human Resources, and then back to the Department of Administrative Services in 1997. The divisions in the Department of Administrative Services reported directly to the Chief Administrative Officer (CAO), who reported directly to the LFUCG Mayor. For ten years, this was the structure under which the Division of Risk Management operated and it was directly

responsible for administering the LFUCG self-insurance program, claims management, and safety programs.

In May 2007, the new LFUCG administration recognized the need to change the reporting structure so that all directors reported to a commissioner instead of solely to the CAO. This was accomplished through a reorganization that went into effect on July 1, 2007. The reorganization placed the Division of Risk Management under the Department of Law. On July 8, 2008, the Division of Risk Management was placed under the Department of Finance and Administration, but the administration of the self-insurance program and claims management remained with the Department of Law. In April 2010, the Director of Risk Management was informed that his position would be eliminated as part of the proposed budget.

### LFUCG Self-Insurance Fund

LFUCG operates a self-insurance fund for workers' compensation, property and casualty, general liability, health, dental, and vision care programs. Self-insurance means that a certain amount of funds are set aside and maintained by LFUCG to pay for any future claims or losses that may occur. LFUCG mitigates financial losses for the workers' compensation, property and casualty, and general liability programs by purchasing reinsurance from a commercial insurance carrier. This reinsurance is also referred to as excess insurance coverage and begins paying for LFUCG claims at a predetermined dollar amount. The commercial excess insurance would begin to cover LFUCG claims and losses at the amount above the self insured retention (SIR). The SIR is set based upon the amount negotiated in the contract between LFUCG and the excess insurance carrier.

LFUCG retains staff to administer some aspects of the self-insurance program, but it contracts with vendors to be TPAs for certain services such as claims adjusting. In the past, LFUCG has paid for these TPA services through either a separate contract or as a service bundled with an excess insurance contract. For the health, dental, and vision care programs, a third party vendor provides all administration services with no duties performed by LFUCG staff.

### Analysis of Director of Risk Management Observations

During an initial interview on June 10, 2010, with the Director of Risk Management to discuss his concerns regarding the potential for fraud, we requested the Director document and submit to us the specific actions he believed may constitute fraudulent activity. This request was made due to the volume of documents he provided to us during our initial interview and our

desire to understand those issues he thought may have resulted in fraud. Our office had received and reviewed the Fraud Risk Assessment (FRA) questionnaires at that point, but thought it necessary to clarify specifically what actions the Director believed constituted fraud.

On June 14, 2010, we received a memorandum from the Director containing 11 "observations" detailing those actions he believed may have been fraudulent. The majority of the "observations" he provided were similar to issues raised in the FY 2008 and FY 2009 FRA questionnaires the Director submitted to the external auditors. Other specific items included in the "observations" were not expressed in either the FY 2008 or FY 2009 questionnaire.

In the full report, we present each of the 11 "observations" provided by the Director of Risk Management to our office, along with a summary analysis of each observation. In some instances, an observation may include several issues rather than just one issue. We also include an analysis of an additional issue raised in the FY 2009 FRA questionnaire that was not included in the 11 "observations."

Based on over 40 interviews and the extensive review of thousands of documents related to the 11 "observations" and FRA questionnaires, we found no evidence to suggest fraud occurred, or any indication of misrepresentation or concealment of material facts.

### Questions Related to Insurance Procurement and Fraud Allegation Review Process

This office was specifically requested to address certain questions related to the city's insurance procurement and the process used to review the fraud allegations. The following are our responses to specific questions we were asked to address:

#### **Question 1: Was purchasing insurance through KLC a better deal for LFUCG?**

It is not possible for the APA to determine if the decision to purchase insurance through KLC was a better decision than to continue insurance services with the previous insurance vendors. Purchases for professional services such as insurance are not typically evaluated based solely on lowest price, but rather the lowest evaluated price, also known as "best value." Evaluating proposals based on best value means that a number of different factors are included in the decision-making process with price being only one of them. Based on this, it appears that as long as the procurement methods employed are appropriate and within the confines of all laws and policies, it is incumbent on management and the Council to determine which proposals are going to be of greatest benefit to LFUCG.

**Question 2: Was the Internal Auditor’s review of the FY 2009 FRA questionnaire sufficient?**

According to the Director of Internal Audit, he and the Deputy Director conducted a preliminary review of the information contained in the 2009 FRA questionnaire to determine if there was predication for further review of the issues. He stated that it was their professional judgment during this process that proper predication did not exist; thus, upon making this determination, it was determined that a full fraud examination would not be conducted.

Based on our review of the Internal Auditor’s working papers and the process followed in considering these issues, we believe that although the procedures followed to conduct a preliminary review may vary based on professional judgment, the approach taken was sufficient to lead the Director and Deputy Director of Internal Audit to a reasonable conclusion to not proceed into a full fraud examination.

**Question 3: Who had custody of the FY 2008 and FY 2009 FRA questionnaires completed by the Director of Risk Management?**

In addition to three Risk Management staff recalling having either seen the documents or hearing the Director of Risk Management speak of completing the documents, we found only a few individuals actually had a complete copy of either the FY 2008 or FY 2009 questionnaires until after April 2010. Prior to April 2010, the only individuals to have an actual copy of the FY 2008 FRA questionnaire were the Director of Risk Management and the external auditor. As for the FY 2009 FRA questionnaire, prior to April 2010, the only individuals to have a copy of the complete FY 2009 FRA questionnaire were the Director of Risk Management, the external auditor, and the internal auditor. Beginning in April 2010, the following had complete copies of the FRA questionnaires: the Director of Risk Management’s two attorneys, a Council member, the LFUCG Special Investigative Committee, and the APA. The Director of Risk Management provided a copy of the FRA questionnaires to a LFUCG staff attorney and Commissioner of Finance and Administration; however, it is our understanding that they did not read the questionnaires. The Commissioner of Law received a redacted version of the FY 2009 questionnaire on September 30, 2009.

**Question 4: How was the identity of the employee making the allegations of potential fraud made known to LFUCG management, internal audit, and Council?**

The LFUCG employee that completed the FRA questionnaire had already expressed similar opinions related to the procurement of insurance either through

private discussions with other LFUCG management personnel as well as in staff meetings. Related to the FY 2009 FRA questionnaire, the employee informed the Director of Internal Audit that he had expressed concerns to the external auditors and they would probably be discussing them with him. In both FY 2008 and 2009 financial audits, the contact person for the financial audits felt they were already aware of the employee’s issues and thought that any evidence of fraud would have already been reported to them or the Council by the employee. In April 2010, the LFUCG employee contacted a Council member that his job was being eliminated because of his submission of the FRA questionnaire.

**Findings and Recommendations**

**Finding 1: The Senior Advisor for Management was not required to inform an employee that he was the subject of a preliminary investigation for possible fraud allegations.**

The Senior Advisor for Management informed the Commissioner of Law about a preliminary review conducted by the Office of Internal Audit even though there was no requirement to do so. The Commissioner of Law then filed an Open Records request with the Director of Internal Audit to inspect and make copies of any and all documents relating to this investigation. The Director of Internal Audit was instructed by a LFUCG staff attorney that, pursuant to KRS 61.878(3), he must provide the documentation and that no names should be redacted. Even though state law allows this documentation to be provided once requested, there was no requirement or procedure established that the subject of a preliminary review conducted by the Office of Internal Audit should be notified. In addition, it is questionable whether the identity of the LFUCG employee should have been redacted due to the confidentiality promised by the external and internal auditors when the FRA questionnaire was submitted.

**Recommendations:** We recommend LFUCG develop procedures as to when and how information provided in a confidential manner to the external or internal auditors should be reported, and to which entities and persons. Confidential allegations found not to be credible, should not be reported to the individual against whom the allegations were made so that the issue of retaliation never arises. When responding to an Open Records request from a “public agency employee” for records related to him or her, further legal analysis should be conducted before deciding whether the names and identifying information of the persons making documented allegations of fraud who are promised confidentiality and who may have a reasonable expectation of privacy should be redacted from the documentation provided.

To address communications of fraud allegations from external auditors, the LFUCG audit contact person should inform the external auditors that any fraud allegations go directly to the Director of Internal Audit without any additional information being provided to the contact. Documentation should be maintained of the issues received by Internal Audit. Under this method, information will be reported to the Internal Audit Board that is made up of individuals from LFUCG senior management and Council members. See Finding 4. This will allow members from management and its legislative oversight entity to be involved in the investigation and conclusion. Voting and ex-officio members of the Internal Audit Board should sign confidentiality statements before serving in this capacity. Information reported to the Internal Audit Board should not be reported to other members of management or Council even if it relates to that individual.

**Finding 2: The external auditors released the Director of Internal Audit's conclusion memo to a Council member without redacting the name of the LFUCG employee.**

Due to an information request from a LFUCG Council member, the external auditors provided the September 22, 2009, preliminary review conclusion memo that was written by the Director of Internal Audit to the Director of Risk Management. The release of this memo publicly identified that an employee brought issues of fraud to the external auditors and provided the name and position of the employee. By providing this memo to be inspected by a Council member, this issue was then discussed in open Council meetings because it was no longer considered confidential. The release of this memo also led to critical comments regarding the Office of Internal Audit during a public meeting.

**Recommendations:** LFUCG should develop procedures to inform the Council of confidential issues brought to the attention of the external auditors through closed meetings as appropriate so that private or critical information that could result in an employee disciplinary action is not discussed publicly. A procedure should be established for possible fraud allegations to be communicated to the Office of Internal Audit for disclosure to the Internal Audit Board.

**Finding 3: The Internal Audit Board was advised that closed meetings could not be conducted to discuss confidential issues.**

Based on legal advice from a staff attorney in the LFUCG Department of Law, the LFUCG Internal Audit Board was advised that it cannot go into a closed meeting, which has led to the lack of discussion by the full Board of confidential allegations made by an employee in a FRA questionnaire. To address confidentiality issues, the October 7, 2003 Internal

Audit Board meeting minutes document that it was decided the Director of Internal Audit would consult only the Board Chair to "keep it confidential from the individuals involved in the audits." According to interviews with former Board members, this practice was developed because the Board did not feel at liberty to discuss, in an open meeting, allegations that could "defame" an LFUCG employee. Because the preliminary review of the FRA questionnaire was found not to substantiate the allegations of fraud, the issue was not brought to the attention of the full Board at an open meeting. The Office of Internal Audit's inability to provide full disclosure and discuss confidential issues with the Board should be addressed so that the Board can be aware of issues affecting LFUCG.

**Recommendations:** Based on the reasoning in OAG 01-OMD-18 and in consultation with the Office of the Attorney General, we recommend the full Internal Audit Board be informed in a closed session of allegations that come to the attention of Internal Audit, provided that the discussions might lead to disciplinary measures being taken against an LFUCG employee. In addition, we recommend the Board obtain independent legal counsel when dealing with matters that may create a conflict of interest for employees within the Department of Law. In conjunction with the recommendations for Finding 4, we recommend that a confidentiality statement be signed by all members to ensure confidentiality when needed to allow for full disclosure to the Board members.

**Finding 4: The Office of Internal Audit is organizationally independent within LFUCG but the Internal Audit Board has not established operating procedures.**

The placement of the Office of Internal Audit meets the Institute of Internal Auditor's standard for organizational independence. However, its governing body, the Internal Audit Board, has not established bylaws under which to operate that are subject to Council approval. Even if changes are made to the membership of the Internal Audit Board, the organizational placement should not change.

**Recommendations:** We recommend that LFUCG consider amending Ordinance No. 63-2002 to expand the number of Internal Audit Board members by increasing the number of members from the community at large, with the goal that a majority be constituted by the community at large members. This will also assist in achieving a quorum at Board meetings and will allow for more independence. If the ordinance is amended as recommended, the majority of the members will be from the community at large, yet there will still be direct input from Council and administration members. The additional Board members should be recommended by the majority of the Council, appointed by the Mayor, and approved by the majority of the Council. We

recommend the amended ordinance address the process to follow if the Mayor does not appoint a Council recommendation to the Internal Audit Board. This process could allow for the Council to approve the appointment by a two-thirds majority vote. We recommend the amended ordinance limit the number of consecutive terms that voting Board members and the Board Chair can serve, as well as, criteria under which a Board member can be removed. In addition, we recommend the amended ordinance specify that the Board select the Chair from the community at large members.

The LFUCG Internal Audit Board should adopt bylaws and rules that reflect Ordinance No. 63-2002 or any amendments. Bylaws should also address confidentiality issues, conflicts of interest, criteria for entering into a closed session, and any action necessary to consistently “supervise, coordinate, evaluate, monitor, and implement the internal audit function.” To ensure the Council’s knowledge and acceptance and to comply with Ordinance No. 63-2002, the bylaws and rules should be presented for Council approval. The bylaws should also require the Internal Auditor to periodically report audit findings and other issues to the Council’s Budget and Finance Committee, or other committee as desired by the full Council.

**Finding 5: LFUCG has no established method for employees and citizens to anonymously report issues of concern.**

LFUCG has a very detailed Ethics Act that addresses complaints and retaliation, but it does not provide a process for employees or citizens to report anonymous complaints without fear of retaliation. KRS 61.102 provides for public agency employees to bring forward reports or complaints without fear of retaliation or reprisal. During the FY 2009 financial audit, the external auditors noted the lack of a process for filing anonymous complaints and suggested that a process be established. Louisville Metro Government has developed the Louisville Metro Ethics Tipline to allow employees and citizens a method to confidentially report concerns. LFUCG has not acted to develop this or another process for an employee or other person to report complaints or concerns in a confidential manner that addresses the issue of retaliation.

**Recommendations:** LFUCG should implement a process to receive, distribute, investigate, and resolve anonymous concerns from its employees and citizens. The reporting method used to accomplish this reporting could be a third party vendor, tipline, email, or a mailing address. This function should be assigned to a specific entity within LFUCG to administer and distribute concerns for investigations. The Internal Audit Board should be informed of complaints received, how they were reviewed, recommendation as

to whether a full investigation should be initiated, and the final resolution of each complaint. Documentation should be maintained representative of each complaint received, the date it was shared with the Board, and the resolution of the complaint. This method would ensure that the Internal Audit Board would be knowledgeable of the complaints and would expedite a vote on which issues to investigate further.

**Finding 6: The Office of Internal Audit did not establish policies or procedures regarding employee complaints or concerns unless provided in the form of a “special request.”**

As discussed in Finding 3, the Office of Internal Audit Policies and Procedures Manual did include procedures for actions to be taken by the Director of Internal Audit when receiving a special audit request. However, audit requests come in many forms and it was not clear in the procedures what exactly constitutes a special request for audit. In addition, this procedure did not address who should receive confidential reports from the external auditors and the process that should be followed to address requests or information from external auditors. Also, it appears that the Administration, Council, or LFUCG employees may not be aware of the process outlined in the Internal Audit Policies and Procedures Manual to request special internal audit services.

**Recommendations:** The Office of Internal Audit should develop policies, rules, or procedures to address concerns, issues, or potential fraud allegations reported by external auditors, anonymous complaints, and others. To ensure all parties have a clear understanding, policies should clearly define what constitutes a special request for audit services and provide procedures detailing how those requests will be communicated and reviewed. A process should be developed to ensure appropriate communication to the Internal Audit Board and to protect a complainant’s confidentiality, unless otherwise required by law to disclose this information. Any potential limitations of confidentiality should be explained to the complainant. For anonymous concerns, a method to receive and track complainants in order to obtain additional information should be included in the procedures.

All the policies, rules, or procedures should be submitted to the Council for review and approval as required by the Charter of the Office of Internal Audit. Approved procedures for submitting complaints or concerns to the Office of Internal Audit should be communicated to the Administration, Council, and LFUCG employees. These procedures should include the specific method(s) to make a complaint, i.e. email, phone, meeting, or other.

**Finding 7: Procurement policies have no clear hierarchy of authority, occasionally conflict, and have not been approved by Council.**

LFUCG currently uses three separate procurement policies which present various concerns including: unclear lines of authority and conflicting policies that allow for alternate processes to procure services. In addition, no procurement policies have been approved by Council as required by state law. Given that two different administrative authorities have issued procurement policies, there appears to be at least some conflict or confusion regarding the ultimate authority for issuing procurement policy. This situation is compounded by the fact that the Council has never approved procurement procedures or adopted them as part of an administrative code, even though it is required by KRS 68.005 and 67.712(2). The result is procurement practices with no direction or approval from the legislative body of LFUCG, and potentially confusing procurement policies that could result in haphazard procurement administration.

**Recommendations:** LFUCG should reevaluate both the CAO Policy #1 and the Division of Central Purchasing Policies and Procedures. It should be determined whether the CAO Policy #1 should continue, and if so, changes should be made to ensure a more transparent process that defines when CAO Policy #1 can or should be used instead of using the policies established by the Division of Central Purchasing.

The Council should develop and adopt procurement procedures as part of the LFUCG Code of Ordinances. These procedures should reflect the best practices accepted by professional procurement associations and provide a clear directive to administrative staff. This may include the adoption of the local public agency portion of the Model Procurement Code at KRS 45A.343-KRS 45A.460, but at a minimum should include requirements in KRS 45A.360(1): conditions and procedures for delegations of purchasing authority; prequalification, suspension, debarment, and reinstatement of prospective bidders; modification and termination of contracts; conditions and procedures for the purchase of perishables and items for resale; conditions, including emergencies, and procedures under which purchases may be made by means other than competitive sealed bids; rejection of bids, consideration of alternate bids, and waiver of informalities in offers; confidentiality of technical data and trade secrets information submitted by actual and prospective bidders or offerors; partial, progressive, and multiple awards; supervision of store rooms and inventories, including determination of appropriate stock levels and the management, transfer, sale, or other disposal of government-owned property; definitions and classes of contractual services and procedures for acquiring them; procedures for the verification and

auditing of local public agency procurement records; and, annual reports from those vested with purchasing authority as may be deemed advisable.

The Council should ensure the authority for procurement oversight is clearly defined within the administrative structure to ensure there is no confusion or conflict within the delineation of oversight and authority.

**Finding 8: No consistent procurement method was used for purchasing insurance broker services.**

The procurement of insurance broker services by LFUCG was not conducted using a consistent procurement methodology over the last nine years. These broker services were acquired using two different procurement methods, alternating every few years. Each of these methods is allowable under the procurement policies currently used by LFUCG, but they employ entirely different concepts for purchasing services. One procurement method is openly competitive to any potential vendors, while the other does not require any form of competition or include more than one vendor in the process. As the nature of an insurance broker service has not changed over time, it is not clear why such different procurement methods have been employed as it appears that a vendor could receive some form of special treatment. It may also prevent LFUCG from receiving the benefits of a competitive process.

While LFUCG was not obligated by either state law or LFUCG procurement policies to purchase insurance broker services using a competitive bidding process, varying the procurement method over the last nine years suggests some confusion and a lack of sufficient planning by administrators as to determine the most efficient methods to purchase insurance services. This may be due in large part to the somewhat disjointed authority over the procurement of professional services.

**Recommendations:** A consistent, transparent method of procurement should be adopted to alleviate any potential appearance of special treatment for any particular vendor. LFUCG should consistently employ a competitive procurement method, when possible. We recommend a schedule of activity be developed to assist in properly planning for the procurement process ensuring that sufficient time is allocated to accomplish the process. Also, see recommendations for Finding 7.

**Finding 9: LFUCG does not use a quantitative scoring method for competitively bid vendor proposals.**

LFUCG procurement practices for competitive bidding do not use a documented quantitative scoring method to evaluate vendors' bid proposals. A scoring method for choosing a vendor is required by LFUCG Procurement



Regulations, but was not implemented in LFUCG practices or the Division of Central Purchasing Policy Manual. Instead, the current practice uses an evaluation method that is more subject to the personal preferences of those reviewing proposals.

**Recommendations:** LFUCG should develop a consistent policy that will more clearly require a documented quantitative evaluation method of vendor proposals during a competitive bidding process. Policies should also detail the responsibility to assemble an evaluation team and the representation to be included on the evaluation team. To ensure transparency, we recommend the process followed by the evaluation team, including the team selection, instructions, member evaluations, and final selection be carefully documented. All procurement policies should be adopted by the Council as part of the Administrative Code as referenced in Finding 7.



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## Chapter 1

# Introduction and Background

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### Scope

On June 3, 2010, the Auditor of Public Accounts (APA) announced that based on information received by this office and requests by the Director of Internal Audit and the Mayor for the Lexington-Fayette Urban County Government (LFUCG), we would conduct an independent examination of questions raised by a city employee's allegation concerning procurement issues. The State Auditor also spoke with the LFUCG Vice-Mayor regarding the Urban County Council's (Council) plan to create a Special Investigative Committee to look into these issues. The APA initiated an examination of the allegations, the process used by the external and internal auditors to review those allegations, and the procurement process for insurance services. To accomplish this examination, the APA developed the following objectives:

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- Examine the LFUCG procurement process related to excess insurance services, including contracts with insurance brokers and agents, insurance carriers, and third party administrators (TPA). Determine if the procurement process complied with any required policies and if improvements to the procedures could be made.

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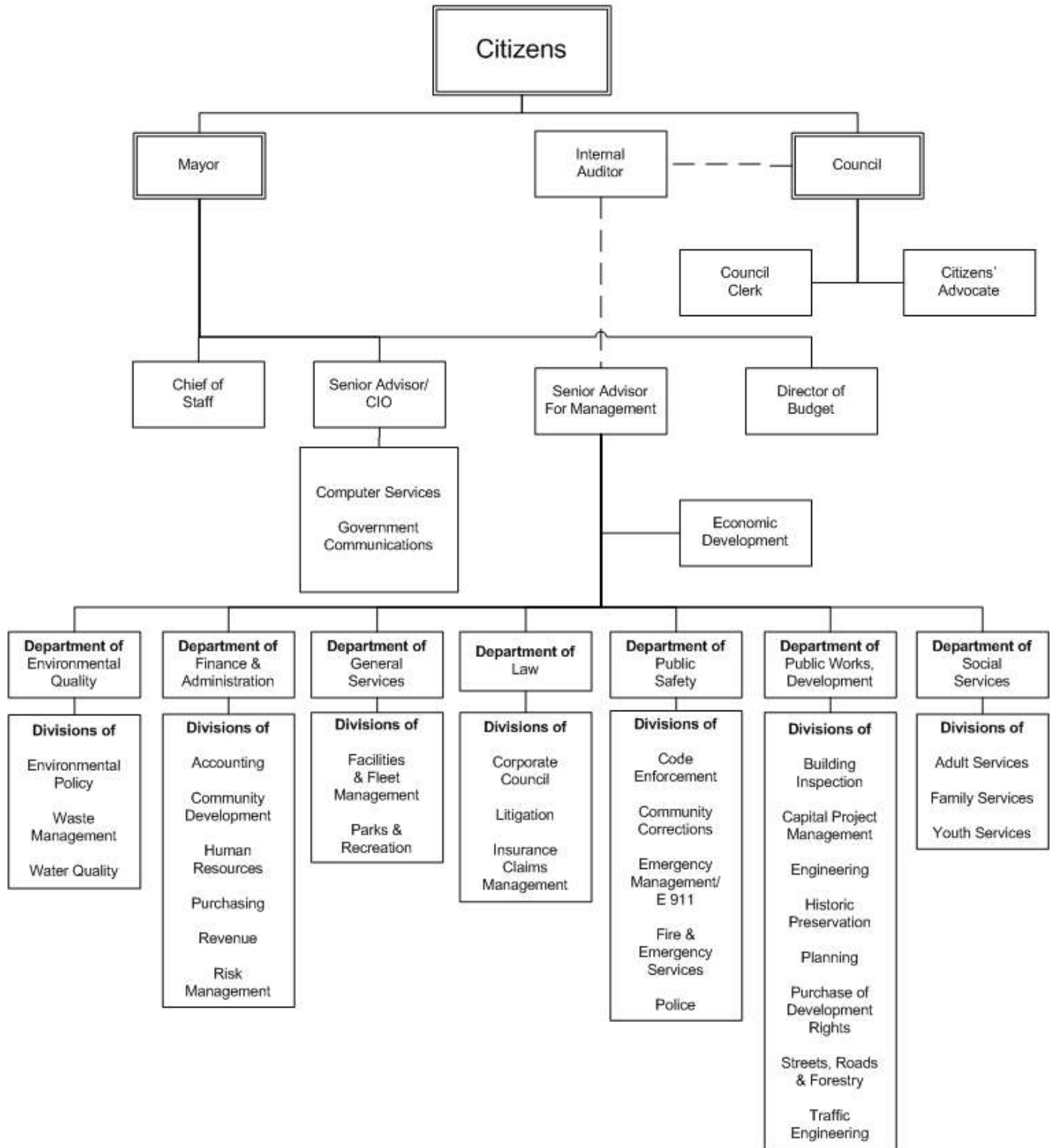
**Chapter 1****Introduction and Background**

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The Mayor is currently assisted in administering the executive branch by three senior advisors and seven department commissioners, each of whom is appointed by the Mayor. The seven departments are each divided into divisions, which are managed by directors. These directors are civil service employees and not subject to political appointment or removal.

The following organizational chart illustrates the current chain of command within the executive branch of LFUCG.

# Lexington-Fayette Urban County Government Organizational Chart



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The issues addressed in this examination were raised by the Director of Risk Management in the FY 2008 and FY 2009 Fraud Risk Assessment (FRA) questionnaires distributed by the LFUCG external auditors in accordance with Generally Accepted Auditing Standards in the performance of the annual financial audit. A more detailed description of the Division of Risk Management responsibilities is provided in the following section.

**LFUCG’s Division of Risk Management**

The Office of Risk Management was originally created in 1983 by Ordinance No. 145-83 and placed in the Department of Finance to manage its self-insurance programs. In 1985, it became the Division of Risk Management. From 1986 to 1996, the Division of Risk Management was placed in various departments, ranging from Administrative Services, Department of Personnel, Department of Insurance and Human Resources, and then back to the Department of Administrative Services in 1997. The divisions in the Department of Administrative Services reported directly to the Chief Administrative Officer (CAO), who reported directly to the LFUCG Mayor. For ten years, this was the structure under which the Division of Risk Management operated and it was directly responsible for administering the LFUCG self-insurance program, claims management, and safety programs.

In May 2007, the new LFUCG administration recognized the need to change the reporting structure so that all directors reported to a commissioner instead of solely to the CAO. This was accomplished through a reorganization that went into effect on July 1, 2007. The reorganization placed the Division of Risk Management under the Department of Law. After the reorganization, the following table outlines the changes that the Division of Risk Management has undergone.

**Table 1: Timeline of the Organizational Changes in the Division of Risk Management**

July 1, 2007	All Divisions reporting to the CAO are moved under a department effective this date through resolution 153-2007. As a result, the Division of Risk Management was placed under the authority of the Department of Law and reported to the Commissioner of Law.
February 22, 2008	An outside vendor was selected to perform an organizational review of LFUCG. The final report recommended that the Division of Risk Management be transferred to the Department of Finance and Administration, but the administration of the self-insurance program and claims management should remain the responsibilities of the Commissioner of Law.
July 8, 2008	Division of Risk Management was placed in the Department of Finance and Administration under the authority of the Commissioner through resolution 183-2008.  Resolution 183-2008 separated the Division of Risk Management as recommended by the management audit report.

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December 2008 (Approximately)	Per the former Commissioner of Finance and Administration, supervision of the Division of Risk Management was unofficially and temporarily placed back under the authority of the Department of Law to allow the former Commissioner of Finance and Administration time to focus on the implementation of LFUCG’s new accounting software. It was reported that the temporary transfer of supervision to the Department of Law occurred a couple of months prior to the Commissioner leaving LFUCG in February 2009.
October 2009	A new Commissioner of Finance and Administration was appointed. The Division of Risk Management was again placed under the authority of the Department of Finance and Administration. The functions related to the administration of the self-insurance program and claims management remained the responsibilities of the Commissioner of Law.
December 2009 through April 2010	The Commissioner of Finance and Administration performed an expense reduction exercise to address the budget decrease for FY 2011. According to the Commissioner, this exercise included analyzing job responsibilities. Her recommendations included the elimination of positions within the Division of Human Resources and the Division of Risk Management.
Apr. 13, 2010	The Commissioner of Finance and Administration and the Senior Advisor for Management met with the Director of Risk Management to explain the Mayor’s proposed budget and that his position will be abolished.

Source: Auditor of Public Accounts based on information and documents provided by LFUCG.

**LFUCG Self-Insurance Fund**

LFUCG operates a self-insurance fund for workers’ compensation, property and casualty, general liability, health, dental, and vision care programs. Self-insurance means that a certain amount of funds are set aside and maintained by LFUCG to pay for any future claims or losses that may occur. LFUCG mitigates financial losses for the workers’ compensation, property and casualty, and general liability programs by purchasing reinsurance from a commercial insurance carrier. This reinsurance is also referred to as excess insurance coverage and begins paying for LFUCG claims at a predetermined dollar amount. The commercial excess insurance would begin to cover LFUCG claims and losses at the amount above the self insured retention (SIR). The SIR is set based upon the amount negotiated in the contract between LFUCG and the excess insurance carrier.

Depending on various factors in obtaining insurance, such as market pressures and the claims history of LFUCG, the SIR can dramatically change over time. The following table illustrates how these LFUCG retention levels have changed over the last 10 years for insurance programs like automobile liability, general liability, and workers’ compensation. The SIR for automobile physical damage is \$100,000 and for property is \$250,000. Neither of these insurance types have undergone the noticeable changes seen in Table 2.

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**Table 2: LFUCG Self Insured Retentions from FY 2001 to FY 2011**

<b>Policy Period</b>	<b>Auto/General Excess Liability Insurance</b>	<b>Policy Period</b>	<b>Excess Workers' Compensation Insurance</b>
7/1/00 – 7/1/01	\$350,000	7/1/00 – 7/1/01	\$300,000
7/1/01 – 7/1/02	\$350,000	7/1/01 – 7/1/02	\$300,000
7/1/02 – 7/1/03	\$500,000	7/1/02 – 7/1/03	\$500,000
7/1/03 – 10/1/04	N/A*	7/1/03 – 7/1/04	\$500,000
10/1/04 – 10/1/05	\$1,000,000	7/1/04 – 7/1/05	\$500,000
10/1/05 – 10/1/06	\$1,000,000	7/1/05 – 7/1/06	\$750,000
10/1/06 – 10/1/07	\$1,000,000	7/1/06 – 7/1/07	\$750,000
10/1/07 – 11/1/08	\$1,000,000	7/1/07 – 7/1/08	\$750,000
11/1/08 – 11/1/09	\$1,500,000	7/1/08 – 7/1/09	\$750,000
11/1/09 – 7/1/10	\$2,000,000	7/1/09 – 7/1/10	\$750,000
7/1/10 – 7/1/11	\$2,000,000	7/1/10 – 7/1/11	\$750,000

Source: Information provided by the LFUCG Department of Law.

\* LFUCG had no excess liability insurance from July 1, 2003 to October 1, 2004.

As seen in Table 2, the SIR increased for these types of insurance. Most notable are the changes related to auto and general liability insurance. While a number of issues may factor into these changes, a restrictive market for excess liability insurance for local government entities is typically cited. An example of this is the period between July 2003 and October 2004 when LFUCG had no excess liability insurance coverage. The SIR did not apply at that time and the self-insurance fund retained all financial risk, with responsibility for all claims and losses. Unfavorable renewal terms offered by the market for casualty coverages was cited by the Director of Risk Management as the reason to forgo the excess coverage and to assume the risk.

LFUCG retains staff to administer some aspects of the self-insurance program, but it contracts with vendors to be TPAs for certain services such as claims adjusting. In the past, LFUCG has paid for these TPA services through either a separate contract or as a service bundled with an excess insurance contract. For the health, dental, and vision care programs, a third party vendor provides all administration services with no duties performed by LFUCG staff.

The following table provides a timeline of insurance services purchased by LFUCG since July 2006. The timeline includes only those insurances or insurance services that have historically been presented to the Council for formal action. For this reason, the timeline does not include the procurement of insurance services with premiums typically less than \$10,000.



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**Table 3: LFUCG Insurance Procurement Timeline**

June 22, 2006	First and second reading and passage of resolution 415-2006 to renew contracts for FY 2007 through Marsh USA, Inc. with USF Insurance Co. for Fourth of July special events policy, General Star Indemnity Co. for special events excess liability policy, Midwest Employers Casualty Co. for excess workers' compensation, ACE USA for International Package insurance and Factory Mutual for excess property insurance.
July 1, 2006	LFUCG enters into a three-year Client Service Agreement with Marsh USA, Inc. to act as a risk management advisor, consultant and insurance broker. Agreement approved through resolution 218-2006 on April 25, 2006. Agreement to run July 1, 2006 through June 30, 2009 with an option to renew for two additional years.
September 14, 2006	First reading of resolution 578-2006 to renew contracts through Marsh USA with The Insurance Company of Pennsylvania (AIG) for excess general liability, excess automobile liability, excess public official's liability, and excess terrorism liability insurance. Insurance coverage for the term October 1, 2006 through October 1, 2007.
September 28, 2006	Second reading and passage of resolution 578-2006.  First reading of resolution 606-2006 to contract with Marsh USA for Aviation Liability insurance for Police helicopter with ACE Insurance Co. Insurance for the term October 21, 2006 through October 21, 2007.
October 5, 2006	Second reading and passage of resolution 606-2006.
October 19, 2006	First and second reading and passage of resolution 630-2006 to contract with Everest Indemnity Insurance Co. for asbestos liability insurance coverage through Marsh USA for the term October 16, 2006 through October 16, 2007.
June 7, 2007	First reading of resolution 311-2007 to renew contracts for FY 2008 through Marsh USA, Inc. with USF Insurance Co. for Fourth of July special events policy, General Star Indemnity Co. for special events excess liability policy, Midwest Employers Casualty Co. for excess workers' compensation, ACE USA for International Package insurance and FM Global for excess property insurance.
June 21, 2007	Second reading and passage of resolution 311-2007.
July 24, 2007	Marsh contacts KLC to solicit a quote for LFUCG for its excess liability program that expires with AIG on October 1, 2007.
August 23, 2007	KLC presents quote to Commissioner of Law, Director of Risk Management, various Risk Management personnel, and representatives of Marsh USA.

