

**Examination of Certain Policies, Procedures,
Controls, and Financial Activity of
Metropolitan Sewer District**



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The Auditor Of Public Accounts Ensures That Public Resources Are Protected, Accurately Valued, Properly Accounted For, And Effectively Employed To Raise The Quality Of Life Of Kentuckians.

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CRIT LUALLEN
AUDITOR OF PUBLIC ACCOUNTS

December 16, 2011

Arnold J. Celentano, P.E., Chairman
Metropolitan Sewer District Board
700 West Liberty Street
Louisville, Kentucky 40203-1911

RE: Examination of Certain Policies, Procedures, Controls, and Financial Activity of Metropolitan Sewer District

Dear Chairman Celentano:

We have completed our examination of certain controls and management practices of the Metropolitan Sewer District (MSD). The enclosed report presents, in total, 27 findings and offers approximately 150 recommendations to strengthen MSD's controls and management oversight procedures.

Examination procedures included interviews with current and former MSD Board members, current and former MSD staff members, MSD special board counsel, MSD co-bond counsels, MSD financial advisor, and others. In conjunction with a review of applicable MSD policies and procedures, a sample of travel voucher reimbursements and purchasing card expenditures was examined to determine whether expenditures were appropriate and made in compliance with MSD policies.

Our examination also included a review of MSD Board governance, conflicts of interests, ethics policies, procurement policies and activities, investment policies and activities, legal services policies and activities, policies related to internal audit, as well as other selected policies. Our examination included records and information for the period July 1, 2008 through June 30, 2011, unless otherwise specified. The objectives developed by the Auditor of Public Accounts for this examination include:

- Determine whether policies governing contract procurement are adequate, consistently followed, and provide for a transparent process;
- Determine whether policies governing the internal audit process are adequate, consistently followed, and provide for timely reporting;
- Determine compliance with policies and other requirements associated with increasing MSD customer rates;



Chairman Celentano
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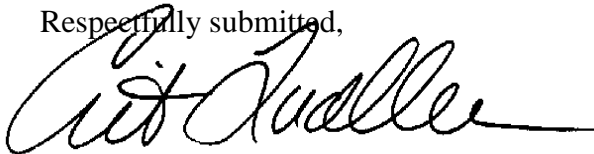
- Review and evaluate MSD Board policies using the APA's thirty-two recommendations developed for public and non-profit boards;
- Review certain financial transactions and determine compliance with MSD policies and reasonableness of the expenses; and,
- Determine if conflicts of interest exist.

The purpose of this examination was not to provide an opinion on financial statements or activities, but to ensure that processes are in place to provide strong oversight of financial activity through a review of MSD organization's policies, Board governance, certain internal controls, and other financial transactions.

Due to the nature of certain findings discussed within this report, we are referring these issues to the Louisville Metro Police Department Public Integrity Unit and to the Internal Revenue Service to determine whether further investigation by those offices are warranted.

The Auditor of Public Accounts requests a report from MSD on the implementation of audit recommendations within (60) days of the completion 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.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Crit Luallen", written in a cursive style.

Crit Luallen
Auditor of Public Accounts



Examination of Certain Policies, Procedures, Controls, and Financial Activity of Metropolitan Sewer District

Examination Objectives

On July 28, 2011, the Auditor of Public Accounts (APA) informed the Executive Director and Board Chair of the Louisville-Jefferson County Metropolitan Sewer District (MSD) by letter that due to the Louisville-Jefferson County Metro Government (Louisville Metro) Mayor's request for an audit and concerns expressed to this office regarding certain financial and other activities, it would perform a review of certain issues at MSD. Specifically, the examination would include a review of the organization's policies, internal controls, and certain other financial transactions.

The purpose of this examination was not to provide an opinion on financial statements, duplicate work of annual financial audits, or evaluate the amount of rate increases, but to address the following objectives:

- Determine whether policies governing contract procurement are adequate, consistently followed, and provide for a transparent process;
- Determine whether policies governing the internal audit process are adequate, consistently followed, and provide for timely reporting;
- Determine compliance with policies and other requirements associated with increasing MSD customer rates;
- Review and evaluate MSD Board policies using the APA's thirty-two recommendations developed for public and non-profit boards;
- Review certain financial transactions and determine compliance with MSD policies and reasonableness of the expenses; and,
- Determine if conflicts of interest exist.

The scope of this review includes records, activities, and information for the period July 1, 2008 through June 30, 2011, unless otherwise specified, as the time period of certain documents reviewed and various issues discussed with those interviewed may have varied.

Background

Created in 1946 by the Kentucky General Assembly, MSD was formed as a special district to handle sewers in Louisville and at that time the unincorporated Jefferson County, now known jointly as Louisville Metro. Generally speaking though, the three core areas of service that MSD provides include wastewater collection and treatment, stormwater drainage services, and flood protection.

MSD operates and maintains 3,200 miles of wastewater collection sewer lines which collect wastewater from over 200,000 homes, businesses, and industries throughout Louisville Metro. Wastewater flows to MSD's 286 pumping stations, six regional water quality treatment centers, and numerous smaller water quality treatment centers in the service area.

MSD maintains the stormwater drainage system for the Louisville Metro area. Responsibilities include the construction, repair and maintenance of drainage swales, storm sewers, ditches, and drainage channels in most of Louisville Metro. Areas not served by MSD include the cities of St. Matthews, Shively, Anchorage, and Jeffersontown. Residents and businesses in those municipalities are served by their respective cities.

MSD operates and maintains Louisville Metro's Ohio River flood protection system. The system includes about 25 miles of earthen levee, 4.5 miles of reinforced concrete floodwalls, 16 flood pumping stations, moveable and sandbag street closures to seal street passages in levees and floodwalls, and floodwall service openings and service doors.

As of FY ending 2010, MSD, a component unit of the Louisville Metro government, reported operating revenues of \$171,590,108 with cash and investments of \$478,603,152. During FY 2010, MSD employed a total of 677 employees.

Consent Decree

In August 2005, MSD entered into a court-ordered Consent Decree with the Kentucky Department for Environmental Protection, the EPA and the U.S. Department of Justice. The Consent Decree reached in response to pending litigation regarding alleged violations by MSD of the Federal Clean Water Act and KRS 224 concerning sanitary and combined sewer overflows, required MSD to create an action plan to address the following issues:

- An aging sewer system that lacked the capacity to handle the current sewage and stormwater volume during wet weather;
- Sewer overflows that polluted the river and streams throughout Louisville Metro, which violated the Federal Clean Water Act; and,
- A responsibility to keep the public informed about potential health risks, financial impacts, and construction project activity.

To address the challenges of improved water quality and meet the requirements of the Consent Decree, MSD began a comprehensive sewer improvement initiative known as Project WIN, or Waterway Improvements Now. Project WIN included the implementation of sewer improvement projects to minimize the impact of combined sewer overflows, eliminate sanitary sewer overflows, and rehabilitate the community's aging sewer system. In addition, involved keeping the public informed of potential health risks, financial impacts, and construction project activity. MSD believed that Project WIN, estimated to cost approximately \$850 million over a 20 year period, would achieve the sewer overflow abatement objectives outlined in the Consent Decree by 2024.

Revenue and Other Means of Financing

MSD's revenues primarily come from wastewater and stormwater service fees, charges for extending wastewater lines and connecting new customers, and surcharges associated with the federally-mandated Consent Decree. Known collectively as the Schedule of Rates, Rentals, and Charges, these fees, charges, and surcharges may be modified in order to create enough revenue to cover expenses. In addition, MSD may issue negotiable interest-bearing bonds.

MSD's rates must generate enough income to cover its projected operation and maintenance expenses, debt service expenses, and cash funded capital expenditures. In addition, MSD's debt service coverage must be at least 110 percent and the working capital target is \$25 million. This is equivalent to what is currently two

months of operating expense, which would give MSD enough time to get a bond issued.

If the projected budgets result in the need for rate increases due to the requirements from the 1993 Resolution not being met, then the MSD Finance Director must determine how the schedule of rates should be amended to ensure the requirements are met. For the most part, MSD rate increases have been consistent with the projected increases identified in the Consent Decree financing plan.

A 6.5 percent increase in wastewater and stormwater volume and service charges, as well as optional and quality charge rates that are assessed to commercial and industrial wastewater customers, was implemented in FY 2008, 2009, 2010, and 2011. Because the proposed increase was not greater than seven percent, MSD did not have to gain approval from the Metro City Council for these modifications to their Schedule of Rates, Rentals, and Charges.

Auditors observed through various means of documentation, including Board minutes, correspondence, and newspaper clippings, that MSD followed all of the relevant requirements for modifying its Schedule of Rates, Rentals, and Charges in FY 2008, 2009, 2010, and 2011.

MSD: The Board

Currently, the Louisville Metro Mayor appoints, with the approval of the Louisville Metro Council, the members of MSD's governing Board. The MSD Board is composed of eight members, no more than five of which may be affiliated with the same political party. Starting in 1977, the members were to be selected and appointed so that no more than one member resides in any one state senatorial district.

The Board, which has statutory authority to enter into contracts and agreements for the management, regulation and financing of MSD, manages its business and activities. The Board has full statutory responsibility for approving and revising MSD's budgets, for financing deficits and for disposition of surplus funds. KRS 76.060 requires the board to fix the salaries and compensation of the officers and employees it engages, which salaries and compensation, however, shall be in line with that paid by the city and county for similar services.

While it is the responsibility of the Louisville Metro Mayor to appoint individuals to the positions of Executive Director, Secretary-Treasurer, and Chief Engineer, these individuals are supervised by the MSD Board. At this time, the Executive Director is serving as Secretary-Treasurer and the Design Manager within the Engineering Division is acting as Chief Engineer, due to vacancies in the positions of Chief Engineer and Engineering Director.

The MSD Board also may employ professional and technical advisors, experts, and other employees as it deems requisite for the performance of its duties. Presently, the MSD Board employs individuals for the following positions: Legal Counsel and Secretary to the Board. Board Legal Counsel is employed through MSD's legal services contract, with the Board Legal Counsel reporting to the MSD Board and the MSD Legal Director. The Board Assistant, who performs the functions of "Secretary to the Board," is, however, an employee of MSD who reports to the Board and to the Executive Director's Assistant.

MSD: The Staff

MSD is currently organized into 10 divisions including: Executive Offices, Legal, Human Resources, Finance, Physical Assets, Regulatory Services, Engineering, Infrastructure and Flood Protection, Operations, and Information and Technology.

The Executive Offices Division is headed by the Executive Director of MSD. The remaining nine divisions are headed by at least one director, with the exception being the Operations Division which has two directors: 1) Director of Operations and Maintenance for Morris Foreman Wastewater Treatment Plant; and 2) Director of Emergency Response and Metro Operations. All of the division directors report to the Executive Director. Both the Internal Auditor and the Controller report directly to the Finance Director and are not specifically identified on the organizational chart. As of July 11, 2011, 632 of the 656 authorized positions at MSD were filled.