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September 11, 2007	Commissioner of Law presents Insurance resolution to the Council during Council Work Session. Passed with one nay vote. Motion is made to place the insurance issue into the Intergovernmental Committee. This motion failed by a vote of 11-3.
September 13, 2007	First reading of resolution 463-2007 for the procurement of excess general liability, excess automobile liability, excess public official’s liability and excess law enforcement liability. Insurance to be provided through KLC from ACE Insurance Company for the term October 1, 2007 to October 1, 2008. KLC’s proposal included loss control, appraisal, and TPA services.
September 27, 2007	Second reading and passage of resolution 463-2007 referenced above.
October 18, 2007	First reading of resolution 574-2007 to procure aviation liability insurance through Marsh USA from ACE USA for the period October 21, 2007 through October 21, 2008 and asbestos insurance coverage through Marsh from Everest Indemnity Co. for the period October 16, 2007 through October 16, 2008.
November 1, 2007	Second reading and passage of resolution 574-2007 referenced above.
June 10, 2008	Recommendation made not to purchase separate special events insurance coverage. Documented in an email between the Commissioner of Law to a KLC employee. The email documents LFUCG’s “excellent loss experience” with festival exposure and its “non-aggregated policy in place” as basis for this recommendation.
June 26, 2008	First and second reading and passage of resolution 388-2008 for the procurement of excess workers’ compensation insurance through KLC from New York Marine, excess property insurance through KLC from Public Entity Property Insurance Program (PEPIP), and international package insurance through Marsh USA from ACE USA. Insurance coverage for FY 2009.  Resolution 388-2008 included cancelling LFUCG’s contract with Underwriter’s Safety and Claims (US&C) for workers’ compensation claims services.
July 1, 2008	LFUCG contract with Marsh for broker services cancelled effective July 1, 2008.
July 24, 2008	KLC announced as exclusive insurance broker with respect to the international, asbestos, aviation and other smaller insurance coverages by letter from LFUCG Claims Manager to various insurance companies.
August 14, 2008	First and second reading and passage of resolution 465-2008 for the procurement of workers’ compensation claims services for FY 2009 from Collins & Company, Inc., the third party claims administrator for KLC.
August 2008	ACE initiates a claims audit in advance of upcoming renewals for excess liability coverage.

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September 19, 2008	Email from ACE to KLC regarding LFUCG, documents ACE's concerns after recent review of LFUCG's loss history. The excess carrier is concerned by losses exceeding the \$1 million SIR, noting that many of the losses were not new, and given the size of the loss, should have been made known to the carrier previously. ACE indicates that they have no interest in renewing excess liability insurance coverage for FY 2009.
September 2008	ACE grants LFUCG a one month extension from October 2008 to November 2008, for its excess liability insurance.
October 2, 2008	First reading of resolution 605-2008 for the renewal of aircraft liability insurance through KLCIA from ACE USA for the term October 21, 2008 through October 21, 2009.
October 13, 2008	Claims Manager notifies Commissioner of Law via email that the asbestos removal group is no longer performing any outside removal projects; therefore, they would not be purchasing an asbestos policy for FY 2009.
October 23, 2008	Second reading and passage of resolution 605-2008.  First and Second reading and passage of resolution 612-2008 for the procurement of excess general liability, excess automobile liability, excess public official's liability and excess law enforcement liability insurance. Insurance to be provided through KLC from Insurance Company of the State of Pennsylvania (an AIG group) for the term of November 1, 2008 to November 1, 2009. SIR for excess general liability increased from \$1 million to \$1.5 million.
June 25, 2009	First and second reading and passage of resolution 467-2009 for the procurement of excess workers' compensation insurance through KLC from New York Marine, excess property insurance through KLC from PEPPI, and international package insurance through KLC from ACE USA for FY 2010.
August 27, 2009	First reading of resolution 588-2009 for the procurement of workers' compensation claims services for FY 2010 from Collins & Company, Inc.
September 3, 2009	Second reading and passage of resolution 588-2009.
October 15, 2009	First and second reading and passage of resolution 674-2009 for the procurement of excess liability insurances through KLC from Ironshore Insurance Ltd. for the term of November 1, 2009 to July 1, 2010.

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November 2, 2009	Central Purchasing approved and issued Purchase Order Number LF00065598 to renew a short-term aviation liability insurance policy to run 10/21/09 – 7/1/10. Renewal processed by KLC with coverage remaining with ACE American Insurance Co. Due to premium being \$13,066.58, under the \$20,000 threshold, the renewal did not go before the Council for approval.
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Source: Auditor of Public Accounts based on information and documents provided by LFUCG.

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## Chapter 2

# Observations and Questions

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### Introduction to Observations and Questions

In response to a difficult economy and diminishing revenues, LFUCG government, as have the majority of other state and local government entities at this time, has attempted to increase efficiencies and reduce expenditures. In an April 13, 2010 budget address before the Council, the Mayor presented a “Back to Basics Budget,” which “eliminates some expenditures which have been longstanding parts of LFUCG, but it focuses on maintaining basic services, especially in public safety.”

The Mayor’s proposal included various areas of efficiencies for the government, including the areas of Human Resources and Risk Management. According to the current LFUCG Commissioner of Finance and Administration, all Commissioners were tasked with taking a look at their own programs and identifying possible cost savings and efficiencies to bring to the Mayor as part of the initial budget process. The Commissioner of Finance and Administration stated that the proposal to eliminate positions in Human Resources and the Risk Management position were based upon her comprehensive review that included considering recent technology implementation, the recent reorganizations recommended as part of LFUCG’s management audit performed by an outside vendor, and current job duties of employees. Based on our understanding, the Commissioner of Finance and Administration was not aware at this time of the FRA questionnaires completed by the Director of Risk Management.

In May 2010, reports of potential fraudulent activity within LFUCG were raised publicly. Questions were asked regarding who may have been aware of fraud, when were those individuals aware of fraud or the potential of fraud, and what measures were taken to address those concerns.

On June 3, 2010, the APA announced that this office would conduct an independent examination of questions raised by a city employee’s allegations concerning procurement issues. As part of our examination at LFUCG, we were asked to review these questions and to determine if there is any evidence of fraud or improper activity.

During an initial interview on June 10, 2010, with the Director of Risk Management to discuss his concerns regarding the potential for fraud, we requested the Director document and submit to us the specific actions he believed may constitute fraudulent activity. This request was made due to the volume of documents he provided to us during our initial interview and our desire to understand those issues he thought may have resulted in fraud. Our office had received and reviewed the FRA questionnaires at that point, but thought it necessary to clarify specifically what actions the Director believed constituted fraud. On June 14, 2010, we received a memorandum from the Director containing 11 “observations” detailing those actions he believed may have been fraudulent. The majority of the “observations” he provided were similar to issues raised in the FY 2008 and FY 2009 FRA questionnaires the Director submitted to the external auditors. Other specific items included in the “observations” were not expressed in either the FY 2008 or FY 2009 questionnaire.

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To sufficiently document our review of the issues, and to answer the questions presented to our office by the administration, Council, and others, we have included this memorandum of “observations” provided to us by the Director of Risk Management as an exhibit to provide a context for our conclusions within this report. See Exhibit 3. The questions raised during this examination include, whether fraud existed and whether sufficient consideration was given to the issues raised in the questionnaires by both the external and internal auditors.

Our office received the FRA questionnaires from multiple sources including one source who did not request the documents remain confidential. Given the circumstances by which we received this copy of the questionnaires, together with the Director of Risk Management’s willingness to provide the APA with detailed observations of the allegations referencing the questionnaires, we chose to attach the questionnaires with the signature redacted. This allows for public transparency of the issues that were reviewed by this office and a Special Investigative Committee of the Council. The FY 2008 and FY 2009 FRA questionnaires are provided as Exhibits 1 and 2 of this report.

In this section of the report, we will present each of the 11 “observations” provided by the Director of Risk Management to our office and specific questions raised, along with a summary analysis of each observation. In some instances, an observation may include several issues rather than just one issue.

**Observation 1:**  
**“Excess**  
**AL/GL/POL**  
**Insurance**  
**Renewals for FY**  
**2008”**

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Issues identified within Observation 1 by the Director of Risk Management:

- “the Commissioner of Law chose to ignore the recommendation and various other positive factors related to the AIG policy (pricing, conditions, etc.) and proceeded to manipulate the final matrix to the degree that it clearly favored the KLC policy from ACE.”
- “the Commissioner of Law allowed KLC to dictate the conditions of the ACE policy. The LFUCG request in the insurance applications process requested a bundled and unbundled quote so that any additional services offered (Loss Control, TPA’s, etc.) could be evaluated on a comparative basis. This was not provided and KLC’s quotes were allowed to stand as presented.”
- “156 hours of the 1000 hours for loss control were used to train KLC employees in Legal Liability Risk Management Institute loss control for Police, Fire and Community Corrections.”

On July 2, 2007, members of the Division of Risk Management, held a teleconference with the LFUCG contracted broker to discuss the placement strategy for the upcoming insurance renewals, including excess auto liability, excess general liability, and political official’s liability for the period of October 1, 2007 through October 1, 2008. On August 17, 2007, the Director of Risk Management advised the Commissioner of Law of the July 2, 2007 meeting and presented him with the broker’s placement strategy letter developed as a result of that meeting.

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# Observations and Questions

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On July 24, 2007, the broker acting on behalf of its client, LFUCG, contacted the KLC to determine whether it was interested in providing an insurance quote for the upcoming excess liability insurance renewals for LFUCG.

Between July 24, 2007 and September 11, 2007, we identified numerous email messages documenting that substantial communication occurred between the broker, KLC, and various Division of Risk Management personnel, including the Director of Risk Management and the Commissioner of Law. Emails document that the Director of Risk Management directly requested KLC to present its quote through the broker and in an unbundled form.

The Director of Risk Management expressed to KLC, the Commissioner of Law, and others through an email on August 17, 2007, “it would be nice to conduct business with the KLC since they are in our back yard. However, Marsh is our exclusive broker of record for the coverages you are quoting and as such we would be in violation of our contractual agreement if we moved forward with this meeting.” Following this email, the Commissioner of Law questioned the use of the term “exclusive” because it was not found during his review of the current broker contract. While the Director of Risk Management stated that the term “exclusive” may have been left out of the broker contract, it was his belief that KLC was acting in an unethical manner by not working through the broker.

Later in the same email series on August 17, 2007, the Commissioner of Law states, “I have no problem with Marsh evaluating and advising us about KLC’s and everyone else’s proposal, I do not see how this violates any ethical rules. We can advise Marsh that we will have the meeting. In fact, it would suit me to have presentations from other companies as well.”

According to KLC officials, the reason for not sharing the information with the broker prior to presentation to LFUCG personnel was because they believed the broker would be giving a “last look” to the incumbent carrier, allowing the incumbent carrier to submit a lower offer than proposed by other carriers.

On August 23, 2007, KLC presented its proposal for excess insurances to the Commissioner of Law, various members of the Division of Risk Management, including its Director, and broker representatives. The proposal presented by KLC included 1000 hours of loss control, appraisal, and claims services provided by its TPA. The loss control, appraisal, and claims services were additional services offered by KLC that were not requested in the initial request for proposals by the broker, nor offered by the incumbent carrier.

Following the presentation, the broker and the Director of Risk Management, as well as two other Risk Management personnel, analyzed the documentation to provide senior management with a comparison of the two proposals.

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During the analysis process, the Director of Risk Management voiced concern to the Commissioner of Law regarding the financials of KLC. From interviews with various LFUCG Risk Management personnel, it is our understanding that an analysis of KLC's financials was performed to assist LFUCG in determining KLC's financial ability to meet its obligations as KLC was not rated with AM Best and was not supported by the State Guarantee fund. According to the Director of Risk Management in an email to the Commissioner of Law on August 31, 2007, the analysis of KLC's Insurance Services (KLCIS) identified that the KLC liability and property pools were losing members and its administrative costs were increasing from 2005 to 2006.

As we understand through our interviews with various LFUCG and KLC employees, the proposal presented by KLC for the excess insurances in the fall of 2007 was not a product supported by KLCIS as part of its insurance pools, but rather the proposal was a special package designed for LFUCG, with KLC providing loss control, appraisal, and TPA services and a separate carrier providing the excess insurance coverage; therefore, the issue regarding KLCIS and an AM BEST rating was not an issue. The carrier who provided the coverage and assumed the risk, did meet the requirement for an AM BEST rating. In addition, because KLC was not the carrier providing the excess insurance coverage, there would be no need for a cut-through endorsement as KLC would not need to be endorsed by the State Guarantee Fund.

On September 4, 2007, the Director of Risk Management submitted to the Commissioner of Law both an analysis from the broker and Risk Management for excess auto liability, excess general liability, and excess political official's liability, which included an executive summary prepared by the Director of Risk Management, and a spreadsheet prepared by the broker. At the end of the executive summary, the Director of Risk Management asked for "Senior Management's review and recommendation for excess Auto/General/Public Officials Liability Insurance for the period October 1, 2007 to September 30, 2008" based on the information provided in the analysis and summary.

On September 6, 2007, the broker emailed the Director of Risk Management to provide LFUCG with a matrix comparing seven areas of consideration between the two insurance proposals. In the email correspondence the broker representative states, "[w]hile there may be times when the best option is self-evident (for example, all terms, conditions, and services are identical but the cost of one program is \$2,000,000 less than the rest), there is generally not a "right answer" and only our clients can weigh the differences in the context of what is important to their organization/entity. In your case, the good news is that we have presented two good, albeit different, options for LFUCG to consider."



The broker representative further states that the attached matrix is “a short list (in no particular order) of what could be considered key points to help guide LFUCG in a decision.” The broker’s email, along with the new matrix, was forwarded to the Commissioner of Law shortly after it was received by the Director of Risk Management. In response, the Commissioner of Law requested the broker to provide a recommendation as to the best coverage, noting that the broker did not have difficulty in providing a recommendation for the workers’ compensation coverage earlier in the year.

On September 10, 2007, the broker emailed the Commissioner of Law and the Director of Risk Management to explain that the broker may have a conflict in making a recommendation as KLC was a client to the broker and there could be a perception that they favor KLC in making a recommendation. Following this statement, the broker representative states, “[b]oth are excellent programs. Which is a better fit depends on which criteria are most important to you all.” The broker representative states that the Director of Risk Management “has provided his thoughts regarding what terms and conditions are most important to LFUCG” and, “based on this information and what we understand the needs and priorities of LFUCG to be, the AIG program appears to better fit your needs.” However at the end of the email, the broker representative states, “[c]onversely, if you were to tell me that the cost differential is not an issue; that the Loss Control services proposed by KLC are needed; that LFUCG is not concerned about the potential for a large sexual abuse claim; etc., then KLC would be the better fit.”

Following this series of emails, the Commissioner of Law and the Director of Risk Management discussed revising the matrix to be presented to the Council. On September 10, 2007, the Director of Risk Management provided the Commissioner of Law the Division of Risk Management’s final analysis of the two proposals submitted for the excess liability insurances. See Exhibit 4. In a September 11, 2007 email, the Commissioner of Law states, “[p]lease revise your comparison handout to eliminate the issues we resolved yesterday.” He further stated, “[t]he handouts should reflect those savings we discussed yesterday so we are comparing apples to apples.” The Director of Risk Management indicates in his response that he has made the adjustments and “also provided some additional cost breakdown to show an adjustment for future broker fees that will more than offset the price difference of the AIG v. KLC quotes. This will provide an estimated future savings of \$14,971.” The Director of Risk Management then asks the Commissioner of Law, “[d]o you not want to count the value of the Loss Control Services to offset the cost of the overall quote? It is a service that you will be receiving that has value.”

During interviews with the Director of Risk Management, he stated that while he made the adjustments to the matrix that was presented to the Council on September 11, 2007, he did so because he felt “beat down” and ultimately went along with the changes that he made. See the final matrix presented to the Council on September 11, 2007 at Exhibit 5. While examining the emails provided by the Director of Risk Management and those provided by other LFUCG personnel, the emails indicate that the Director was actively participating in the adjustments by making additional recommendations to the Commissioner for ways to adjust the matrix.

The Director of Risk Management stated in his summary observations provided to the APA, “[f]urther the savings that was supposed to be realized by cutting Marsh’s contract (\$79,000, net \$76,000) in half never materialized. Marsh was paid its full fee for FY 2008. The advisory of Marsh earning its full fee for FY 2008 was given to the Commissioner of Law in an e-mail dated August 30, 2007 prior to the final matrix presentation.”

To support this statement, the Director of Risk Management provided our auditors with email correspondence that had been highlighted. The highlighted sentences in the correspondence provided by the Director of Risk Management states, “I believe we will owe them for this work as well as the recent rounds of marketing for AL/GL, along with their day to day consulting of the LFUCG account through the first quarter of this fiscal year. So we will not save \$80,000 this year.” However, in examining the full email correspondence and not just the highlighted sentences, we found that the Director did not clearly state that the full amount had been earned but rather indicated that the possibility still existed to pro-rate the cost to be incurred for broker services. The next two sentences following the highlighted section read, “[w]e already owe them for work performed. How much will depend on the pro rata discussions we have with them.”

Furthermore, on February 21, 2008, the Director of Risk Management stated in an email to the Commissioner of Law, “As part of the justification for going with KLC last year, you asked me to provide you with areas where we could possibly cut cost so that we could afford the premiums being submitted by KLC. I advised that since KLC was bundling claims service with their proposal, you could discontinue the contract with RMSC (approximately \$56,000/yr.) for claims services and cut Marsh’s contract in half (\$79,000/2=\$39,500).” While this email supports the Director of Risk Management’s statements that he had been asked to adjust the premium as part of justifying the KLC premium, the email correspondence also indicates that the Director of Risk Management was actively participating in the adjustment of the matrix, as he acknowledges that he advised the Commissioner of Law of specific adjustments that could be made.

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## Chapter 2

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After reviewing the full process for selection of an excess insurance carrier in the fall of 2007 for the excess auto liability, excess general liability, and excess political official's liability lines of coverage for the period October 1, 2007 to October 1, 2008, we have identified no indications of fraudulent activity. On September 11, 2007, the recommendation to select KLC was presented to the Council and documentation does not indicate any intent to circumvent the selection process. Further, through our examination of this issue, we found that the presentation to the Council of excess liability insurance proposals provided by the Commissioner of Law provided a choice between two vendors rather than a single vendor, as had historically been provided.

Finally, regarding the 1000 hours of loss control services, KLC provided the Director of Risk Management with a detail of how the 1000 hours would be distributed. The loss control hours were billed at \$90 an hour for a total cost of \$90,000. The loss control hours for this period would be used to provide Legal Liability Risk Management Institute (LLRMI) loss control training for Police, Fire, and Community Corrections.

On January 23, 2008, the Director of Risk Management discussed the breakdown of how the 1000 hours were being distributed. In that email the Director of Risk Management states, "156 hours are for KLC personnel to travel and observe LLRMI train, audit and meet with LFUCG operations." He did not state at that time that the hours were being used to train KLC employees.

According to a KLC insurance underwriter, the balance of the loss control hours was allotted to the hours that KLC Loss Control staff were involved to facilitate training, in the audits performed, as well as additional work performed to review auto claims history to determine where they needed to start driver training going forward during 2008-2009. Furthermore, she stated, "in no way were any of the hours outlined for LFUCG used by KLC Loss Control staff for any personal gain or continued education."

The only written evidence we have to assist in addressing this issue is the January 23, 2008 email from the Director of Risk Management to the Commissioner of Law, along with the KLC spreadsheet providing LFUCG with a detail of the loss control hours. It appears from the Director of Risk Management's response to the Commissioner of Law that he understood at that time loss control hours were not being used to benefit KLC employees.

## Observations and Questions

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**Observation 2:  
“LFUCG  
Management  
Audit, August  
2007 to February  
2008”**

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Issues identified within Observation 2 by the Director of Risk Management:

- “Numerous factual errors were presented regarding job titles, responsibilities, etc. I was asked to provide a rebuttal to the official Management Partners report. Only part of the rebuttal made it to the LFUCG Council for review. It was my understanding that the Council aide responsible for assembling the report removed important attachments that were referenced as “best practices.”
- “Many of the recommendations were factually incorrect.”
- “Misrepresentation and concealment of material facts that allowed personnel of knowledge (Director of Risk Management, Contract Specialist, Risk Management Analyst) to be moved out of the line of important decision making on insurance procurement, claims administration and exposure analysis.”
- “The Fire Chief was allowed to present his factual errors report and respond but the Director of Risk Management was not.”
- “The Senior Advisor to the Mayor advised the Council Members that Risk Management had a philosophical difference in opinion of how things were being organized.”
- “It is my understanding that Directors from other divisions were allowed to see the draft audit report and make corrections to factual errors before the report was released.”

It should be noted that while the “observations” we received from the Director of Risk Management indicates that this item corresponds with a section of the FY 2008 FRA questionnaire, this issue was not included in the FY 2008 or FY 2009 FRA questionnaire.

In early 2007, LFUCG issued a Request for Proposal (RFP) for a management audit. The RFP was awarded to a vendor and the management audit work began in the fall of 2007. Based on interviews with the vendor and representatives of the administration and management, there was no predetermined list of cost savings provided to the vendor. By February 2008, the work was complete and the audit report, containing over 400 recommendations, was issued by the vendor.

On June 17, 2008, during a Council Planning Committee meeting, Committee members began discussing reports of potential “factual errors” within the management audit report. In light of the possibility that factual errors may exist, and the potential impact factual errors would have on the implementation of the recommendations, the Committee directed a Council aide to send a notice to the division directors for them to send to the aide by August 15, 2008, any discrepancies they have identified in the management audit report. The aide was then directed to send the division director discrepancies “to CMs, CA, and administration by 9/5/08.” The same motion was made and voted upon in the June 24, 2008, Council work session.

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On June 18, 2008, the Council aide submitted through email a request to LFUCG Directors, Commissioners, and the Senior Advisor for Management, stating “[i]f you and/or your staff can identify any factual errors, particularly those impacting your division operations, please forward those to my attention no later than Friday August 15. These will be tabulated and forwarded to the Council and appropriate administration staff.”

A similar email was sent to LFUCG Commissioners on the same day, June 18, 2008, from the Senior Advisor for Management, stating “[p]er the request from yesterday’s planning committee meeting please ask your directors if they have noted any perceived FACTUAL errors in the management audit report to forward those to” the Council aide as soon as possible.

As a result of the requests for response by the Committee, the Council aide received 13 responses, six of which identified several “factual errors” identified by division directors. The response submitted by the Director of Risk Management was approximately 13 pages, and was accompanied by an appendix of information including the Director’s resume, opinions from risk management peers, news articles, and job descriptions of various positions across the nation.

In the Director’s June 14, 2010 observations to the APA, he states, “[i]t was my understanding that the Council aide responsible for assembling the report removed important attachments that were referenced as “best practices.” In discussing the issue with the Director further, he stated that he recalled seeing a packet of information to be presented to the Planning Committee that did not include his attachments that were submitted to the Council aide. On August 13, 2010, the Director emailed to this office pages from a packet he believed had been presented to the Committee. A review of that information included the Director’s report but not the attachments.

We requested a copy of the report of discrepancies submitted to the Mayor, the Council, and various members of the administration on September 5, 2008. The report provided to our auditors includes all the documentation provided by the Director to our auditors in association with his 13 page report entitled “Factual Errors or Incomplete Information,” and, therefore, does not appear that any of the information identified as “best practices” was removed from the Council’s report.

We then contacted the Council aide to discuss the September 5, 2008 memorandum. The Council aide stated that to the best of his recollection the memorandum, containing 118 pages, including all the attachments provided by the Director of Risk Management, was mailed out to all those addressed in the memorandum. When asked if a condensed version of the divisions’ responses was presented to the Planning Committee, the Council aide initially could not recall providing a shorter version, but after pulling the packet presented to the Planning Committee during its October 21, 2008, meeting he acknowledged that an abbreviated version was presented to the Planning Committee on that date. The

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Council aide recalled that the Director of Risk Management had included several attachments such as his personal resume with the error report he submitted; however, the Committee was interested in discussing the factual errors during this meeting.

On October 21, 2008, the Committee began discussing the division director discrepancy reports that were submitted to the Council aide. Because of the volume of issues at hand, the Committee made the decision during its meeting to form a three member work group, later referred to in an email from the Council aide as the Management Audit Sub-Committee, to review the reports. The three member work group included the Vice-Mayor and two Council members.

On November 7, 2008, the Council aide emailed the Council Chair of the Committee's Sub-Committee and her aide to discuss the Management Audit Sub-Committee. According to the aide, from his perspective, "I think this group has 2 charges: investigate the so called factual errors and consider the status of the audit implementation." Further, he states, "I think within the factual error discussion it will be important to distinguish between factual error and opinion. Quite a bit of what the divisions provided was opinion; this is definitely evident in Planning, Emergency Management and Risk Management."

Subsequent to this email, it is our understanding through discussions with members of the LFUCG administration, Council members, and the Director of Risk Management that a meeting was held to discuss the concerns of the Division of Fire and Emergency Services. In discussing the issue with the Chair of the Sub-Committee, she stated that it was her understanding from the Council aide that the issues pertaining to the other groups were opinion and were not factual in nature and that was why the Sub-Committee did not review those issues.

Although the Sub-Committee was advised by a Council aide that the Division of Risk Management's issues were opinion, the actual reports were provided to them previously through the September 5, 2008, report from the Council aide and as such were available for their review and their own consideration as to factual errors versus opinion.

Based on the facts of this situation, we found that the decision not to discuss the "factual errors" brought forth by the Director of Risk Management further was a decision based on the information provided to the Management Audit Sub-Committee. Information provided by the Director of Risk Management to our auditors agrees exactly to that which was provided to others by the Council aide on September 5, 2008. As such, we found no indication of misrepresentation or concealment of material facts in this situation.

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**Observation 3:  
“Excess Property  
and Workers’  
Compensation  
renewals, FY  
2009”**

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Issues identified within Observation 3 by the Director of Risk Management:

- For excess workers’ compensation coverage, KLC presented “a first quote of \$259,976 then modified it to \$247,338.”
- For excess property, KLC presented a quote of “\$246,000 that included adjusting services. The LFUCG already had a property adjuster as a civil service employee. This was a duplication of services and cost the LFUCG an additional \$46,140 in premiums.”
- “The blue sheet that authorized expenditures from the Division of Risk Management budget was signed off by the Director of Litigation. At the time of her sign-off, she did not have authorization to sign for the Risk Management budget.”
- As part of KLC’s submissions to LFUCG for workers’ compensation, the current TPA under contract with LFUCG “was allegedly NOT AN APPROVED TPA.” The Broker notified the Commissioner of Law by email advising that the current TPA was an approved TPA for the vendor named in the KLC proposal.
- The workers’ compensation TPA services were placed with a new TPA under a no-bid contract.
- The bid for workers’ compensation TPA services was initially \$288,000; however, the bid was allowed to be lowered twice to a final price of \$139,000 per year.
- It appears through an email dated May 26, 2008, the Commissioner of Law presented the proposed TPA with the contract in place with the current TPA for service comparison and pricing.
- “Misrepresentation and concealment of material facts by the Commissioner of Law to allow conflicts of interest to continue between KLC’s officer (Bill Hamilton) and Collins and Company.”
- The Commissioner of Law “concealed material facts about the incumbent workers’ compensation TPA (US&C) being approved to perform work for New York Life and Marine Insurance Company thus causing the LFUCG to pay more for TPA services and not allowing US&C to complete the last year of its three year LFUCG Council approved contract.”

The issues presented within this observation can be grouped into four topics. The first topic is the selection of an excess workers’ compensation carrier in June 2008; the second topic is the selection of an excess property carrier in June 2008; the third is the related administrative review process used for presenting the selections of insurance carriers to the Council; and the fourth topic relates to the transition made to a new TPA for workers’ compensation formally approved in August 2008. In order to more clearly address the Director’s issues, each topic will be covered separately within this section.

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### *Excess Workers' Compensation Coverage*

In May 2008, email correspondence between the Commissioner of Law, the LFUCG broker, and KLC document discussions between all three parties of KLC's quote for excess workers' compensation coverage. Based on our review of this email correspondence, we found no evidence to suggest that KLC was allowed to modify its quote for excess workers' compensation coverage. Rather, the email correspondence documents a miscommunication between KLC and the broker. LFUCG was given a discount by KLC on its rate and the rate per hundred dollars of payroll was then applied by the broker to a corrected payroll amount.

### *Excess Property Coverage*

For the excess property quote, KLC presented a quote from its carrier in the amount of \$246,000, including adjusting services. The other competitor's proposal was for \$199,867, not including adjusting services. Historically, the adjusting services for LFUCG were provided by a LFUCG employee.

On June 24, 2008, the recommendation to approve the excess property carrier proposed by KLC was presented to the Council. During this meeting, a Council member asked whether the KLC proposal was the lowest bid. The Commissioner of Law stated that based purely on dollar amount, the KLC proposal was more expensive. However, he pointed out that the proposal did include adjusting services, which were not part of the competitor's bid. The Council member then asked what would happen to the employee currently performing the adjusting services in-house. The Commissioner stated that he understood that the position would not be lost as it was scheduled to be temporarily transferred as part of the proposed budget. Following the questions presented to the Commissioner of Law, the Council unanimously voted to place the related resolution on the docket for first reading.

On June 26, 2008, the Commissioner of Law responded again to the Mayor and Council through a memorandum addressing the excess property insurance renewal. Within this memorandum, the Commissioner of Law summarized the proposals and stated, as he had in the June 24, 2008, Council meeting, "I recognize that the difference is significant and, if you feel we need to proceed with the FM Global quote, we will make that work." The Council unanimously approved the resolution to select the KLC proposal on June 26, 2008, through resolution 388-2008.

The LFUCG Claims Adjuster remained with the Department of Law as part of claims management and continued to do adjusting for auto physical damage claims, pursued subrogation and performed investigative work. The TPA performed property adjusting for a period of one year and starting July 2009, the Claims Adjuster again was responsible for property adjusting.

### *Administrative Review Process*

As of June 24, 2008, the Director of Risk Management was the Director responsible for the Risk Management budget; however, according to the "blue sheet" submitted to the Council, the Director of Litigation signed the sheet instead of the Director of Risk Management, requesting funding for the proposed purchase of excess workers' compensation, excess property, and international package insurances.



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The blue sheet is the form used by LFUCG to present resolutions to the Council for a vote. According to the *Administrative Review Process (Blue Sheet)* under the Division of Central Purchasing Policies and Procedures, “[c]ommissioners/division directors must complete all required information in Section I and sign where indicated.” The language within these procedures is not clear as to whether a director’s signature is required or optional. The sheet itself indicates that the signature is optional, as it states “Director and/or Commissioners.”

Regardless of whether a second signature is optional or not, the Director of Litigation did sign the blue sheet, indicating her authority at that time to direct payment from the Risk Management funds. She was not to have officially assumed the responsibility for such a purchase until July 8, 2008, when the Council passed resolution 183-2008, transferring Risk Management to the Department of Finance and Administration with the exception of claims and litigation which remained in the Department of Law. However, given that the blue sheet indicates that the signature is optional, and the Commissioner of Law’s designee signed the form indicating his approval, it does not appear that the Director’s signature impacted the process. Issues pertaining to the LFUCG procurement process have been documented under Findings 7 through 9, along with recommendations for improvement of the procurement process.

### *Third Party Administrator*

In 2008, the transition to a new TPA for workers’ compensation was the direct result of selecting the proposal for excess workers’ compensation presented by KLC. According to KLC, the proposal it submitted required the use of its TPA, the same TPA LFUCG began using in the fall of 2007 as a result of its excess auto liability, general liability, and political official liability carrier selection.

Because the use of a specific TPA service for workers’ compensation claims was a stipulation for the selection of the KLC proposal, LFUCG did not go through a competitive bid process to select the TPA vendor. Because of the inconsistencies and flexibility afforded within LFUCG’s procurement process, which are later reported in Finding 7, the lack of a competitive bid process is not a violation of LFUCG’s current policies in this instance. Furthermore, we found no evidence that the Commissioner of Law was informed of the conflict of interest between KLC and the TPA vendor.

KLC notified LFUCG that its current TPA would not be an approved TPA for KLC’s proposal. The statement by KLC that the current LFUCG TPA would not be an approved vendor was interpreted by some to indicate that the proposed excess workers’ compensation carrier would not accept the current TPA; however, after reviewing documentation relating to this issue, we found that the current TPA was not approved by KLC as part of the proposal to LFUCG. In other words, if LFUCG had not wished to select the proposal presented by KLC, then LFUCG would not have had to change its TPA; however, because LFUCG selected the proposal presented by KLC, the package required LFUCG to transition to a new TPA.

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Regarding the pricing of the TPA services and the Director's concern that the bid was allowed to be lowered twice, we identified through email correspondence that the TPA's quote was lowered on one occasion from \$288,000 annually to \$148,800 at the request of LFUCG based on a change in policy "parameters." The parameters are detailed in an email. On May 14, 2008, the quote was lowered a second time to \$11,600 a month, which would be \$139,200 for the year. Within this email the TPA states, "[w]e have "sharpened the pencil" so to speak as much as we possibly can and leave services at what we feel that LFUCG would need to make this a successful and cost savings program."

On June 22, 2006, through resolution 417-2006, LFUCG entered into a three-year administrative service agreement with a TPA to provide third-party claims administration services for workers' compensation claims to end on June 30, 2009. On June 24, 2008, as part of the resolution to purchase excess workers' compensation, excess property and international package insurances, LFUCG cancelled this service agreement. Then on August 14, 2008, through resolution 465-2008, LFUCG approved hiring the new TPA to provide professional services for workers' compensation claims for FY 2009.

Although the TPA reduced its proposed rate on two occasions, these changes occurred prior to the presentation of the final cost proposals for excess workers' compensation insurance being provided to LFUCG in a matrix by the broker. It does not appear that these revisions in the TPA's proposal were in any way inappropriate. If the TPA proposals were allowed to be revised after the final matrix for the workers' compensation, there possibly could be an issue as the TPA service was technically a requirement of the workers' compensation coverage presented by KLC.

The next issue we considered was the email dated May 26, 2008, in which it appears the Commissioner of Law presented the proposed TPA with the contract in place with the current TPA to compare service and pricing. The Commissioner of Law did in fact share the current TPA service agreement with KLC and in turn to the proposed TPA. However, we take no issue with this action by the Commissioner of Law as the TPA agreement was a current agreement and not a proposed document. This document would be considered an open record and as such was available for review by the public, including KLC and the proposed TPA.

After examining the issues presented within this observation we found no evidence to suggest a misrepresentation or concealment of material facts by the Commissioner of Law or any other LFUCG personnel. Many of the Director of Risk Management's issues appear to stem from either a lack of information or misunderstanding of fact.

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**Observation 4:**  
**“Primary**  
**Insurance for**  
**Employee’s Auto**  
**Presentation by**  
**Commissioner of**  
**Law, June 3, 2008”**

Issues identified within Observation 4 by the Director of Risk Management:

- “On June 3, 2008, the Commissioner of Law stood before the LFUCG Council in a Services Committee meeting and advised the Council Members that the LFUCG could provide “primary insurance” for employee automobiles while driving on government business.”
- “On two prior occasions, the Commissioner of Law was provided with information received from the State Insurance Department that this was not authorized under KRS 304.9-100.”
- “Upon consistent and thorough questioning by Council Members, the Commissioner of Law tempered his recommendation to state that he still had some tweaking to do with the State Insurance Department before he could finalize his recommendation.”
- “Misrepresentation and concealment of material facts provided prior to making a presentation before LFUCG Council.”

In the spring of 2008, the LFUCG administration and Council were considering the possible cost efficiencies and savings opportunities suggested in the February 2008 management audit report. One area of potential cost savings for LFUCG was through a reduction in its vehicle fleet. Within the management audit report, the vendor recommended, among other things, developing incentives to encourage employees to use personal vehicles when it is more economical to do so, and streamlining the employee mileage reimbursement process.

As part of the consideration of the management audit recommendation to develop incentives to encourage employees to use personal vehicles, the Commissioner of Law, along with KLC and Risk Management personnel, discussed the possibility of providing primary insurance for employee automobiles while driving on government business.

Email correspondence provided to this office by the Director of Risk Management supports that the Director advised the Commissioner of Law on May 21, 2008, that “[p]roviding primary insurance coverage would place the LFUCG in a position acting as an insurance agent,” which he believed “would be in direct conflict with state insurance laws under KRS 304.11-030.”

Emails provided by the Director to our auditors also show that the Director advised the Commissioner of Law on May 28, 2008, “[a]s a safety valve for this policy, I would recommend that you contact Sharon Burton, General Counsel, Office of Legal Services, Insurance Legal Division, Kentucky Insurance Office and explain what it is that you are proposing to do. She may be able to shed some additional light and direction on this policy.”

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On June 2, 2008, the Director of Litigation, on behalf of the LFUCG contacted the General Counsel of the Kentucky Department of Insurance (DOI) to present to her the proposed provisions for the new fleet policy and to request her guidance and comments. The Director of Litigation explained that they were planning on making a presentation to the Council the next afternoon and could use her advice. On June 3, 2008, the Director of Litigation received a response from the DOI General Counsel indicating doubts about the proposed plan and forwarded it to the Commissioner of Law who then forwarded the email to KLC to discuss further.

A Services Committee meeting was held at 1 p.m. on June 3, 2008. According to the meeting minutes, “Commissioner of Law, stated they have enlisted the assistance of KLC concerning the collision comprehensive coverage that may require a little tweaking.” Further, while the Commissioner of Law confirmed that the Department of Law was prepared to say that LFUCG will be primary insurance provider for employees driving their own cars, the Commissioner also noted there were still issues on the collision coverage that needed to be worked out.

On June 4, 2008, the Commissioner of Law notified other LFUCG personnel, including the Director of Litigation and the Claims Manager, that the General Counsel for KLC believed that the question posed to DOI on June 2, 2008 by the Director of Litigation was inaccurate. This email states, “[i]nstead of our insuring a vehicle, he believes that the employee is required to have their own insurance. LFUCG is simply agreeing to indemnify for a loss in consideration of using personal vehicle.”

Later on June 4, 2008, the Claims Manager responds by email back to the Commissioner of Law, and others including the Director of Risk Management, “Leslye and I reviewed the response from the Office of Insurance for the Commonwealth of Kentucky and feel that the writer misunderstood the question. She felt that we would name the auto and the driver on our self-insurance contract and this is not correct. We are covering the LFUCG’s employers liability for the actions of the (agent) employee that is driving his/her vehicle on government business. That is perfectly legal as she points out in her last paragraph.”

After reviewing all available documentation pertaining to this issue, including the additional email correspondence obtained through LFUCG and DOI, we found no evidence to indicate that any material facts were misrepresented or concealed in relation to this matter.

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It is evident that the details of the proposal were still under review by the Department of Law at the time of the June 3, 2008, Services Committee meeting and that this was clearly communicated to the members of that Committee at that time. It appears from the June 4, 2008, email between various LFUCG personnel including the Director of Risk Management that the Director of Risk Management was aware that the issue was still being evaluated at that time.

Ultimately, it is our understanding from the Commissioner of Law that no further revisions were made to the proposed fleet policy and no policy change ever occurred.

**Observation 5:**  
**“Loss Control**  
**Survey Reporting,**  
**E-mail dated**  
**February 14,**  
**2008”**

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Issues identified within Observation 5 by the Director of Risk Management:

- “In an e-mail sent to the Director of Risk Management by the Commissioner of Law regarding Loss Prevention Surveys performed by Risk Management staff, the Commissioner of Law suggested that Risk Management Loss Control staff not commit to writing deficiencies found during Loss Prevention surveys until after the deficiency was fixed.”
- “Concealment of material facts from compliance officials or employees due to fear of the identified hazards being discovered in an open records request.”
- “Further to this concern is the current effort to dissolve the Division of Risk Management that historically has been able to perform these surveys and maintain adequate records of compliance. Decentralization of this effort may possibly lead to relaxed compliance.”

On February 14, 2008, the Commissioner of Law sent an email to the Director of Risk Management and the Risk Manager, copying two members of LFUCG’s Department of Law and the Commissioner of Environmental Quality, which stated, “[g]entlemen: I note where there will be a RM inspection at Department of Environmental Quality. From the emails I have received, it appears that the plan is for the inspection to be completed, a written report generated, and then sharing the report with LFUCG. I propose that before the report is reduced to writing, the results of the inspection be shared with the Commissioner of the Department and necessary corrective action can be taken, then some report may be generated. My concern is that a report reveal items that have a reasonable justification and are not a problem. I am also concerned that the report would be subject to open records or discovery in litigation. Let me know if this procedure is acceptable.”

On the same day, the Director of Risk Management responded to the Commissioner of Law, including all parties to the original email and stated, “I am delighted to see that Senior Management wishes to be more involved in the Loss Prevention Survey process. I share your concern for open records and discovery litigation where it might be found that a hazard was observed during a Loss Prevention Survey, was documented and failed to be properly corrected. This could potentially impose civil and criminal penalties against Risk Management staff, you, the Mayor,

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Commissioners or Directors if an employee was severely injured or killed due to inaction on the part of management and found to be negligent in their duties to provide a workplace free from recognized hazards.”

Further, after describing the need and importance of “Worksite Analysis,” the Director states, “[i]tems that can be fixed on site at the time of the visit will be communicated to the Division staff member(s) involved in the survey and so noted on the final report if the item fixed had the potential to cause harm to employees or assets of LFUCG. Per your proposal, we can visit with the Commissioner of the responsible division to review a draft of the report that will be published. However, this visit should take place no later than 14 days after the visit and sooner if items have been observed that may cause Immediate Danger to Life, Health or Environment.”

According to a later email by the Commissioner of Environmental Quality responding to both the Director and the Commissioner of Law, “[m]y intent in asking top be involved early was not just for legal reasons but also ethical ones. I do not want people to be hurt.”

While the Commissioner of Law does voice concern with open records issues in the February 14, 2008 email, the communications as a whole appear to indicate that the desire of the commissioners is to have the deficiencies or hazards communicated to those in charge so that corrective actions can be taken in a more timely manner, rather than waiting for the report to be issued before addressing the issues. We found no indication that there was intent to conceal material facts from compliance officials or employees.

**Observation 6:**  
**“Memo to LFUCG**  
**Council from**  
**Commissioner of**  
**Law dated June**  
**19, 2009 regarding**  
**KLC Insurance**  
**Placement and**  
**Fees”**

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Issues identified within Observation 6 by the Director of Risk Management:

- “The Commissioner of Law responded to an inquiry by council Members On June 19, 2009, advising of the LFUCG’s relationship with KLC. In that letter, he made statements that were a material misrepresentation of the fact with reference to the number of quotes received during insurance renewals and about Risk Management recommending cancellation of the Marsh Broker agreement with the LFUCG because it wasn’t getting its monies worth.”
- “Material misrepresentation and concealment of the facts. The Division of Risk Management received more quotes (5) than represented in the Commissioner of Law’s memo and did not recommend the termination of Marsh because it wasn’t getting its monies worth.”

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In examining these issues, we obtained a copy of the June 19, 2009 memorandum from the Commissioner of Law to the Mayor and Council regarding KLC, Insurance Placement and Fees along with documentation of the insurance quotes received through the broker in the spring of 2007, and various email documentation discussing the broker and the quality of the services received from the broker.

In the June 19, 2009 memorandum from the Commissioner of Law to the Mayor and Council, the Commissioner does indicate that the broker presented only two quotes for workers' compensation. In examining the quotes received, LFUCG received three quotes for first dollar coverage for workers' compensation insurance and two quotes for excess workers' compensation insurance.

While LFUCG did receive five quotes in total, it is our understanding that LFUCG is self-insured for workers' compensation, and as such, the three quotes for first dollar coverage would have only been relevant if LFUCG were to decide to drop its self-insurance on workers' compensation. If LFUCG were to no longer be self-insured on workers' compensation, then it would have a need for a carrier to provide the first dollar coverage.

In discussing the June 10, 2009 memorandum with the Commissioner of Law and an Administrative Specialist Senior within the Department of Law, it was explained that the memorandum was referring to the two quotes for excess workers' compensation, which is the type of insurance LFUCG purchased in the spring of 2007, not first dollar coverage.

The second concern expressed in reference to the June 19, 2009 memorandum was the Commissioner's statement, "Risk Management agreed that the cost we incurred did not justify the service we were receiving from Marsh." The Director of Risk Management provided email correspondence to our auditors dating back to August 30, 2007, in which the Director supports Marsh and its services to LFUCG.

However, in discussing the issue with other former Risk Management personnel, it was communicated that they had not always been satisfied with the broker's services. According to the Commissioner of Law, he believed from his discussions with various Risk Management personnel at that time, his statement in the memorandum is accurate.

After considering information from all sources, we found no evidence to support that a material misrepresentation of fact occurred through issuance of this memorandum to the Mayor and the Council. While the memorandum technically was in error regarding the number of quotes received pertaining to workers' compensation coverage, it is reasonable to believe that the first dollar coverage would not be considered when writing this memorandum as LFUCG was self-insured.

Regarding the statement that Risk Management agreed the broker costs did not justify the service received from the broker, the email correspondence provided by the Director of Risk Management shows that he was in support of the broker; however, there were others within the Division who expressed a different opinion indicating that they were now receiving better service. The Commissioner's reference to Risk Management agreeing that the broker's services did not justify the cost could certainly be understood that the Director of Risk Management agreed with this statement as well. However, the Commissioner did not state that he was referring to the Director of Risk Management, and as such, we found no evidence to discredit this statement. If the Commissioner had specifically stated that this statement was made by the Director of Risk Management, then we would have found this to be a misrepresentation.

**Observation 7:  
"Grants Program  
– Conversation  
with [ ], Director  
of Community  
Development  
(retired) – no  
documentation."**

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Issues identified within Observation 7 by the Director of Risk Management:

- "While processing a Safety Grant from the KLC, the Commissioner of Law wanted the Director of Risk Management to process the request without the assistance of the Division of Community Development."
- "I inquired with the Director of Community Development at that time if she had been having problems with grants. She indicated that there were some problems with the administration where she would not sign off but she was not specific about the problems. However, at a later date I was advised that it had something to do with the Division of Police grants."
- "Concealment of grant information from the Division of Community Development."

Before addressing this particular issue, it should be clarified that while an issue involving the grants program was included in the FRA questionnaire completed by the Director of Risk Management for the FY 2009 audit period, the Director did not include an issue regarding the KLC Safety Grant and the Commissioner of Law. The concern reported in the FRA questionnaire pertained to requests to use grant money for items not listed in the original grant requests, not processing of the grant through Community Development.

On February 25, 2009, the Director of Risk Management was processing a Safety Grant Application through KLC for LFUCG's Division of Traffic Engineering in the amount of \$922.50 for purchasing vests. During the process, the Director contacted the Grants Manager within Community Development to determine what further actions he needed to take to process the application. The Grants Manager stated that the Council was required to authorize the submission of grant applications and asked the Director to send her a copy of the application and she would blue sheet it so that it can be presented to the Council for review. Following this email, the Director notified the Commissioner of Law of his communications with the Grants Manager, to which the Commissioner advises the Director, "[w]e will blue sheet."



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Later, on March 5, 2009, the Commissioner of Law emailed the Director and asked him why Community Development had prepared the blue sheet and blue sheet memo in view of his email stating “[w]e will blue sheet.” The Commissioner states that he asked the Director to do the blue sheet and it was completed by Community Development after he gave his instructions, and he was “trying to find out how this happened.” The Director states, “I took “we” to mean the LFUCG would do a blue sheet to get the grant.”

In discussing the \$922.50 safety grant for the Division of Traffic Engineering and the process that was followed to present the grant to the Council, the Commissioner of Law stated that it was his understanding from the email correspondence between the Grants Manager and the Director of Risk Management that the application needed to be blue sheeted quickly.

According to the Commissioner of Law, grant applications have historically been processed by Community Development because the majority of grants awarded to LFUCG are Community Development Block Grants (CDBG). Since this was a small dollar safety grant and not a large CDBG grant, he did not see the need in having Community Development place the grant application on a blue sheet to be presented to Council when Risk Management could have taken care of that so that it would be presented to Council for approval.

After examining this issue, we found no evidence to suggest intent to conceal the safety grant from the Division of Community Development. Furthermore, the safety grant processing issue does not appear to have any correlation to the other issue raised in this particular observation. As was explained above, the issue raised in the FY 2009 FRA questionnaire pertained to requests to use grant money for items not listed in the original grant requests, not processing the grant through Community Development.

**Observation 8:**  
**“Actuarial**  
**Services –**  
**Conversation with**  
**Manager of**  
**Claims”**

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Issues identified within Observation 8 by the Director of Risk Management:

- “The Manager of Claims reported to me that the Commissioner of Law wanted him to use the same actuarial services that KLC was using.” Subsequently, the Claims Manager said, “he advised that the KLC Actuary of the increments (\$500) that the LFUCG incumbent actuary had been bidding in prior years resulting in the KLC actuary bidding \$160 less than the LFUCG incumbent.”
- “Disclosure of bids to other bidders.”

Before addressing this concern, it is important to note that the issue is presented differently in the FY 2009 FRA questionnaire submitted to the external auditor by the Director of Risk Management. The FRA questionnaire response states that the Claims Manager advised the KLC actuary of the LFUCG incumbent actuary bids.

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The way this issue is expressed in the FRA questionnaire may lead the reader to believe that the employee is alleging that current year bids or quotes were shared with a competitor, rather than bidding history from prior years as was indicated by the Director's observations. This is a significant point of clarification as sharing historical bid or quote information would be subject to open records while sharing the current bid or quote of a competing vendor would not be subject to open records and would be unethical.

As part of this examination, we asked the Claims Manager if he had ever shared current year bids or quotes with a competing vendor. The Claims Manager stated that he had not ever shared a competitor's information with a competing vendor.

During the course of this examination, the issue was discussed before the Special Investigative Committee on August 23, 2010. A question was raised regarding how the Claims Manager could have submitted a letter to a competitor on July 28, 2008 then received a detailed proposal on the next day. The indication was that the Claims Manager had to have had prior contact with the vendor before the date of that letter.

In reviewing email correspondence between the Claims Manager and KLC, we found the Claims Manager had contacted KLC personnel on July 23, 2008, stating, "LFUCG is in need of an end of fiscal year actuarial report on our Self-insured Fund. We would like for you to get a quote for us from the actuarial consultants that you use for your Fund. I am writing Towers Perrin and AMI Risk Consultants Inc for their bids. Please ask your actuary to submit a copy of the bid to me. We need the report completed by the later part of August so ask the consultant to send the quote asap."

The letters to AMI Risk Consultants, Inc. and Towers Perrin were not released until July 23, 2008 and July 24, 2008, respectively. A quote dated July 28, 2008, from AMI Risk Consultants was received. A letter to Practical Actuarial Solutions, the KLC actuary, was later released on July 28, 2008, with the respective quote dated July 29, 2008. It is our understanding from discussing the issue with the Claims Manager, that the quotes were not date stamped when they were received and thus no record exists to determine when the bids actually were received by LFUCG. Regardless, the vendor was aware of LFUCG's intent to seek a quote from the company as early as July 23, 2008. Therefore, the quote from the incumbent carrier dated the same date as the letter to the competitor formally documenting LFUCG's request for a quote from that vendor does not identify that the competitor was given any inside information pertaining to the incumbent's quote.

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**Observation 9:  
“Self-Insurance  
Fund Cost  
Allocation Ratio  
Changes to  
General Fund,  
Sanitary Sewer  
Fund and Urban  
Services Fund for  
FY 2010 budget”**

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Issues identified within Observation 9 by the Director of Risk Management:

- “In December of 2008, I inquired with the ex-Risk Management Accountant about why he had changed the cost allocation ratios (loss history & exposures) for the claims fund. In the past, it had been 60% based on loss history and 40% based on exposures such as payroll, vehicles, property, etc. In the calculations he was preparing for FY 2010, he changed the percentages to be 30% Loss History and 70% Exposures which obviously relieves pressure on the General Fund and places greater pressure on the Sanitary Sewers and Urban Services Fund. However, the new ratios are not a fair representation of the loss history as the majority of the losses have occurred in the General Fund and the percent of losses is exponentially greater than the percent of exposure cost. When I inquired about who told him to do this, he said that I did. I was not his supervisor at the time of these changes and I could find no documentation to support his allegation.”
- “Misrepresentation of material facts that place greater pressure on dedicated funds that are not attributable to the actual ratios that should be used.”

LFUCG’s self-insurance costs are funded through three funds, the LFUCG General Fund, the LFUCG Full Urban Services Fund, and the Sanitary Sewer Fund. The cost allocation ratios referenced by the Director of Risk Management within this observation are used as part of LFUCG’s budgeting process, just a part of the calculation to determine the percentage of costs that should be allocated between these three funds. According to the Risk Management Accountant, the allocation of costs between these three funds is proportionate to the risk exposure associated with the personnel and physical assets of each fund.

It is our understanding from information provided by both the Director of Risk Management and the Risk Management Accountant that historically LFUCG has used a 60 percent loss history and 40 percent exposure split in its calculation; however, in FY 2009, the calculation for the upcoming FY 2010 budget was determined to be based on 30 percent loss history and 70 percent exposure.

According to the Risk Management Accountant, at the time the change in the allocation ratios was made, Risk Management historical data used in the calculation, which included LFUCG’s entire loss history dating back to 1981, did not correspond with changes within LFUCG. The changes as the Risk Management Accountant described them included the moving and merging of divisions across LFUCG, personnel and system changes and upgrades, along with changes in accounting packages used by LFUCG.

On March 26, 2009, the Director of Risk Management emailed the Risk Management Accountant and stated, “I also note that the funding formula has now been changed at the bottom of the spreadsheet, 70% Exposure, 30% Loss History. Just Curious, When and who changed this?” In response to this inquiry, the Risk Management Accountant responded, “FY 09, you” indicating the Director of Risk Management had directed him to do so.

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While the Director of Risk Management states that he was not the supervisor at the time of these changes and he could find no documentation to support the statement by the Risk Management Accountant, the Risk Management Accountant states that he stands by that statement noting that the change in the risk allocation ratio was approved by the Director of Risk Management, Department of Law personnel and the Division of Budgeting. He further states that while he could not recall the specific date that he was transferred to the Division of Accounting, he was still active in Risk Management at that time. After discussing the issue further with the Risk Management Accountant, he stated that his current position, although within accounting, is still as the Risk Management Accountant, only now his duties have expanded to include other accounting functions.

The Risk Management Accountant states that in FY 2010, the risk allocation ratio for FY 2011 was changed back to 60 percent Loss History and 40 percent Exposure; however, the loss history used for this allocation ratio does not include the entire loss history data dating back to 1981, but rather only the last 10 years of loss history, providing a better representation of the current LFUCG structure. According to the Risk Management Accountant, the decision to use 10 years of loss history was communicated to him from the Department of Law.

While examining this issue, we found no evidence to refute either individual's statement pertaining to who may have reviewed or approved the change in the risk allocation ratio for FY 2010. However, after reviewing the limited documentation available to support this issue and statements made by both the Director of Risk Management and the Risk Management Accountant, we found no indication of fraud or wrong doing, but rather a management decision made as part of the budget process.

**Observation 10:  
"Re-direction of  
Loss Control  
Funds to pay for  
Appraisal  
Services"**

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Issues identified within Observation 10 by the Director of Risk Management:

- "The Division of Risk Management was not consulted on Loss Control needs prior to the purchase of Loss Control Services from KLC."
- "Redirection of Funds that were supposed to be used for Loss Control Services."
- "Concealment of available pricing alternatives which would have not allowed the LFUCG to maximize its training dollars opportunities."

The Director of Risk Management included this issue in the written observations he provided to the APA; however, this issue was not part of the original FRA questionnaire. It is significant to note that the Director of Risk Management did not mention this issue in the FRA questionnaire. To our knowledge, this particular concern was never expressed to either the external or internal auditors.

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On October 23, 2008, the LFUCG passed resolution 612-2008 to purchase excess auto, excess general, and excess public official's liability insurances through KLC from the Insurance Company of the State of Pennsylvania (an AIG Group) for the term November 1, 2008 to November 1, 2009. As part of this purchase, KLC provided LFUCG 500 hours of loss control services at a rate of \$90 per hour, totaling \$45,000 in loss control hours.

Through review of various email correspondence between KLC personnel, the Claims Manager, the Director of Risk Management and other LFUCG personnel in late 2008, it is evident that the Director of Risk Management was not part of the initial discussions pertaining to the purchase of the 500 hours of loss control services; however, he was asked to participate in the determination as to how those hours would be best used by LFUCG.

On November 24, 2008, the Director of Risk Management expressed through an email to the Claims Manager, "proper protocol for this purchase" would have been to discuss the needs of LFUCG with the Director and the Risk Manager before purchasing the services from KLC. In response, the Claims Manager stated that the loss control service was considered part of the insurance procurement program, and that procurement responsibility fell under the Department of Law. However, the Claims Manager expressed his interest in having the Director involved in deciding how the 500 hours of loss control services were to be used.

According to various email correspondence and as confirmed by LFUCG personnel and KLC through our interview process, it is clear that in late 2008, LFUCG had not allocated the 500 loss control hours to be provided by KLC to any specific services. While it is true that the Division of Risk Management was not involved in the initial procurement of the services the Division of Risk Management was active in determining how the hours may be used to benefit LFUCG.

As part of its involvement in the determination of how to proceed with the 500 hours of loss control services provided by KLC, the Director of Risk Management and the Risk Manager met with KLC personnel to discuss the use of the loss control hours. On December 8, 2008, the Director of Risk Management made recommendations to the Claims Manager through email correspondence, copying the Risk Manager, the Commissioner of Finance and Administration and the Commissioner of Law regarding how the 500 loss control hours should be used. In discussing the potential uses of the 500 KLC loss control service hours, consideration was given to providing driver simulator training to LFUCG employees. It was estimated based on the rate available through KLC, that LFUCG could train approximately 100-120 employees for a cost between \$25,000 to \$30,000 for 250-300 loss control hours.

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In his December 8, 2008 email to the Claims Manager, the Director of Risk Management suggests that LFUCG could obtain this service at a lower rate, allowing LFUCG to train more employees by working through the service provider directly rather than working through KLC. The recommendation made by the Director of Risk Management was to “work out a more favorable rate from KLC or request a refund from KLC and allow the LFUCG Division of Risk Management to coordinate the Driving Simulator hours.”

Ultimately, LFUCG was able to provide driver simulator training to its employees at a lower rate with KLC covering the cost as part of its loss control services to LFUCG. Because the services were purchased at a lower rate, LFUCG went from potentially being able to train 100-120 employees to having 216 openings available for employee training, which provided a significant increased benefit.

It is evident that the intervention by the Director of Risk Management in the driver simulator training discussions did assist LFUCG in obtaining a better training rate and allowed LFUCG to provide loss control training to a far greater number of LFUCG employees than originally estimated based on the rate provided by KLC. However, there is no evidence that there was any intent by KLC, or anyone else, to conceal available pricing alternatives.

Within his December 8, 2008 email, the Director of Risk Management made another recommendation for 125-150 hours of loss control hours suggested by KLC to be spent on LFUCG Parks. The Director proposed to use “50 hours of those hours be transferred to Police, Community Corrections and Fire to assist with recommendations generated from the Liability Risk Management Institute Audit.” Further, he recommends that the remainder of those hours not be used and the associated cost be reimbursed back to LFUCG to help offset an anticipated budget deficit for the current fiscal year.

Later on January 7, 2009, the Director of Risk Management notified KLC that another suggested possible loss control service, 50-75 hours of online training, was determined to be a duplication of training resources already available to LFUCG employees and as such, those services would cause an unwarranted expense for LFUCG.

Between the savings realized from the driver simulator training and the decision to decline the online university training hours, LFUCG was left with excess hours of KLC loss control services that LFUCG had not allocated for a specific use.

Through separate interviews with the Commissioner of Law, the Claims Manager, and KLC representatives, we understand that KLC and LFUCG’s excess property insurance carrier made the recommendation for property appraisals to be performed on LFUCG’s properties. On December 16, 2008, KLC submitted a memorandum to the Commissioner of Law stating, “[a]t the suggestion of PEPiP, LFUCG’s property insurance carrier, we obtained a quote from Hirons for performing

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appraisals on LFUCG's property that is valued at \$50,000 or greater. PEPiP is really interested in working with LFUCG to improve the quality of the property schedule information."

According to the Claims Manager it was his understanding that the excess property insurer felt the coverage levels were not adequate and asked that a reassessment of LFUCG's properties be performed. At that time, there was a question as to whether the report of property values maintained by LFUCG was even a complete or accurate representation of the properties owned by LFUCG.

As part of this December 16, 2008 memorandum, KLC suggests "LFUCG consider funding the balance of the charge, \$25,500 by offsetting this amount against the \$45,000 already paid to KLC for the 500 hours of loss control for the 08/09 liability program." The Director of Risk Management stated that he did not make any further recommendations for the use of loss control hours after this memorandum was shared with him by the Commissioner of Law. On December 22, 2008, the Commissioner of Law notified the KLC Senior Underwriter to proceed with the property appraisal as proposed. As reported to LFUCG by KLC in its memo dated December 16, 2008, the property appraisals total cost was \$51,000.

The costs for the appraisal service were covered in part by the remaining KLC loss control hours, with the remainder covered by the LFUCG excess property carrier. After the appraisals were completed in March 2009, LFUCG personnel evaluated the appraisals to make recommendations on properties they felt would not be rebuilt or rebuilt with the same functionality, materials, or design if a total loss was incurred.

According to the Claims Manager, while the appraisals increased the property values of the LFUCG properties, LFUCG's overall policy coverage remained the same as it had for years prior, capped at \$500 million. He further stated that he had no issue with the loss control hours being used for the purpose of the property appraisals, noting that LFUCG was receiving better coverage as a result of the appraisals. He explained that the study was beneficial in that if LFUCG had a total loss on a single property, the property would be valued more accurately and LFUCG would be in a better position to receive the true replacement cost of the building with less questions raised by the insurer regarding the buildings value. In addition, the Commissioner of Law noted that the appraisals allowed LFUCG to receive a lower rate per \$100 of property value, going from 4 percent to 3.51 percent per \$100.

After considering all of this information, we again found no evidence of fraud or wrongdoing. It is apparent to our auditors that the loss control hours were presented to LFUCG as part of its insurance procurement in the fall of 2008, the procurement of which was the responsibility of the Department of Law after July 8, 2008, per Council Resolution 183-2008.

It is evident that the Department of Law did request the Director of Risk Management to participate in the discussions with KLC as to how the 500 hours of loss control services provided by KLC would be used.

Ultimately, the determination was made by senior management to proceed with the property appraisal suggested by PEPiP, LFUCG's excess property insurance carrier, and proposed by KLC to be paid for in part using the value of the remaining unallocated loss control hours. LFUCG incurred no additional costs for the property appraisals and received the benefit of an updated listing of properties and values that allowed for a lower insurance rate per \$100 of property covered.

**Observation 11:  
"Data Analytics  
discontinuation for  
the Director of  
Risk Management  
& certain Staff –  
Risk Management  
information  
System Access,  
May 2010"**

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Issues identified within Observation 11 by the Director of Risk Management:

- "On or about April 27, 2010, the Department of Law shut the Risk Management Information system down for the entire Risk Management staff with the exception of the Safety Manager. Two weeks later it was turned back on for the Administrative Specialist so that Risk Management reports could be continued."
- "Possible concealment of critical data that may reveal trends in excess expenditures for claims."
- "the Year-To-Date data for FY 2008 v. FY 2009 was compromised when the Department of Law decided to discontinue entering financial data in October 2008 then decided to begin entering it again around August 2009. The Division of Risk Management was without critical financial data to perform severity trend analysis for over 15 months."

It is significant to note that this observation expressed by the Director of Risk Management was not part of the original FRA questionnaires. This is significant because to our knowledge this particular concern was never expressed to either the external or internal auditors.

The first issue in this observation pertains to the Division of Risk Management's access to the risk management information system. After reviewing documentation provided to this office regarding this issue and after discussing the matter in interviews with various LFUCG personnel, including the Director of Risk Management and an Administrative Specialist Senior within the Department of Law, we found access to the risk management system was available to the Division of Risk Management.

The access to the risk management information system was not directly given to each employee of Risk Management; however, it is available to certain members of its Division, which allows the Division access to the information to perform any necessary analysis.



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According to the Administrative Specialist Senior, LFUCG pays a licensing fee for the use of the risk management information system software. Currently, LFUCG pays the licensing rights for 10 and the software is being used by employees within Accounting, Claims Management, and Law Administration. In light of these facts, we found no evidence to suggest concealment of critical data that may reveal trends in excess expenditures for claims.

The second issue as presented within this observation indicated a decision was made by the Department of Law not to enter financial data information within the risk management information system between October 2008 and August 2009. While addressing this matter, we found the decision made by the Department of Law was not as simple as what was presented through the Director's memorandum to our office.

LFUCG insurance claims and risk management information is maintained through the use of licensed software. The software program is a commonly used program by self-insured organizations, insurance pools and TPAs to manage all risk and claims processes on a single system.

In the fall of 2007, as part of the its excess insurance procured through KLC, the new claims information was processed by the TPA and stored on the claims database, while LFUCG maintained its historical information within its own database. On a periodic basis, KLC would provide the claims data to LFUCG to be populated into its own system for maintenance along with the remainder of historical data.

In 2008, LFUCG encountered some problems using this process due to a difference in the codes used to process claims information by LFUCG and the TPA that affected how workers' compensation claims were being recorded in the system. For example a code enforcement officer, a corrections officer and a police officer would all be coded as a police officer in the KLC data. LFUCG would historically code these positions separately so that insurance claims reports when analyzed would give LFUCG an accurate representation of specifically where the workers' compensation claims were occurring. According to KLC personnel, part of the problem was the codes that were established in LFUCG's system were not identical to those within the KLC system.

In the fall of 2008, LFUCG began updating its own claims and risk management information system with the goal of eventually having the TPA start using LFUCG's database. In an email dated January 6, 2009, the Administrative Specialist Senior notified the Claims Manager and other LFUCG personnel, "[d]uring the interim, while we are waiting for the upgrade installation, we will not have accurate financial reports." She then advised, "[n]ot until all the data is brought over AND Collins starts using our database will we have accurate financial reports."

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Following that email notification, the Claims Manager emailed the Director of Risk Management and stated, “I was hoping to get a head start on the monthly reports but evidently because of coding issues and People Soft, no financial information can be entered into Riskmaster. So until [ ] gets the upgrade and upload of data into the new Riskmaster X then I will not be able to provide reports. We may go one whole fiscal year without financial updates.”

Based on these correspondence and discussions with various LFUCG personnel it appears that the decision to not include the financial information in the claims and risk management information system was not a matter of intentionally preventing any one person from viewing the information or inhibiting Risk Management from providing accurate information through its reporting. Further, LFUCG was still receiving regular financial reports from KLC during this period of time. The issue appears to be a broader matter of working through system problems and upgrading a significant software system within LFUCG.