Findings and Recommendations

Finding 1: Governance policies for the MSD Board did not address several critical responsibilities necessary for proper and effective oversight.

Policies applicable to the Board governance of MSD did not exist for several critical areas of responsibility necessary for proper and effective oversight of MSD. Auditors found no evidence of policies related to:

- Annual or new Board member orientation regarding fiduciary responsibilities as board members;
- Documentation of Board review of budget to actual expenditures in the meeting minutes;
- An independent procedure for reporting complaints and whistleblower policy;
- Independent reporting by the Internal Auditor directly to the Board;
- Documentation in the meeting minutes of annual Board review of MSD compensation policies, and executive staff salaries and bonuses; and,
- Review and approval of executive staff travel by the Board.

Recommendations: We recommend the Board provide in their annual orientation training for new and returning Board members a clear understanding of MSD's organizational structure and operations, their responsibilities as Board members, as well as their legal and fiduciary roles, and the purpose of the board on which they serve. In addition, the orientation should address ethical requirements of Board members and staff and any significant policy changes adopted by MSD during the previous year. We also recommend that the orientation be facilitated by a knowledgeable independent party, who can participate in and oversee the orientation training.

We recommend that the Budget Committee perform a regular review of budget to actual expenditures to monitor costs in each account and report to the Board. The name and number of budget categories should provide transparency and sufficient detail to allow Committee members to accurately identify the types of expenses attributed to each category. This review should be documented in the Board and Budget Committee meeting minutes. Periodically, the Budget Committee should receive and review a listing of expenditures with sufficient detail to question transactions as necessary.

We recommend the Board develop a whistleblower reporting policy by creating and documenting an independent process whereby employees and/or volunteers have the option to directly make the Board aware of concerns involving matters that specifically need Board oversight. We recommend the Board establish methods that allow for concerns to be reported directly to their attention by all staff, including anonymous concerns, and any complaints against executive staff. The Board should further develop a process by which concerns are brought to the attention of the Board and ensure a process exists to analyze,

investigate and resolve issues brought to its attention. The internal audit function could be used to ensure that concerns brought to the Board are independently investigated and findings reported directly to the Board.

We recommend the Board adopt a policy to review and approve the salary and bonus incentives of the executive staff on an annual basis to ensure that the compensation paid is equitable to the responsibilities and duties of each position. We further recommend the Board annually review MSD's personnel and compensation policy, including the range of increases, by which salary increases and bonus payments are made to all staff. The salaries should be reviewed specifically by the Board to ascertain appropriate use of funds given the mission of MSD, and such review should be documented in the minutes. These actions should be documented in the meeting minutes.

We recommend the Board, or a designated committee of the Board, pre-approve executive staff travel, including estimated costs. The Board meeting minutes should document the review conducted by the Board. We also recommend the Board require a report of the actual travel expenses of executive staff, with Board approval, prior to expense reimbursement. The expense reports should sufficiently detail the expenses associated with meals, lodging, transportation, and entertainment of each trip, as well as the business purpose of each expense item.

Finding 2: Certain policies were not documented or sufficient to ensure accountability.

MSD's policies and procedures related to purchasing card procedures, reimbursements to MSD, executive staff reimbursements, reporting lost or stolen financial information, and inventory controls of fixed assets were not sufficiently comprehensive to provide proper control and accountability needed for a public agency. Although MSD has implemented various policies and procedures in an attempt to provide control and oversight of its organization, several of the policies were limited and did not include necessary critical procedures.

Recommendations: We recommend MSD strengthen their purchasing card procedure by making it a formal policy. We recommend the policy include information requiring a business purpose be documented and address how MSD or the Board will handle expenses that are considered improper or disallowed expenses. We also recommend the Board review purchasing card expenditures of the Executive Director. We further recommend MSD include a procedure concerning reimbursement by an employee when a purchasing card is used for personal use in a formal policy. A

timeframe when staff is required to reimburse MSD for any personal expenditure that may have been incurred should also be included in the policy. Currently, MSD does not use credit cards and therefore has no policy, but if credit cards ever become the preferred method of payment of goods, then we recommend a strong credit card policy should be developed.

We recommend policies be implemented to ensure that the Board or a designated committee of the Board review and approve all executive staff reimbursements and supporting documentation to ensure the reimbursements are for reasonable and necessary expenditures. Such reviews and approvals also will help ensure that duplicate payments are not made.

We recommend MSD adopt written policies for the backup of electronic financial information. Moreover, policies should include a process to report any lost or missing financial information or records.

We recommend MSD adopt and implement property and inventory control policies and procedures to identify and account for all furniture, equipment, or other items valued over a certain specified dollar amount, with the specific dollar amount included in policy. Such policies and procedures should include recording of the name of individual in receipt of furniture/equipment; description of furniture/equipment; vendor name; model and serial numbers; acquisition date; and, acquisition cost. We further recommend such inventory policies and procedures include an annual, or periodic, physical inventory of all fixed assets. Dispositions of property should also be reflected in inventory accounting. The property inventory and control policy should be made available to all employees who have responsibility for property assets and should include sufficient detail to ensure accurate and appropriate accounting for property inventory. MSD should include its inventory and property control policies in its Policy Manual.

Finding 3: MSD lacked management oversight and enforcement of established policies.

MSD management has not consistently followed, nor has it required its staff to follow, policies and procedures established by the Board and management to provide fairness in its business practices, to manage risks, and to hold itself accountable to ratepayers. Policies and procedures are only effective if personnel are informed that such exist, are trained in how to

implement the policies, are required to follow the policies, and are held accountable by management when violations of policy occur. Further, and perhaps most critical, management must lead by example and demonstrate significant respect for the established organizational policies and procedures. We identified noncompliance in the following policy areas:

- Procurement of professional services;
- Procurement of computers;
- Reimbursements of employees' education expenses; and,
- Reimbursements of employees' travel and training expenses.

Recommendations: We recommend the MSD Board discuss with its executive management the need for proper oversight and governance of its operations. Although it is not the Board's responsibility to oversee day-to-day business operations of the organization, the MSD Board is responsible to ensure strong leadership is in place and is working within the boundaries the Board has established. We also recommend the MSD Board require supervisory personnel to be re-trained on key organizational policies. The trainings should occur in-house at MSD facilities and could be conducted by MSD's own Human Resource Department staff or its Legal Department staff. Employee attendance for the training should be required and documented. Upon completion of training, MSD personnel should be required to sign an affidavit stating that they have been trained and understand their responsibilities as an MSD employee to abide by the policies and procedures of the organization. The statement should further acknowledge that the employee understands the consequences of not following the different policies. We further recommend MSD hold its personnel accountable to the policies. If a violation of policy occurs, such as an employee not submitting a reimbursement request in a timely manner the employee should understand that a reimbursement will not be made. All levels of MSD management should consistently follow and enforce adopted policies. Finally, we recommend the Board evaluate the current MSD Education Assistance Program to ensure it is structured to provide the best benefit to the organization and the ratepayers.

Finding 4: MSD ethics policies for Board members, appointed executive staff members, and employees were not sufficient to address conflicts.

MSD revised its ethical policies for Board members, appointed executive staff, and employees during the APA's period of review with an intent for improvement, but such policies still lack some

significant provisions pertaining to certain ethical issues. The lack of strong, enforceable ethics policies allowed the potential for, as well as actual, conflicts of interest by certain MSD Board members, executive staff, and other employees. Although sanctions exist for employee violations of the ethics policies, no policies for investigating unethical activity of employees exist. Further, there are no policies detailing the investigation of unethical activity or criteria to impose sanctions or disciplinary procedures for violations by Board members, the Executive Director, or the Chief Engineer. Finally, no ethical policies exist for reporting improprieties directly to the Board.

Recommendations: To remain independent in their decision-making regarding entities doing business with MSD, or seeking to do business with MSD, Board members, executive staff, and other employees should avoid any situations that are actual conflicts between their private interests and their duties on behalf of MSD, or that have the potential to present conflicts. Neither should they accept gifts and gratuities that compromise the impartiality of their decision-making on behalf of MSD, or that give the appearance that MSD actions are based on personal benefit, favors, or relationships, rather than objective decision-making. We recommend the Board establish a comprehensive code of ethics, applicable to Board members, appointed executive staff members, and all employees. MSD may want to consider having someone skilled in establishing ethical standards for public employees and board members assist in the drafting of such policy standards. Upon adoption by the Board, the code of ethics should be incorporated into the two Policies and Benefits Manuals for employees (unit and non-unit), as well as any manual given to Board members during orientation. We recommend MSD provide initial training for Board members, appointed executive staff and employees on the code of ethics, as well as a review annually. In establishing a financial disclosure policy, we recommend the MSD Board members, as well as all executive team members, annually file with an appropriate committee of the Board, and by a specified date, a statement detailing financial interests held. Required information should be prescribed by an appropriate committee of the Board. The policy should further require an affirmative statement by the filer that he or she has no interest that would cause a conflict with his or her official duties. Sanction for noncompliance with the filing requirements also should be detailed in the policy. To ensure compliance with the code of ethics adopted, MSD should develop and implement policies, procedures, and responsibilities

regarding reporting, investigation, and resolution of allegations of ethical misconduct as detailed in the recommendations of Finding 1 regarding a whistleblower policy.

Finding 5: Several conflicts of interest existed that gave the appearance of improprieties by certain MSD Board and staff members.

MSD's Policies and Benefits Manuals for employees and MSD's Conflict of Interest Policy for Board members and appointed executive staff, were not effective in preventing conflicts of interest for Board members, executive staff, and other employees. Several instances of specific conflict of interest situations were identified that may have contributed to unfair business practices. It is impossible to determine if the vendors/contractors MSD used provided the best services at the best cost when relationships allowed the potential for favoritism and influence of independent decision-making.

Recommendations: We recommend the MSD Board, within its comprehensive code of ethics, provide standards of conduct for conflicts of interest that prohibit Board members, appointed executive staff, and employees from the following:

- Having a primary contract, subcontract, or agreement with MSD, either directly, by a family member, or through a business which is at least five percent owned;
- Representing a person of business privately before MSD;
- Using his or her position to obtain a financial gain, a benefit, or an advantage for oneself, a family member, or others;
- Using confidential information acquired during his or her tenure to further his or her own economic interest or that of another person;
- Holding outside employment with, or accepting compensation from, any person or business with which he or she has involvement as part of his or her official position for MSD; and,
- Involvement in discussions and decisions pertaining to the areas in which there is a conflict of interest.