**“KLC failed to go to the market and attempted to ... increase premiums ... raise the self-insured retention ... [and] lower the limits of the policy ....”**

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Issue identified within the FY 2009 FRA questionnaire by the Director of Risk Management:

- “KLC failed to go to the market and attempted to: 1) increase premiums by \$250,000; 2) raise the self-insured retention by \$500,000; 3) lower the limits of the policy to \$2million from \$5million. This delayed the renewal of these very important insurance policies by one month resulting in placing the insurance back with the excess carrier (AIG) before KLC was involved with LFUCG’s insurance program.”

In 2008, LFUCG’s excess liability insurance carrier voiced concern regarding losses exceeding the \$1 million SIR. On September 19, 2008, through an email to KLC, the excess liability insurance carrier stated that many of the losses above the \$1 million SIR were not new, and given the size of the loss, should have been made known to the carrier previously. The excess carrier goes on to state, “[g]iven the very large fluctuation in the losses there is no way we can support a renewal as currently structured. I understand that you are in the market through Alliant and would strongly encourage you to place this outside the League’s program as we don’t have an interest in offering renewal terms.”

Ultimately, the LFUCG excess insurance carrier granted LFUCG a one month extension for coverage from October 2008 to November 2008, to allow LFUCG more time to find an excess insurance carrier. On October 17, 2008, the Commissioner of Law submitted a memorandum and an attachment to the Mayor and Council discussing the proposal for an excess insurance carrier. The attachment to this memo indicates that LFUCG received four options from an excess insurance carrier for the policy term of November 1, 2008 through November 1, 2009.

While the SIR did increase by \$500,000, and the insurance was placed back with the previous excess insurance carrier, it seems clear that KLC went to the market and that there were other ongoing business issues which caused a delay in the renewal of the excess insurances for FY 2009.

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This office was specifically requested to address certain questions related to the city's insurance procurement and the process used to review the fraud allegations. The following are our responses to specific questions we were asked to address:

**Question 1: Was purchasing insurance through KLC a better deal for LFUCG?**

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It is not possible for the APA to determine if the decision to purchase insurance through KLC was a better decision than to continue insurance services with the previous insurance vendors. Purchases for professional services such as insurance are not typically evaluated based solely on lowest price, but rather the lowest evaluated price, also known as "best value." Evaluating proposals based on best value means that a number of different factors are included in the decision-making process with price being only one of them.

Insurance for governmental entities such as LFUCG can contain many components, and the components offered by each vendor may be different. Vendors may offer varying levels of coverage while also providing "value added items" to provide additional services such as bundling TPA claims services or training for LFUCG staff. The importance of each "value added item" depends on the value the purchaser believes is added and is at the discretion of management and those in authority to evaluate the proposal and to approve the contract.

During the procurement process for FY 2008 excess liability insurance that took place in September 2007, LFUCG's contracted broker of insurance did not want to provide a recommendation between the KLC proposal and that of the other vendor. In a September 6, 2007 email, the vendor stated, "[w]hile there may be times when the best option is self-evident (for example, all terms, conditions, and services are identical but the cost of one program is \$2,000,000 less than the rest), there is generally not a "right answer" and only our clients can weigh the differences in the context of what is important to their organization/entity. In your case, the good news is that we have presented two good, albeit different, options for LFUCG to consider." This demonstrates that LFUCG's broker, contracted to provide consultation and expertise to LFUCG concerning insurance, did not think there was a definite answer as to which proposal was the best. Further details of this procurement decision are found in the discussion of Observation #1.

In addition to comparing specific proposals at a point in time, it is also difficult to compare insurance coverage and prices over time. Prices offered to LFUCG could rise or fall due to the fluctuation of the number of claims LFUCG had in previous years or due to market demands insurance vendors may experience at the time. Due to these unknown aspects, comparing prices and components from one year to the next is not an accurate method to assess whether LFUCG received the best deal. See Table 2 for increased LFUCG self-insured retention.

The APA has reviewed the insurance costs at LFUCG from FY 2006 through FY 2011, including payments to vendors and in-house costs. While no determination can be made as to whether LFUCG has obtained the best value overtime, certain costs can be reviewed to determine if any extreme variations have occurred in

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payments made to vendors for excess insurance coverage. The following table includes the total contracted costs for excess insurance coverage paid or anticipated to be paid to various insurance related vendors. This includes: the cost for broker or agent services; premiums for workers’ compensation, property, and liability insurance; and, the contracted amounts for the TPAs providing claims adjusting services.

**Table 4: Total Contracted Costs for TPA and Excess Insurance Coverage**

<b>Fiscal Year</b>	<b>TPA</b>	<b>Premium</b>	<b>Total Contract Amounts</b>
2006 – Workers’ Comp	\$84,000	\$290,743	\$374,743
2006 – Property	*	227,200	227,200
2006 – Liability	74,000	512,738	586,738
2006 - Broker			75,000
<b>FY2006 Total</b>			<b>\$1,263,681</b>
2007 – Workers’ Comp	\$100,000	\$239,937	\$339,937
2007 – Property	*	237,000	237,000
2007 – Liability	90,000	474,132	564,132
2007 – Broker			79,000
<b>FY2007 Total</b>			<b>\$1,220,069</b>
2008 – Workers’ Comp	\$100,000	\$265,613	\$365,613
2008 – Property	*	232,890	232,890
2008 – Liability	**	615,000	615,000**
2008 – Broker			75,959
<b>FY2008 Total</b>			<b>\$1,289,462</b>
2009 – Workers’ Comp	\$139,200	\$247,338	\$386,538
2009 – Property	25,000	221,000	246,000
2009 – Liability	**	560,109	560,109**
2009 – Broker			-
<b>FY2009 Total</b>			<b>\$1,192,647</b>
2010 – Workers’ Comp	\$139,200	\$258,930	\$398,130
2010 – Property	*	268,031	268,031
2010 – Liability	50,000	363,738	413,738
2010 – Broker			15,000
<b>FY2010 Total</b>			<b>\$1,094,899</b>
2011 – Workers’ Comp	\$99,600	\$257,931	\$357,531
2011 – Property	*	261,590	261,590
2011 – Liability	99,600	534,438	634,038
2011 – Broker			-
<b>FY2011 Total</b>			<b>\$1,253,159</b>

Source: Information provided by the LFUCG Department of Law.

\* Claims adjusting provided by in-house staff member.

\*\*TPA services and loss control training bundled with premium.

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As seen in the table, the amounts contracted for excess insurance coverage does not fluctuate significantly, but cost is not the sole indicator of whether the insurance products purchased were a good deal. Levels of insurance coverage and services provided have changed over time. An evaluation based on cost only shows that the amount spent on excess insurance coverage has remained relatively unchanged since FY 2006. Based on this, it appears that as long as the procurement methods employed are appropriate and within the confines of all laws and policies, it is incumbent on management and the Council to determine which proposals are going to be of greatest benefit to LFUCG.

**Question 2: Was the Internal Auditor's review of the FY 2009 FRA questionnaire sufficient?**

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In August 2009, the Director of Risk Management informally discussed, with the Director of Internal Audit, his recent submission of a FRA questionnaire to the external auditor as part of its FY 2009 financial statement audit. According to the Director of Risk Management, the purpose of this informal discussion was to notify the Director of Internal Audit that the external auditor would be contacting him to discuss the information contained within the questionnaire.

On August 19, 2009, the external auditor first met with the Director of Internal Audit regarding issues reported in the questionnaire submitted by the Director of Risk Management. On the following day, the Director of Internal Audit emailed the external auditor stating, "I think it would assist my evaluation if I have a copy of the questionnaire that brought the matter to your attention." While the external auditor agreed that a copy of the questionnaire would be helpful to the Internal Auditor, the external auditor believed the document should be shared by the Director of Risk Management as there was a stipulation that the employee's response would be confidential and used for the audit analysis.

On August 21, 2009, the Director of Risk Management provided the FY 2009 FRA questionnaire he completed, for the external auditor, to the LFUCG Director of Internal Audit by email. In the email correspondence, the Director of Risk Management states, "I must request that this information be handled with the utmost of discretion and confidentiality between you and me." Further he states, "I feel this information is ripe for major controversy and I would like to avoid this in as much as you and I can try to determine if the information rises to the level of further action."

The Internal Auditor, as requested by the Director of Risk Management, consulted with him before sharing the information contained within the file with his Deputy Director as stated in the August 21, 2009 email to the Director of Risk Management "his duties include assisting me in the evaluation of all such matters." He further states, "[h]e and I have worked together on a number of highly sensitive projects and we will treat this matter accordingly."

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After giving permission to the Director of Internal Audit to share the information with his Deputy Director, the Director of Risk Management then stated, “[m]y hopes are that it will only need to be reviewed by your office and you can help rationalize the information being shared. Thanks for your review and again I stress discretion and confidentiality.”

One question that has been raised regarding the Internal Auditor’s evaluation of the FY 2009 questionnaire is why the Internal Auditor did not directly discuss the issues with certain individuals named in association with the contents of the questionnaire.

It has been explained by the Director of Internal Audit to our auditors that as he and his Deputy Director evaluated the contents of the FY 2009 FRA questionnaire, they attempted to maintain the Director of Risk Management’s confidentiality. For this reason, when reviewing the information in the FRA questionnaire, the Director of Internal Audit and his Deputy evaluated the processes and procedures involved in these issues to determine actions taken rather than directly questioning those individuals involved. Our review of the Internal Auditor’s preliminary review working papers supports the Internal Auditor’s statement.

In one instance, an issue expressed in the FY 2009 questionnaire stated that an employee told the Director of Risk Management that he shared a vendor’s bid proposal for actuarial services with another vendor bidding to provide the same service. In this situation, a reasonable person would assume that there is a chance that the employee, if they did make that statement, may have shared that information only with the Director of Risk Management and not with anyone else. Therefore, the Internal Auditor would have potentially exposed the Director of Risk Management as the source of the information had he directly discussed the concern with the employee.

Rather than directly approaching the employee to ask them whether he had shared information with a vendor, the Director of Internal Audit contacted the Director of Purchasing to make inquiry into the process through which Actuarial services could be procured based on LFUCG’s current procurement policies.

In addition to contacting the Director of Purchasing, the Director of Internal Audit also made direct inquiries to the Director of Accounting, and the external auditor. In addition to inquiries, the Internal Auditor examined various documentation, including documentation submitted by the Director of Risk Management to the external auditor as support for certain statements made within the FY 2009 FRA questionnaire.

According to the Director of Internal Audit, he and the Deputy Director conducted a preliminary review of the information contained in the 2009 FRA questionnaire to determine if there was predication for further review of the issues. He stated that it was their professional judgment during this process that proper predication did not

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exist; thus, upon making this determination, it was determined that a full fraud examination would not be conducted.

Predication, a standard adopted by certified fraud examiners, is defined as “the totality of circumstances that would lead a reasonable, professionally trained, and prudent individual to believe a fraud has occurred, is occurring, or will occur.” This should be considered throughout the fraud examiners process. The Association of Certified Fraud Examiners (ACFE) states that a fraud examination should not be conducted without proper predication.

Based on our review of the Internal Auditor’s working papers and the process followed in considering these issues, we believe that although the procedures followed to conduct a preliminary review may vary based on professional judgment, the approach taken was sufficient to lead the Director and Deputy Director of Internal Audit to a reasonable conclusion to not proceed into a full fraud examination.

**Question 3: Who had custody of the FY 2008 and FY 2009 FRA questionnaires completed by the Director of Risk Management?**

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Our office was asked by Council members, Special Investigative Committee members, and the LFUCG management to document our understanding of who was in possession of the FY 2008 and FY 2009 FRA questionnaires completed by the Director of Risk Management.

As we performed this examination, we repeatedly made inquiries as to who had either seen or possessed a copy of the FY 2008 or FY 2009 FRA questionnaires completed by the Director of Risk Management. Through interviews, we identified three former employees of the Division of Risk Management who stated they either knew of the questionnaire or viewed the questionnaire because the information was shared with them by the Director of Risk Management at the time the questionnaires were completed. While discussing the matter in an interview with the Director of Risk Management on July 6, 2010, he stated that he had given a copy of one of the questionnaires to a Risk Management employee to review for grammatical errors. The Director later stated in a phone interview that he did not recall ever sharing the questionnaires with his staff, although recently he had heard reports from them that he had.

In addition to his staff recalling having either seen the documents or hearing the Director of Risk Management speak of completing the documents, we found only a few individuals actually had a complete copy of either the FY 2008 or FY 2009 questionnaires until after April 2010. Prior to April 2010, the only individuals to have an actual copy of the FY 2008 FRA questionnaire were the Director of Risk Management and the external auditor. As for the FY 2009 FRA questionnaire, prior to April 2010, the only individuals to have a copy of the complete FY 2009 FRA questionnaire were the Director of Risk Management, the external auditor, and the internal auditor.

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The following is a chart summarizing the ultimate distribution of the FY 2008 and FY 2009 FRA questionnaires, based on the information we were provided during this examination:

**Table 5: Distribution of FRA Questionnaires**

July 9, 2008	Director of Risk Management submits his response to the FY 2008 audit FRA questionnaire to the external auditor.
July 8, 2009	Director of Risk Management submits his response to the FY 2009 audit FRA questionnaire to the external auditor.
Aug. 21, 2009	The Director of Risk Management emails the Director of Internal Audit the FY 2009 FRA questionnaire. The Director of Risk Management grants the Director of Internal Audit permission to share the FY 2009 with the Deputy Director of Internal Audit.
Sept. 30, 2009	The Commissioner of Law receives a redacted version from the Director of Internal Audit as a result of his open records request of the FY 2009 FRA questionnaire submitted by the Director of Risk Management. A staff attorney reviewed the redacted copy of the FRA questionnaire prior to the Commissioner of Law receiving the document.
Mid April to Late April	The Director of Risk Management provides a copy of the FY 2008 and FY 2009 FRA questionnaires to his attorney.
Late April To Early May	The Director of Risk Management provides a copy of the FY 2008 and FY 2009 FRA questionnaires to another private attorney.
May 6, 2010	Council member meets with APA to discuss concerns pertaining to LFUCG and also provides APA with a copy of the FY 2008 and the FY 2009 FRA questionnaires.
May 20, 2010	Director of Risk Management provides a sealed envelope and an email with a copy the FY 2008 and FY 2009 FRA questionnaires to an Attorney within the Department of Law.
May 22, 2010	Director of Risk Management provides the FY 2008 and FY 2009 FRA questionnaires by email to the Commissioner of Finance and Administration.
June 7, 2010	Internal Auditor provides APA with a copy of the FY 2009 FRA questionnaire after initiation of the APA examination.



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June 10, 2010	Director of Risk Management provides APA with a copy of the FY 2008 and FY 2009 FRA questionnaires.
June 17, 2010	External auditor provides APA with a copy of the FY 2008 and FY 2009 FRA questionnaires.
June 30, 2010	External auditor provided LFUCG Council Clerk’s office a copy the FY 2008 and FY 2009 FRA questionnaires for the Special Investigative Committee.
Exact Date Unknown	Director of Risk Management provides a copy of the FY 2008 and FY 2009 FRA questionnaires to the Special Investigative Committee.
August 23, 2010	Special Investigative Committee allows access to the FY 2008 and FY 2009 questionnaires to the Commissioner of Law.

Source: APA based on interviews and documentation obtained during the course of the LFUCG examination

While the chart above clearly details who had custody of each of the FRA questionnaires and at what time, below is additional explanation regarding the distribution of the FRA questionnaires.

As shown in the chart above, the FY 2008 FRA questionnaire was never distributed to the Internal Auditor. The Director of Risk Management provided the Internal Auditor only the FY 2009 questionnaire. The FY 2008 and the FY 2009 FRA questionnaires were never distributed to anyone within the LFUCG Administration until May 20, 2010, with the exception of the Commissioner of Law, who received a redacted version of the FY 2009 questionnaire on September 30, 2009. The distribution of the redacted FY 2009 FRA question to the Commissioner of Law is further discussed in Finding 1.

Distribution of the FY 2008 and FY 2009 FRA questionnaires by the Director of Risk Management to certain members of the LFUCG Administration began after the documents were requested by a Council member in May 2010.

On May 12, 2010, a Council member requested a copy of the FY 2008 and FY 2009 FRA questionnaires from the Commissioner of Finance and Administration. The Council member’s request was then shared by the Commissioner of Finance and Administration and the Director of Revenue with the Director of Risk Management.

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On May 20, 2010, the Director of Risk Management submitted a copy of the FY 2008 and FY 2009 FRA questionnaires by email and in a sealed envelope to an Attorney in the Department of Law. While the Attorney did open the emailed file, it is our understanding that this occurred in the presence of the Director of Risk Management and that the document was then closed. It is our understanding that the sealed envelope was not opened.

On May 21, 2010, the Attorney returned the unopened sealed envelope to the Director of Risk Management along with a memo stating, "I understood that you thought you were being compelled to disclose the documents, but that is not the case. LFUCG's external and internal auditor have reviewed the documents, determined they contain no evidence of fraud or wrong doing, and both have determined you submitted them in confidence and that their confidentiality should be respected and maintained. If you wish to waive the confidentiality of the documents and publicly disclose them, you may do so, but that must be your decision and your act. In the meantime, I will continue to hold the documents you have provided me in confidence."

According to an email from the Director of Risk Management to the Commissioner of Finance and Administration on May 22, 2010, the same Council member contacted the Director of Risk Management directly and made a request for the questionnaires. Per this email, the Director of Risk Management states, "[s]ince I report directly to you, I am sending you the documents by PDF under a separate e-mail."

On May 24, 2010, the Commissioner of Finance and Administration notified the Council member that she had returned the documents to the Director of Risk Management because, "it isn't my proper role, as Commissioner of Finance, to review the findings of the Internal Auditor's office on these type of matters or to breach the confidentiality conferred on the documents when he submitted them to the Internal Auditor." She further states that she has advised the Director of Risk Management, "if he is dissatisfied with the Internal Auditor's findings and wishes to publicize the documents, he is completely free to do so but I cannot accept responsibility for doing so as his representative."

On August 20, 2010, in OAG 10-ORD-164 the Attorney General determined that the 2009 FRA questionnaire was a work paper of the Office of Internal Audit and, as such, was not subject to disclosure under the Open Records law.

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**Question 4: How was the identity of the employee making the allegations of potential fraud made known to LFUCG management, internal audit, and Council?**

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The LFUCG employee that completed the FRA questionnaire had already expressed similar opinions related to the procurement of insurance either through private discussions with other LFUCG management personnel as well as in staff meetings. Related to the FY 2009 FRA questionnaire, the employee informed the Director of Internal Audit that he had expressed concerns to the external auditors and that they would probably be discussing them with him. For the FY 2008 and 2009 financial audits, LFUCG management assumed who the employee was when the nature of the allegation was reported to them by the external auditors. In both instances, the contact person for the financial audits felt they were already aware of the employee's issues and thought that any evidence of fraud would have already been reported to them or the Council by the employee.

The external auditors must comply with the Statement on Auditing Standards 99, *Consideration of Fraud in a Financial Statement Audit*. This standard requires the auditor to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement, whether caused by error or fraud. One method used by the external auditors to fulfill their responsibility as it relates to fraud, was to make inquiries with management and employees about their knowledge of fraud within LFUCG. This inquiry was conducted via a FRA questionnaire that was emailed to LFUCG commissioners, directors, and managers. The email message sent with the questionnaire stated that the questionnaire was designed to gather and document information regarding the nature and likelihood of fraudulent activities in the Government. The message ended with the statement, “[y]our responses will be confidential and only used as part of our audit analysis.”

This auditing standard requires the auditors to evaluate the information obtained and determine whether there is a need to perform additional or different audit testing. Some issues raised by employees will be addressed in the normal course of the audit, while others may require additional testing. The auditor should report evidence that fraud may exist to the appropriate level of management. Fraud involving senior management and fraud that causes a material misstatement of the financial statements should be reported to the audit committee. The auditor may also wish to communicate other risks of fraud that are not related to the material misstatement of financial statements.

*Process in the FY 2008 Financial Audit*

During the financial audit for FY 2008, the external auditors received 18 FRA questionnaire responses from LFUCG employees that had to be evaluated to determine the proper audit testing requirements. After this evaluation, the only comments that resulted in additional testing were the ones submitted by the Director of Risk Management. The external auditors met with the former Commissioner of Finance and Administration and the Director of Accounting to notify them that one of the FRA questionnaires alleged improprieties with insurance procurement. No names were discussed but the LFUCG management involved felt sure that it was the Director of Risk Management because he was very

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vocal about how LFUCG should not have purchased insurance through KLC. Both individuals felt they had heard everything that the employee knew about the issue. Because he was so vocal about his opinions, they felt that if there was evidence of fraud it would have already been reported to management or the Council. The former Commissioner of Finance and Administration had attended a commissioners' meeting where the procurement of insurance was openly discussed and knew that the Commissioner of Law thought a change in the procurement of insurance would be beneficial as long as it was affordable. The former Commissioner of Finance and Administration did not think fraud was an issue because it was a transparent management decision and does not recall if she reported the issue to senior management due to its confidential nature.

The additional procedures conducted by the external auditors included interviews with the Commissioner of Law, Senior Advisor for Management, and Director of Purchasing. These individuals were asked questions about the process but they were not told about the FRA questionnaire or the nature of the allegations in order to protect the employee's confidentiality. According to the external auditors, the following documents were obtained and reviewed: the LFUCG Council's resolution approving the insurance contract; the internal processing form for purchases; LFUCG's written policies for procurement of professional services; LFUCG's contract with Marsh; and internal correspondence related to the insurance procurement process.

After the interviews and examination of documents, the external auditors determined that no evidence of fraud existed. They concluded that the policy in place was followed and supported by the proper documentation. The FY 2008 FRA questionnaire was not provided to any individual by the external auditor and the matter was not reported to any other entities.

### *Process in the FY 2009 Financial Audit*

During the financial audit for FY 2009, the external auditors received 16 FRA questionnaire responses from LFUCG employees that had to be evaluated to determine the proper audit testing requirements. Again the only comments that resulted in additional testing were the ones submitted by the Director of Risk Management. Because this was the second time that similar claims were made, the external auditors judged that the matter should be communicated to management and to the Office of Internal Audit. This time, both the then-acting Commissioner of Finance and Administration and the Director of Internal Audit expressed that they knew the identity of the employee when the external auditors reported the allegations to them.

The external auditors informed the Director and Deputy Director of Internal Audit that they had received fraud allegations related to the insurance process. The Director of Internal Audit asked if it was the Director of Risk Management because this employee had notified him recently that he had brought concerns to the attention of the external auditors. This employee told the Director of Internal Audit

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that the external auditors would probably contact him about the concerns. The external auditors confirmed that it was the Director of Risk Management and that the concerns were similar to the ones he had made during the FY 2008 financial audit.

The Director of Internal Audit told the external auditors that he would need to know the allegations in order to investigate further. The external auditors refused to provide the FRA questionnaire but did send an email to the Director of Risk Management. In this email communication, the external auditors stated that Director of Internal Audit informed them that the Director of Risk Management had already spoken to him about these matters. The email informed the Director of Risk Management that the Director of Internal Audit would like a copy of his responses to the FRA questionnaire. Because the external auditors had stipulated that the responses would be confidential, they thought the FRA questionnaire should come from the Director of Risk Management.

The Director of Risk Management provided the FY 2009 FRA questionnaire, along with other documents, to the Director of Internal Audit through email. His attached message requested discretion and confidentiality and stated that he would need to be notified before disclosure to another individual or party. The Director of Risk Management stated that “the only reason for reporting this to the external auditors in the first place is because of the employee comments below me and the anonymous council member inquiries.” He stated that “this information is ripe for major controversy and I would like to avoid this in as much as you and I can try to determine if the information rises to the level of further action.”

When the external auditors reported the allegations related to insurance procurement to the acting Commissioner of Finance and Administration, the external auditors thought he was aware of the allegations because the acting Commissioner stated the Director of Risk Management’s name immediately. While the acting Commissioner of Finance and Administration stated he was not aware of the specific information reported on the FRA questionnaire, the Director of Risk Management had repeatedly talked to him and others about what the Director believed to be a bad decision LFUCG made purchasing insurance through KLC and that it was costing LFUCG more money. The acting Commissioner of Finance and Administration expressed his confusion to the external auditors about the issues being fraud since he was not aware of any personal gain. He felt the procurement of insurance was a management decision. The external auditors explained that they had reviewed the information and found no evidence of fraud.

The acting Commissioner of Finance and Administration was concerned that fraud allegations were made while he was temporarily assigned to this position. Based on email communications from the Director of Internal Audit, the acting Commissioner of Finance and Administration knew the external auditors had reported an issue to the Director of Internal Audit. He immediately contacted the

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Director of Internal Audit to discuss the issue. The acting Commissioner of Finance and Administration told the Director of Internal Audit that he was going to discuss the issue with the Senior Advisor for Management. The Director of Internal Audit asked to be a part of the meeting. The Senior Advisor for Management advised that they should cooperate with the external auditors and the Director of Internal Audit informed him that he was looking into the issue. Based on interviews with the staff, the nature of the allegations was discussed but no names were used because confidentiality had been promised. The Senior Advisor for Management asked that the Director of Internal Audit let him know when his review was complete and if he found any problems.

The Director of Internal Audit also informed the Chair of the Internal Audit Board about the preliminary work he was conducting and asked him to attend a meeting that he had requested with the external auditors and the acting Commissioner of Finance and Administration. As discussed in Finding 3, it was the practice to refer confidential issues to the Board Chair to determine if further investigation is needed. The fraud allegations were discussed in further detail but no names were used. The external auditors confirmed that they had seen no indication of fraud in their review.

A preliminary review was conducted by the Director and Deputy Director of Internal Audit regarding the FY 2009 FRA questionnaire. The Director of Internal Audit sent a memo to the Director of Risk Management on September 22, 2009 stating “that there is no credible evidence that a fraudulent act has occurred, is occurring, and/or will occur.” The memo stated that “no further action will be taken regarding the concerns you brought to M&B’s attention in your July 6, 2009 FRA response. We appreciate your input in M&B’s FRA process.” The Director of Risk Management replied, “[t]hank you for your review of these concerns by LFUCG employees and Council members.” This memo was provided to the external auditors for their working papers as documentation that the issue had been addressed. On May 11, 2010, the external auditors provided the memo to a Council member, as further discussed in Finding 2. This memo can be seen at Exhibit 6.

Based on the response by the Director of Risk Management, the Director of Internal Audit felt that the employee was satisfied with the investigation and the matter was closed. The Director of Internal Audit felt that if he was not satisfied he could have made a special request for an audit.

### *Recent Actions Related to the FRA Questionnaire*

On April 13, 2010, the Director of Risk Management contacted a Council member to report that his position was being eliminated due to retaliation of his submission of the FRA questionnaires. Another Council member was also contacted by the Director of Risk Management about his concerns related to insurance procurement and whether the Council was getting correct information. It is not known whether the FRA questionnaires were discussed.

## Observations and Questions

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At some point after the decision was made to eliminate his position, the Director of Risk Management contacted an attorney. This attorney was provided with copies of the FY 2008 and FY 2009 FRA questionnaires. At some point in late April or mid-May of 2010, this attorney felt that he had to dismiss himself due to a potential conflict, so the Director of Risk Management engaged another attorney who was also provided copies of the FY 2008 and FY 2009 FRA questionnaires.

On May 6, 2010, a Council member met with executive staff within the APA and provided copies of the FY 2008 and FY 2009 FRA questionnaires. This Council member requested the meeting to discuss a list of issues related to LFUCG. These issues included KLC insurance, risk management, and that the Director position in risk management was being eliminated. After this office determined on June 3, 2010 to perform an examination of insurance procurement issues, the Council member was asked the source of the FRA questionnaires. The Council member, who also served on the Council's Special Investigative Committee, stated they did not realize that these documents were the documents that were being requested by the Special Investigative Committee and must not have realized the significance of the documents. The Council member could no longer locate the copies of the documents and did not know the source of the documents.





**Findings and Recommendations**

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**Finding 1: The Senior Advisor for Management was not required to inform an employee that he was the subject of a preliminary investigation for possible fraud allegations.**

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The Senior Advisor for Management informed the Commissioner of Law about a preliminary review conducted by the Office of Internal Audit even though there was no requirement to do so. The Commissioner of Law then filed an Open Records request with the Director of Internal Audit to inspect and make copies of any and all documents relating to this investigation. The Director of Internal Audit was instructed by a LFUCG staff attorney that, pursuant to KRS 61.878(3), he must provide the documentation and that no names should be redacted. Even though state law allows this documentation to be provided once requested, there was no requirement or procedure established that the subject of a preliminary review conducted by the Office of Internal Audit should be notified. In addition, it is questionable whether the identity of the LFUCG employee should have been redacted due to the confidentiality promised to the employee by the external and internal auditors when the FRA questionnaire was submitted to them.

During the FY 2009 financial audit, the acting Commissioner of Finance and Administration met with the Senior Advisor for Management to inform him about a report from the external auditors that possible fraud allegations were brought to their attention. The Director of Internal Audit attended the meeting and informed the Senior Advisor for Management that he was doing a preliminary review of the issue and that he would let him know if any problems were found.

The Director of Internal Audit informed the Senior Advisor for Management that his investigation was over and no evidence of fraud was found. In a written memorandum dated September 22, 2009, the Director of Internal Audit notified the Director of Risk Management that Internal Audit’s preliminary review had found no credible evidence that fraud had or was occurring. On September 23, 2009, the Commissioner of Law filed a request pursuant to the Open Records Law with the Director of Internal Audit “to inspect and to make copies of any and all documents relating in any way to any investigation by your office or by LFUCG’s financial auditors of LFUCG’s placement of insurance in 2008 and 2009.”

While the FRA questionnaire is not considered an open record according to state law, KRS 61.878(3) allows a public agency employee “to inspect and to copy any record including preliminary and other supporting documentation that relates to him.” The statute’s only limitation is that the public agency employee “shall not have the right to inspect or to copy any examination or any documents relating to ongoing criminal or administrative investigations by an agency.” In this situation, the Open Records request was submitted the day after the investigation was complete, so it was no longer an on-going investigation.

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## Chapter 3

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The Director of Internal Audit had never been involved in this type of request, so he consulted with a staff attorney in the Department of Law. The attorney informed him that even though the FRA questionnaire was a preliminary document, the Director of Internal Audit would have to provide it pursuant to KRS 61.878(3). His support for this conclusion was that it “relates to” the Commissioner of Law, who is a “public agency employee.” He did advise that the portions of the document that do not relate to the Commissioner of Law should be redacted.

The Director of Internal Audit also asked the attorney if the name in the documentation identifying the LFUCG employee making the fraud allegation could be redacted to protect confidentiality. The attorney responded “[n]o. Though I understand the reasoning (in this and other situations).” Therefore, the Director of Internal Audit understood that he was required by state law to provide this information without redacting the identity of the employee. The Commissioner of Law received a redacted FY 2009 FRA questionnaire and the September 22, 2009 memo sent to the Director of Risk Management from the Director of Internal Audit. These documents can be seen at Exhibits 6 and 7.

As for the decision not to redact the name of the LFUCG employee who made the fraud allegations in the FY 2009 FRA questionnaire, the decision was made on the advice of LFUCG legal counsel based on a series of Attorney General’s Open Records Opinions stating that a “public agency employee” requesting records pursuant to KRS 61.878(3) relating to the employee enjoys a broader right of access to records relating to the employee than a member of the general public (05-ORD-118). In addition, 03-ORD-068 states that a “public agency employee” requesting records relating to the employee is generally entitled to inspect and copy such records in their entirety. OAG 07-ORD-199, however, states that “the identity of a complainant can be withheld under KRS 61.878(1)(a) where the complainant’s privacy interest outweighs the public’s interest in disclosure . . .,” and that “the names and contact information of the complainants and witnesses may be withheld” in circumstances “where the complainant requests anonymity or could reasonably expect confidentiality.” Therefore, it appears to be an open legal question whether the right of a “public agency employee” to records related to the employee includes the right to have disclosed to him or her the name of the individual creating a record relating to the “public agency employee” when the individual creating the record that makes allegations of fraud against the “public agency employee” has been promised confidentiality and who has a reasonable expectation of privacy that the employee’s name will not be disclosed.

Through interviews with the Director of Internal Audit, it was asked why the Director of Risk Management was not notified about the Open Records request. The Director of Internal Audit’s response was that this request was “new territory” and he was not required to notify the employee. In regards to the request from the Director of Risk Management during Internal Audit’s preliminary review that he be

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## Chapter 3

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notified before disclosure to another individual or party, the Director of Internal Audit considered that this request was secondary to state law because the employee's permission was not needed or required. During the preliminary review, the Director of Internal Audit did honor this request from the Director of Risk Management and sent an email to the Director of Risk Management asking for permission to share the FRA questionnaire with the Deputy Director of Internal Audit. The Director of Risk Management gave his permission and stated that he "would like to concur with the sharing of this information with anyone outside your office." The Director of Internal Audit considered this request as pertaining to the preliminary review and not applicable when state Open Records law required its disclosure.

While state Open Records law allowed the Commissioner of Law to inspect those portions of the FRA questionnaire that related to him, the law does not state that public agency employees are required to be notified of all records related to them. According to the Senior Advisor for Management's interview with the Special Investigative Committee on August 20, 2010, under an LFUCG ordinance the subject of a complaint was required to be notified within 10 days of the receipt of the complaint. He stated that he knew this issue had been investigated twice by the external auditors and once by the Office of Internal Audit and he did not think an individual should be able to make illegitimate claims without being held accountable. After three reviews, he felt that it appeared that the employee was making false allegations.

While there is a LFUCG ordinance that requires the subject of a complaint to be notified within 10 days of the receipt of the complaint, this ordinance relates to a complaint provided to the LFUCG Ethics Commission. According to LFUCG Code of Ordinances Section 25-23, the "ethics commission shall acknowledge receipt of a complaint to the complainant within ten (10) working days from the date of receipt. The commission shall forward within ten (10) working days to each officer or employee who is the subject of the complaint a copy of the complaint and a general statement of the applicable provisions of this chapter."

The FRA questionnaire was not a complaint issued to the Ethics Commission. This ordinance did not apply to information submitted to the LFUCG external auditors in confidentiality and there were no requirements that it should have been reported to the subject of the allegations.

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## Chapter 3

# Findings and Recommendations

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**Recommendations** We recommend LFUCG develop procedures as to when and how information provided in a confidential manner to the external or internal auditors should be reported, and to which entities and persons. Confidential allegations found not to be credible, should not be reported to the individual against whom the allegations were made so that the issue of retaliation never arises. When responding to an Open Records request from a “public agency employee” for records related to him or her, further legal analysis should be conducted before deciding whether the names and identifying information of the persons making documented allegations of fraud who are promised confidentiality and who may have a reasonable expectation of privacy should be redacted from the documentation provided.

To address communications of fraud allegations from external auditors, the LFUCG audit contact person should inform the external auditors that any fraud allegations go directly to the Director of Internal Audit without any additional information being provided to the contact. Documentation should be maintained of the issues received by Internal Audit. Under this method, information will be reported to the Internal Audit Board that is made up of individuals from LFUCG senior management and Council members. See Finding 4. This will allow members from management and its legislative oversight entity to be involved in the investigation and conclusion. Voting and ex-officio members of the Internal Audit Board should sign confidentiality statements before serving in this capacity. Information reported to the Internal Audit Board should not be reported to other members of management or Council even if it relates to that individual.

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**Finding 2: The external auditors released the Director of Internal Audit’s conclusion memo to a Council member without redacting the name of the LFUCG employee.**

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Due to an information request from a LFUCG Council member, the external auditors provided the September 22, 2009, preliminary review conclusion memo that was written by the Director of Internal Audit to the Director of Risk Management. The release of this memo publicly identified that an employee brought issues of fraud to the external auditors and provided the name and position of the employee. By providing this memo to be inspected by a Council member, this issue was then discussed in open Council meetings because it was no longer considered confidential. The release of this memo also led to critical comments regarding the Office of Internal Audit during a public meeting.

At a Budget and Finance Committee meeting on April 27, 2010, the LFUCG external auditors presented the FY 2009 financial audit. A Council member asked about the process involved if an employee brings issues to their attention during the audit. Specifically, the Council member wanted to know how many of these requests have there been over the past three years and where the external auditors sent them after their review was complete. The Council member expressed concern that employee issues would only be reported to LFUCG management, not the Council. The external auditors responded that they thought this kind of information could be provided to the Council member, if requested.

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## Chapter 3

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On April 28, 2010, the aide to the Council member sent an email request to the external auditors for information as to the number of complaints/reports of possible fraud, the external auditor's recommendations for each complaint/report, the person in LFUCG that had reviewed the complaint/report, and any additional background information that would explain the complaints/report. The external auditors responded with a letter on May 11, 2010, stating that, for the past three financial audits, inquiries with LFUCG management and employees about their knowledge of fraud had been made and "only two instances of possible fraud were communicated to us via these inquiries. A LFUCG employee in the Division of Risk Management communicated the same instance of possible fraud to us in 2008 and 2009." The letter explained that for FY 2008, the matter was reported to the Commissioner of Finance and Administration and the FY 2009 instance was reported to the acting Commissioner of Finance and Administration and the Director of Internal Audit. Attached to this letter was a copy of the September 22, 2009 memo prepared by the LFUCG Director of Internal Audit that describes the Director's conclusion from his preliminary review.

The release of this memo not only identified the LFUCG employee, but also resulted in critical comments regarding the Office of Internal Audit. At a May 25, 2010 Council Committee of the Whole, the Council member in receipt of the September 22, 2009 memo announced that issues of fraud had been brought up by the Director of Risk Management. The Council member went on to say that the Internal Auditor knew there was fraud and did not interview the employee or investigate further. The memo clearly states, "In conducting our preliminary review... there is no credible evidence that a fraudulent act has occurred, is occurring, and/or will occur."

The cover letter has also caused confusion by stating that "only two instances of possible fraud were communicated to us via these inquiries." Based on information provided by the external auditors at the request of the APA, there were other employees that responded to the FRA questionnaire with concerns. However, the two responses from the Director of Risk Management were the only instances that resulted in additional testing. The external auditor received 18 FRA questionnaire responses during the FY 2008 financial audit and 16 were returned during the FY 2009 audit. These responses contained issues that had to be evaluated to determine the proper audit testing requirements.

No explanation has been provided as to why this memo was provided or why the employee's name and position were not redacted. It was sent without the knowledge or consent of the LFUCG Director of Internal Audit. This memo was only provided to the external auditors as documentation to be included in their working papers. On May 21, 2010, the Director of Internal Audit communicated to the external auditors that providing this memo was "a significant breach of professional courtesy." He stated that, "[e]ven assuming this document would have been subject to open records laws (and this has not been officially established as

**Findings and Recommendations**

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such by the LFUCG Dept. of Law),” the “name should have been redacted to protect his confidentiality, consistent with” the external auditors’ “own representation of confidentiality made to him regarding his answers” to the FRA questionnaires.

***Recommendations***

LFUCG should develop procedures to inform the Council of confidential issues brought to the attention of the external auditors through closed meetings as appropriate so that private or critical information that could result in an employee disciplinary action is not discussed publicly. A procedure should be established for possible fraud allegations to be communicated to the Office of Internal Audit for disclosure to the Internal Audit Board.

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**Finding 3: The Internal Audit Board was advised that closed meetings could not be conducted to discuss confidential issues.**

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Based on legal advice from a staff attorney in the LFUCG Department of Law, the LFUCG Internal Audit Board was advised that it cannot go into a closed meeting, which has led to the lack of discussion by the full Board of confidential allegations made by an employee in a FRA questionnaire. To address confidentiality issues, the October 7, 2003 Internal Audit Board meeting minutes document that it was decided the Director of Internal Audit would consult only the Board Chair to “keep it confidential from the individuals involved in the audits.” According to interviews with former Board members, this practice was developed because the Board did not feel at liberty to discuss, in an open meeting, allegations that could “defame” an LFUCG employee. Because the preliminary review of the FRA questionnaire was found not to substantiate the allegations of fraud, the issue was not brought to the attention of the full Board at an open meeting. The Office of Internal Audit’s inability to provide full disclosure and discuss confidential issues with the Board should be addressed so that the Board can be aware of issues affecting LFUCG.

The issue of confidential allegations is not addressed within the Office of Internal Audit Policies and Procedures Manual. The only documentation for the handling of confidential issues is the Board meeting minutes. During the Board meeting on October 7, 2003, a Board member representing the Council stated there was a need for a temporary process for bringing issues involving the administration, Mayor, or Council to the Internal Audit Board. He said that the process was needed to address those kinds of issues without information getting back to those areas of government before a review can be done. He suggested that “these items could be referred to the Chair for delegation, since the Chair is an outside individual” and “this would keep it confidential from the individuals involved in the audits.” While this practice may have been understood and accepted by the Internal Audit Board members serving at that time, it was not documented in policy for future Board members’ knowledge or discussion.

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The decision to not go to the full Board was also influenced by advice from a staff attorney within LFUCG's Department of Law. On September 3, 2009, the Director of Internal Audit sent an email to the staff attorney seeking his agreement that the Board could go into a closed meeting when discussing a possible fraud allegation. Specifically, the Director of Internal Audit stated the following:

It seems very clear to me that if the Internal Audit Board must discuss preliminary information regarding a fraud allegation in which specific individuals have been named, or in which it can be easily determined who the potential perpetrator is, this should be a closed session under this exception. Obviously, if the fraud allegation proves true, disciplinary action would ensue as a direct result of the Board's discussion about the fraud and the investigation the Board instructed Internal Audit to conduct.

The staff attorney replied that the exception related to discussing the discipline of employees, KRS 61.810(1)(f), did not apply because the Board has no employees. He stated that it is the findings and reports of Internal Audit that lead to the discipline of an employee, not the Board's discussions. He also advised that when discussing these matters, the Board should avoid using names of employees. The staff attorney ended his response by stating that he would not seek an opinion from the Attorney General unless directed to do so by the Commissioner of Law.

In March 10, 2009, a new Board member representing the Council asked how special requests were handled. The Director of Internal Audit explained the existing process and how it places significant responsibility on the Director and the Board Chair to decide whether to honor a special request for an audit and when to conduct it. It was noted in the minutes that the special request approval process needs to be formalized in writing, and the responsibility to decide whether to honor or deny requests should shift from the Chair to the full Board. The Director of Internal Audit then provided the following proposal to the Board to document the special request process:

In the event the Director of Internal Audit receives a special request from members of the Administration, Council, or LFUCG employee(s) for an audit not included in the Annual Audit Plan approved by the Internal Audit Board, the Director of Internal Audit shall inform the Board Chair of the special request. Upon approval by the Board Chair, the Director of Internal Audit shall conduct a preliminary assessment of available information and evidence to determine if an audit is warranted. The Director of Internal Audit shall present this information and evidence, along with his opinion as to the merits of the request, to the Board for consideration and a vote whether to honor the request and where to insert it in the Audit Plan. The Director of Internal Audit shall then inform the requestor

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in writing of the Board's decision. If the request is denied, the requestor will be informed that they may directly appeal the decision to the Board.

A motion was made to approve the proposed special request process, and it was approved 4-0. Therefore, the Office of Internal Audit Policies and Procedures Manual does include the procedures to be followed when the Director of Internal Audit receives a special request.

The Director of Internal Audit stated that he did not go to the full Internal Audit Board with the issues raised by the external auditors concerning the allegations made in the FRA questionnaire because he did not consider this a special request. The external auditors told the Internal Auditor that they did not find any evidence of fraud but wanted to report it to satisfy the requirements of financial auditing standards on identifying the risks of fraud.

The Director of Internal Audit contacted the Board Chair, and together, they attended a meeting with the external auditors. The broad issues raised in the questionnaire were discussed and it was decided that a preliminary assessment would be conducted before the issue was brought before the full Board in an open meeting. The Board Chair did not want to share information that might be perceived as detrimental to an individual's reputation, in order to protect LFUCG from a potential lawsuit.

From our research and discussions with the Office of the Attorney General, OAG 01-OMD-18 appears to support the argument that the Internal Audit Board could claim an exception under the provisions of KRS 61.810(1)(f). This exception reads as follows:

Discussions or hearings which might lead to the appointment, discipline, or dismissal of an individual employee, member, or student without restricting that employee's, member's, or student's right to a public hearing if requested. This exception shall not be interpreted to permit discussion of general personnel matters in secret;



OAG 01-OMD-18 supports the proposition that a public agency board, like the Internal Audit Board of LFUCG, may discuss, in closed session, issues related to allegations of fraud perpetrated by an LFUCG employee because substantiated allegations could lead to the discipline of the perpetrator/employee. While the Internal Audit Board is not responsible for taking disciplinary action against employees, its duty is to supervise and implement the internal audit function, which has the responsibility of assessing and making recommendations for improving LFUCG governance. In order to carry out this responsibility, the Office of Internal Audit must communicate risk and control information to the Internal Audit Board, senior management, and the Council. While the Office of Internal Audit is not responsible for determining what constitutes appropriate disciplinary action, discussing its audit work and findings with the Internal Audit Board could lead to the discipline of an LFUCG employee by responsible management or the Division of Human Resources.

OAG 01-OMD-18 also provides an example that a city council can go into a closed meeting to discuss specific matters of personnel involving any municipal employee, not just city council members. This opinion points out that the exception provided by KRS 61.810(1)(f) was meant to protect the privacy of all municipal employees and not just the direct members of the city council. Based on this logic, the Internal Audit Board members should be able to go into closed meetings to protect the privacy of any LFUCG employee involved in fraud allegations.

The Office of Internal Audit is authorized by its charter to obtain full and unrestricted access to LFUCG systems, records, personnel, and physical properties necessary to fulfill its purposes. The charter requires that personnel will respect confidentiality, value, and ownership of information they receive and will not disclose information without appropriate authority unless there is a legal or professional obligation to do so. This seems to require the Office of Internal Audit to report to the Internal Audit Board any confidential information related to LFUCG employees in a closed session of the Board.

***Recommendations*** Based on the reasoning in OAG 01-OMD-18 and in consultation with the Office of the Attorney General, we recommend the full Internal Audit Board be informed in a closed session of allegations that come to the attention of Internal Audit, provided that the discussions might lead to disciplinary measures being taken against an LFUCG employee. In addition, we recommend the Board obtain independent legal counsel when dealing with matters that may create a conflict of interest for employees within the Department of Law. In conjunction with the recommendations for Finding 4, we recommend that a confidentiality statement be signed by all members to ensure confidentiality when needed to allow for full disclosure to the Board members.

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## Findings and Recommendations

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**Finding 4: The Office of Internal Audit is organizationally independent within LFUCG but the Internal Audit Board has not established operating procedures.**

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The placement of the Office of Internal Audit meets the Institute of Internal Auditor’s standard for organizational independence. However, its governing body, the Internal Audit Board, has not established bylaws under which to operate that are subject to Council approval. Even if changes are made to the membership of the Internal Audit Board, the organizational placement should not change.

According to the Institute of Internal Auditors’ Organization Independence Standard, the chief audit executive must report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. The internal audit activity must be free from interference in determining the scope of internal auditing, performing work, and communicating results.

At LFUCG, the Director of Internal Audit reports to the Internal Audit Board that was established by the Council to supervise, evaluate, monitor, and implement the internal audit function of LFUCG. The seven-member Board includes five voting and two non-voting members. The voting members are to include:

- Two members from the community at large with accounting/auditing certifications. One is recommended by the Council, appointed by the LFUCG Mayor, and approved by the Council. The other is appointed by the LFUCG Mayor, and approved by the Council.
- Two LFUCG Council members.
- The LFUCG Mayor or his designee.

The other two non-voting members are the Council Administrator and the Chief Administrator Officer. This makeup of members allows the Office of Internal Audit to have a connection with the executive and legislative branches of LFUCG, as well as community members.

The Director of Internal Audit currently reports for administrative purposes to the Senior Advisor for Management. This arrangement ensures that the internal audit function is not isolated from the Administration and its department heads. The Senior Advisor for Management is responsible for signing the Director’s timesheets and leave requests, but the Director manages the Office of Internal Audit’s budget that is approved by the Internal Audit Board for presentation to the Council.

The LFUCG Council approved Ordinance No. 63-2002 creating the Internal Audit Board in March 2002. According to the ordinance, “the board shall determine its own bylaws, rules and order of business and shall provide for keeping a record of its proceedings. Such bylaws shall be subject to approval by the urban county council.” However, the Internal Audit Board has not created any bylaws or rules under which to operate.

## Findings and Recommendations

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In order for the Internal Audit Board to go forward with several of the recommendations in this report, bylaws and rules are needed to address the issues for the Board to be fully effective in its responsibility to “supervise, coordinate, evaluate, monitor, and implement the internal audit function.” Developing such bylaws and rules that are then presented to the Council for approval as required by the Board Charter should improve the understanding and confidence in the processes followed by the Board and Internal Audit in performing their function.

***Recommendations*** We recommend that LFUCG consider amending Ordinance No. 63-2002 to expand the number of Internal Audit Board members by increasing the number of members from the community at large, with the goal that a majority be constituted by the community at large members. This will also assist in achieving a quorum at Board meetings and will allow for more independence. If the ordinance is amended as recommended, the majority of the members will be from the community at large, yet there will still be direct input from Council and administration members. One approach could be for the number of additional Board members to be equally initiated by the Mayor and the Council. Qualified potential candidates should be selected from accounting, auditing, or legal professional associations to serve as the additional Board members. The amended ordinance could address the process to follow if the Mayor does not appoint a Council recommendation to the Internal Audit Board. This process could allow for the Council to approve the appointment by a two-thirds majority vote. We recommend the amended ordinance limit the number of consecutive terms that voting Board members and the Board Chair can serve, as well as, criteria under which a Board member can be removed. In addition, we recommend the amended ordinance specify that the Board select the Chair from the community at large members.

The LFUCG Internal Audit Board should adopt bylaws and rules that reflect Ordinance No. 63-2002 or any amendments. Bylaws should also address confidentiality issues, conflicts of interest, criteria for entering into a closed session, and any action necessary to consistently “supervise, coordinate, evaluate, monitor, and implement the internal audit function.” To ensure the Council’s knowledge and acceptance and to comply with Ordinance No. 63-2002, the bylaws and rules should be presented for Council approval. The bylaws should also require the Internal Auditor to periodically report audit findings and other issues to the Council’s Budget and Finance Committee, or other committee as desired by the full Council.

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## Findings and Recommendations

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**Finding 5:  
LFUCG has no  
established method  
for employees and  
citizens to  
anonymously  
report issues of  
concern.**

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LFUCG has a very detailed Ethics Act that addresses complaints and retaliation, but it does not provide a process for employees or citizens to report anonymous complaints without fear of retaliation. KRS 61.102 provides for public agency employees to bring forward reports or complaints without fear of retaliation or reprisal. During the FY 2009 financial audit, the external auditors noted the lack of a process for filing anonymous complaints and suggested that a process be established. Louisville Metro Government has developed the Louisville Metro Ethics Tipline to allow employees and citizens a method to confidentially report concerns. LFUCG has not acted to develop this or another process for an employee or other person to report complaints or concerns in a confidential manner that addresses the issue of retaliation.

LFUCG's only policy for reporting complaints is located in their Code of Ordinance under Chapter 25, which is cited as the LFUCG Ethics Act. The stated purpose of the Ethics Act is as follows:

It is the purpose of this chapter to provide a method of assuring that standards of ethical conduct and financial disclosure requirements for officers and employees shall be clearly established, uniform in their application, and enforceable, and to provide the officers and employees with advice and information concerning potential conflicts of interest which might arise in the conduct of their duties.

The Ethics Act contains requirements that include conflicts of interest, receipts of gifts, use of public property, post-employment restrictions, and nepotism. Section 25-23 provides the method for filing complaints related to provisions of the Ethics Act. The following are the paraphrased process steps documented in this section.

1. All complaints must be in writing and signed by the complainant under penalty of perjury. The ethics commission must acknowledge receipt of a complaint to the complainant within 10 working days from the date of receipt. The commission must forward within 10 working days to each officer or employee who is the subject of the complaint a copy of the complaint.
2. Within 30 days of the receipt of a proper complaint, the ethics commission must conduct a preliminary inquiry concerning the allegations in the complaint. The subject of the complaint will be given the opportunity to respond and be represented by counsel.
3. All proceedings and records related to the preliminary inquiry must be confidential until a final determination is made.
4. If the preliminary review determines that the complaint is outside its jurisdiction, frivolous, or without factual basis, the inquiry is terminated. This conclusion is documented in writing and sent to the complainant and all officers and employees against whom the complaint was filed.
5. If the preliminary review determines that the complaint is within the commission's jurisdiction and appears to be based on factual information, a hearing will be initiated.

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Section 25-29 of the Ethics Act provides protection to the complainant. It states that no officer or employee will subject the complainant to reprisal or use any official authority to discourage, restrain, or discriminate against an officer or employee who brings a complaint in good faith. This section also protects any officer or employee that supports, aids, or substantiates a complaint. It does not prohibit disciplinary or punitive action if an officer or employee discloses information that he knows to be false, exempted from required disclosure, or confidential under law.

While the Ethics Act provides a very detailed transparent process to address ethical violations of this Act, it does not address anonymous reports or a method for private citizens to report financial or other potential issues or concerns. Section 25-29 provides protection to complainants that file a report with the Ethics Commission but it does not address confidential issues reported to the Office of Internal Audit.

As discussed in Finding 1, the Senior Advisor for Management informed the Commissioner of Law that the Commissioner was the subject of an allegation. This was only required if a complainant filed a report with the Ethics Commission.

At the conclusion of the FY 2009 financial audit, the external auditors issued a Management Letter that summarizes comments and suggestions regarding internal controls and operating efficiency. One of their comments in this document was that LFUCG's current policies do not provide for the filing of anonymous complaints. The external auditors recommended that LFUCG establish a policy and process that allow concerns to be brought to their attention, including anonymous concerns. The policy should include reporting procedures and management's responsibility to address the issues reported.

There are various methods to implement an anonymous reporting mechanism. One method for accomplishing anonymous reporting of concerns or other issues used by Louisville Metro Government is the Louisville Metro Ethics Tipline, which provides Metro Government employees and citizens a resource to confidentially report concerns of alleged unethical or illegal actions. It is intended to be a mechanism to anonymously report concerns without fear of retaliation. Louisville Metro contracted with an independent provider for the tipline services. The contract is administered by their Office of Internal Audit. The Ethics Tipline reports are sent to designated Louisville Metro departments based on the type of incident reported while the Office of Internal Audit receives copies of all reports. When the investigation is closed, the report is subject to public disclosure under Kentucky Open Records laws. If the complainant reveals their identity, it may be disclosed publicly, but anonymous reports will not be identified. Other methods that could be used include advertising on the LFUCG and Internal Audit web pages an address or email account where concerns can be sent, and an internal tipline number operated by internal auditors.

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**Recommendations** LFUCG should implement a process to receive, distribute, investigate, and resolve anonymous concerns from its employees and citizens. The reporting method used to accomplish this reporting could be a third party vendor, tipline, email, or a mailing address. This function should be assigned to a specific entity within LFUCG to administer and distribute concerns for investigations. The Internal Audit Board should be informed of complaints received, how they were reviewed, recommendation as to whether a full investigation should be initiated, and the final resolution of each complaint. Documentation should be maintained representative of each complaint received, the date it was shared with the Board, and the resolution of the complaint. This method would ensure that the Internal Audit Board would be knowledgeable of the complaints and would expedite a vote on which issues to investigate further.

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**Finding 6: The Office of Internal Audit did not establish policies or procedures regarding employee complaints or concerns unless provided in the form of a “special request.”**

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As discussed in Finding 3, the Office of Internal Audit Policies and Procedures Manual did include procedures for actions to be taken by the Director of Internal Audit when receiving a special audit request. However, audit requests come in many forms and it was not clear in the procedures what exactly constitutes a special request for audit. In addition, this procedure did not address who should receive confidential reports from the external auditors and the process that should be followed to address requests or information from external auditors. Also, it appears that the Administration, Council, or LFUCG employees may not be aware of the process outlined in the Internal Audit Policies and Procedures Manual to request special internal audit services.

The following is the portion of the Office of Internal Audit Policies and Procedures Manual that discusses special requests.

In the event the Director of Internal Audit receives a special request from members of the Administration, Council, or LFUCG employee(s) for an audit not included in the Annual Audit Plan approved by the Internal Audit Board, the Director of Internal Audit shall inform the Board Chair of the special request. Upon approval by the Board Chair, the Director of Internal Audit shall conduct a preliminary assessment of available information and evidence to determine if an audit is warranted. The Director of Internal Audit shall present this information and evidence, along with his opinion as to the merits of the request, to the Board for consideration and a vote whether to honor the request and where to insert it in the Audit Plan. The Director of Internal Audit shall then inform the requestor in writing of the Board’s decision. If the request is denied, the requestor will be informed that they may directly appeal the decision to the Board.

Special requests by individuals or groups outside of the LFUCG will be forwarded to the Citizens' Advocate as approved by the Internal Audit Board. If the Citizens' Advocate then requests assistance from the Office of Internal Audit, that request will be addressed in the same manner as an Administration or Council request described above.

This policy was strengthened on March 10, 2009, to involve the full Internal Audit Board in the process. However, the Policies and Procedures Manual does not define the term "special request" nor does it discuss confidentiality issues or the method in which these requests can be provided to the Office of Internal Audit.

In the case of confidential reports from external auditors about possible fraud allegations, it is not clear if these should be handled in the same manner as a special request. If so, then the full Internal Audit Board should have been presented with the allegation and evidence in order to vote on whether to investigate further.

It is also not evident that the option of a special request has been clearly or routinely communicated to the Administration, Council, or LFUCG employees. In the Internal Audit Board meeting minutes from March 10, 2009, the Director of Internal Audit asks the Board members that are also Council members to emphasize the special request process, but it is not known if this occurred.

As discussed in Chapter 2, the Director of Internal Audit thought the Director of Risk Management was satisfied with the investigation because he did not make a special request for an audit. However, there is no evidence that this option was provided to the employee.

***Recommendations***

The Office of Internal Audit should develop policies, rules, or procedures to address concerns, issues, or potential fraud allegations reported by external auditors, anonymous complaints, and others. To ensure all parties have a clear understanding, policies should clearly define what constitutes a special request for audit services and provide procedures detailing how those requests will be communicated and reviewed. A process should be developed to ensure appropriate communication to the Internal Audit Board and to protect a complainant's confidentiality, unless otherwise required by law to disclose this information. Any potential limitations of confidentiality should be explained to the complainant. For anonymous concerns, a method to receive and track complainants in order to obtain additional information should be included in the procedures.

All the policies, rules, or procedures should be submitted to the Council for review and approval as required by the Charter of the Office of Internal Audit. Approved procedures for submitting complaints or concerns to the Office of Internal Audit should be communicated to the Administration, Council, and LFUCG employees. These procedures should include the specific method(s) to make a complaint, i.e. email, phone, meeting, or other.

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## Chapter 3

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**Finding 7:  
Procurement  
policies have no  
clear hierarchy of  
authority,  
occasionally  
conflict, and have  
not been approved  
by Council.**

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LFUCG currently uses three separate procurement policies which present various concerns including: unclear lines of authority and conflicting policies that allow for alternate processes to procure services. In addition, no procurement policies have been approved by Council as required by state law. These three policies include the LFUCG Procurement Regulations, Division of Central Purchasing (Central Purchasing) policies and procedures manual, and a policy memorandum from the CAO. While these three policies generally follow similar procurement methods, each is sufficiently unique to cause the procurement requirements to be confusing.

Given that two different administrative authorities have issued procurement policies, there appears to be at least some conflict or confusion regarding the ultimate authority for issuing procurement policy. This situation is compounded by the fact that the Council has never approved procurement procedures or adopted them as part of an administrative code, even though it is required by KRS 68.005 and 67.712(2). The result is procurement practices with no direction or approval from the legislative body of LFUCG, and potentially confusing procurement policies that could result in haphazard procurement administration.

According to Central Purchasing staff, the primary procurement policies referenced and followed for purchases made for LFUCG are the *Division of Central Purchasing Policies and Procedures*. This manual was originally written by the Central Purchasing and is updated as needed. The Director of Central Purchasing has the authority to approve any of the changes to the manual within the constraints of state law. Since LFUCG has not adopted the Model Procurement Code found at KRS 45A.343 – 45A.460, the primary state law governing LFUCG procurement is found at KRS 424.260 and 67.712(2). KRS 424.260 provides a very general standard for the competitive bidding process for local government entities.

In addition to the Central Purchasing policy manual, the Division also maintains the *Lexington-Fayette Urban County Government Procurement Regulations*. While the title of this document may imply a greater authority, according to Central Purchasing staff it does not carry any more authority than the policy manual. In fact, the regulations are also maintained by Central Purchasing, and the Director may approve any changes as needed. The document, which has been in effect since 1983, appears to have been based on the Model Procurement Code, but the author(s) of the regulations is unknown and they have never been approved by Council. This is reflected by the fact that the LFUCG Council adopts either resolutions or ordinances, not regulations.

The final procurement policy was developed by the CAO in 1996 by issuing Chief Administrative Officer Policy Memorandum #1 (CAO Policy #1). See Exhibit 8. It is specific to the purchase of professional services only, and gives the CAO great authority in the choice of vendors. The CAO may approve a contract for professional services with a value less than \$50,000. For contracts greater than that amount, the CAO may choose the vendor with final approval by the Council. There are no requirements for, or mention of, any type of competitive methods to be used.



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There are seven factors given for the CAO to base the vendor decision on, but they are only to be “considered.” According to the Director of Central Purchasing, he felt this policy may have been developed because at the time there was no clear process for purchasing professional services, which are exempt from the competitive bidding process. It is unclear what authorized the CAO to issue such a policy.

As already stated, having three separate procurement policies with no designated hierarchy for their authority could make it difficult for those conducting the procurement process to ensure that they are following all proper procurement requirements. Further complicating that issue is when these different policies conflict with each other. Without a designated precedence of the policies, it may be difficult to ensure a consistently applied procurement process.

*Lack of  
Authoritative  
Hierarchy Within  
Procurement  
Policy  
Administration*

Under LFUCG Code of Ordinances, the CAO controls and supervises all departments and their respective commissioners, but a person has not been appointed to the CAO position since July 1, 2007. Instead the position of Senior Advisor for Management has taken over many of the duties assigned to the CAO. This position was created by ordinance 153-2007, but it does not transfer the specific duties of the CAO to the new position. In effect, while the Senior Advisor for Management may take on the supervisory role once held by the CAO, that position is not the CAO, nor does it meet the same qualifications for the CAO position as outlined in the LFUCG Charter and KRS 67A.025. It is questionable whether the Senior Advisor for Management has the procurement authority of a policy specifically granting the authority to the CAO position.

Also questionable is whether the CAO could have issued CAO Policy #1 and inserted the CAO position directly into the procurement process. While this position does have supervisory oversight over the departments and commissioners, and, in essence, directs their activities, the duties of the CAO specifically granted by the LFUCG Charter and Code of Ordinances do not include procurement. Oversight and control of procurement for LFUCG, is instead, expressly given to the Division of Central Purchasing by the Charter. Specifically, it states,

The Division of Central Purchasing shall be responsible for making all purchases for the Merged Government, its departments, agencies, divisions and such boards and commissions as the Council may direct. Said division shall administer a system of centralized purchasing best suited to obtain the greatest economic savings and value in the procurement of all necessary supplies, materials, equipment, contractual services, insurance and surety bonds, and such other items as may be prescribed by the Council.

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Based on this language, it would appear that the authority to grant the CAO position approval rights over professional service contracts would come in the form of a policy from Central Purchasing, not from the CAO. According to the Director of Central Purchasing and documentation provided, the CAO policy has never been adopted directly into the Central Purchasing Policy Manual, although the Policy is referenced as a part of the process and included as an attachment. Central Purchasing may consider this to indicate approval of the overall administrative authority held by the CAO position, while still retaining the procurement authority granted under the Charter.

According to both the Central Purchasing Policy Manual and the LFUCG Procurement Regulations, Central Purchasing shall decide whether a purchase must be made by competitive sealed bidding. While the CAO policy only applies to professional services, which are already exempt from the competitive bidding process, the regulations further state,

Exemptions of the listed categories of items and services from competitive sealed bids does not preclude the use of other competitive techniques (informal quotes, competitive proposals, etc.) when the Purchasing Director determines that use of the alternate techniques in purchasing such items and/or services best serves the interest of the Urban County Government.

This further places Central Purchasing as the lead authority for all types of procurement; however, the CAO policy does not mention any competitive techniques and it only requires the CAO to consult with the Director of Central Purchasing on any decisions, providing no final authorizing authority. In general, the lack of an authoritative policy hierarchy, and the resulting conflicts, reflects how potential confusion could arise within the procurement process by having two separate administrative bodies.

### *Conflicting Procurement Policies*

The conflict of policies is further exemplified within Central Purchasing itself. As noted, Central Purchasing maintains both Procurement Regulations and a separate policy manual. A review of the language of these two documents indicates that the Regulations take some form of precedence over the policy manual. The Regulations state,

These Regulations, along with applicable portions of Kentucky Revised Statutes and the Charter of the Lexington-Fayette Urban County Government shall govern all procurement activities of the Lexington-Fayette Urban County Government.

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The Central Purchasing Policy Manual appears to support this authority by stating,

This manual was developed to supplement the Urban County Government Procurement Regulations. The Regulations contain the rules that govern the purchasing system. This manual contains the methods and procedures that make the system work.

Though the delineation of authority for these two documents appears clear based on this language, the Director of Central Purchasing has stated that there is no real line of authority placing one with greater authority than another. This is likely true since both documents are maintained by Central Purchasing and either can be changed at any time by the Director of Central Purchasing. It is left to Central Purchasing to interpret the documents that they have written, which can lead to potential conflicts or inconsistencies in what may be required in one document and what is implemented in another.

An example of this is seen in the requirements for competitive sealed bidding. According to the Regulations, there are two methods for evaluating and awarding a contract using competitive sealed bidding, which is lowest bid price or lowest evaluated bid price. The method required for lowest evaluated price requires the inclusion of “objective measurable criteria and formulas or computation methods to be used in evaluation.” This statement essentially requires that the evaluation method include some form of quantitative scoring to be included. The Central Purchasing policy manual does not completely follow this more specific requirement.

While the policy manual recognizes the two separate methods of evaluating sealed bids based on lowest price and lowest evaluated price, it is less specific in the type of criteria being used to determine the winning bidder for those evaluated using lowest evaluated price. The policy manual only requires that “the factors to be evaluated and the method of evaluation must be stated in the invitation for bids.” Given that the policy manual states that it “contains the methods and procedures that make the system work,” specific quantitative scoring would not necessarily be required in the evaluation methods. In fact, this has resulted in LFUCG not using specific measurable criteria in competitive sealed bidding evaluation procedures, leaving the process open to a greater chance of bias by individuals. Finding 9 further discusses the lack of scoring in competitive sealed bidding.

*Council Did Not  
Adopt  
Procurement  
Procedures as  
Required By Law*

Much of the potential confusion in policy and oversight authority could have likely been avoided had the Council adopted purchasing procedures as part of the LFUCG Code of Ordinances as required by KRS 68.005(1). This statute directs all fiscal courts to adopt a county administrative code, to include the “procedures and designation of responsibility for” a number of administrative items. This includes “County purchasing and award of contracts.”