Board members, appointed executive staff, and other employees who abstain from involvement in discussions and decisions as recommended above should not be present during such discussions, and such abstention should be documented in writing and placed in the employee's personnel file or recorded in the minutes of a Board meeting. To ensure compliance with the conflict of interest policies adopted, MSD

should develop and implement policies, procedures and responsibilities found in Finding 1 regarding reporting and resolution of complaints. Finally, we reiterate MSD's Policy and Benefits Manuals that state: "As public servants, employees must display a high standard of ethical behavior that ensures the public that employees do not use their positions to provide special privileges to themselves, to other individuals or organizations."

Finding 6: MSD's primary legal services contract has been with the same attorney's firm since 1984 while never being competitively negotiated or advertised.

MSD has not competitively negotiated or advertised their primary contract to provide legal services to the MSD Board, Legal Director, Executive Director, and act as "Bond Counsel" as needed. Since 1984, the same attorney has acted as the MSD Board Legal Counsel and that same attorney's law firm (Firm) has received MSD's contract to provide multiple types of legal services for an average annual amount paid to the Firm of \$1 million over the past three fiscal years. As the MSD Board Legal Counsel, this attorney reviews and approves all matters prior to their submittal to the MSD Board for action, along with all of the other outside legal services requested by MSD. Therefore, the attorney's relationship with the MSD Board could impair the Board's objectivity and independence related to advertising this contract to other law firms. Even though MSD Procurement Regulations give the Board the authority to waive any procurement requirement if it is in the best interest of MSD, a decision to continually authorize this contract with no request for proposals, competitive negotiations, or advertising is not a responsible action by the board of a public entity. Without advertising this contract, public confidence in the entity may be diminished and a concern exists that MSD is overpaying for legal services.

Recommendations: We recommend that MSD designate this contract as an applicable professional services contract that should be periodically advertised and competitively negotiated to ensure MSD's best interests are met. Due to the multiple types of legal services that can be assigned to this Firm and attorney, the contract should be separated based on the type of legal services needed. An analysis should be performed to determine the need for outside legal services. Based on the results of the analysis, a separate request for proposals should be developed for advertising each type of service and an evaluation committee should be created to evaluate the responses using specific criteria.

The evaluation committee should consist of staff members that are informed and knowledgeable regarding the services needed by MSD. We recommend the Board consider whether Board Legal Counsel should be independent of all other legal services.

Finding 7: Board Legal Counsel given approval authority in MSD Board process.

Through authority granted by the MSD Board, the Board Legal Counsel could potentially hinder the Board's control and intervene in the managerial process. A MSD Board resolution issued in 1984 provides the Board Legal Counsel an approval and oversight role over all matters coming before the Board. Specifically, the resolution states that Board Legal Counsel, "shall review and approve all matters including resolutions, agenda items, and all other documents prior to their submittal to the MSD Board for action." This approval authority over all matters prior to their submission to the Board could be used to subvert Board control and keep certain items or issues from being brought before the Board if the Board Legal Counsel refused to approve such items for the agenda. This could include the review of the Board Legal Counsel's contract, which is identified as a potential conflict in Finding 6. This would limit both the Board's authority to determine items they wanted to review and discuss, and management's ability to present items to the Board seeking approval or input. The preemptive review process also limits the ability of the Board and MSD management to control the costs of the services provided by the Board Legal Counsel and duplicates work performed by internal staff.

Recommendations: We recommend the MSD Board rescind the 1984 resolution that requires a review and approval of all matters by the Board Legal Counsel prior to presentation to the Board. Secondary reviews by Board Legal Counsel of issues or documents presented to the Board should be performed only upon request by the Board, Executive Director, or Legal Director and only for the specific incidence of the request. We recommend the Board not make a blanket request of the Board Legal Counsel to review all documents or issues of a certain type.

Finding 8: Legal services contract lacks centralized oversight.

The MSD internal Legal Director does not have appropriate levels of control and monitoring authority over the primary outside legal service contract. Currently, the contracted law firm acts as Board Legal Counsel, MSD's litigation representation, EPA Consent Decree representation, and co-bond counsel. Each of these four services has a separate oversight authority

within MSD that is responsible for reviewing invoices and approving the expenses. This removes the legal experience and expertise of the Legal Director from the process of reviewing all aspects of outside legal services. It has also allowed for the influence of other reviewing authorities to potentially interfere with the authority of the Legal Director. This has resulted in weakening the authority of the Legal Director, who is employed to provide internal legal expertise and is directly responsible for ensuring the legal compliances and defenses of MSD.

Recommendations: MSD should ensure that the internal Legal Director is responsible for legal contract compliance and reviewing all invoices associated with legal service contracts. The MSD Legal Director should regularly report on legal service expenditures and any related issues to the Board. Final approval authority for Board Legal Counsel services should remain with the Board to ensure an independent counsel, but all other legal services may have final approval by the Legal Director. Due to departmental budgetary oversight, other MSD authorities may still need to retain final payment approval. MSD should also develop a formal procedure for vendors to protest a denial of certain expenses and request in writing an additional review of those expenses by a secondary authority. For legal service contracts, such a secondary review may be conducted by the Executive Director, the Board, or a designated Board committee. The final decision of the secondary review should be documented in writing with an explanation as to the final decision. Individual Board members should refrain from attempting to influence the management process of MSD in a unilateral manner. Requests for changes to management should be made during Board meetings or meetings of Board committees and have the support of a majority of the members.

Finding 9: MSD's legal services contract terms are not well defined and are silent as to settlement procedures and conflict of interest disclosures.

MSD's legal services contract terms are not well defined and could result in MSD not maintaining sufficient control over the amount spent for contracted legal services. Aggravating this issue is that multiple types of legal work are included within one contract, which is discussed further in Finding 6. While the contracted firm (Firm) is relied on to abide by the ethics of the legal profession, the contract is silent as to MSD's expectations regarding legal settlements and the disclosure as to whether the Firm represents any clients

with a potential conflict of interest with MSD. A contract with an outside entity should be clear in its expectations, designate a point of contact to oversee the terms of the contract, and include controls to govern the amounts allowed to be billed. Without these criteria, MSD cannot effectively and efficiently control the costs and use of this contract.

Recommendations: We recommend that MSD amend its contract for legal services to ensure that MSD adequately controls the costs and responsibilities of the outside legal firm. Revisions should address the following areas:

- Specifically, define the experience requirements for billing at the partner or associate rates. The contract should require a justification if the partner rate is used by more than one attorney on the case. For optimal monitoring by MSD, the contract should require a written determination for each assigned case as to the expected number of attorney partners, associates, and paralegals, etc. This determination should also include a not-to-exceed amount to be paid to the Firm for the assigned case. The Firm must obtain written prior approval to exceed the maximum amount specified.
- Separate the types of legal work into individual contracts to improve monitoring efforts.
- Designate the MSD Legal Director to assign contracted legal work as needed.
- Require prior approval of any costs other than for time spent on a case by a Firm attorney from the Legal Director. This includes any costs related to travel, meals, expert witnesses, mock juries, and other costs incurred not related to the Firm's time costs.
- Include a term that specifies the settlement process that should be followed by the Firm.
- Include a term that requires the Firm to disclose any actual or potential conflict of interest between MSD and any of the Firm's other clients.

Finding 10: MSD spent \$2.1 million for co-bond counsel services with no documented justification.

Between June 4, 2009 and August 24, 2011, MSD paid its bond counsels a total of \$2.1 million for legal services to issue bonds with a total par value of \$1.75 billion. The legal fees for each bond transaction were paid in equal amounts to two firms, each of which has served MSD as bond counsel consistently since 1997. MSD officials, including its former Finance Director, could not provide a clear understanding as to the duties performed by each bond counsel, the need for co-bond

counsel, and the process through which the financial team, including the co-bond counsel, were selected.

Recommendations: We recommend the MSD Board formally adopt a policy to select bond counsel and a financial advisor through a competitive selection process using either a RFP or RFQ. This competitive process should assist in determining those most qualified to perform the services, while also provide an opportunity to control the costs of issuing bonds. If co-bond counsel is desired, justification for co-bond counsel should be provided to the Board for its review and approval. The RFP or RFQ should state the services desired, the length of the engagement, the evaluation method, the selection process, and a cost proposal to provide services. If co-bond counsel is being engaged the RFP, RFQ, or engagement letter should specify the roles and responsibilities and tasks assigned to each firm to minimize potential duplication of work and costs. MSD should ensure proper oversight of legal counsel to ensure work is progressing and coordinated as required by the RFP, RFQ, or engagement letter. We further recommend the MSD Board be fully apprised of the RFP, RFQ, and engagement letter for procuring services, the method used to select bond counsel and financial advisor, the tasks to be performed by counsel and financial advisor, their fees and other bond issue costs.

Finding 11: The lack of a policy development process results in duplication of work and potentially unnecessary legal fees.

MSD lacks a defined process for the initiation and development of policies, which has resulted in duplicative work and potentially unnecessary legal fees. Policies at MSD may be created or revised through a variety of avenues. The MSD Board or the Executive Director may request that MSD staff develop or revise policies. Staff may also begin this process internally and bring new or revised policies to management for discussion and to determine whether it should be brought to the Board. Further, the Board or Executive Director may also request the MSD Board Legal Counsel to produce policies. There is no specification for which of these methods should be, or may be, employed in the policy development process. This can allow for certain individuals, including staff or the Board Legal Counsel, to work toward developing the same policy at the same time, without the knowledge of the other parties work.

Recommendations: MSD should develop a policy or process by which policies are to be initiated and developed and subsequently brought before the Board. This should include who has the authority to initiate

policy development and who has the authority to authorize the expense of Board Legal Counsel to assist in the process. When making an initial request for a new or revised policy, use of internal staff should be considered first, when possible, to ensure the most cost effective methods of policy development are used. A determination for the need of outside legal expertise should be made in consultation with the internal legal staff.

Finding 12: The Louisville Green Corporation bylaws specify by name the President and the special legal counsel.

The bylaws drafted for the Louisville Green Corporation in 2005 by the MSD Board Legal Counsel, specify by name who will be the President and who will be employed as special legal counsel. Instead of referring to a position title or including a provision that the corporation may employ or contract for independent counsel, the actual names of MSD's Executive Director and the MSD Board Legal Counsel are used in this document. To avoid the need to amend bylaws, this document should not contain individual's names and should only include fundamental items that will not change. Specificity related to a position or detailed duties should be accomplished through policy manuals or board resolutions. By specifying the actual names of individuals, an appearance exists that the attorney was ensuring that his personal interests were represented and not those of his clients when he drafted these bylaws. Further, this circumvented a transparent, competitive process to select the legal counsel for Louisville Green.

Recommendations: We recommend the Louisville Green Board amend its bylaws to remove specific names of individuals. The Louisville Green bylaws should be free of any redundant or unnecessary terms that may complicate the governance of this corporation. Further, we recommend the Louisville Green Board select a legal counsel through a transparent, competitive process as similarly recommended in Finding 6.