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Though KRS 68.005 specifically applies to fiscal courts, KRS 67.712(2) states,

Whenever rights, powers, privileges, immunities, and responsibilities are granted to the fiscal court in general statutes, the same shall be considered a grant in those counties in which a consolidated local government has been adopted pursuant to KRS Chapter 67C to the officer or officers in whom such functions are vested pursuant to KRS 67C.103(1) and 67C.105(1), respectively, of the consolidated local government, and shall be considered a grant in those counties in which an urban-county government has been adopted pursuant to KRS Chapter 67A to the legislative body of the urban-county government.

This establishes the responsibility to include purchasing within the administrative code of an urban county government such as LFUCG. As the legislative body for LFUCG, the Council should have adopted purchasing procedures as part of the LFUCG Code of Ordinances.

These conflicts of policy and the general lack of clarity in procurement authority discussed here allow the potential for the procurement process to be implemented inconsistently and to cause confusion for staff, Council members, and the general public. This result could have been avoided had the Council provided a clear directive and guidance on procurement procedures through the adoption of an administrative code that includes procurement policies. An example of this is the Model Procurement Code, which has been adopted by the Commonwealth of Kentucky.

Found at KRS Chapter 45A, the Kentucky Model Procurement Code addresses a full range of procurement issues and methods, providing clear procedures for many different types of services and commodities. Since it has been enacted into law by the Kentucky General Assembly, it carries the highest weight of authority over procurement and can only be changed through the legislative process. It provides a clear directive to those administrators who developed the policies as to how procurement is to be carried out. If a conflict ever arises between those administrative policies and the adopted administrative code, the line of authority has already been established due to the primacy of the Model Procurement Code.

This could be accomplished by the Council through the adoption of the local public agency portion of the Model Procurement Code found at KRS 45A.343 – KRS 45A.460, by developing its own procurement procedures as part of the LFUCG Code of Ordinances, or a combination of both. This will provide those who administer the procurement process for LFUCG a guide from which to develop consistent procurement methodology and oversight.

**Findings and Recommendations**

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*Recommendations* LFUCG should reevaluate both the CAO Policy #1 and the Division of Central Purchasing Policies and Procedures. It should be determined whether the CAO Policy #1 should continue, and if so, changes should be made to ensure a more transparent process that defines when CAO Policy #1 can or should be used instead of using the policies established by the Division of Central Purchasing.

The Council should develop and adopt procurement procedures as part of the LFUCG Code of Ordinances. These procedures should reflect the best practices accepted by professional procurement associations and provide a clear directive to administrative staff. This may include the adoption of the local public agency portion of the Model Procurement Code at KRS 45A.343-KRS 45A.460, but at a minimum should include requirements in KRS 45A.360(1): conditions and procedures for delegations of purchasing authority; prequalification, suspension, debarment, and reinstatement of prospective bidders; modification and termination of contracts; conditions and procedures for the purchase of perishables and items for resale; conditions, including emergencies, and procedures under which purchases may be made by means other than competitive sealed bids; rejection of bids, consideration of alternate bids, and waiver of informalities in offers; confidentiality of technical data and trade secrets information submitted by actual and prospective bidders or offerors; partial, progressive, and multiple awards; supervision of store rooms and inventories, including determination of appropriate stock levels and the management, transfer, sale, or other disposal of government-owned property; definitions and classes of contractual services and procedures for acquiring them; procedures for the verification and auditing of local public agency procurement records; and, annual reports from those vested with purchasing authority as may be deemed advisable.

The Council should ensure the authority for procurement oversight is clearly defined within the administrative structure to ensure there is no confusion or conflict within the delineation of oversight and authority.

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**Finding 8: No consistent procurement method was used for purchasing insurance broker services.**

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The procurement of insurance broker services by LFUCG was not conducted using a consistent procurement methodology over the last nine years. Since at least 1982, LFUCG has used a third party firm, known as a broker, to facilitate the procurement of insurance services through insurance companies. Over the last nine years, these broker services were acquired using two different procurement methods. The procurement methods have alternated every few years. Each of these methods is allowable under the procurement policies currently used by LFUCG, but they employ entirely different concepts for purchasing services. One procurement method is openly competitive to any potential vendors, while the other does not require any form of competition or include more than one vendor in the process. As the nature of an insurance broker service has not changed over time, it is not clear why such different procurement methods have been employed as it appears that a vendor could receive some form of special treatment. It may also prevent LFUCG from receiving the benefits of a competitive process.

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## Chapter 3

# Findings and Recommendations

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For almost 30 years, insurance broker services have been used by LFUCG. These types of vendors are hired to identify insurance companies and solicit quotes on behalf of LFUCG for insurance coverage including: excess liability, excess workers' compensation, aviation, special events, and other small lines of coverage. Brokers also offer expertise in the field of insurance and typically have current knowledge of the insurance markets. It is the responsibility of the broker to use this expertise to assist in evaluating all the options received from the insurance market and select the most appropriate one. Since insurance according to KRS 304.09.052 can only be sold in the state of Kentucky through a licensed agent or broker, payments for the insurance services are made to the contracted broker. The broker then passes the payment on to the insurance carrier. The broker receives fees from LFUCG as outlined in the contract for all services provided.

This brokering process removes formal competitive bidding of the actual insurance products from the control of LFUCG, and makes it the responsibility of the broker to seek out a sufficient number of insurance companies to submit proposals to ensure a competitive process that will result in favorable insurance quotes. This responsibility makes the selection of a vendor to provide insurance broker services very important and places a great deal of trust in the vendor.

The following table contains a history of the companies that have held the insurance broker contracts with LFUCG since 1982, and the procedure that was used to procure the service. While the procedure prior to 2001 is not known, it does illustrate the use of insurance broker services for an extensive time period.

**Table 6: Insurance Broker/Agents 1982 – Present**

<b>Broker/Agent</b>	<b>Broker Contract Period</b>	<b>Procurement Method</b>
Marsh & McLennan	1982 – 1988	Unknown
AON	1988 – 2001	Unknown
Marsh USA, Inc.	2001 – 2006	CAO Policy #1
Marsh USA, Inc.	2006 – 2008	Competitive Bid/ RFP
KLC Insurance Services	2008 – 2010	CAO Policy #1
Alliant Insurance Services	2010 – 2011	Competitive Bid/RFP

Source: LFUCG

As seen in the table, the procurement of insurance broker services alternated between two different methods. CAO Policy #1 was used as the procurement policy in 2001. This contract lasted three years and was extended two more by action of the Council. CAO Policy #1 was also the procurement policy used in 2008 and 2009. A competitive sealed bidding process was used in 2006 for a two year contract and for the most recent procurement of insurance services in 2010 for a contract period through the middle of 2011.

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## Chapter 3

# Findings and Recommendations

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CAO Policy #1 was designed to establish a procurement process for professional services, which can be exempt from the competitive bidding process according to LFUCG procurement policies. It allows for a contract with a vendor to be approved by the CAO without a competitive bidding process or approval from the Council for all contracts less than \$50,000. For contracts over \$50,000, the CAO may choose the vendor without competitive bidding, but must recommend this choice to the Council for final approval. CAO Policy #1 can be found at Exhibit 8 and the Division of Central Purchasing policy for professional services is at Exhibit 11.

In contrast, a competitive bidding process is administered by the Division of Central Purchasing that publicly advertises a RFP for the service being purchased. The specifications of the services are included in the RFP, which is openly available to any interested vendors. The interested vendors may submit a responding proposal, known as a bid. These proposals are opened and evaluated by a group that can consist of staff members, Council members, and outside professionals who evaluate the bids based on lowest price or best value. The vendor proposal chosen by the evaluation group is then sent to the Council for final approval of the bid.

An example of the use of CAO Policy #1 for broker services is the purchase of excess liability insurance through KLC in October 2008. KLC had been the excess insurance agent for LFUCG since 2007 and the excess workers' compensation agent since June 2008, both of which were purchased in conjunction with the Marsh broker contract. On July 1, 2008, LFUCG canceled the Marsh broker contract. Shortly after this, KLC was appointed the exclusive insurance broker by way of a letter sent to various insurance companies by the LFUCG Claims Manager. There was no documented procurement procedure for this service, because there was no direct fee associated with the broker services as there had been with Marsh. Since there was no direct fee, no contract was required. According to KLC officials, all broker services were under verbal direction of the Commissioner of Law.

In September of 2008, the insurance carrier providing excess insurance indicated it was not interested in providing insurance after the contract term expired in October of 2008. LFUCG staff stated that due to the short time frame before insurance expired, a faster procurement process was required to obtain a new insurance carrier. Because CAO Policy #1 does not include a formal vendor search process and only requires the approval of the CAO and Council for amounts over \$50,000, it was used to retain KLC as the broker/agent but with a new insurance carrier company. The Council approved the contract October 23, 2008.

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## Chapter 3

# Findings and Recommendations

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The broker contract with Marsh USA prior to this arrangement with KLC was determined through a competitive sealed bid process outlined in the *Division of Central Purchasing Policies and Procedures Manual*. An RFP was issued by the Division of Central Purchasing, containing the full scope of work to be completed by the vendor. Six different vendors submitted proposals in response. These proposals were evaluated by a team of LFUCG staff including the Director of Risk Management, other Risk Management staff, and outside professionals who determined which vendor provided the best proposal. It was not evaluated on lowest price, but rather by the best value to LFUCG. This recommendation was then sent before the Council for final approval at an agreed upon price of \$79,000 per year.

The procurement procedure implemented by LFUCG in April 2010 for excess insurance coverage through June 30, 2011, was completed using a competitive sealed bidding process; however, it appears the process was changed from the methods employed in prior years. While there is currently a broker for insurance services, as noted in the chart, the broker is not under an exclusive contract as KLC had been the previous two years. Instead, LFUCG conducted a competitive bidding process that would allow any insurance broker or insurance agent to present a proposal for excess property, liability, or workers' compensation. In essence, the competitive process was open to any licensed insurance broker or agent that was willing to provide a quote for excess insurance to LFUCG.

This process occurred after LFUCG attempted to obtain a single insurance broker similar to the contract it previously had with Marsh USA in 2006. An RFP was issued, but the two proposals received failed to meet the qualifications established in the RFP. As a result, the new approach to obtain insurance was developed. The result of using this new approach to purchasing insurance was that three different vendors submitted proposals with quotes for insurance coverage. There is no fee paid directly to the current broker, Alliant Insurance Services, for bringing these proposals to LFUCG, nor is LFUCG obligated to exclusively use that broker in the future.

There are benefits to using either of the procurement methods used for purchasing insurance broker services. For the process outlined in CAO Policy #1 the benefit is speed and flexibility for the administration. It allows staff to avoid the bidding process and attempt to find a vendor through other means. It also allows negotiation with a vendor after a proposal is made in order to get a better price or value. However, this process does not lend itself to being transparent or competitive among vendors. It also has the appearance that the evaluation method is more susceptible to the biases of administrators who have the authority to influence vendor choices and the appearance that one vendor may be receiving preferential treatment.



If documented and conducted properly, a competitive bidding process is a more transparent evaluation method. It also allows vendors to be included that were not previously known and not just preselected by administrators. This process is much slower due to the various steps that must be implemented to ensure it is fair. It may also be less effective when the market does not have a sufficient number of vendors to achieve the objective of a true competitive process to compete for the service to be purchased.

While LFUCG was not obligated by either state law or LFUCG procurement policies to purchase insurance broker services using a competitive bidding process, varying the procurement method over the last nine years suggests some confusion and a lack of sufficient planning by administrators as to determine the most efficient methods to purchase insurance services. This may be due in large part to the somewhat disjointed authority over the procurement of professional services caused by CAO Policy #1. This policy creates an obvious conflict between the authority of the Division of Central Purchasing, which is designated by LFUCG Charter with procurement oversight, and the authority of the CAO, who is not specifically responsible to procure professional services. The procurement policies for professional services maintained by Central Purchasing encourage the use of “competitive proposals or other forms of competition.” The CAO policy does not suggest any type of competition. The issue of conflicting procurement policies is further discussed in Finding 7.

Competition, and specifically, competitive bidding, is generally regarded as having a positive impact on procurement by public agencies. This is reflected in most procurement codes and policies, such as the Model Procurement Code in KRS Chapter 45A, and even the LFUCG Central Purchasing Policy Manual. Each requires that competitive bidding is the first procurement method considered unless specifically excluded. Even upon exclusion from a formal bidding process, some form of competitive method is available. This indicates that, when possible, some competitive means is nearly always available to public entities and should be implemented to help ensure the best available price or value for the service being purchased.

Competitive bidding will also support a more transparent procurement process and remove the possible appearance of special treatment for particular vendors. This will require a sufficient amount of planning to ensure that there is time to complete the procurement process, but this should not be a problem with insurance services with specific ending dates for contracts. It will also require that the process is well documented to evidence a fair and unbiased process is followed. This will likely require that LFUCG adopt a proposal evaluation process that includes quantitative scoring as discussed in Finding 9.

## Findings and Recommendations

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**Recommendations** A consistent, transparent method of procurement should be adopted to alleviate any potential appearance of special treatment for any particular vendor. LFUCG should consistently employ a competitive procurement method, when possible. We recommend a schedule of activity be developed to assist in properly planning for the procurement process ensuring that sufficient time is allocated to accomplish the process. Also, see recommendations for Finding 7.

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**Finding 9:**  
**LFUCG does not use a quantitative scoring method for competitively bid vendor proposals.**

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LFUCG procurement practices for competitive bidding do not use a documented quantitative scoring method to evaluate vendors' bid proposals. A scoring method for choosing a vendor is required by LFUCG Procurement Regulations, but was not implemented in LFUCG practices or the Division of Central Purchasing Policy Manual. Instead, the current practice uses an evaluation method that is more subject to the personal preferences of those reviewing proposals.

According to LFUCG staff, proposals submitted by vendors during a competitive bidding process are evaluated by a committee primarily of LFUCG staff, but may include Council members or outside parties. These committees review each of the vendor proposals, openly discuss evaluation team members viewpoints, and then vote for the vendor based on the perceived strengths and weaknesses of the presentation. The vendor with the majority of votes either receives the contract or is recommended to receive the contract if Council approval is required. This more subjective evaluation differs from that required in the Procurement Regulations.

Section 4.7 of the LFUCG Procurement Regulations establishes that when vendor bids are to be evaluated on the principle of lowest evaluated price, measurable criteria should be used in the decision making process. See Exhibit 9. Specifically the regulations states:

If the bid is to be awarded on the basis of lowest evaluated bid price, the method of award shall be clearly stated in the Invitation for Bids, along with the objective measurable criteria and formulas or computation methods to be used in evaluation.

This regulation appears to be based on the competitive bidding section of the Model Procurement Code found at KRS 45A.370. While the Model Procurement Code has not been adopted by LFUCG, this regulation clearly intends that the choice of a vendor will be made by applying a quantitative score to each vendor proposal based on "measurable criteria" that have been disclosed to all vendors desiring to submit a bid proposal. This makes the process of choosing a vendor more transparent and less subject to desires or influences of an individual or small group within the evaluation team.

Current policies used by the Division of Central Purchasing exemplify how changing the specific requirements seen in the regulations can make the criteria used for choosing a vendor vague. See Exhibit 10. The policy states:

**Findings and Recommendations**

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The bid may be awarded to the bidder who submits the lowest evaluated bid that provides the best value to the Lexington-Fayette Urban County Government.

If best value award is to be used, the factors to be evaluated and the method of evaluation must be stated in the invitation for bids.

While these policies require that the factors being used to evaluate the bids be placed in the invitation for bids, there is no requirement for any measurable criteria or documentation of the computational methods used to determine the winning vendor. This has resulted in the current practice of taking a vote amongst the evaluation committee members with each individual's decision based on whatever criteria they have determined to be the most important. In comparison to a process with documented scores, instructions provided to evaluation team members regarding the evaluation process, and openly advertised scoring criteria, this is not the most transparent method of choosing a vendor.

***Recommendations***

LFUCG should develop a consistent policy that will more clearly require a documented quantitative evaluation method of vendor proposals during a competitive bidding process. Policies should also detail the responsibility to assemble an evaluation team and the representation to be included on the evaluation team. To ensure transparency, we recommend the process followed by the evaluation team, including the team selection, instructions, member evaluations, and final selection be carefully documented. All procurement policies should be adopted by the Council as part of the Administrative Code as referenced in Finding 7.



**EXHIBITS**



**FRAUD RISK ASSESSMENT**

CLIENT: LFUCG

BALANCE SHEET DATE: 6/30/08

Instructions: Statement on Auditing Standards (SAS) No. 99 entitled *Consideration of Fraud in a Financial Statement Audit* requires auditors to make inquiries of client personnel regarding the risks of fraud in the Government. The questions that follow are designed to gather information regarding the nature of and likelihood of fraudulent activities in your Government. Please answer all questions and return to Mountjoy & Bressler, LLP. You can return this via email, mail it to us at 175 E. Main Street, Ste 200, Lexington, KY 40507 or drop it off to us in the accounts payable department on the 3<sup>rd</sup> floor. Please return this questionnaire by July 16, 2008.

Thank you for your assistance.

1. Are you aware of any fraudulent activity or violations of laws at LFUCG?  
**I can't say with certainty that I'm not aware of any fraudulent activity or violations of laws at the LFUCG. There were questions by the Risk Manager of Claims & Underwriting addressed to the Commissioner of Law (who took charge of insurance procurement) about the procurement process for excess workers' compensation and property insurance this year and whether it followed the model procurement codes for the state. The Commissioner of Law advised the Risk Manager of Claims & Underwriting in an e-mail that he inquired with the Director of Purchasing and stated that the Director of Purchasing indicated there were no problems. Under model procurement code, the Director of Purchasing is supposed to provide a letter stating it is ok to engage in non-competitive bidding if an emergency exist. I am not aware of any emergencies related to the latest round of insurance procurement proposals.**
2. If fraudulent activity did exist, where do you believe the Government would be most vulnerable?
  - 1) **Areas where cash is received**
  - 2) **Procurement of professionals services above \$50,000 where selection committees have not been used.**
3. Has any fraud been reported to you during the fiscal year?
  - 1) **There is speculation by my peers that since I was not involved in the final review and blue sheet preparation for the Property & Workers' Compensation Insurance procurement (part of my job duties) that something potentially fraudulent was taking place. However, since I have not seen the excess insurance proposals presented to the LFUCG Council for FY 2009 excess Property & Workers' Compensation Insurance, I can't say with certainty that my peer's assumptions are accurate.**
  - 2) **I was advised by a Risk Management subordinate that one of the officers of a vendor (Kentucky League of Cities) recently picked by LFUCG is suspected of possibly being in violation of KRS 304.48-160 (having a direct or indirect financial interest in Collins & Company, a third party administrator (TPA) doing business with KLC). Collins & Company is housed in the building (225 E. Main, Georgetown, KY 40324) owned by the KLC officer.**

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- 3) A third party administrator (Underwriters Safety & Claims) that administered the LFUCG's workers' compensation claims adjusting for 7 years was allegedly not approved by the excess insurance carrier to adjust claims for the LFUCG according to the Commissioner of Law. Further verbal investigation reveals that US&C was approved by the excess workers' compensation carrier. Speculation is that due to the financial interest by the officer of KLC with Collins & Company that US&C was still not approved to continue handling workers' compensation claims for the LFUCG.
- 4) The Commissioner of Law reported to the Council in a June 3, 2008 presentation that the self insurance funds could be used to provide "primary" insurance coverage for personal autos of employees that had to drive on LFUCG business. On two separate occasions prior to the presentations in e-mails, the Commissioner of Law was advised that insuring personal autos not owned by the LFUCG would be in violation of KRS 304.39-080.
4. As auditors, we are particularly concerned with material financial statement fraud that is commonly directed by Management. Is there any reason anybody would say that you told them to do something that is illegal or unethical?  
**Not that I am aware of.**
5. Has anyone in the Government asked you to do something that you thought was illegal or unethical such as withholding information from the auditors, altering documents or making fictitious entries in the accounting records?
- 1) **The Commissioner of Law excluded certain matrix comparisons of the competitors for the FY 2008 Excess Liability Insurance bids and he also waived the requirements for a competitor (Kentucky League of Cities) to submit bids directly to the broker prior to the presentations of bids.**
  - 2) **In an e-mail sent to the Director of Risk Management, the Commissioner of Law suggested that Risk Management Loss Control not commit in writing deficiencies found during Loss Prevention surveys until after the deficiency was fixed. Considering budgetary constraints and the severity of the deficiency which could be an imminent threat to life or health, the Commissioner of Law was advised about OSHA requirements regarding documentation of safety hazards. Risk Management continues to document and report findings as of this writing. Subsequently, the Risk Management Director and Loss Control staff has been moved from under the supervision of the Commissioner of Law to the Commissioner of Finance.**
6. Are you aware of any weaknesses in the Government's internal controls that would provide anyone with the opportunity to commit fraud against the Government?
- 1) **The lack of financial interest disclosure by the officers or employees of vendors, sub-contractors to the vendors, etc. doing business with the LFUCG. Vendors selected outside the model procurement process will be allowed to administer the LFUCG self-insurance claims fund using additional subcontractor services not reviewed or approved through the formal RFP process.**



- 2) Failure to perform due diligence of vendors financial statements that would indicate financial troubles.
- 3) Failure to follow the Self Insurance Master Contract that was approved by Mayor and Council in 1987. It requires that the Property & Casualty self insurance program be administered by the Division of Risk Management. Further, it requires that the LFUCG purchase Insurance from A or better rated Insurance carriers. KLC has no AM Best insurance rating.

7. Have you committed fraud against the Government, including the intentional misstatement of the financial statements?  
**To the best of my knowledge, I have not committed fraud intentionally against the Government.**

Signature \_\_\_\_\_

Date 7-9-2008

Title:



**FRAUD RISK ASSESSMENT**

CLIENT: LFUCG

BALANCE SHEET DATE: 6/30/09

Instructions: Statement on Auditing Standards (SAS) No. 99 entitled *Consideration of Fraud in a Financial Statement Audit* requires auditors to make inquiries of client personnel regarding the risks of fraud in the Government. The questions that follow are designed to gather information regarding the nature of and likelihood of fraudulent activities in your Government. Please answer all questions and return to Mountjoy & Bressler, LLP. You can return this via email, mail it to us at 175 E. Main Street, Ste 200, Lexington, KY 40507 or drop it off to us in the accounts payable department on the 3<sup>rd</sup> floor. Please return this questionnaire by June 26, 2009.

Thank you for your assistance.

1. Are you aware of any fraudulent activity or violations of laws at LFUCG?

During the workers' compensation and property insurance renewals for FY 2009, the combined cost of premiums and TPA services was not disclosed to the LFUCG Council during the Blue sheet process by the Department of Law. This made the workers' compensation carrier (New York Life and Marine) and the property carrier (PEPIP), both presented by the Kentucky League of Cities, appear to be the best proposal. In prior bids by the KLC, the TPA cost has been included with the premium. This year, KLC unbundled this cost so that the premiums for workers' compensation would be less than the competition. However, the TPA services offered through KLC were \$39,000 more than the incumbent TPA resulting in an approximate net increase of \$21,000 for workers' compensation premiums and TPA cost. Also, the incumbent property carrier (Factory Mutual) was about \$47,000 less in cost. Further, the workers' compensation TPA (Collins & Company) for New York Life and Marine that is also handling the LFUCG's self-insured portion of workers' compensation claims did not have to undergo a bid process to be awarded the business thus resulting in the termination of Underwriters Safety & Claims which had a three year contract awarded as a result of the RFQ process under the model procurement codes of Kentucky.

A LFUCG Council Aide representing two anonymous Council members presented to me the attached June 19, 2009 Memo (Attachment #2) from the Commissioner of Law to the Mayor and LFUCG Council regarding Kentucky League of Cities Insurance Placement and Fees. The Council Aide asked me if the statements made by the Commissioner of Law were true. The memo includes what appears to be false statements on page 2, first and second paragraphs. It would appear the intent of the statement is to discredit the services of Marsh (LFUCG Broker) in their efforts to assist the LFUCG acquire Workers' Compensation and Property insurance. As you will see in the subsequent documents in attachment #2, the MMC Transparency Disclosure Form clearly shows that Marsh received five (5) quotes for Workers'

Compensation insurance and not two (2) as noted in the memo. In the second paragraph on page 2, it states that "Risk Management agreed that the cost we incurred did not justify the service we were receiving from Marsh." This is a false statement as you will read in the attached e-mail to Logan Askew from dated August 30, 2007. Risk Management did not make a statement like the one quoted from this memo. Risk Management provided an explanation of the insurance market conditions resulting in less quotes from eligible excess insurance carriers. False statements such as these have misled the LFUCG Council into believing that the LFUCG was not receiving good service from Marsh and therefore justified the switch to the Kentucky League of Cities. In fact for the FY 2009 AL/GL renewals that were held in October, 2008, KLC failed to go to the market and attempted to: 1) increase premiums by \$250,000; 2) raise the self-insured retention by \$500,000; and 3) lower the limits of the policy to \$2million from \$5million. This delayed the renewal of these very important insurance policies by one month resulting in placing the insurance back with the excess carrier (AIG) before KLC was involved with LFUCG's insurance program.

2. If fraudulent activity did exist, where do you believe the Government would be most vulnerable?
  - Areas where cash is handled; and
  - Professional services contracts
3. Has any fraud been reported to you during the fiscal year?
  - A. Paula King, Director of Community Development indicated that there were some issues with the Grants program where she would not sign off on certain request from senior management because they were requesting to use money for other items not listed in the original grant request. She would not elaborate on specifics but in a subsequent conversation I discovered it involved the Division of Police. This is a red flag and concern for possible mishandling of grants money from federal and state sources.
  - B. The Manager Claims reported to me that the Commissioner of Law wanted him to use the same actuarial services that KLC was using. Subsequently, Mr. Sweeney advised the KLC Actuary of the LFUCG incumbent actuary bids resulting in the KLC Actuary bidding \$160 less than the incumbent actuary.
4. As auditors, we are particularly concerned with material financial statement fraud that is commonly directed by Management. Is there any reason anybody would say that you told them to do something that is illegal or unethical?

In December of 2008, I inquired with the ex-Risk Management Accountant about why he had changed the cost allocation ratios (loss history & exposures) for the claims fund. In the past, it had been 60 percent based on loss history and 40 percent based on exposures such as payroll, vehicles, property, etc.

(See Attachment #1A) In the calculations he was preparing for FY 2010, he changed the percentages to be 30% loss history and 70% exposures which does not correctly reflect the allocation of losses and exposures. Loss history is the amount of payments made from the LFUCG self-insurance claims fund. Exposures are for the premiums paid for excess insurance above the self-insurance fund. He said I told him to do it. At the time of his action, I was no longer his supervisor. When I inquired about an e-mail to provide proof that I told him to do this, he could not produce one. The consequences of this action results in more money being allocated from the Sanitary Sewers fund instead of the General Services Fund. This action by this accountant does not accurately reflect the ratios of losses and exposures as they should be calculated for allocations from the various division funds to fund the self-insured claims fund. (See attachment behind #1A to this reply for documentation)

5. Has anyone in the Government asked you to do something that you thought was illegal or unethical such as withholding information from the auditors, altering documents or making fictitious entries in the accounting records?

To the best of my knowledge, no.

6. Are you aware of any weaknesses in the Government's internal controls that would provide anyone with the opportunity to commit fraud against the Government?

Yes. In prior years selection committees made up of professionals with experience in the areas of insurance provided invaluable feedback on insurance renewals and now you no insurance professionals involved in this annual process. As a result, the AL/GL Self-insured retentions have increased by \$500,000 per occurrence, premiums for property have increased by \$85,000 per year and third party administrator cost has increased by approximately \$108,000 per year. A TPA for workers' compensation and property adjusting services was hired that did not have to go through the model procurement code RFQ process.

7. Have you committed fraud against the Government, including the intentional misstatement of the financial statements?

To the best of my knowledge, no.

Signature: \_\_\_\_\_

Date: July 6, 2009

Title: \_\_\_\_\_





Lexington-Fayette Urban County Government  
DEPARTMENT OF FINANCE & ADMINISTRATION

Jim Newberry  
Mayor

Linda Rumpke  
Commissioner

MEMORANDUM

TO: Brian Lykins, Executive Director  
Information Technology and Special Audits  
Auditor of Public Accounts

FROM: \_\_\_\_\_

DATE: June 14, 2010

RE: FY 2008 and FY 2009 Fraud Assessment Reports

SUBJECT: 1) Observations 2) Issues

During our meeting on Thursday, June 10, 2010 you indicated to me that due to the volume of information I was providing you it would be desirable if I would provide you with my observations of what I thought was fraud and further delineate the issues.

**FY 2008 Fraud Assessment Report Observations**

1. **Excess AL/GL/POL Insurance Renewals for FY 2008** –  
(Cross reference item # 3 (2) on page 1 and item # 5 (1) on page 2 of the FY 2008 Fraud Assessment Report)  
As observed from the executive summary, various matrices and the KRS attachment (KRS 304.48-160, Self-Insured Liability Officers not having a direct or indirect financial interest in Third Party Administrators) were provided to the Commissioner of Law by Marsh and the Division of Risk Management prior to the actual presentation to LFUCG Council on September 11, 2007. Both Marsh and the Division of Risk Management provided detailed documents including a final e-mail on September 10, 2010 from Todd Lanham, VP with Marsh that provided a strong recommendation to purchase insurance from AIG. With this information in hand and against the professional advice of his staff, the Commissioner of Law chose to ignore the recommendation and various other positive factors related to the AIG policy (pricing, conditions, etc.) and proceeded to manipulate the final matrix to the degree that it clearly favored the KLC policy from ACE. Further, the Commissioner of Law allowed KLC to dictate the conditions of the ACE policy. The LFUCG request in the insurance

applications process requested a bundled and unbundled quote so that any additional services offered (Loss Control, TPA's, etc.) could be evaluated on a comparative basis. This was not provided and KLC's quotes were allowed to stand as presented. It was later determined that the \$615,000 quote by KLC was allocated to \$379,000 for premiums, \$100,000 for Loss Control and the remainder \$136,000 for TPA or administrative overhead. 156 hours of the 1000 hours for loss control were used to train KLC employees in Legal Liability Risk Management Institute loss control for Police, Fire and Community Corrections.

**Issues:** Misrepresentation and concealment of material facts notated in numerous matrix evolutions provided by Marsh and Risk Management, purchase of questionable extra services (TPA services) that were a conflict of interest with KLC's officer (Bill Hamilton) in violation of KRS 304.48-160. The strong presentation by the Commissioner of Law in favor of KLC induced the LFUCG Council to approve a contract with KLC paying more for services than what was necessary thereby spending an extra \$124,000 for other services and did not allow RMSC to finish its three year contract that had been approved by Council. Further, the savings that was supposed to be realized by cutting Marsh's contract (\$79,000, net \$76,000) in half never materialized. Marsh was paid its full fee for FY 2008. The advisory of Marsh earning its full fee for FY 2008 was given to the Commissioner of Law in an e-mail dated August 30, 2007 prior to the final matrix presentation.

**2. LFUCG Management Audit, August 2007 to February 2008 –**

(Cross reference item # 6 (3) on page 3 of the FY 2008 Fraud Assessment Report) The LFUCG spent approximately \$500,000 to perform a management audit of all divisions of government to determine if they were operating efficiently and effectively. I provided copious amounts of information on the LFUCG Self-Insurance Policy (Master Contract), best practices, job summaries, cost savings, statistics (cost of risk), policies and procedures, staff development, etc. The information provided was not notated in the final analysis of the audit report. Instead, numerous factual errors were presented regarding job titles, responsibilities, etc. I was asked to provide a rebuttal to the official Management Partners report. Only part of the rebuttal made it to the LFUCG Council for review. It was my understanding that the Council Aide responsible for assembling the report removed important attachments that were referenced as "best practices." The audit section on the Division of Risk Management was performed by a former solicitor general of Cincinnati and an Environmental Engineer (?). Neither of these individuals had a Risk Management background. Many of the recommendations were factually incorrect. Based on a four year average (FY 2004-2007), only 2.5% of all claims against the LFUCG were litigated and only 4% of all payments from the claims fund were related to legal fees or settlement of litigated claims. This analysis clearly showed that not every claim was a precursor to litigation. I was concerned about the movement of important personnel from Risk Management to Law and General Services as this would impact the continuity of business flow and backup personnel on critical Risk Management Information System reporting.

**Issues:** Misrepresentation and concealment of material facts that allowed personnel of knowledge (Director of Risk Management, Contract Specialist, Risk Management



Analyst) to be moved out of the line of important decision making on insurance procurement, claims administration and exposure analysis issues. The Fire Chief was allowed to present his factual errors report and respond but the Director of Risk Management was not. The Senior Advisor to the Mayor advised the Council Members that Risk Management had a philosophical difference in opinion of how things were being organized. It is my understanding that Directors from other divisions were allowed to see the draft audit report and make corrections to factual errors before the report was released. Months before the Council approved the report, personnel from Risk Management were being moved around without regard for the division's mission essential duties.

3. **Excess Property and Workers' Compensation renewals, FY 2009 –**  
 (Cross reference item # 1 and 3 (1) on page 1 and 3 (3) on page 2 in the FY 2008 Fraud Assessment Report)

Marsh USA and KLC again presented proposals for Workers' Compensation and Property insurance. For Workers' Compensation, Marsh presented Liberty Mutual with a quote of \$272,970 and KLC presented New York Life and Marine with a first quote of \$259,976 then modified it to \$247,338. For Property, Marsh presented Factory Mutual (incumbent carrier) with a quote of \$199,860 and KLC presented a quote from Public Entity Property Insurance Program (PEPIP) of \$246,000 that included adjusting services. The LFUCG already had a property adjuster as a civil service employee. This was a duplication of services and cost the LFUCG an additional \$46,140 in premiums.

Workers' Compensation Quote

Carrier	Quote	TPA Cost	Total	Difference from Marsh Quote
Marsh Quote	\$272,970	\$91,000*	\$363,970	N/A
KLC – 1 <sup>st</sup> Quote	\$259,976	\$139,200	\$399,176	+\$35,206
KLC – 2 <sup>nd</sup> Quote	\$247,338	\$139,200	\$386,538	+\$22,568
With KLC low Quote but US&C as TPA	\$247,338	\$91,000	\$338,338	(\$48,200) Additional savings over low KLC quote

\* Estimated based on actual number of Lost Time and Medical Only Claims.

Property Quote

Carrier	Quote	TPA Cost	Total	Difference from Marsh Quote
Factory Mutual	\$199,860	Employee in house	\$199,860	N/A
PEPIP (AIG)	\$246,000	Included	\$246,000	+\$46,140

The acceptance of New York Life and Marine along with the requirement to use KLC's TPA, Collins and Company resulted in an approximate net increase for workers' compensation and TPA services of approximately \$22,568. Depending on the number of Lost Time and Medical Only claims, the increase in cost could be larger.

My job description Mr. Tom Sweeny who was responsible for Claims and Underwriting (Insurance Procurement). I was only allowed to attend several meetings where we discussed the initial renewals and then comparisons of the property proposals between AIG and Factory Mutual. I did receive copies of e-mails but beyond that I was excluded from significant e-mail exchanges and all further meetings. The Manager of Claims advised me the Commissioner of Law did not want me to know what the final selection was until after the presentation to Council.

The Commissioner of Law recommended KLC's choices, New York Life and Marine for Workers' Compensation and Public Entity Property Insurance Pool (AIG) for Property. The blue sheet that authorized expenditures from the Division of Risk Management budget was signed off by the Director of Litigation. At the time of her sign-off, she did not have authorization to sign for the Risk Management budget. The Council had not officially approved the switch of insurance procurement to the Department of Law under the Director of Litigation.

As part of the KLC submissions, the LFUCG's Workers' Compensation TPA (Underwriters Safety & Claims) was allegedly NOT AN APPROVED TPA. On May 22, 2008, I received a telephone call from Barbara Whalen, Marsh Asst. VP of Underwriting and she advised that John Logan, Marsh VP and Office Manager sent an e-mail to the Commissioner of Law advising Underwriters Safety & Claims (US&C) was an approved TPA for New York Life and Marine. Apparently, the Commissioner of Law ignored this advisory and chose to place the TPA services with Collins and Company under a no-bid contract. Collins and Company rents a building from Bill Hamilton an officer of KLC.

In an e-mail dated May 12, 2008 from Barbara Whalen with Marsh, she advised that Collins and Company provided a bid of \$288,000 for Workers Compensation TPA services. This was \$213,000 higher than what was paid the prior year with US&C. The bid was allowed to be lowered twice to a final price of \$139,200 per year. This was \$64,200 higher than the prior year.

At no time during any of this bidding was Underwriters Safety & Claims allowed to participate. US&C was in its second year of a three year contract that had been approved by the LFUCG Council through a RFP process.

In an e-mail dated May 26, 2008 from Logan Askew to Jim Johnston, it appears that Commissioner Askew is sharing Underwriters Safety & Claim contracts with Collins and Company President Jim Johnston for service comparison and pricing.

On June 30, 2008 I was advised by the Director of Litigation, Leslie Bowman to send a cancellation notice to Underwriters Safety & Claims. At the same time, I was also advised to cancel the Marsh contract.

**Issues:** Misrepresentation and concealment of material facts by the Commissioner of Law to allow conflicts of interest to continue between KLC's officer (Bill Hamilton) and

Collins and Company. Also, the Commissioner of Law, according to Barbara Whalen, Asst. VP at Marsh, on May 22, 2008 concealed material facts about the incumbent workers' compensation TPA (US&C) being approved to perform work for New York Life and Marine Insurance Company thus causing the LFUCG to pay more for TPA services and not allowing US&C to complete the last year of its three year LFUCG Council approved contract.

**4. Primary Insurance for Employee's Auto Presentation by Commissioner of Law, June 3, 2008 --**

(Cross reference item # 3 (4) on page 2 of the FY 2008 Fraud Assessment Report) On June 3, 2008, the Commissioner of Law stood before the LFUCG Council in a Services Committee meeting and advised the Council Members that the LFUCG could provide "primary insurance" for employee automobiles while driving on government business. On two prior occasions, the Commissioner of Law was provided with information received from the State Insurance Department that this was not authorized under KRS 304.9-100. The statute states that an entity cannot act as an insurance agent without the proper licensing and oversight by the Office of Insurance for the Commonwealth of Kentucky. Further, an entity cannot provide a security for property it does not own. The Commissioner of Law was advised to call Sharon Burton, Commissioner of Insurance for Kentucky before any final decisions were made. Further the LFUCG Self-Insurance policy clearly states it will only provide coverage above that which is provided by the employee's own insurance policy. Council aides were also provided with this information prior to the June 3, 2008 Services Committee meeting. Upon consistent and thorough questioning by Council Members, the Commissioner of Law tempered his recommendation to state that he still had some tweaking to do with the State Insurance Department before he could finalize his recommendation.

**Issue:** Misrepresentation and concealment of material facts provided prior to making a presentation before LFUCG Council. Actual implementation of this recommendation would have put greater pressure on the LFUCG Self-Insurance Fund and been in violation of KRS 304.9-100 as well as the LFUCG Self-Insurance Policy Master Contract (1987).

**5. Loss Control Survey Reporting, E-mail dated February 14, 2008 -**

(Cross reference Item # 5 (2), page 2 of FY 2008 Fraud Assessment Report) In an e-mail sent to the Director of Risk Management by the Commissioner of Law regarding Loss Prevention Surveys performed by Risk Management staff, the Commissioner of Law suggested that Risk Management Loss Control staff not commit to writing deficiencies found during Loss Prevention surveys until after the deficiency was fixed. In his e-mail, he stated, "My concern is that a report reveal items that have a reasonable justification and are not a problem. I am also concerned that the report would be subject to open records or discovery in litigation." The Director of Risk Management reported back to the Commissioner of Law that this is a standard operating procedure of Risk Management to provide these reports to identify potential loss producing deficiencies so that the assets of the LFUCG can be protected. To not "officially" report a problem until after it was fixed would be

concealment of a hazard analysis report and frowned upon by OSHA and possibly lead to fines or penalties. OSHA requires that the employer operate in good faith to identify hazards, document those hazards, make employees aware of the hazards and then work to engineer out the hazard, administratively address the hazards or provide the proper protective equipment for employees to protect them from the hazards. At no time does OSHA condone the concealment of a hazard in an official report until after it is fixed.

**Issue:** Concealment of material facts from compliance officials or employees due to fear of the identified hazards being discovered in an open records request. This would place the LFUCG in non-compliance with the OSHA Safety & Health Management Guidelines, 29 CFR 1910 or the KOSH Administrative Guidelines KAR. Failure to document the hazard until it is fixed would place the LFUCG in a position of unawareness and concealment of potentially hazardous conditions that could lead to imminent danger of life or health. Appropriate documentation and follow-up provides OSHA with proof that Worksite Analysis is being performed in compliance with OSHA standards. Further to this concern is the current effort to dissolve the Division of Risk Management that historically has been able to perform these surveys and maintain adequate records of compliance. Decentralization of this effort may possibly lead to relaxed compliance.

#### **FY 2009 FRAUD ASSESSMENT REPORT OBSERVATIONS**

**6. First part of cross reference is a repeat of Item #3 above.**

**Memo to LFUCG Council from Commissioner of Law dated June 19, 2009 regarding KLC Insurance Placement and Fees -**

(Cross reference Item # 1, part two, page 1 – Memo to Council from Commissioner of Law)

The Commissioner of Law responded to an inquiry by Council Members On June 19, 2009, advising of the LFUCG's relationship with KLC. In that letter, he made statements that were a material misrepresentation of the fact with reference to the number of quotes received during insurance renewals and about Risk Management recommending cancellation of the Marsh Broker agreement with the LFUCG because it wasn't getting its monies worth. Further, a council aide delivered the June 19, 2009 memo to me and inquired if the memo was true. I would not respond to the informal request as I did not want it to appear I was doing anything behind my supervisor's back. Apparently, the Council was beginning to suspect the relationship with KLC and the Commissioner of Law continued to ignore the conflicts of interest by the KLC Officer who rented his building to Collins and Company. This was reported in the in the local newspaper in early June 2009.

**Issue:** Material misrepresentation and concealment of the facts. The Division of Risk Management received more quotes (5) than represented in the Commissioner of Law's memo and did not recommend the termination of Marsh because it wasn't getting its monies worth.

**7. Grants Program – Conversation with Paula King, Director of Community Development (retired) – no documentation.**

(Cross Reference Item # 3 (A), page 2 of FY 2009 Fraud Assessment Report)

While processing a Safety Grant from the KLC, the Commissioner of Law wanted the Director of Risk Management to process the request without the assistance of the Division of Community Development. I inquired with the Director of Community Development at that time if she had been having problems with grants. She indicated that there were some problems with the administration where she would not sign off but she was not specific about the problems. However, at a later date I was advised that it had something to do with the Division of Police grants. I was unable to gather any specific information but it certainly raised a red flag.

**Issue:** Concealment of grants information from the Division of Community Development.

**8. Actuarial Services – Conversation with Manager of Claims Tom Sweeney –**

(Cross reference Item # 3 (B), page 2 of FY 2009 Fraud Assessment Report)

The Manager of Claims reported to me that the Commissioner of Law wanted him to use the same actuarial services that KLC was using. Subsequently, Mr. Sweeney said he advised that the KLC Actuary of the increments (\$500) that the LFUCG incumbent actuary had been bidding in prior years resulting in the KLC actuary bidding \$160 less than the LFUCG incumbent. The LFUCG incumbent actuary provided a bid of \$12,000 for FY 2009 actuarial reports. The KLC actuary provided a bid of \$11,840 according to Mr. Sweeney.

**Issue:** Disclosure of bids to other bidders.

**9. Self-Insurance Fund Cost Allocation Ratio Changes to General Fund, Sanitary Sewer Fund and Urban Services Fund for FY 2010 budget –**

(Cross Reference Item # 4, page 2 of FY 2009 Fraud Assessment Report)

In December of 2008, I inquired with the ex-Risk Management Accountant about why he had changed the cost allocation ratios (loss history & exposures) for the claims fund. In the past, it had been 60% based on loss history and 40% based on exposures such as payroll, vehicles, property, etc. In the calculations he was preparing for FY 2010, he changed the percentages to be 30% Loss History and 70% Exposures which obviously relieves pressure on the General Fund and places greater pressure on the Sanitary Sewers and Urban Services Fund. However, the new ratios are not a fair representation of the loss history as the majority of the losses have occurred in the General Fund and the percent of losses is exponentially greater than the percent of exposure cost. When I inquired about who told him to do this, he said that I did. I was not his supervisor at the time of these changes and I could find no documentation to support his allegation.

**Issue:** Misrepresentation of material facts that place greater pressure on dedicated funds that are not attributable to the actual ratios that should be used.

**10. Re-direction of Loss Control Funds to pay for Appraisal Services –**

(This item was not on the original Fraud Assessment Reports)

For FY 2009 Excess AL/GL/POL renewals, \$50,000 in Loss Control Services was purchased. The Division of Risk Management was not consulted on Loss Control needs prior to the purchase of Loss Control Services from KLC. The Claims Manager attempted to go directly to the Manager of Safety and Loss Control without consulting the Director of Risk Management. Through an intervention, I suggested various efforts that would help with follow-up of the prior year's Legal Liability Risk Management Institute audit and also Driver Simulator Training for as many as employees as possible. Ultimately, I was able to get \$25,000 for Loss Control and the other \$25,000 was re-directed by the Department of Law to perform Property Appraisals. The Driving Simulator negotiations with KLC and the Manager of Claims resulted in quote of \$250 per employee which would have only allowed 100 employees to be trained. Further follow-up by me with the company providing the service revealed that the simulator could train up to 24 employees per day at a cost of \$200 per employee or \$2000 per day. At the rate (\$250/employee) the KLC was offering it would have cost \$6000 per day. Ultimately, I was able to take control of the set-up of this service and schedule 241 employees at an average cost per employee of \$103.73. This was a savings of \$146.27 per employee or 58.5% less than the original quote. This was \$35,251 of added value services at no extra cost to the LFUCG.

**Issue:** 1) Redirection of Funds that were supposed to be used for Loss Control Services. 2) Concealment of available pricing alternatives which would have not allowed the LFUCG to maximize its training dollars opportunities.

**11. Data Analytics discontinuation for the Director of Risk Management & certain Staff – Risk Management Information System Access, May 2010 –**

(This item was not on the original Fraud Assessment Reports)

On or about April 27, 2010, the Department of Law shut the Risk Management Information System down for the entire Risk Management staff with the exception of the Safety Manager. Two weeks later it was turned back on for the Administrative Specialist so that Risk Management reports could be continued. While this was not on the original fraud assessment report it is necessary to report this as a possible concern moving forward. The director and his staff should have full access to the Risk Management Information System so that drill down analysis of loss data can be performed by all staff that has a need for this data.

**Issue:** Possible concealment of critical data that may reveal trends in excess expenditures for claims. An example was the amputation of finger tip claims at the Community Corrections facility. In 2005 and 2006, Correction Officers suffered two claims where their fingertips were amputated due to door checks. One claim cost approximately \$10,000 and the other cost approximately \$11,000. Two years later a similar claim occurred with less severity and it cost \$25,000. There was also a concern by the Claims Manager that he was seeing excessively high car rental fees with Enterprise Car Rental Company. Disparity of these type claims need to be investigated by Risk Management staff and a determination made if LFUCG assets are being expended unnecessarily. Concealing this information from Risk

Management staff raises unnecessary suspicions. Further, the Year-To-Date data for FY 2008 v. FY 2009 was compromised when the Department of Law decided to discontinue entering financial data in October 2008 then decided to begin entering it again around August 2009. The Division of Risk Management was without critical financial data to perform severity trend analysis for over 15 months. The financial data that has been loaded into the Risk Management Information System cannot be sorted as it came to the LFUCG in a pdf form to be uploaded as an attachment. The LFUCG Department of Law could only upload the final cost of multiple payments which took from what I understand three employees approximately 6 months to complete.

To the best of my knowledge, these are the observations and issues that I am currently aware of that caused me concerns. There may be other issues pending that I have concerns about but because of inadequate information or inability to confirm the information, I have not included them in this report.

I am available at your convenience to discuss them.

H: PRJ/Memo20100614-State Auditors.doc

Cc: Tiffany D. Welch, Special Examinations Auditor  
Jettie Sparks, Performance Audit Manager





Lexington - Fayette Urban County Government  
 Division of Risk Management  
 October 1, 2007 - September 30, 2008 AL/GLP/POL Comparisons

<u>PROGRAM CONSIDERATIONS</u>	<u>AIG</u>	<u>KLC</u>	<u>Comments</u>
Price at \$1M Retention	\$491,481	\$615,010	KLC +\$123,529
Loss Control/Safety Services	0 Hours - AIG 8320 Hours - RM Staff	1,000 Hours	RM Staff provides loss control services for LFUCG. 23 of 29 classes LFUCG offers would be duplicated by KLC.
Aggregated Vs Non-Aggregated Coverage	\$5M Aggregate (POL, EBL, & Products)	No Aggregate	While KLC provides no aggregate, LFUCG has no historical loss history that would require this feature.
Defense Inside Vs Outside the Limit	Inside	Outside	This arrangement does not allow erosion of Policy Limits.
Sexual Abuse Coverage	\$5M / Occurrence	\$1M / Claims Made	AIG provides for favorable reporting period with higher limits.
Claims Handling Services	Risk Management Services Corp (\$53,000 FY 2007)	Collins & Co. (Bid \$93,000 FY 2007)	RMSC provides good services at reasonable cost - in state company.
Consent to Handling Claims within SIR	Yes	No	This feature is unacceptable as it allows no cost control oversight by the LFUCG. KLC TPA has \$1 million authority to spend LFUCG money without input unless granted in writing by KLC TPA.
Cost of Risk Benchmark	N/A	None	This is a standard benchmark throughout the industry that compares the insurance cost to total "actual" operating budget. LFUCG Currently 2.35% of National Average 2 - 4%.
Cut through endorsement	Yes	No	ACE obligation is to KLC, not the LFUCG.
Financials	A+ Rated	Non-Rated	Financials of KLC are not being audited by AM Best for comparison to like organizations.
Backed by State Guarantee Fund	Yes	No	No financial backing in event of KLC failure other than assessments against insureds.
Stringent state oversight on financials and insurance policy forms	Yes	No	AIG is an admitted carrier in Kentucky and must file forms and pricing w/State Insurance Department. KLC does not have to file with State Insurance Department.
Participation Agreements	N/A	?	If no Participation Agreement, what binds LFUCG to KLC/ACE



Lexington - Fayette Urban County Government  
 Division of Risk Management  
 October 1, 2007 - September 30, 2008 AL/GL/POL Comparisons

<u>PROGRAM CONSIDERATIONS</u>	<u>AIG</u>	<u>KLC</u>	<u>Comments</u>
Price at \$1M Retention (SIR)	\$491,481	\$615,010	KLC price includes Claims Handling (TPA), Loss Control (1000 Hours) and Property/Vehicle Appraisal Services
AL/GL/POL Limits	\$5M Aggregate (POL, EBL, & Products)	\$5M No Aggregate	No Aggregate is preferable
Defense Inside Vs Outside the Limit	Inside	Outside	KLC arrangement does not allow erosion of Policy Limits.
Sexual Abuse Coverage	\$5M / Occurrence	\$1M / Claims Made	LFUCG loss experience has been below \$1million SIR & limits offered
Claims Handling Services	Risk Management Services Corp (\$53,000 FY 2007)	Collins & Co. (service included in proposal)	Will use current TPA cost to offset proposal price difference
Consent to Handling Claims within SIR	Yes	Yes	KLC agrees to allow LFUCG to participate in claims handling decisions and use LFUCG attorneys
Cut through endorsement - State Guaranty Fund	Yes	No	KLC has assured the LFUCG would be kept financially whole in the event KLC were to liquidate
			KLC premium adjustments
	-	\$64,000	TPA/Appraisals adjustment
	-	\$39,500	1/2 broker fee
	-	\$35,000	Loss Control Services
		<u>\$138,500</u>	KLC premium adjustments
<b>AIG Premium</b>	<b>\$491,481</b>	<b>\$476,510</b>	<b>KLC Adjusted Premium</b>





Lexington-Fayette Urban County Government  
OFFICE OF INTERNAL AUDIT

Jim Newberry  
Mayor

Joe Kelly  
Senior Advisor for Management

**INTERNAL AUDIT MEMORANDUM**

DATE: September 22, 2009  
TO:  
FROM: Bruce Sahli, Director of Internal Audit  
RE: Fraud Concerns Brought to the Attention of Mountjoy Bressler

We have performed a preliminary review of the concerns you brought forth in your July 6, 2009 response to the Mountjoy & Bressler (M&B) Fraud Risk Assessment (FRA). This information was brought to our attention by Drew Ulmer of M&B.

In meetings with Drew Ulmer and Randy Davis, M&B Partner-in-Charge of the LFUCOG annual financial audit, they informed us that their audit procedures did not find credible evidence of fraud in the areas of concern you identified in your July 6, 2009 FRA response. They also informed us they were bringing this information to our attention solely as a precautionary matter to satisfy the requirements of their Statements on Auditing Standards.

In conducting our preliminary review of those concerns you brought to M&B's attention, we agree with M&B's assessment that there is no credible evidence that a fraudulent act has occurred, is occurring, and/or will occur. According to the Association of Certified Fraud Examiners, a fraud examination should not be conducted if the totality of circumstances would lead a reasonable, professionally trained, and prudent individual to believe a fraud has not occurred, is not occurring, and/or will not occur. Therefore, no further action will be taken regarding the concerns you brought to M&B's attention in your July 6, 2009 FRA response. We appreciate your input in M&B's FRA process.

With Best Regards,

Bruce Sahli  
Director of Internal Audit





Lexington-Fayette Urban County Government  
OFFICE OF INTERNAL AUDIT

Jim Newberry  
Mayor

Joe Kelly  
Senior Advisor for Management

INTERNAL AUDIT MEMORANDUM

DATE: September 29, 2009  
TO: Logan Askew, Commissioner of Law  
FROM: Bruce Sahli, Director of Internal Audit  
RE: Open Records Request  
Log No. 0004

Dear Logan:

This is in response to the above referenced open records request received on September 25, 2009 for any and all documents relating in any way to any investigation by Internal Audit or by LFUCG's financial auditors of LFUCG's placement of insurance in 2008 and 2009. The documents you requested, except for the final memo issued by this Office, are exempt from public inspection under KRS 61.878(1)(i) as they are preliminary in nature. However, under KRS 61.878(3), as a public agency employee you have the right to inspect and copy any record, including preliminary and other supporting documentation, that relates to you. Therefore, documents or portions of documents that relate to you are available for your inspection. The portions of such documents containing preliminary information that do not relate to you have been redacted.

Those documents related to your request that are subject to open records are now available for your inspection in the Office of Internal Audit during regular business hours. After you have inspected the documents, copies may be made at ten cents per page. Please see myself or Chris Ensslin for assistance. These records will be available for your inspection for thirty (30) days from the date of this letter. After thirty (30) days, the records will be returned to the filing system and this matter will be considered closed.

With Best Regards,

Bruce Sahli  
Director of Internal Audit



Lexington-Fayette Urban County Government  
OFFICE OF INTERNAL AUDIT

Jim Newberry  
Mayor

*Examined and  
copied by  
Logan Askew  
on 9/30/09.*

**INTERNAL AUDIT MEMORANDUM**

DATE: September 22, 2009  
TO:  
FROM: Bruce Sahli, Director of Internal Audit  
RE: Fraud Concerns Brought to the Attention of Mountjoy Bressler

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With Best Regards,

Bruce Sahli  
Director of Internal Audit



**FRAUD RISK ASSESSMENT**

CLIENT: LFUCG

BALANCE SHEET DATE: 6/30/09

Instructions: Statement on Auditing Standards (SAS) No. 99 entitled *Consideration of Fraud in a Financial Statement Audit* requires auditors to make inquiries of client personnel regarding the risks of fraud in the Government. The questions that follow are designed to gather information regarding the nature of and likelihood of fraudulent activities in your Government. Please answer all questions and return to Mountjoy & Bressler, LLP. You can return this via email, mail it to us at 175 E. Main Street, Ste 200, Lexington, KY 40507 or drop it off to us in the accounts payable department on the 3<sup>rd</sup> floor. Please return this questionnaire by June 26, 2009.

Thank you for your assistance.

1. Are you aware of any fraudulent activity or violations of laws at LFUCG?  
During the workers' compensation and property insurance renewals for FY 2009, the combined cost of premiums and TPA services was not disclosed to the LFUCG Council during the Blue sheet process by the Department of Law. This made the workers' compensation carrier (New York Life and Marine) and the property carrier (PEPIP), both presented by the Kentucky League of Cities, appear to be the best proposal. In prior bids by the KLC, the TPA cost has been included with the premium. This year, KLC unbundled this cost so that the premiums for workers' compensation would be less than the competition. However, the TPA services offered through KLC were \$39,000 more than the incumbent TPA resulting in an approximate net increase of \$21,000 for workers' compensation premiums and TPA cost. Also, the incumbent property carrier (Factory Mutual) was about \$47,000 less in cost. Further, the workers' compensation TPA (Collins & Company) for New York Life and Marine that is also handling the LFUCG's self-insured portion of workers' compensation claims did not have to undergo a bid process to be awarded the business thus resulting in the termination of Underwriters Safety & Claims which had a three year contract awarded as a result of the RFQ process under the model procurement codes of Kentucky.

A LFUCG Council Aide representing two anonymous Council members presented to me the attached June 19, 2009 Memo (Attachment #2) from the Commissioner of Law to the Mayor and LFUCG Council regarding Kentucky League of Cities Insurance Placement and Fees. The Council Aide asked me if the statements made by the Commissioner of Law were true. The memo includes what appears to be false statements on page 2, first and second paragraphs. It would appear the intent of the statement is to discredit the services of Marsh (LFUCG Broker) in their efforts to assist the LFUCG acquire Workers' Compensation and Property Insurance. As you will see in the subsequent documents in attachment #2, the MMC Transparency Disclosure Form clearly shows that Marsh received five (5) quotes for Workers'

Compensation insurance and not two (2) as noted in the memo. In the second paragraph on page 2, it states that "Risk Management agreed that the cost we incurred did not justify the service we were receiving from Marsh." This is a false statement as you will read in the attached e-mail to Logan Askew from Patrick Johnston dated August 30, 2007. Risk Management did not make a statement like the one quoted from this memo. Risk Management provided an explanation of the insurance market conditions resulting in less quotes from eligible excess insurance carriers. False statements such as these have misled the LFUCG Council into believing that the LFUCG was not receiving good service from Marsh and therefore justified the switch to the Kentucky League of Cities. In fact for the FY 2009 AL/GL renewals that were held in October, 2008, KLC failed to go to the market and attempted to: 1) increase premiums by \$250,000; 2) raise the self-insured retention by \$500,000; and 3) lower the limits of the policy to \$2million from \$5million. This delayed the renewal of these very important insurance policies by one month resulting in placing the insurance back with the excess carrier (AIG) before KLC was involved with LFUCG's insurance program.

- 2. If fraudulent activity did exist, where do you believe the Government would be most vulnerable?

[Redacted]

- 3. Has any fraud been reported to you during the fiscal year?

[Redacted]

B. The Manager Claims reported to me that the Commissioner of Law wanted him to use the same actuarial services that KLC was using. Subsequently, Mr. Sweeney advised the KLC Actuary of the LFUCG incumbent actuary bids resulting in the KLC Actuary bidding \$160 less than the incumbent actuary.

- 4. As auditors, we are particularly concerned with material financial statement fraud that is commonly directed by Management. Is there any reason anybody would say that you told them to do something that is illegal or unethical?

[Redacted]

[REDACTED]

5. Has anyone in the Government asked you to do something that you thought was illegal or unethical such as withholding information from the auditors, altering documents or making fictitious entries in the accounting records?

[REDACTED]

6. Are you aware of any weaknesses in the Government's internal controls that would provide anyone with the opportunity to commit fraud against the Government?

[REDACTED]

7. Have you committed fraud against the Government, including the intentional misstatement of the financial statements?

[REDACTED]

Signature: \_\_\_\_\_

Date: July 6, 2009

Title:



Mayor Jim Newberry

LEXINGTON-FAYETTE URBAN COUNTY GOVERNMENT  
Department of Law

TO: Jim Newberry, Mayor  
Members, Urban County Council

FROM: Department of Law

DATE: June 26, 2008

RE: FY 09 Property Insurance Renewal

After Tuesday's meeting, I received an email from Councilmember James asking for confirmation on which proposal was the lowest.

FM Global's quote of \$199,867 is the lowest for the premium to be paid, but premium is not the only cost to consider. KLC's quote is \$245,700. Below is the grid I included in my Memo dated June 23:

<u>Item</u>	<u>KLC</u>	<u>FM Global</u>
Premium	\$245,700	\$199,867
Auto Adjusting	\$ 29,400	In-house
Subrogation	\$ 30,430	In-house
Salaries for Adjusters	Included	\$ 66,000
<b>Totals</b>	<b>\$305,530</b>	<b>\$265,867</b>

Like our liability insurance renewal last year, the analysis of the quotes is complicated since the KLC quote includes all property adjusting services, except automobile claims. The FM Global quote contemplates that our property adjusting will be handled by our employee claims adjuster.

The LFUCG claims adjuster is also in charge of subrogation claims (when LFUCG seeks recovery for property damage that was caused by a third party).

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\*\*P.O. Box 34028

Lexington, KY 40588

(859) 258-3500

Fax:(859) 258-3538

www.lfucg.com

\*\*Please note new mailing address

Jim Newberry, Mayor  
Members, Urban County Council  
June 26, 2008  
Page 2 of 2

A couple of Councilmembers have indicated their preference that the claims adjuster position not be abolished. The Mayor has recommended that the claims adjuster, and two other risk management positions, be temporarily assigned to General Services.

At this point, there are too many variables to know what will happen after the temporary assignment is complete. If the claims adjuster position remains, this person can continue to oversee subrogation and auto claims even if the KLC proposal is selected.

\*

As I indicated, it is difficult to quantify the value to LFUCG of having all of our insurance and adjusting service in one place. I consider it valuable and efficient. However, I recognize that the difference is significant and, if you feel we need to proceed with the FM Global quote, we will make that work.

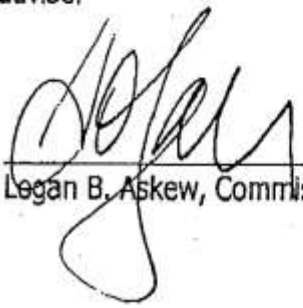
\*

Another question posed at Tuesday's meeting by Councilmember James involved our procurement process. Our procurement process applies to goods purchased by LFUCG. Under that process, a written bid packet is prepared and publicized by Purchasing. Bidders then submit bids, and LFUCG selects the lowest bid which meets the bid specifications.

*Jim says insurance is professional service.*

With professional services, a different process is used. LFUCG makes a request for proposals. Submissions will include the basic service advertised, and any additional features that the submitter wishes to include. Our professional services process does not require that the lowest proposal be accepted. LFUCG will select the lowest and best proposal.

If you have any other questions, please advise.



Logan B. Askew, Commissioner



Lexington-Fayette Urban County Government  
DEPARTMENT OF LAW

Jim Newberry  
Mayor

Logan Askew  
Commissioner

TO: Jim Newberry, Mayor  
Members, Urban County Council

FROM: Department of Law

DATE: June 19, 2009

RE: Kentucky League of Cities – Insurance Placement and Fees

A Councilmember has requested information concerning our insurance relationship with KLC. In view of the recent news stories about KLC and the proposed insurance renewals to be considered next week, I send this response to all of you.

At this time, we have the following insurance coverages in effect:

- Kentucky Self-Insured Auto Surety Bond
- Workers' Compensation Excess Insurance
- Liability Excess Insurance (Auto, General, Public Officials)
- Property Excess Insurance
- International Package
- Aviation Liability

In the past, we have also had special events coverage for the July 4 celebration and asbestos liability, but we have not renewed those coverages. The costs did not justify the remote risks.

Until July 1, 2008, Marsh USA, Inc. ("Marsh") acted as our broker to solicit quotes for insurance and to advise us generally as to our insurance needs. Marsh was selected in 2001 through an RFP process. Marsh charged us a flat fee for all services as follows:

<u>Agreement Term</u>	<u>Compensation</u>
7/1/2001 – 6/30/2006	\$75,000 per year
7/1/2006 – 6/30/2008	\$79,000 per year

In Charlie Boland's absence in the Spring, 2007, I attended Risk Management's meeting with Marsh to consider the insurance proposals for workers compensation; property, boiler and machinery; and international coverage.

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Jim Newberry, Mayor  
Members, Urban County Council  
June 19, 2009  
Page 2 of 2

I was surprised that only four carriers were contacted and only two quotes were presented for worker's compensation. Only one quote was presented for property, boiler and machinery, as well as the international coverage.

On July 1, 2007, Risk Management became a part of the Law Department. In August, 2007, Marsh met with us again to present the insurance proposals for liability. Only two quotes from the incumbent carrier were presented. Risk Management agreed that the cost we incurred did not justify the service we were receiving from Marsh.

For liability coverage commencing October 1, 2007, we accepted the proposal of ACE, which was solicited by KLC. Since July 2008, KLC has solicited insurance quotes for all insurance lines, and we terminated our agreement with Marsh.

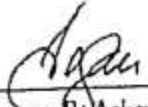
Given our size, LFUCG does not participate in the KLC member cities' insurance pool. Rather, KLC solicits quotes from insurance companies for policies that apply only to LFUCG.

For KLC's services, commissions have been paid by our insurance carriers in the following amounts:

<u>Policy Term</u>	<u>Commissions Earned (paid by carrier)</u>
7/1/2008 - 11/19/2009	\$38,228
Proposed 7/1/2009 - 6/30/2010	\$45,000

In addition to the insurance coverages, KLC has been very helpful in providing insurance and loss control advice.

Please advise if you have any questions.

  
\_\_\_\_\_  
Logan B. Askew, Commissioner

cc: Leslye Bowman, Director of Litigation  
Thomas Sweeney, Claims Manager

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Chief Administrative Office <b>POLICY MEMORANDUM</b>	Date of Issue October 21, 1996 October 12, 1998 REVISED April 21, 2003 REVISED	Expiration Date: N/A	No. 1
TO: ALL Divisions and Departments	Subject: Professional Services		
SIGNATURE:			
COMMENTS:			

I. As used in this Policy Memorandum:

"Professional services" shall mean contractual services of a professional nature, such as engineering, architectural, accounting, legal, medical or consulting services.

II. The Division of Central Purchasing will annually advertise in the newspaper having the highest circulation within Fayette County and other smaller newspapers, as appropriate, an announcement soliciting general letters of interest from individuals and firms to perform various professional services for the government. These letters of interest will be retained on file within the Division of Central Purchasing.

III. Any budget unit of the Urban County Government having funds appropriated to it by the Urban County Council in any fiscal year shall use its regular internal processes and standard Division of Central Purchasing procedures for making non-bid professional services contracts. Any non-bid professional services contract for \$25,000 or more in any one fiscal year, including the payment of \$25,000 or more in any one fiscal year to any one attorney or any one law firm regardless of the number of cases handled, will require the approval of the Chief Administrative Officer (CAO).