Finding 13: MSD Board provides inadequate investment oversight and lacks sufficient information.

MSD invests hundreds of millions of dollars from bond proceeds in a proprietary investment program through a third-party investment management firm that provides MSD with limited reporting on investment holdings and the investment process. This lack of investment information provided by the investment management firm combined with no known inquiries into the details of the investment program by the Board means that the fiduciary body of MSD does not know the level of investment risk and cannot ensure whether investments

are secure through compliance with MSD policies or other regulations.

Recommendations: MSD should, at a minimum, follow current Investment Policy and provide the Board with detailed semi-annual reports as to the holdings of the investment program, investment activities, risk levels of the program, and program strategies. However, we recommend the policies be updated and investment reports be provided to the Board, or to a Board investment committee as recommended in Finding 16, on a monthly basis. Board members should request such information if not provided by staff. MSD should follow the requirements of the current Investment Policy and annually solicit Request for Proposals for investment services that contain all required details of the investment management firm and the services being provided. In the interests of transparency, MSD should not enter into a proprietary investment program that does not disclose all details of the program to the Board members.

Finding 14: MSD financial advisor has conflict of interest.

The financial advisor used by MSD to provide independent evaluations and recommendations for investment opportunities also acts as a program manager for the primary MSD investment program and receives substantial fees based on the gains of those investments. Having a management role in the investment program and receiving fees based on the program profits creates a conflict of interest for the financial advisor and calls into question his ability to act in an independent nature on behalf of MSD.

Recommendations: MSD should undergo an open procurement process on a periodic basis for an experienced financial advisor to provide advice and consultation related to the investment portfolio of MSD. This contract should be separate from other financial services such as the issuance of bonds, which may be negotiated on a per transaction basis. The contract should require the financial advisor to be free of conflicts with any investment firm doing business with MSD. All fees for an investment consultant and advisement contract should be a single fee based upon the amount of funds to be invested and the type of investments that are expected by MSD.

Finding 15: MSD does not have financial staff or Board members with background or specific experience in the types of investments and other related financial activities undertaken at MSD.

MSD does not have staff or Board representation with sufficient financial expertise to adequately understand and analyze the various financial programs and activities undertaken by MSD at the direction of its external investment management firm and financial advisor. Without the expertise and ability to understand and evaluate such programs, MSD's assets may be exposed to unnecessary risk and MSD may not be assured of receiving the most competent, compliant, and economical financial advice.

Recommendations: We recommend that MSD ensure that the finance staff include a person or persons with strong financial and investment knowledge and experience to enable investment and financial strategies to be based on the knowledge and understanding of such activities by MSD staff and not solely on the advice of third party advisors. We further recommend that MSD Board membership include at least one professional who is particularly knowledgeable in investment and financial management activities commensurate with the types of activities in which MSD may engage. In addition, we recommend the MSD Board create an investment committee whose members are responsible for the oversight of investment activity and programs. The committee should include, at a minimum, one professional who particularly knowledgeable in investment and financial management activities. We recommend the investment committee receive detailed reporting of MSD's investment portfolio, all investment activities, programs, trends, and strategies. The investment committee should have a thorough understanding of existing investment policy, and propose additional policies as deemed necessary. The committee should question staff and financial advisors regarding investment activity and programs to evaluate compliance with investment policies.

Finding 16: MSD has insufficient policies regarding investment and other financial activity.

MSD has not updated its Investment Policy since it was adopted on February 27, 1995. Further, no policy has been developed to address the use of interest rate swaps. An entity's policies should be comprehensive and define the roles and responsibilities related to major financial activities including the investment of funds or other financial tools. MSD has increased its investment activity over the years, and has also entered into an extensive number of interest rate swaps that have had a profound impact on the liabilities of MSD.

Recommendations: We recommend that MSD undertake a comprehensive review of its Investment Policy to strengthen Board oversight and to determine what changes are needed to ensure this policy fully addresses the actual investment activities conducted by MSD. In addition, these policies should address the use and monitoring of external financial advisors and provide detailed guidelines related to their use. Further, we recommend MSD develop policies related to interest rate swaps that include the following:

- Objectives for the use of interest rate swaps;
- Conditions for the use of interest rate swaps;
- Guidelines as to the terms and conditions of any MSD swap agreement;
- Criteria related to the use of interest rate swap counterparties;
- Evaluation and management of interest rate swap risks; and,
- Terminating interest rate swaps.

Finding 17: MSD lacks a formal process for initiating, performing, reporting and distribution of its internal audits.

The MSD internal audit function is governed by its Internal Audit Charter, which was formally adopted in July 2008. The Charter describes the internal audit mission and scope of work, including its responsibilities and authority within the organization. While the purpose of this Charter is to establish the basic groundwork for internal audit, it is not designed to provide the details of a formal process to be followed by internal audit in accomplishing its mission and scope of work. MSD has not established a formal process for initiating, performing, reporting, and distributing internal audits.

Recommendations: We recommend the MSD Audit Committee develop and approve procedures for the internal audit function. The adopted procedures should state the process for the Internal Auditor to follow in initiating an audit, including the process for the Audit Committee to be informed of and approve or authorize any audit requests not already on the annual audit plan made by management or other parties. The adopted procedures should also state the acceptable time period for the Internal Auditor to allow management to respond to a draft audit report. The adopted procedures should specify that the Auditor is to inform the Audit Committee if management fails to respond to the draft report within the specified time period and the process to follow to release an audit report when management

fails to respond. The procedures should require the Internal Auditor to inform the Committee when a draft audit is completed for the Audit Committee to review and approve the draft report prior to forwarding the report to management for response. Finally, procedures should require the Audit Committee, after reviewing and approving internal audit reports, to ensure internal audit reports are presented to the full MSD Board for ratification.

Finding 18: Oversight of MSD internal audit function primarily performed by executive management; MSD Audit Committee is not sufficiently engaged with Internal Audit.

Despite an Internal Audit Charter stating the Chief Internal Auditor “reports functionally to the Audit Committee and administratively to the Budget and Finance director,” MSD’s internal audit function is primarily directed and supervised by MSD’s executive management. The current structure of MSD and the lack of engagement by the MSD Audit Committee with its Internal Auditor indicate the MSD Board failed to support an independent internal audit function.

Recommendations: We recommend the MSD Audit Committee perform the annual evaluation of the Internal Auditor. We recommend the MSD Audit Committee approve and recommend to the full Board an annual budget for the Internal Auditor based on the approved internal audit work plan. The Internal Auditor should request directly to the Audit Committee the amount of funds estimated as necessary to conduct those audits. Once approved by the Audit Committee, the annual budget for the Internal Auditor should be ratified by the full Board to be included in the MSD budget by the Finance Director. We also recommend the MSD Board revise the Audit Committee Charter to include within the Committee’s responsibilities the performance of the annual evaluation of the Internal Auditor and the budgeting for the expenses of the Internal Auditor. We recommend the MSD Board revise the organizational chart of MSD to include a direct reporting line from the Internal Auditor to the Audit Committee of the Board. We recommend the MSD Audit Committee consistently approve the annual MSD internal audit work plan as required under the Internal Audit Charter. Further, the Board should revise the Audit Committee Charter language to agree with the language in the Internal Audit Charter as the current Committee Charter only states the Committee is responsible for reviewing the work plan. Additionally, we recommend the MSD Internal Auditor provide routine status updates on audits to the Audit Committee. This will foster continued communication between the Internal Auditor and Audit Committee members. It will allow the Internal Auditor to discuss any problems that may be encountering on an audit with

the Committee in a more timely manner and will allow the Committee an opportunity to discuss any concerns they may have with the thoroughness of a particular audit or regarding other areas of the organization that they may wish to ask her to investigate. Finally, we recommend the MSD Audit Committee consider holding quarterly meetings to ensure continued direct communication with the Internal Auditor.

Finding 19: MSD provided compensation benefits that could be considered excessive for a public entity.

MSD executives received bonuses, deferred compensation, and retirement increases that appear excessive for a public entity. While these actions may have been approved by the MSD Board, the public could consider these actions to be excessive and unnecessary costs incurred by MSD. The former and current executive directors received deferred compensation trust funds, 180 employees in 1999 and the current Executive Director in 2003 received payments to purchase retirement service credits, and significant salary increases and bonuses were provided to executives and other employees during our audit period.

Recommendations: We recommend that MSD review its various methods of providing compensation to executives and other staff and ensure that its compensation structure and programs are fair and equitable to executives and staff and is in the best interests of the public it serves. Expenses incurred by a public entity should be scrutinized due to the public nature of the business. Alternative measures should be evaluated to reduce staffing and a cost-benefit analysis of any retirement buyout considered by MSD so that the Board is aware of the potential costs involved and the goals that should be achieved by additional compensation costs. In addition, the policy providing six-month and annual salary increases and bonuses to new employees should be reconsidered because this policy could provide an excessive increase in compensation to an employee that has not been with MSD a complete year. Furthermore, all forms of compensation, including performance salary increases and bonuses, should be considered if MSD wants to control or freeze its payroll budget.

Finding 20: MSD did not comply with procurement guidelines when procuring certain professional services.

In several cases, MSD contracted for professional services without following its own internal procurement requirements or those in the Model Procurement Code, KRS Chapter 45A, applicable to state agencies for the procurement of personal services. Furthermore, MSD policies allowed the MSD Board to waive all requirements in the regulations if deemed to be in the best interest of MSD.

Recommendations: We recommend MSD implement procedures to ensure compliance with all procurement policies, particularly those pertaining to professional services. Employees responsible for procurement should be sufficiently trained on those policies. Further, we recommend MSD adopt the provisions in the Model Procurement Code in KRS 45A.740, 45A.745, and 45A.750 pertaining to the procurement of architectural and engineering services.

We recommend:

- Procurement Method Determination Forms be completed in a timely manner in accordance with procurement policies and used to document the method by which the agency intends to procure a service. It is a checkpoint to ensure the agency is utilizing the correct procurement method and should not be overlooked or completed after the contract is signed or services are provided;
- MSD centrally maintain all procurement records; and,
- MSD only approve payments that have a signed Purchase Order.

Finally, we recommend that MSD's policy of allowing the Board to waive any or all requirements related to the procurement of professional services be repealed.

Finding 21: Employee usage of MSD computer appears to violate policy.

While attempting to address a MSD procurement issue involving procurements made by the MSD Administrative Services Manager during the audit period, auditors found a significant number of personal user data files stored on the MSD server through a shared network directory designated to the Administrative Services Manager's user profile. While incidental and occasional personal use of MSD Electronic Media is permitted for reasonable activities, it must be minimal according to the MSD Electronic Communications Media Policy.

Recommendations: We recommend MSD provide an updated training to its staff regarding MSD policies,

including its Electronic Communications Media Policy. MSD should require staff to sign-in for the training and maintain the sign-in sheets in accordance with its record retention policy. We further recommend MSD require its personnel to periodically sign an acknowledgment to be placed in the employee's personnel file, when its Electronic Communications Media Policy is updated.