The CAO shall consult with the Department to whom the services are to be provided, the Division of Central Purchasing, a representative from the office of the Urban County Council and others as needed. The CAO shall consider the following factors when he evaluates the proposals received: (1) specialized experienced and technical competence of the person or firm (including a joint venture or association) with the type of service required; (2) capacity of the person or firm to perform the work, including any specialized services, within the time limitations; (3) character, integrity, reputation, judgment, experience and efficiency of the person or firm; (4) past record and performance on contracts with the Urban County Government or other governmental agencies and private industry with respect to such factors as control of cost, quality of work and

POLICY MEMORANDUM 1	Professional Services	Page 2
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ability to meet schedules; (5) familiarity with the details of the project; (6) degree of local employment to be provided by the person or firm in the performance of the contract by the person or firm; and (7) estimated cost of services.

- IV. An approved contract may be completed by using normal purchasing procedures if sufficient funds are appropriated to cover the cost of the services, unless the total cost in any one fiscal year is \$50,000 or more, in which case, adoption of a resolution by the Urban County Council will be required for final approval. In any case where the CAO approves a non-bid professional services contract in an amount between \$25,000 and \$49,999 in any one fiscal year or recommends to the Council the approval of a non-bid professional services contract in the amount of \$50,000 or more in any one fiscal year, the head of the department, division or office who will be supervising the performance of the particular non-bid contract in question, or his designee, will make a written report to the Council concerning the scope of the project, the cost, and the terms and conditions of the contract.
- V. The provisions of this Policy Memorandum shall not apply to any purchase constituting an emergency within the meaning of KRS 424.260.
- VI. The provisions of this Policy Memorandum shall not exempt any written agreement between the government and outside parties from Council approval. It will only exempt from Council approval any purchase order or cash disbursement request for professional services in an amount of less than \$50,000 in any one fiscal year.
- VII. The provisions of this Policy Memorandum will apply to any non-bid professional services contract which is amended in any one fiscal year to reach the threshold amounts specified in this Policy Memorandum. Such amendments shall be subject to the procedures specified herein.

**4.0 SOURCE SELECTION: COMPETITIVE SEALED BIDS****4.1 Bidders List Application and Pre-qualification**

- A. Any person, firm or corporation desiring to receive written notice of procurement requirements of the Lexington-Fayette Urban County Government may make application to have his/her name placed on a bidders list for the types or kinds of goods or services he/she wishes to supply or provide. The Purchasing Director shall specify the form to be followed by the prospective vendor to make application for inclusion on Urban County Government bidders lists.
- B. The Purchasing Director shall establish a program for vendor pre-qualification. To establish such a program, the Purchasing Director shall solicit from each prospective vendor sufficient information to permit evaluation of the vendor's qualifications in terms of:
  - 1. The ability and capacity to perform on a timely basis under contract for the goods or services he wishes to bid on and supply.
  - 2. Good character, integrity, reputation, and experience.
  - 2. Satisfactory performance in prior dealings with the Lexington-Fayette Urban County Government.
  - 3. Satisfactory performance in dealings with other local governments, the Commonwealth of Kentucky and other state governments.
- C. The Purchasing Director may refuse to list any prospective vendor if that vendor does not meet the minimum criteria established for entry on a bidders list. It is the responsibility of the vendor to show that he/she meets criteria established for entry on the bidders list to which he/she seeks to gain entry.
- D. The prospective bidder will be promptly notified in writing if his/her application is disapproved. The reason(s) for disapproval shall be stated in such notification.

- E. A prospective bidder may appeal the disapproval of his/her application by written appeal to the Purchasing Director. The appeal must be filed within two (2) weeks after the date of the notice of disapproval, must state the grounds for appeal with reasonable particularity and must relate directly to the reason(s) for disapproval.
- F. The Purchasing Director may establish the time at which and the conditions under which a prospective bidder whose application has been rejected may reapply for placement on a bidders list.
- G. A bid may be accepted from a bidder who has not pre-qualified, provided that the bidder submits all information required by the Purchasing Director to make a determination of the bidder's qualifications prior to the award of a contract.

#### 4.2 Public Notice

- A. All Invitations for sealed bids shall be published not less than seven (7) nor more than twenty-one (21) days prior to the date set for opening bids.
- B. The date the Legal Notice appears shall not be counted as advertising time.
- C. The Invitation for Bids shall be published as a Legal Notice in the newspaper with the largest circulation in the jurisdiction area of the Lexington-Fayette Urban County Government.
- D. The Invitation for Bids may be placed in other publications when, in the judgment of the Purchasing Director, such placement would best serve the interests of the Lexington-Fayette Urban County Government.
- E. The Purchasing Director may postpone a bid opening date if he determines that such action is in the best interest of the Urban County Government. If a bid opening is postponed, the Purchasing Director shall:
  - 1. Notify in writing all prospective bidders of the postponement and inform prospective bidders of the revised bid opening date.
  - 2. Place an additional Public Notice for the Invitation for Bids if such action is necessary to meet publication requirements established in Section 4.2A.

- 4.3 An Invitation for Bids may be canceled when the Purchasing Director determines that:

- A. Conditions leading to the issuance of an Invitation for Bids change sufficiently to make the proposed purchase unnecessary.
- B. Funds become unavailable for the proposed purchase.
- C. It becomes apparent that no bids will be received because:
  - 1. The item or service requested is currently unavailable.
  - 2. Bid prices will apparently exceed available funds.
  - 3. Major revisions in specifications are necessary to insure that responsive and reasonable bids are received.
- D. Cancellation of an Invitation for Bids may be accomplished by newspaper advertisement or by the delivery of written notice of such cancellation to all known holders of the bid documents.

#### 4.4 Specifications

- A. All specifications used for procurement by the Urban County Government shall be designed to provide the maximum practicable competition consistent with the level of quality required by the Urban County Government.
- B. The Purchasing Director shall review all specifications for openness and accuracy. If a restrictive element is found in specifications submitted by a using agency, the Purchasing Director may require that the specifications be revised to eliminate the restrictive element or that the head of the using agency provide written justification for use of the restrictive element.
- C. The Urban County Government shall determine the level of quality required for any item or service to be purchased. The Urban County Government shall not modify the established level of quality for a purchase for the sole purpose of improving the competitive position of any prospective bidder for that purchase.
- D. The Purchasing Director may, at the request of a using agency, draft specifications for use in the proposed purchase. The using agency shall inform the Purchasing Director fully, in writing, of all requirements concerning the proposed purchase. A draft of such specifications shall be submitted to the using agency for written approval.
- E. The Purchasing Director may adopt a standard format for use in developing specifications, and may restructure specifications submitted by a user agency to conform to that format.

- F. The Purchasing Director shall use design specifications, performance specifications or a combination of design and performance specifications as may be appropriate for each procurement.
- G. "Brand name or equivalent" specifications shall be used only when other types of specifications are unavailable or inappropriate. If "brand name or equivalent" specifications are used, the specifications must:
  - 1. Specify more than one brand name, if possible.
  - 2. Specifically state that an equivalent product may be supplied.
  - 3. Set forth all salient criteria to be met by all products proposed.

It shall be the responsibility of the bidder proposing an equivalent product to demonstrate that the equivalent product proposed meets all criteria established for the product to be furnished.

- H. The Purchasing Director may establish a program for the development of standard specifications, including the procedures to be used to develop standard specifications, and may set forth conditions under which variance from standard specifications may be permitted.
- 4.5 All bids shall be submitted on forms provided for that purpose by the Urban County Government. Bids submitted on forms other than those provided by the Urban County Government shall be rejected as non-responsive. Submission of or modification of bids by telephone or telegraph is not permitted.
  - 4.6 All bids submitted shall include any and all attachments and/or supplementary material required by the Invitation for Bids. Bids submitted without required supplementary material shall be rejected as non-responsive.
  - 4.7 A contract shall be awarded to the responsible bidder who submits a responsive bid for either the lowest bid price or the lowest evaluated bid price.
    - A. If a bid is to be awarded on the basis of lowest bid price, the method of award shall be clearly stated in the Invitation for Bids.
    - B. If the bid is to be awarded on the basis of lowest evaluated bid price, the method of award shall be clearly stated in the Invitation for Bids, along with the objective measurable criteria and formulas or computation methods to be used in evaluation.

#### 4.8 Mistakes in Bids and Bid Withdrawal

- A. No changes or modifications shall be made to any bid after bids have been opened, except for clarification of bid contents when written clarification is specifically requested by the Purchasing Director. No modifications shall be made to the original bid documents, and changes in price shall not be made under any circumstances.
- B. If an error has been made that is obvious on the face of the bid, or if the bidder can demonstrate from worksheets or other documents that an error has been made in the preparation of the bid, the Purchasing Director may allow the bidder to withdraw the bid without penalty.
- C. Errors in extension of unit prices shall not be cause for withdrawal of a bid. When unit prices are requested, the unit price shall govern over the total price shown.
- D. A bid may be withdrawn before the time set for bid opening if the bidder requests such withdrawal in writing.
- E. Withdrawal of any bid, except under conditions set forth herein, shall require forfeiture of bid security if such security has been required by the Invitation for Bids.

#### 4.9 Opening of Sealed Bids

- A. An opening time and place for each bid shall be stated in the Public Notice and Invitation for Bids.
- B. The time set for bid openings shall be established by a clock at the bid opening location designated by the Purchasing Director. It shall be the bidder's responsibility to assure that his/her bid is at the bid opening location before the time set for bid opening.
- C. The Purchasing Director shall, at the time set for opening bids, declare bids to be closed and shall publicly open all bids submitted. If the structure of the Invitation for Bids permits, all bids submitted shall be read aloud.
- D. Bids shall not be examined, inspected or reviewed by any persons present at the bid opening until all bids have been opened.
- E. Any bid received in the Division of Central Purchasing after the time set for opening bids shall be accepted by the bid clerk. The date and time of receipt of the late bid shall be marked on the bid, and the bid clerk shall

sign the date and time entry. The late bid shall be entered as such and shall not be considered for award.

- F. The Purchasing Director shall, with reasonable promptness, prepare a tabulation of all bids received in response to an Invitation for Bids and shall make such tabulation available to the public upon reasonable request.

#### 4.10 Evaluation and Award of Sealed Bids

- A. Within a reasonable time after bids are opened, the Division of Central Purchasing shall review all bids received for compliance with specifications, terms and conditions, and shall arrange for review of the bids by the head of the user agency. The head of the user agency shall submit a written recommendation concerning bid acceptance to the Purchasing Director upon request.
- B. Every bidder shall, upon the request of the purchasing official responsible for the particular procurement, clarify or explain in writing, any matter contained in his/her bid which the purchasing official determines needs clarification or explanation. The bid of any bidder who fails to provide such clarification or explanation when such clarification or explanation is requested shall not be considered for award. The written clarification or explanation of a bid shall be incorporated in and become part of any contract awarded on the basis of that bid.
- C. Alternate bids will be considered for award only if the Invitation for Bids specifically requests that alternates be submitted and establishes conditions under which alternate bids will be considered for award.
- D. After a reasonable evaluation, a contract shall be awarded to the responsive and responsible bidder whose bid (or alternate bid if alternates are requested in the Invitation for Bids) is either the lowest bid price or lowest evaluated bid price, as designated in the Invitation for Bids as the basis for award of the contract.
- E. Acceptance of bids and award of contracts shall be accomplished by enactment of an Ordinance or Resolution by the Urban County Council, or by such other process as the Urban County Council may establish.
- F. If the Purchasing Director determines, in writing, that no satisfactory bids have been received, all bids may be rejected and new bids solicited on the basis of the same or revised specifications. The basis for rejection of all bids and subsequent action taken with respect to the Invitation for Bids shall be recorded in writing and filed in the bid file relating to the particular procurement.



- G. The Purchasing Director shall recommend to the Chief Executive/Administrative Officer the bid to be accepted.
    - 1. Any recommendation to accept a bid other than the lowest responsive bid must be accompanied by an explanatory memorandum from the Commissioner of the Requisitioning Department.
    - 2. If a bid is recommended which will exceed funds budgeted for the procurement, the Head of the Requisitioning Agency shall contact the Division of Budgeting to request appropriation of additional funds.
  - H. The Chief Executive/Administrative Officer shall review the bid documents and shall, upon approval, transmit the documents to the Department of Law.
  - I. The Department of Law shall write an Ordinance or Resolution to accept the bid and shall forward all documents to the Clerk of the Urban County Council.
  - J. The Clerk of the Urban County Council shall place the bid Ordinance or Resolution on the docket. After enactment by the Urban County Council, the Clerk of the Urban County Council shall transmit the Ordinance or Resolution, with the attached Purchase Requisition to the Division of Central Purchasing.
  - K. The Division of Central Purchasing shall issue a Purchase Order.
- 4.11 The Purchasing Director reserves the right to reject any and all bids and to waive technicalities and informalities where such waiver serves the best interest of the Lexington-Fayette Urban County Government. Grounds for rejection of bids include:
- A. Failure of a bid to conform to the essential requirements of an Invitation for Bids.
  - B. Failure to conform to specifications contained in or referred to in any Invitation for Bids unless the Invitation authorized submission of alternate bids and the alternate proposal meets the requirements specified in the Invitation for Bids.
    - 1. The Urban County Government may consider, without rejecting as non-responsive, a bid that proposes to furnish an item or service with minor variances (exceptions) from established specifications,

provided that such variances (exceptions) do not adversely affect the utility or durability of the item or service to be purchased.

- C. Failure to conform to a delivery schedule established in an Invitation for Bids.
- D. Imposition of conditions that would modify the terms and conditions of the Invitation for Bids, or which would limit the bidder's liability to the Lexington-Fayette Urban County Government under terms of a contract awarded on the basis of such Invitation for Bids.
- E. Failure of a bid, as determined by the Purchasing Director, to be reasonable in price.
- F. Determination that a bid was submitted by a bidder determined to be not responsible.
- G. Failure to furnish bid security when such security is required by the Invitation for Bids.

#### 4.12 Bid Conditions

- A. The Purchasing Director shall adopt and revise as necessary general conditions for bidding. The general conditions for bidding shall be applicable to, and shall be included in or incorporated by reference in, all Invitations for Bids issued by the Lexington-Fayette Urban County Government.
- B. The Purchasing Director may, when required by a particular procurement, develop and adopt special bid conditions supplemental to the general bid conditions.
- C. Any bidder who submits a bid in response to an Invitation for Bids shall be deemed to have agreed to comply with all terms, conditions, and specifications of such Invitation for Bids.

#### 4.13 Contract Pricing

The following matters shall be applicable to Invitations for Bids issued, bids submitted, and contracts awarded for the purchase of commodities, supplies, equipment and services.

- A. Discounts shall not be considered unless the Invitation for Bids specifically requests that discounts be shown. All applicable discounts should be included in the bid price.

- B. In the case of a discrepancy in the extension of a price, the unit price shall govern over the total price for all items.
- C. A contract may be awarded to the lowest aggregate bidder for all items, to the lowest aggregate bidder for each group of items, or on an individual item basis, whichever is determined to be in the best interest of the Lexington-Fayette Urban County Government. The methods and basis of evaluation of bids and award of contracts shall be stated in the Invitation for Bids.



### Competitive Bids

All purchases for more than \$20,000, except for those items or services specifically exempted, are required by law to be purchased by competitive sealed bids. This procedure involves public advertising of the invitation for bids, submission of sealed offers by vendors and acceptance of one offer by the Urban County Government. All Urban County Government procurement contracts are established by competitive bids; therefore, any purchase made from an Urban County Government procurement contract is a result of the competitive bid process.

The following kinds of purchases are exempt from the competitive bidding requirement:

1. Purchase of services from a public utility company franchised by the Urban County Government.
2. Purchase of services from a non-profit agency.
3. Purchase of services from licensed professionals (architects, engineers, CPA's, etc.).
4. Purchase of services from craftsmen or tradesmen, provided that they provide only labor and tools and that the Urban County Government supplies materials.
5. Purchase of real property (land and buildings).
6. Purchase of goods or services from a unit of the federal government, a state government or a local government.
7. Purchase of goods or services from an Urban County Government or a Commonwealth of Kentucky "All State Agencies" procurement contract.
8. Purchase of perishable meat, fish and vegetables.
9. Purchase of goods or services under a condition of emergency declared by the Mayor of the Lexington-Fayette Urban County Government.

The use of competitive techniques other than sealed bids may be required for certain of these categories if required by state or federal grants. The Director of Central Purchasing may determine that the use of alternate competitive techniques best serves the interest of the Urban County Government.

The most important element in the competitive bid process is the development of specifications. Specifications are a description of requirements that must be met by the goods or services to be purchased. We use several different types of specifications:

1. Design Specifications – describe precisely how something is to be built. Construction specifications are almost always design specifications.
2. Performance Specifications – establish requirements for evaluating how well an item or item of equipment does a task.
3. A combination of design and performance specifications.
4. Brand Name or Equivalent Specifications – are used infrequently. Specific requirements for use of these specifications are established in the Urban County Government procurement regulations.

Specifications establish the level of quality required for the goods or services to be purchased. While specifications must be drafted to assure that the items purchased will conform to the level of quality required, care must be taken to assure that the specifications do not unduly restrict competition. Unjustifiably restrictive elements in specifications are unacceptable.

Central Purchasing will review all specifications submitted for use in competitive bids. Specifications may be modified to conform to a standard format. Other changes may be suggested. Central Purchasing will draft or assist in drafting specifications upon request.

The competitive bid process differs from written quotations in the formalities that must be observed and legal requirements that must be met. The process requires public advertising, notification of all potential bidders known to be interested in the purchase, a public bid opening and acceptance of bids by the Urban County Council. The steps of the bid process are listed below.

1. Division or department emails proposed specifications to Central Purchasing at [biddocuments@lfucg.com](mailto:biddocuments@lfucg.com).
2. Central Purchasing reviews and approves specifications.
3. Central Purchasing establishes date for opening bids.
4. Central Purchasing places legal notice (advertisement) in local newspaper.
5. Central Purchasing notifies prospective vendors of the invitation for bids and distributes bid documents. (This function may be performed by a consultant hired by the Urban County Government to coordinate a specific construction project.)
6. Central Purchasing opens bids.
7. Central Purchasing transmits copies of bids received to requesting agency for review.
8. Requesting division or department transmits recommendation for bid acceptance to Central Purchasing and assures that sufficient funds are budgeted for the purchase.
9. Central Purchasing transmits recommended bid to the Division of Budgeting.
10. Division of Budgeting approves and transmits bid to the Senior Advisor for Management.
11. Senior Advisor for Management approves and transmits bid to Department of Law.
12. Department of Law drafts ordinance or resolution to accept bid and transmits bid package to Council Clerk.
13. Council Clerk places bid on docket for Council action.
14. Urban County Council gives bid acceptance first reading.
15. Urban County Council gives bid acceptance second reading.
16. Council Clerk sends ordinance or resolution accepting bid to Central Purchasing.
17. Central Purchasing issues purchase order.

The competitive bid process is a lengthy one. It is essential that adequate lead time is permitted to complete the process. The estimated time required to complete the various steps is shown below.

Steps 1 – 4	9 – 21 days
Steps 5 – 6	7 – 21 days
Steps 7 – 8	2 – 30 days
Steps 9 – 13	8 days
Steps 14 – 15	14 days
Steps 16 – 17	3 days
<u>Total Time Required:</u>	<u>43 – 97 days</u>

Award of a bid may be based on one of two conditions:

1. The bid may be awarded to the bidder who submits the lowest bid that meets requirements.
2. The bid may be awarded to the bidder who submits the lowest evaluated bid that provides the best value to the Lexington-Fayette Urban County Government.

If best value award is to be used, the factors to be evaluated and the method of evaluation must be stated in the invitation for bids.





### Professional Services

Professional services are services provided by a person or firm licensed by the state or by an organization approved by the state to provide those services. Professional services include services provided by doctors, lawyers, architects, engineers, planners and Certified Public Accountants.

Per Resolution 167-91, the Lexington Fayette Urban County Government has adopted an administrative plan for a 10% minimum goal for disadvantaged business enterprises participation in Lexington-Fayette Urban County Government construction contracts and professional services contracts. This resolution states that the divisions of the Lexington-Fayette Urban County Government shall make a good faith effort to award at least 10% of their professional services and other contracts to disadvantaged business enterprises. A complete copy of the administrative plan is available in Central Purchasing.

Purchase of professional services differs from the purchase of goods and other services in several ways:

For professional services under \$25,000

1. Purchase of professional services is exempt from the competitive bidding requirement; however, other forms of competition may be used.
2. Purchase of professional services usually requires a written contract along with a purchase order.
3. Central Purchasing will assist in vendor selection for professional services upon request.
4. Purchase of professional services usually involves some form of negotiation.

For professional services \$25,000 and above, the attached CAO Policy will be used by Central Purchasing to solicit proposals through the RFP process. RFP specifications should be emailed to [biddocuments@lfucg.com](mailto:biddocuments@lfucg.com).

**Purchase of Professional Services**

*Note: Only the Mayor is authorized to sign written contracts on behalf of the Lexington-Fayette Urban County Government.*

**Procedures**

1. Select vendor. The use of competitive proposals or other forms of competition is encouraged for all requests, including those under the amount required in the CAO Policy.
2. Complete a purchase requisition.

**If the purchase has no executed contract:**

1. If the request does not have an accompanying executed contract, submit the purchase requisition directly to Central Purchasing. Central Purchasing will submit the request for Council approval via the work session packet.
2. Council Clerk will transmit the ordinance or resolution along with the purchase requisition to Central Purchasing.
3. Central Purchasing will issue a purchase order.

**If the purchase has an executed contract:**

1. Complete an administrative review form (Blue Sheet, Form 43-12) for all contracts \$25,000 or higher. (Contact Central Purchasing at 258-3320 for specific requirements of selection process.)
2. Attach the purchase requisition and proposed contract to the administrative review form.
3. Transmit the administrative review form and attachments to the Office of the Mayor. (See administrative review form for complete administrative review procedure.)
4. Council Clerk will transmit the ordinance or resolution along with the purchase requisition to Central Purchasing.
5. Central Purchasing will issue purchase order.

A purchase requisition must be attached to the administrative review form. A purchase order cannot be issued unless Central Purchasing receives a purchase requisition.

**LEXINGTON-FAYETTE URBAN COUNTY GOVERNMENT**  
**OFFICE OF THE MAYOR RESPONSE**





Lexington-Fayette Urban County Government  
OFFICE OF THE MAYOR

Jim Newberry  
Mayor

October 1, 2010

The Honorable Crit Luallen  
Auditor of Public Accounts  
209 St. Clair Street  
Frankfort, KY 40601-1817

RE: Examination of Allegations of Potential Fraud and Other Related Issues Regarding  
Procurement Practices of Lexington-Fayette Urban County Government

Dear Ms. Luallen:

Thank you for sharing a draft of the report on the examination referenced above. Although we had great confidence in the conclusions reached by both our internal and external auditors relative to the fraud allegations, I requested your examination in light of the serious allegations made on May 25, 2010 by a member of the Urban County Council against the Director of Internal Audit. We appreciate the efforts which your staff has taken to evaluate our internal and external auditors' findings that there was no evidence of fraud, and we are pleased that your staff reached the same conclusion as our auditors.

In addition, we are grateful for your recommendations about steps to improve and strengthen various aspects of our procurement process. The procurement policies at issue were initially adopted in 1983, 1991 and 1996, and as a result, it is helpful to have your assessment of those policies so that we can make changes to improve both the effectiveness and the efficiency of our purchasing operations.

We also appreciate your recommendations relating to the Internal Audit Board. As your report correctly notes, the Board was created in 2002 with a goal of making the internal audit function independent of both the mayor and the council. Consequently, most of your recommendations relating to the Board are more appropriately evaluated by the Board, but we stand ready to assist the Board as it moves to address the report's recommendations.

We appreciate the opportunity to respond to your findings and recommendations, and to that end, we offer the following responses on each chapter, observation, question, finding and recommendation.

**Chapter 1 – Introduction and Background**

We believe that Chapter 1 accurately describes Lexington-Fayette Urban County Government and accurately portrays the circumstances surrounding both the Division of Risk Management and the Self Insurance Fund.

**Chapter 2 – Observations and Questions**

As we understand, on June 10, 2010, the APA staff requested that the Director of Risk Management document and submit to the APA staff the specific actions he believed constituted fraudulent activity. We commend

your staff for making this request at the earliest stages of your examination because it gave the Director the unfettered opportunity to specify whatever fraudulent activity he believed occurred. To the extent the external audit process inhibited his ability to allege fraudulent activity, your June 10 request eliminated those inhibitions. As a result, various issues arose beyond the issues set forth in the 2008 and 2009 Fraud Risk Assessment Questionnaires (FRAQs). We offer the following responses to each of the "Observations" submitted by the Director.

**Observation 1** – We agree with your conclusions that: (a) the selection of an excess insurance carrier for coverage for the period from October 1, 2007 through October 1, 2008 reflected no indication of fraudulent activity, (b) the September 11, 2007 presentation to the Council does not indicate any intent to circumvent the selection process, (c) the September 11, 2007 presentation to the Council by the Commissioner of Law provided a choice between two vendors rather than a single vendor as had historically been provided, and (d) the January 23, 2008 email from the Director of Risk Management reflected that he understood at that time that loss control hours were not being used to benefit KLC employees.

**Observation 2** – We agree with your conclusion that there was no indication of misrepresentation or concealment of material facts in this situation.

**Observation 3** – We agree with your conclusions that: (a) there was no evidence that the Commissioner of Law was informed of the alleged conflict of interest between KLC and the TPA vendor, and (b) there was no evidence to suggest a misrepresentation or concealment of material facts by the Commissioner of Law or any other LFUCG personnel.

**Observation 4** – We agree with your conclusion that there was no evidence to indicate that any material facts were misrepresented or concealed in relation to this observation.

**Observation 5** – We agree with your conclusion that there was no indication that there was intent to conceal material facts from compliance officials or employees.

**Observation 6** – We agree with your conclusion that there was no evidence to support that a material misrepresentation of fact occurred through the issuance of the June 19, 2009 memorandum to the Mayor and Council.

**Observation 7** – We agree with your conclusion that there was no evidence to suggest intent to conceal the safety grant from the Division of Community Development.

**Observation 8** – We agree with your conclusion that the documentation does not support the observation by the Director of Risk Management that a competitor was given inside information pertaining to the incumbent's quote.

**Observation 9** – We agree with your conclusion that there was no indication of fraud or wrong doing, but rather a management decision made as a part of the budget process.

**Observation 10** – We agree with your conclusions that there was no evidence of: (a) any intent by KLC or anyone else to conceal available pricing alternatives and (b) fraud or wrongdoing relative to the use of loss control hours.

**Observation 11** – We agree with your conclusions that: (a) there was no evidence to suggest concealment of critical data that may reveal trends in excess expenditures for claims, (b) the decision not to include the financial information in the claims and risk management information system was not a matter of intentionally preventing

any one person from viewing the information or inhibiting Risk Management from providing accurate information through its reporting, and (c) LFUCG was still receiving regular financial reports from KLC during this time.

**Question 1** – We agree with your conclusion that it is not possible for the APA to determine if the decision to purchase insurance through KLC was a better decision than to continue insurance with the previous insurance vendors.

**Question 2** – Because of a lack of “circumstances that would lead a reasonable, professionally trained, and prudent individual to believe a fraud as occurred, is occurring or will occur,” we agree with your conclusion that the approach taken by the Director and Deputy Director of Internal Audit was sufficient to lead them to a reasonable conclusion to not proceed into a full fraud examination in accordance with standards adopted by the Association of Certified Fraud Examiners.

**Question 3** – We take no exception to your assessment of who had custody of the FRAQs.

**Question 4** – We take no exception to your assessment of how the identity of the employee making the allegations of potential fraud were made known to LFUCG management, internal audit and Council. However, we found it enlightening that on May 6, 2010, approximately one month prior to the creation of the Special Investigative Committee, a Council member who served on the Special Investigative Committee met with your staff and provided a copy of the 2008 and 2009 FRAQs. We also found it troubling and incredible that when your staff asked that Council member after June 3, 2010 to identify the source of the document, the Council member could no longer locate the copies, did not know the source of the documents, did not realize that these documents were the documents that were being requested by the Special Investigative Committee and must not have realized the significance of the documents.

### **Chapter 3 – Findings and Recommendations**

For ease of reference, we have numbered each of your recommendations with a two digit number. The first digit corresponds with the number of the finding with which the recommendation is associated. The second digit corresponds to the paragraph of the recommendations section in which the recommendation is found.

**Finding 1** – We agree with your finding. We also note there is no prohibition against informing an employee that he was the subject of a preliminary investigation for possible fraud allegations.

**Recommendation 1.1** – We agree with your recommendation.

**Recommendation 1.2** – We agree with your recommendation.

**Finding 2** – We agree with your finding.

**Recommendation 2.1** – While we support the goal of informing the Council with confidential issues brought to the attention of the external auditors, we believe this recommendation may be in conflict with provisions of the Open Meetings Act insofar as it proposes closed Council meetings. We look forward to further discussions with your staff to clarify our understanding of this aspect of your recommendation. Otherwise, we agree with your recommendation.

**Finding 3** – We agree with your finding.

**Recommendation 3.1** – We agree with your recommendation. However, we believe these aspects of the Open Meetings Act merits legislative clarification, and we will pursue such a change at the next legislative session.

**Finding 4** – We agree with your finding.

**Recommendation 4.1** – We agree with your recommendation.

**Recommendation 4.2** – We agree with your recommendation, but we defer to the Board's action on the adoption of bylaws and rules.

**Finding 5** – We agree with your finding.

**Recommendation 5.1** – We agree with your recommendation.

**Finding 6** – We agree with your finding.

**Recommendation 6.1** – We agree with your recommendation, but we defer to the Board's action on this matter.

**Recommendation 6.2** – We agree with your recommendation, but we defer to the Board's action on this matter.

**Finding 7** – We generally agree with your findings that there is a lack of clear hierarchy and occasional conflict. We also agree that there is no evidence the 1996 CAO policy was approved by the Council. While we agree that no evidence of Council approval of the 1983 Procurement Regulations and the 1991 Central Purchasing Policies and Procedures Manual has been found thus far, we remain uncertain whether those two documents were approved by the Council. We will continue to evaluate Council records to assess whether those documents were approved by Council. However, we do note that under current processes, the Council approves all contracts, including contracts for purchases of goods and services, other than personal service contracts for amounts less than \$50,000.

**Recommendation 7.1** – We agree with your recommendation.

**Recommendation 7.2** – We agree with your recommendation.

**Recommendation 7.3** – We agree with your recommendation.

**Finding 7** – We agree with your finding.

**Recommendation 7.1** – We agree with your recommendation.

**Finding 8** – We agree with your finding.

**Recommendation 8.1** – We agree with your recommendation.

**Finding 9** – We agree with your finding.

**Recommendation 9.1** – We agree with your recommendation.



Ms. Crit Luallen  
Page Five  
October 1, 2010

We appreciate the opportunity to provide this response to your examination. Your report has done much to clarify the facts giving rise to unfounded allegations of fraud, to enhance the highly desirable independence of the Internal Audit Board and to improve our procurement processes. We look forward to continue to working with your staff as we move toward the implementation of the recommendations.

Sincerely yours,



Jim Newberry  
Mayor

200 East Main Street

Lexington, KY 40507

(859) 425-2255

[www.lexingtonky.gov](http://www.lexingtonky.gov)

HORSE CAPITAL OF THE WORLD



**LEXINGTON-FAYETTE URBAN COUNTY GOVERNMENT**  
**INTERNAL AUDIT BOARD AND OFFICE OF INTERNAL AUDIT RESPONSE**





Lexington-Fayette Urban County Government  
OFFICE OF INTERNAL AUDIT

September 30, 2010

Hon. Crit Luallen  
Auditor of Public Accounts  
209 St. Clair Street  
Frankfort, Kentucky 40601-1817

RE: LFUCG Potential Fraud and Procurement Practices Examination Report

Dear Ms. Luallen:

Please accept this letter as the response of the Lexington-Fayette Urban County Government (LFUCG) Internal Audit Board and Office of Internal Audit relative to your draft examination dated September 27, 2010 of Allegations of Potential Fraud and Other Related Issues Regarding Procurement Practices of Lexington-Fayette Urban County Government.

On behalf of the Internal Audit Board and the Office of Internal Audit, I wish to express our appreciation for the efforts of your staff concerning their comprehensive examination of matters related to these issues. The audit report provides an excellent summation of the issues and offers sound recommendations pertaining to related findings.

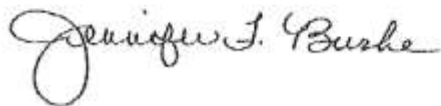
We are pleased that the results of your examination have concluded, as did the Office of Internal Audit and the Special Investigative Committee, that no evidence of fraud exists. We are also pleased that the results of your examination have concluded that the preliminary review process used by the Office of Internal Audit to examine the fraud allegations was sufficient to lead the Director and Deputy Director of the Office of Internal Audit to a reasonable conclusion to not proceed into a full fraud examination.

We concur with the findings and recommendations as they pertain to the Internal Audit Board and the Office of Internal Audit. The Office of the Mayor has provided a separate response to findings and recommendations that are separate from the Internal Audit Board and the Office of Internal Audit.

The Internal Audit Board and the Office of Internal Audit will clearly value and take into advisement the recommendations related to their duties and functions as set forth in the audit report. Given the exhaustive nature of the audit report, the Internal Audit Board reserves the option to review and provide more specific responses to the findings should it later be deemed appropriate or necessary.

In conclusion, it is our expectation that the consideration and implementation of recommended action plans contained in your audit report will further enhance the quality of internal audit services the Internal Audit Board and the Office of Internal Audit provides to the Lexington-Fayette Urban County Government and the citizens of Lexington and Fayette County.

Sincerely,



Jennifer F. Burke  
Acting Chair-LFUCG Internal Audit Board