Finding 22: MSD had no formal records retention policies or records retention training for its employees.

Upon employment, MSD employees were not provided information and training on records retention requirements for the public records created at MSD. No formal policies on records retention procedures are included in the Policies and Benefits manuals for MSD employees. Further, no records retention system for e-mail exists to assure that recorded information of MSD's functions, decisions, procedures, and essential daily transactions, is retained, regardless of format.

Recommendations: To ensure MSD retention schedules and related systems and processes are being effectively carried out, we recommend MSD formally adopt records retention policies to be included in the Policies and Benefits manuals for employees. Such policies should detail employee responsibilities over retaining required books, papers, maps, photographs, discs, software, e-mails, databases, and other electronically generated records. We further recommend an archival policy and system be drafted and adopted specifically regarding proper e-mail retainage. Policies should also include training requirements. Once such policies are adopted by MSD, we recommend that all employees be formally trained on all records retention requirements, including the proper retention of e-mail communications. Upon employment, all new employees should be trained on records retention responsibilities to assure proper retainage of records. MSD also may want to consider having employees sign an acknowledgement that they have read and understand the records management policies.

Finding 23: MSD accounting system coding errors led to misclassified expenditures and failure to issue 1099 forms to its contractors.

Auditors identified accounting system coding errors, both in the classification of MSD expenditures and its vendors. These coding errors led to the misclassification of certain expenditures between

capital projects, between MSD and Louisville Green, Inc., and led to a failure by MSD to issue any 1099s to certain vendors prior to 2009. A 1099 is a federal tax form to report non-salaried income.

Recommendations: We recommend MSD Finance Department be more diligent in ensuring expenditures are coded to the proper projects and cost categories. Further, because the MSD Finance Department personnel partially rely on the department managers and directors to assist them in identifying the appropriate codes to use when entering the expenditures into the accounting system, we recommend the MSD Finance Department review expenditure cost center and classification information provided by those approving the expenditure and question the information that does not appear reasonable or appropriate. We recommend the MSD Finance Department require all necessary financial forms, including W-9s, prior to entering the vendor into the MSD accounting system. Finally, we recommend MSD develop a policy that addresses financial processing activity involving the reporting of W-9 information. The policy should be presented to the MSD Board Policy Committee for approval prior to implementation. The policy should then be posted and distributed to all required personnel to ensure complete institutional knowledge of the newly created and adopted policy.

Finding 24: MSD has not reviewed the computer-based overhead process used to allocate departmental cost to capital projects.

MSD uses a mainframe computer-based process to allocate overhead costs between departments and from departments to maintenance and capital projects. MSD's failure to review the allocation process since its inception in 1999 raises concerns as to the accuracy and applicability of the process to the current MSD structure. Any such misallocation of costs could have a significant impact on financial statements resulting in the over or under allocation of costs to capital projects. Per the current MSD Controller, in the three years that she has been with MSD there has not been a review of the methodology or percentages used in the process.

Recommendations: We recommend MSD review the allocation process on a regular basis and ensure that the process is fundamentally sound and complies with the commonly accepted accounting basis for capitalized project cost. We also recommend that MSD review the allocation process annually and document that the process has been reviewed and approved by the appropriate administrative and executive staff.

Finding 25: MSD made questionable expenditures for parties, donations, travel, training, and other items.

A review of MSD financial records lead auditors to identify MSD funds spent on various questionable items, such as a private tribute party, donations to various organizations, holiday parties, and other miscellaneous items. As a public agency, the MSD Board is responsible for ensuring that funds are used in the most efficient and effective manner possible aligned with its mission and in the best interest the ratepayers that it serves. As such, the benefit of these types of questionable expenditures should be reexamined by the MSD Board and Executive Management.

Recommendations: We recommend MSD refrain from spending funds for activities and items that do not provide a clear benefit to its ratepayers or help fulfill MSD's mission. We recommend MSD management carefully evaluate each discretionary expenditure to ensure funds are efficiently and effectively used in keeping with its mission. We recommend MSD consider seeking reimbursement of the amount it contributed to the private tribute from the MSD employee who authorized the payment with obtaining the appropriate approval from the Executive Director. We recommend that the MSD Board closely scrutinize its expenditures for contributions and donations. If a contribution or donation is being considered, it should have a clear and documented connection to MSD's mission or must be needed to meet a requirement of its EPA Consent Decree. Further, we recommend all contributions and donations under consideration by MSD be presented to the full Board for approval to ensure Board awareness and management accountability MSD. We recommend MSD no longer use public funds for Holiday parties and celebrations. We recommend MSD closely scrutinize travel and conferences, particularly of out-of-state travel. We recommend MSD management also closely scrutinize the number of employees allowed to attend a single conference or meeting. Further, the MSD Board should approve out-of-state travel after being provided with estimated travel costs. Subsequent to the travel, the actual travel expenses should be reported to the Board.

Finding 26: MSD uses the Internal Revenue Service's (IRS) commuting valuation rule to calculate the taxable value of assigned vehicles regardless of the employee's compensation levels.

MSD calculates the taxable benefit of an employer assigned vehicle using the same method for all employees, but this method is not appropriate for all employees. According to MSD's Employee Benefits

policies, MSD employees are taxed for the benefit of a take-home vehicle using the IRS Commuting Valuation method. However, this method cannot be used to determine the taxable benefit for certain employees that meet the definition of a “control employee” per the IRS Taxable Fringe Benefits Guide. Using an inappropriate method to calculate this benefit could result in an understatement of taxable benefits reported to the IRS.

Recommendations: We recommend that MSD comply with IRS guidelines to ensure that the personal benefit of an assigned vehicle is valued appropriately for tax purposes. The MSD policies should be amended to reflect how controlled employees will be determined and the method that will be used to calculate the taxable benefit of assigned vehicles.

Finding 27: The MSD Board allowed a corporation under its authority to administratively dissolve before conveying the corporation’s property to MSD.

In the 1990s, MSD agreed to accept responsibility over a local area subdivision’s wastewater treatment plant that, in exchange, conveyed its stock to MSD. The MSD Board was then named the Board of this organization. While MSD still assumes responsibility for the facility and surrounding property, the MSD Board allowed the corporation under its authority to administratively dissolve before formally conveying the corporation’s property to MSD.

Recommendations: We recommend the MSD Legal Director take the necessary actions to address the situation regarding the dissolved corporation and its related property. We also recommend the MSD Board and its Executive Management evaluate its processes to ensure tasks undertaken by employees are reasonably aligned with their job responsibilities. While it is not inappropriate for the former Executive Director to have filed annual reports on behalf of the Corporation, it is more reasonable and allows for better continuity for the MSD Legal Department to perform that function.

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Impetus and Objectives for Examination

On July 28, 2011, the Auditor of Public Accounts (APA) informed the Executive Director and Board Chair of the Louisville-Jefferson County Metropolitan Sewer District (MSD) by letter that due to the Louisville-Jefferson County Metro Government (Louisville Metro) Mayor's request for an audit and concerns expressed to this office regarding certain financial and other activities, it would perform a review of certain issues at MSD. Specifically, the examination would include a review of the organization's policies, internal controls, and certain other financial transactions.

The purpose of this examination was not to provide an opinion on financial statements, duplicate work of annual financial audits, or evaluate the amount of rate increases, but to address the following objectives:

- Determine whether policies governing contract procurement are adequate, consistently followed, and provide for a transparent process;
- Determine whether policies governing the internal audit process are adequate, consistently followed, and provide for timely reporting;
- Determine compliance with policies and other requirements associated with increasing MSD customer rates;
- Review and evaluate MSD Board policies using the APA's thirty-two recommendations developed for public and non-profit boards;
- Review certain financial transactions and determine compliance with MSD policies and reasonableness of the expenses; and,
- Determine if conflicts of interest exist.

Scope of and Methodology for Examination

The scope of this review includes records, activities, and information for the period July 1, 2008 through June 30, 2011, unless otherwise specified, as the time period of certain documents reviewed and various issues discussed with those interviewed may have varied.

To address these objectives, the APA reviewed documents, conducted interviews, and tested expenditures. Thousands of documents, including emails, invoices, reports, and policies, were supplied by the MSD staff, the MSD Board, and concerned citizens of the Commonwealth in response to our announced involvement in this audit and our request for information. These and other documents were analyzed in relation to the objectives of this review. The findings, or results, from this review are discussed in detail in Chapter 2.

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The APA reviewed certain MSD organizational policies, procedures, and other governing requirements and compared them to the APA's 32 "Recommendations for Public and Nonprofit Boards" regarding financial oversight and internal control processes for board consideration. See Exhibit 1 for a listing of these 32 Recommendations. When performing this comparison, the APA reviewed various documents and manuals provided by MSD, as well as other criteria. When necessary, we made recommendations to develop new or to further strengthen certain policies, controls, and oversight procedures.

The APA conducted interviews with individuals holding the following positions:

- Current and former MSD Board members;
- Current and former members of the MSD executive staff;
- Current and former MSD staff members;
- MSD Special Board Counsel;
- MSD co-bond counsels; and,
- MSD financial advisor.

Auditors judgmentally sampled certain types of expenditures for fiscal years (FY) 2009, 2010, and 2011 to determine the presence of required documentation, reasonableness of expenditures, and compliance with MSD policies. These expenditures included capital project and other contract transactions, travel reimbursements, education reimbursements, donations, and purchasing card transactions. The findings from this review are discussed in detail in Chapter 2.

MSD: The Agency

Created in 1946 by the Kentucky General Assembly, MSD was formed as a special district to handle sewers in Louisville and at that time the unincorporated Jefferson County, now known jointly as Louisville Metro. While wastewater treatment was added with the construction of the Morris Forman plant in the late 1950s, the basic mission remained the same until 1987 when MSD assumed the responsibility of providing drainage and flood protection to most areas of Jefferson County.

As of FY ending 2010, MSD, a component unit of the Louisville Metro government, reported operating revenues of \$171,590,108 with cash and investments of \$478,603,152. During FY 2010, MSD employed a total of 677 employees.

Purpose/Duties

According to the MSD Board bylaws, the purpose of MSD is to provide adequate and effective sewer and drainage facilities and services for the benefit of the general public within the district area in accordance with Chapter 76 of the Kentucky Revised Statutes (KRS), as may be amended. More specifically, KRS 76.080 empowers joint metropolitan sewer districts, such as MSD, with the following powers:

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- To have jurisdiction, control, possession, and supervision of the existing sewer and drainage system of the city of the first or second class; to maintain, operate, reconstruct, and improve the same as a comprehensive sewer and drainage system; to make additions, betterments, and extensions thereto within the district area; and to have all the rights, privileges, and jurisdiction necessary or proper for carrying such powers into execution. No enumeration of powers in KRS 76.010 to 76.210 shall operate to restrict the meaning of this general grant of power or to exclude other powers comprehended within this general grant.
- To prepare or cause to be prepared and to be thereafter revised and adopted, plans, designs, and estimates of costs, of a system of trunk, intercepting, connecting, lateral, and outlet sewers, storm water drains, pumping and ventilating stations, disposal and treatment plants and works, and all other appliances and structures which in the judgment of the board will provide an effective and advantageous means for relieving the district area from inadequate sanitary and storm water drainage and from inadequate sanitary disposal and treatment of the sewage thereof, or such sections or parts of such system of the district area as the board may from time to time deem proper or convenient to construct, consistent with the plans and purposes of KRS 76.010 to 76.210, and may take all steps the board deems proper and necessary to effect the purposes of KRS 76.010 to 76.210.
- To construct any additions, betterments and extensions to the facilities of the district, within or without the district area, and to construct any construction subdistrict facilities or additions, betterments and extensions thereto, within or without the district area, by contract or under, through, or by means of its own officers, agents and employees. No construction or extensions shall be started within the city of the first or second class until, firstly, the city's director of works, and secondly, its board of aldermen have approved the plans. No construction or extensions shall be started in any city of the second, third, or fourth class until the governing authorities of such city or cities have approved the plans. No construction or extensions shall be started in any other part of the county until the plans have been approved, firstly, by the county engineer and, secondly, by the fiscal court.
- To establish, construct, operate, and maintain, as a part of the sewer and drainage system of the district, sewage treatment and disposal plants and systems and all the appurtenances and appliances thereunto belonging. The sewage treatment and disposal plants may be located in the city, or beyond the limits of the city in the county in which the city is located, as the board deems expedient.
- To acquire and hold the personal property the board deems necessary and proper for carrying out the corporate purposes of the district and to dispose of personal property when the district has no further need therefore.

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- To acquire by purchase, gift, lease, or by condemnation, real property or any interest, right, easement, or privilege therein, as the board determines necessary, proper and convenient for the corporate purposes of the district, and to use the same so long as its corporate existence continues, and same is necessary or useful for the corporate purposes of the district. Condemnation proceedings may be instituted in the name of the district pursuant to a resolution of the board declaring the necessity for the taking, and the method of condemnation shall be the same as provided in the Eminent Domain Act of Kentucky. When the board by resolution declares that any real property which it has acquired, or any interest therein, is no longer necessary or useful for the corporate purposes of the district, the real property and interest therein may be disposed of.
- To make bylaws and agreements for the management and regulation of its affairs and for the regulation of the use of property under its control and for the establishment and collection of sewer rates, rentals and charges, which sewer rates, rentals and charges, applicable within the limits of a city of the first or second class, shall be subject to the approval, supervision and control of the legislative body of the city as hereinafter provided.
- To make contracts and execute all instruments necessary or convenient in the premises.
- To borrow money and to issue negotiable bonds and to provide for the rights of the holders thereof.
- To fix and collect sewer rates, rentals, and other charges, for services rendered by the facilities of the district, which sewer rates, rentals, and other charges, applicable within the limits of a city of the first or second class, shall be subject to the approval, supervision and control of the legislative body of such city as hereinafter provided.
- To enter on any lands, waters and premises for the purpose of making surveys, and soundings and examinations.
- To approve or revise the plans and designs of all trunk, intercepting, connecting, lateral and outlet sewers, storm water drains, pumping and ventilating stations, disposal and treatment plants and works proposed to be constructed, altered or reconstructed by any other person or corporation, private or public, in the whole county, in order to ensure that such proposed construction, alteration or reconstruction shall conform to and be a part of a comprehensive sewer and drainage system for the said county. No sewers, drains, pumping and ventilating stations, or disposal and treatment plants or works shall be constructed, altered or reconstructed without approval by the board of the district. Any such work shall be subject to inspection and supervision of the district.

Generally speaking though, the three core areas of service that MSD provides include wastewater collection and treatment, stormwater drainage services, and flood protection.

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MSD operates and maintains 3,200 miles of wastewater collection sewer lines which collect wastewater from over 200,000 homes, businesses, and industries throughout Louisville Metro. Wastewater flows to MSD's 286 pumping stations, six regional water quality treatment centers, and numerous smaller water quality treatment centers in the service area.

MSD maintains the stormwater drainage system for the Louisville Metro area. Responsibilities include the construction, repair and maintenance of drainage swales, storm sewers, ditches, and drainage channels in most of Louisville Metro. Areas not served by MSD include the cities of St. Matthews, Shively, Anchorage, and Jeffersontown. Residents and businesses in those municipalities are served by their respective cities.

MSD operates and maintains Louisville Metro's Ohio River flood protection system. The system includes about 25 miles of earthen levee, 4.5 miles of reinforced concrete floodwalls, 16 flood pumping stations, moveable and sandbag street closures to seal street passages in levees and floodwalls, and floodwall service openings and service doors.

History

Louisville's first sewers were built around 1850, routing wastewater to the Ohio River. By the end of the 19th century, a 99-mile network of clay, brick, and timber-lined sewers moved the wastewater of the 204,000-person community directly to the river and streams. In 1946, MSD replaced the second Commissioners of Sewerage, an organization formed to design, build, and manage sewer and drainage work in Louisville between 1919 and 1944.

Early Emphasis on Wastewater Collection and Treatment

MSD stopped building combined storm and sanitary sewer lines in the mid-1950s. A separate drainage fee or drainage property tax had been discussed in the early 1950s, but city government wouldn't allow it. The City of Louisville, which had given its old combined sanitary and storm sewer system to MSD when it was formed in 1946, would contend for decades to come that MSD was responsible for drainage in the city; MSD would counter that its only income, from sanitary sewer fees, had to go for much-needed sanitary sewer improvements.

New Sources of Revenue

In the 1960s, new federal clean-water programs began to provide the financial assistance necessary for sanitary sewer improvements. But with the additional funds from the federal government came more stringent wastewater standards in the form of the Water Quality Act of 1965. One of the pressing problems facing MSD in 1965 was the industrial waste being discharged into the sewers. For generations, many Louisville businesses and industries had been dumping and flushing their waste. It mingled in the sewer lines before emerging in Beargrass Creek or the Ohio River.

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In 1967, with backing from the Chamber of Commerce, the MSD Board adopted a sewer surcharge based on the amount of solids and grease in industrial waste. Plants with a significant amount of waste could reduce their surcharges by pre-treating their water to remove waste before discharging it to the sewers.

A 1968 state law made it possible for MSD to expand by assessing property owners a share of the costs of providing them with new sewers. This eliminated the need to form sewer sub-districts, a very cumbersome process, and provided an additional source for revenue.

Previously Assigned Responsibility or Unfunded Services

Due to a reported lack of adequate financing from the beginning, MSD limited its stormwater drainage work in the City of Louisville. However, by the mid-1950s, Jefferson County government contracted with MSD to manage its drainage program outside the city limits, with the county agreeing to pay all the costs. By the 1970s, the county still hired MSD to handle its drainage program in unincorporated areas of Jefferson County, but progress depended on county appropriations.

Each new suburban city that incorporated found itself immediately responsible for its own drainage program. Other government agencies were responsible for drainage on their land: the state highway department, the airport authority, the city-county parks department, the state parks department. While each government agency was responsible for drainage within its own boundaries, no government agency had the responsibility, or the authority, to make sure these drainage programs worked well together.

In 1987, MSD assumed the responsibility of providing drainage and flood protection to most areas of Jefferson County, including the City of Louisville. MSD also assumed the operation and maintenance of the Ohio River Flood Protection System. Prior to this, public stormwater drainage and flood protection was the responsibility of more than 90 government entities.

Another Source of Revenue

Financing for drainage improvement projects would be handled through a drainage user fee based on the "impervious area" (pavement, roofs, etc.) on a property. Single-family residences would all be charged the same rate, eventually set at \$1.75 per month, and commercial and industrial properties would be charged \$1.75 per month for each 2,500 square feet of impervious area. MSD pledged that the rate would not be increased for five years. The fee would be considered as a public utility service charge, similar to sewer, water, gas, electricity and telephone service charges; government agencies would pay it, as well as schools and non-profit organizations. In mid-2006, MSD began providing free sewer and drainage services to the Metro government, a service valued at \$3.3 million in 2010.

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The urbanized and developing areas of the county would be included, but not the farmland in the outer reaches. Third and fourth-class cities would be given the option of joining the program, or continuing to handle their own drainage. As the program developed, five suburban cities decided to keep their own drainage programs: Anchorage, Jeffersontown, St. Matthews, Shively, and Prospect. All others joined the new program.

Consent Decree

The Federal Clean Water Act of 1972 requires the U.S. Environmental Protection Agency (EPA) to develop water quality criteria that accurately reflect the latest scientific knowledge. The EPA provides guidance to the Commonwealth of Kentucky for developing and adopting water quality standards. Criteria are developed to protect aquatic life, as well as human health.

In the mid-2000s, portions of Louisville Metro's 500 miles of combined sewers were more than 100 years old and improvements to the sewer system were needed to reduce sewer overflows that compromised area water quality. In August 2005, MSD entered into a court-ordered Consent Decree with the Kentucky Department for Environmental Protection, the EPA and the U.S. Department of Justice. The Consent Decree reached in response to pending litigation regarding alleged violations by MSD of the Federal Clean Water Act and KRS 224 concerning sanitary and combined sewer overflows required MSD to create an action plan to address the following issues:

- An aging sewer system that lacked the capacity to handle the current sewage and stormwater volume during wet weather;
- Sewer overflows that polluted the river and streams throughout Louisville Metro, which violated the Federal Clean Water Act; and,
- A responsibility to keep the public informed about potential health risks, financial impacts, and construction project activity.

To address the challenges of improved water quality and meet the requirements of the Consent Decree, MSD began a comprehensive sewer improvement initiative known as Project WIN, or Waterway Improvements Now. Project WIN included the implementation of sewer improvement projects to minimize the impact of combined sewer overflows, eliminate sanitary sewer overflows, and rehabilitate the community's aging sewer system. In addition, Project WIN involved keeping the public informed of potential health risks, financial impacts, and construction project activity. MSD believed that Project WIN, estimated to cost approximately \$850 million over a 20 year period, would achieve the sewer overflow abatement objectives outlined in the Consent Decree by 2024.

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In April 2009, MSD entered into an amended Consent Decree to address sanitary sewer overflows and unauthorized discharges from MSD's sanitary sewer system, combined sewer system, water quality treatment centers, and discharges from MSD's combined sewer overflow locations identified in the Kentucky Pollutant Discharge Elimination System permit for the Morris Forman Water Quality Treatment Center.

As part of its Consent Decree, MSD committed to implementing Green Infrastructure demonstration projects at 19 locations within the Louisville Metro area during the next two calendar years. A study summarizing the business case value of green initiatives was developed as part of the Integrated Overflow Abatement Plan (IOAP). It assigned a value per unit of installed green practice to MSD, which is based on the reduction of overflows, decreased plant flows and the "right sizing" of IOAP gray projects. Planned green infrastructure projects will be evaluated for determining the total benefit received by MSD and the community based on various technologies used. MSD believes that green infrastructure projects will be as effective as traditional concrete or "gray" infrastructure projects but they can be constructed at a lower cost.

A financing plan relating to the Consent Decree was prepared and reviewed by the MSD Wet Weather Advisory Team, MSD Executive Management, and various consultants working on the Consent Decree project plans. Customers may obtain updates on Project WIN progress and construction by logging onto MSD's Project WIN Web site (www.msdlouky.org/projectwin). Customers also may sign up to receive water quality warnings and other Project WIN updates.

Revenue and Other Means of Financing

MSD's revenues primarily come from wastewater and stormwater service fees, charges for extending wastewater lines and connecting new customers, and surcharges associated with the federally-mandated Consent Decree. Known collectively as the Schedule of Rates, Rentals, and Charges, these fees, charges, and surcharges may be modified in order to create enough revenue to cover expenses. In addition, MSD may issue negotiable interest-bearing bonds.

History of Rate Modification at MSD

Prior to the formation of MSD, most of the local financing for sewer work came from bond issues. These were all "general obligation" bonds, which the city pledged to pay back out of future tax revenue. However, when the Commissioners of Sewerage went out of business, they warned the new district that "a systematic and continuing method of financing all this sewer work would have to be devised. City tax revenues were simply not enough to do the job."

From its inception, MSD decided to charge citizens "user fees" based on the amount of water discharged into the sewers. User fees could be based on the consumption shown on the Louisville Water Company's water bills and the water company would collect the sewer fee along with the water bill, turning the proceeds over to MSD.

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The first proposal was for a sewer fee that was half the amount charged by the water company at that time, with volume discounts for large users. It also added a 33 1/3 percent discount for all users who paid their bills promptly, but this was eliminated in mid-1956. There was also the matter of the \$17 million in outstanding sewer bonds, which the new sewer district did not take over from the City of Louisville. City taxpayers' money would be used to pay off these bonds for years to come, leading some city opponents to charge that the fees amounted to "double taxation." The water company's own rate schedule provided a political solution to this, as it charged users outside the city twice as much as those inside the city. At 50 percent of the current water rates, MSD's charges would also be twice as high outside the city, where customers wouldn't be paying taxes to retire the old sewer bonds.

Prior to 1979, MSD needed approval from both the Board of Aldermen and the Fiscal Court to change its rates. Often one entity would offer its approval while the other would deny the increase, making the need for additional revenue greater with each passing year and, consequently, increasing the amount of the necessary rate change in the following fiscal year.

But in October 1979, MSD, the Board of Aldermen, and the Fiscal Court came to an agreement: MSD would be allowed to increase its rates whenever the money it had available to repay its bonds fell below 110 percent of the amount that would be required to make the payments. The Board of Aldermen and Fiscal Court would have to give their approval only if the total amount of the rate increases would top more than seven percent in any one-year period.

According to MSD, the "seven percent solution" of 1979 kept its rate increases well below seven percent in any one-year period. MSD further believed that considering rate increases more often would allow them to keep up with inflation without encountering strong public opposition.

In 1985, the Board approved two new policies: guaranteed maximum assessments, and financial assistance for low-income customers.

A guaranteed maximum assessment would be the maximum a property owner would be charged for a share of the costs for building new lines to provide sewer service. The guarantees would be issued, in writing, before a sewer project began. If the project cost more than anticipated, MSD would pay the difference; if it cost less, the property owners would share in the savings.

The financial assistance plan provided several ways to ease the burden on low-income and elderly customers. The details would vary depending on the customer's circumstances; in some cases, the assessments wouldn't have to be paid until the property was sold.

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The 1993 Sewer and Drainage System Revenue Bond Resolution (the 1993 Resolution), and its supplements require MSD to provide “available revenues,” as defined in the 1993 Resolution, sufficient to pay 110 percent of each year’s “aggregate net debt service” on Revenue Bonds and 100 percent of “operating expenses.”

- “Available revenues,” as used only for purposes of the Resolution, means all revenues and other amounts received by MSD and pledged as security for payment of bonds issued pursuant to the Resolution, but exclude any interest income which is capitalized in accordance with generally accepted accounting principles.
- “Aggregate net debt service” is aggregate debt service on all bonds issued pursuant to the Resolution, excluding (i) interest expense which, in accordance with generally accepted accounting principles, is capitalized and which may be paid from the proceeds of debt and (ii) other amounts, if any, available or expected to be available in the ordinary course for payment of debt service. MSD’s debt service coverage, calculated on the foregoing basis, was 170 percent in 2010 and 133 percent in 2009.
- “Operating expenses” include all reasonable, ordinary, usual or necessary current expenses of maintenance, repair and operation determined in accordance with generally accepted accounting principles and the enterprise basis of accounting. “Operating expenses” do not include reserves for extraordinary maintenance and repair, or administrative and engineering expenses of MSD which are necessary or incidental to capital improvements for which debt has been issued and which may be paid from proceeds of such debt. MSD is not allowed to include depreciation expense in the formula authorized by the Louisville Metro Government to calculate allowable rate increases.

Although net operating income is the most significant component of the factors which go into determining MSD’s debt service coverage, other sources, including investment income and current period payments of property owner assessments also are included in “available revenues” and “net revenues” for purposes of demonstrating MSD’s performance under the several debt service ratio tests of the 1993 Resolution.

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Current Rate Modification Process

The budget process for the following fiscal year normally starts in January and is concluded in early May. The budget process and the rate setting process are interrelated, as the MSD Finance Director must project the operations and maintenance budget, the capital budget, and the projected debt service due to future borrowings for the upcoming fiscal year in order to determine if an increase in rates is necessary. MSD's rates must generate enough income to cover its projected operation and maintenance expenses, debt service expenses, and cash funded capital expenditures. In addition, MSD's debt service coverage must be at least 110 percent and the working capital target is \$25 million. This is equivalent to what is currently two months of operating expense, which would give MSD enough time to get a bond issued.

To develop the budget for the upcoming year, the MSD Finance Director must consider both historical and current year financial information. The proposed budgets are reviewed by the appropriate supervisors, managers, and division directors. In addition, the executive management team reviews these budgets, as do budget personnel in the Finance Division and the Engineering Division. The capital and operating budget summaries are also reviewed by external parties such as rating agencies, a financial advisor, and an engineering consultant.

If the projected budgets result in the need for rate increases due to the requirements from the 1993 Resolution not being met, then the MSD Finance Director must determine how the schedule of rates should be amended to ensure the requirements are met. For the most part, MSD rate increases have been consistent with the projected increases identified in the Consent Decree financing plan. The numbers that feed into the rate increase calculation are reviewed by the numerous internal and external parties listed in the previous paragraph that review the budget.

MSD staff will present a preliminary rate resolution with the proposed change in rates to MSD board members during an open meeting of the MSD Board. If MSD management or the MSD Board does not believe these increases are feasible, then the operation and maintenance budget, the capital budget, and projected debt service due to future borrowings would all need to be adjusted to account for the revenue that will not be realized.

Once the Board approves the preliminary rate resolution, MSD must publish a public notice of the agency's intent to modify its Schedule of Rates, Rentals, and Charges. Once the notice is published, a 30 day comment period begins and the MSD Board must wait until this period ends before adopting a final rate resolution, making the changes final.

In addition to the public notice, MSD is required by local ordinance to notify the Metro City Council at least 60 days prior to the MSD Board's approval of the final rate resolution if the rate of increase is four percent or greater and must receive approval from the Metro City Council if the rate of increase is greater than seven percent.

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At the end of the 30-day comment period, comments from the public, MSD Board members, rating agencies, and financial advisors are reviewed and MSD may make changes to the preliminary rate resolution without another 30-day comment period.

The final rate resolution must be presented to the MSD Board for adoption within 60 days of the publication of the public notice. Once adopted, final budget calculations are produced based on the approved rate changes, which are implemented on August 1 of that year.

Rate Modification Process Test

A 6.5 percent increase in wastewater and stormwater volume and service charges, as well as optional and quality charge rates that are assessed to commercial and industrial wastewater customers, was implemented in FY 2008, 2009, 2010, and 2011. Because the proposed increase was not greater than seven percent, MSD did not have to gain approval from the Metro City Council for these modifications to their Schedule of Rates, Rentals, and Charges.

Auditors reviewed documentation for each of the past four years to determine if all of the following requirements were met:

- A preliminary rate resolution listing the modifications to the Schedule of Rates, Rentals, and Charges was presented & approved by the MSD Board.
- Because the proposed increase noted in the preliminary rate resolution was greater than 4 percent, an explanation of the modification was delivered to the Metro Council at least 60 days prior to MSD Board approval of the final rate resolution.
- A public notice of the agency's intent to modify its Schedule of Rates, Rentals, and Charges was published after the preliminary rate resolution was approved.
- MSD provided customers with 30 days to offer comment on the proposal before adopting a final rate resolution.
- The final rate resolution was presented for adoption by the MSD Board within 60 days after the notice was published.

Auditors observed through various means of documentation, including Board minutes, correspondence, and newspaper clippings, that MSD followed all of the relevant requirements for modifying its Schedule of Rates, Rentals, and Charges in FY 2008, 2009, 2010, and 2011.

Issuing Bonds

Pursuant to KRS 76.150, MSD may issue negotiable interest-bearing revenue bonds for any of its corporate purposes and it may issue negotiable interest-bearing revenue bonds to refund any of its bonds at maturity, or any time before maturity with the consent of the bond holders, or pursuant to the bonds redemption provisions. The bonds are signed in the name of MSD by the Chairman or Vice-Chairman of the MSD Board and attested by the signature of the Board Secretary/Treasurer.

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MSD regularly issues revenue bonds and bond anticipation notes, but recently it has issued a different type of bond known as Build America Bonds (BAB). BABs allow the issuer to receive a subsidy equal to 35 percent of future interest payments from the federal government. These funds are expected to be used for additional expansions to the wastewater and drainage systems, plant expansions, flood protection systems, and other wastewater and stormwater projects.

The following table lists the bonds issued by MSD during 2009, 2010, and 2011.

Table 1: Bonds Issued by MSD in 2009, 2010, and 2011

Description of Issue	Par Value of Bonds Issued
Series 2009A Revenue Bonds	\$76,300,000
Series 2009A Bond Anticipation Notes	226,300,000
Series 2010A Bond Anticipation Notes	226,300,000
2009 Revenue Bonds	225,800,000
2009 Build America Bonds	180,000,000
Series 2010A Build America Bonds	330,000,000
Series 2011A Bond Anticipation Notes	226,340,000
Series 2011A Revenue Bonds	<u>263,360,000</u>
Total	\$1,754,400,000

Source: Auditor of Public Accounts based on information provided by MSD.

MSD: The Board

Originally, MSD was run by a five-member board, three appointed by the Mayor of Louisville and two appointed by the Jefferson County Judge/Executive. Currently, the Louisville Metro Mayor appoints, with the approval of the Louisville Metro Council, the eight members of MSD's governing Board. The Board, which has statutory authority to enter into contracts and agreements for the management, regulation and financing of MSD, manages its business and activities. The Board has full statutory responsibility for approving and revising MSD's budgets, for financing deficits and for disposition of surplus funds.

The selected financial and personnel data provided in the table below summarizes the financial activity of the MSD operation. As of FY ending 2011, MSD had operating revenue of \$185 million, cash and investments of \$442 million and long term debt obligations of \$1.8 billion. Per the table below, operating revenue is the total of all wastewater and stormwater revenues. Cash and investments include restricted and unrestricted cash and investments. Long term debt excludes current maturities of long term debt but includes Bonds payable and Bond Anticipation Notes which are short term obligations issued by MSD in lieu of long term bonds.

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Table 2: Selected Financial Data and Number of MSD Employees

	FYE 2009	FYE 2010	FYE 2011**
Operating Revenues	\$167,555,987	\$171,590,108	\$185,675,930
Operating Expenses:			
Service and Administrative Costs	\$68,677,632	\$69,951,044	\$76,999,392
Depreciation and Amortization	56,791,683	55,417,365	58,547,059
Total Operating Expenses	\$125,469,315	\$125,368,409	\$135,546,451
Cash and Investments	\$127,576,150	\$478,603,152	\$442,034, 979
Long Term Debt *	\$1,370,441,844	\$1,736,173,018	\$1,801,168,368
Number of Employees	668	677	672

Source: Auditor of Public Accounts based on MSD's audited financial statements and information provided by MSD.

* Includes short term Bond Anticipation Notes issued in lieu of Bonds.

** Unaudited financial information provided by MSD.

Duties and Functions

The MSD Board is to conduct itself pursuant to its bylaws. The bylaws state that the functions of the Board shall include, but not be limited to, the following:

- Manage, control, and conduct the business, activities, and affairs of the district as prescribed by KRS Chapter 76.
- Adopt an annual operating budget for revenues and expenditures and also an annual capital projects budget.
- Approve all contracts with MSD and any contract or agreement exceeding the original amount approved by the Board shall require resubmission to, and approval by, the Board prior to payment. The Board may authorize the Executive Director to approve contracts in an amount below \$50,000 or emergency contracts without the Board's approval.
- Establish, enforce, and collect rates, rentals, and charges for services rendered so that the same will be adequate to meet all bond requirements, operations, and maintenance of the sewer and drainage system.
- Employ an Executive Director subject to applicable provisions of KRS 76.060.
- Employ a Secretary to the Board.
- Approve all policies, codes, and regulations necessary for the management and regulation of the affairs of MSD.

While it is the responsibility of the Louisville Metro Mayor to appoint individuals to the positions of Executive Director, Secretary-Treasurer, and Chief Engineer, these individuals are supervised by the MSD Board. KRS 76.060 requires the board to fix the salaries and compensation of the officers and employees it engages to be in line with that paid by the city and county for similar services.

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The MSD Board also may employ professional and technical advisors, experts, and other employees as it deems requisite for the performance of its duties. Specifically mentioned in the bylaws, is the MSD Board's ability to employ a Special Legal Counsel who will advise the Board on legal matters concerning the Board and MSD.

Presently, the MSD Board employs individuals for the following positions: Legal Counsel and Secretary to the Board. Board Legal Counsel is employed through MSD's legal services contract, with the Board Legal Counsel reporting to the MSD Board and the MSD Legal Director. The Board Assistant, who performs the functions of "Secretary to the Board," is, however, an employee of MSD who reports to the Board and to the Executive Director's Assistant.

While the legal services contract for the MSD Board Legal Counsel outlines the duties of the Legal Counsel, the MSD bylaws specify the duties of the Secretary to the Board. These duties shall be:

- To attend all meetings of the MSD Board and record its proceedings;
- To attest and fix the corporate seal to all instruments requiring such action;
- To provide routine administrative assistance to Board members in areas such as the coordination of appointments and scheduling of meetings, and to assist the Secretary/Treasurer in preparation of the Board's agenda and minutes of meetings;
- To perform data-gathering activities;
- To notify the news media and other interested parties of Board meetings;
- To maintain the Board's Policy Manual;
- To perform such other duties as the Board or Chairman of the Board may assign; and,
- To annually prepare a schedule of regular meetings to be held during each calendar year.

Board Structure & Composition

With the consolidation of local government in Jefferson County as Louisville Metro, all members of the MSD Board are appointed by the Louisville Metro Mayor for a term of three years and until their successors are appointed and qualified. The MSD Board is composed of eight members, no more than five of which may be affiliated with the same political party. Starting in 1977, the members were to be selected and appointed so that no more than one member resides in any one state senatorial district. The Louisville Metro Mayor may also appoint one additional member to the board who may be a resident of any state senatorial district in the county.

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Any MSD Board member appointed by the Louisville Metro Mayor may be removed by the Louisville Metro Mayor, for cause, after a hearing by the Louisville Metro Mayor and after at least 10 days notice in writing have been given to the member, in which the notice must embrace the charges presented against the member. The Board member, at the hearing, may be represented by counsel. The finding of the Louisville Metro Mayor will be final, and removal results in the vacancy of that particular board office.

Under KRS 76.060, the Board must elect from its members a chairman and a vice-chairman in July of each year, and the chairman and vice-chairman must be of different political affiliation. The Chairman of the Board presides at all meetings of the Board, appoints all committees, appoints the Chairperson of committees, signs documents and contracts as designated by the Board, and performs other duties as the Board may designate. The Vice-Chairperson performs all of the duties of the Chairperson in the temporary absence or disability of the Chairman unless otherwise provided by the Board. A vacancy in the elected office of Chairman and/or Vice-Chairman shall be filled by majority vote of the Board.

Committees

Pursuant to Board bylaws, the standing committees of the Board of MSD include the Policy Committee, the Budget Committee, Audit Committee, and Personnel Committee. The Board may create any special committees as it desires from time to time. The Chairperson of each committee, with the approval of the Board, may appoint additional members from the community to serve on such subcommittees.

While each committee has its own Chairperson, the Chairman of the Board serves as an ex-officio member of all committees, but is not permitted to vote on any matter pending before the committee, is not obligated to attend meetings of the committee, nor is counted in determining if a quorum of the committee is present.

A committee meets on the call of the Chairman of the Board, Chairperson of the committee, or any two members of the committee, and a majority of the committee membership constitutes a quorum at any committee meeting. Duties and procedures of Committees shall be approved by the Board and entered into the Policy Manual of the Board.

A proposed annual operating budget for revenues and expenditures, as well as an annual capital projects budget, is submitted by the Budget Committee to the MSD Board for adoption before the first day of each fiscal year. Under KRS 76.040, the fiscal year of MSD begins on July 1st of each year and ends on June 30th the next following year. The Budget Committee approval is required for any total department expenditures in excess of the adopted budget. The annual audit report is presented to the Board and the Board must adopt the same.

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Other Boards

MSD Board members are also members of the Board of Directors of the Louisville and Jefferson County Regional Sewer Corporation (Regional Sewer Board), members of the Louisville and Jefferson County Flood Plain Management Board, members of the Louisville Green Corporation, and P-B Corporation.

Meetings

Under KRS 76.050, regular meetings of the MSD Board are held at least once per month. Unless ordered otherwise by the Board or Chairman of the Board, the regular meetings of the MSD Board occur on the second and fourth Monday of each month.

The chairman or any two members of the Board may at any time call a special meeting by either written or oral communication giving the time and place of such meeting, and such meeting may be held if each member receives at least 24 hours notice of this meeting or if such notice is left at the residence or place of business of each member 24 hours prior to the meeting. Also, prior notification of this meeting must be given to the news media and public, as required by the Kentucky Open Meetings Law.

Under the bylaws of the MSD Board, a majority of those Board members currently in office and duly sworn, constitute a quorum, and the affirmative vote of at least three members of the MSD Board is necessary for the adoption of any motion, measure, or resolution. All meetings of a quorum of the members of the MSD Board where actions are taken by the agency are open to the public, except under specific circumstances. Therefore, meetings of the MSD Board are subject to the “open meetings law” under KRS 61.805-61.850.

No member of the MSD Board shall vote on a question in which he or she has an interest beyond that of a member of the MSD Board except in the election of officers. The minutes shall clearly state the name of the person disqualifying himself or herself in all cases where conflict of interest is raised.

Compensation

MSD Board members are paid \$75.00 for each meeting of the Board attended and \$50.00 for attendance at any meeting of a committee which has been authorized or duly appointed by the Board. In no instance can a Board member be paid for more than one meeting per day, receive more than \$1,800.00 during any fiscal year of the Board, or be paid for more than 24 board meetings and 28 committee meetings held during any fiscal year of the Board. Pursuant to Article IV of the bylaws of the Board, members of the Board may be reimbursed for reasonable expenses incurred while on MSD business.

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MSD: The Staff

MSD is currently organized into 10 divisions including:

- Executive Offices;
- Legal;
- Human Resources;
- Finance;
- Physical Assets;
- Regulatory Services;
- Engineering;
- Infrastructure and Flood Protection;
- Operations; and,
- Information and Technology.

As of July 11, 2011, 632 of the 656 authorized positions at MSD were filled. The following table summarizes the organization of these positions across the 10 divisions at MSD.

Table 3: Current Organizational Summary of Positions at MSD

Division	Authorized	Actual	Vacant
Executive Offices	7	7	0
Legal	6	5	1
Human Resources	16	14	2
Finance	20	19	1
Physical Assets	40	39	1
Regulatory Services	61	55	6
Engineering	49.5	42.5	7
Infrastructure and Flood Protection	219	218	1
Operations	172.5	167.5	5
Information and Technology	65	65	0
Total	656	632	24

Source: Auditor of Public Accounts based on the Louisville and Jefferson County Metropolitan Sewer District Organizational Chart, July 11, 2011.

Starting with FY 2000 and ending with FY 2011, the following table lists the total of staff employed at MSD in a given year and the change between that year's total and the previous year's total.

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Table 4: Number of MSD Employees and Annual Gross Wages Paid

Fiscal Year	Number of Employees	Annual Percentage Change	Adjusted Gross Wages*	Annual Percentage Change
2000	843	--	\$38,908,668	--
2001	690	-18.15%	\$29,338,826	-24.60%
2002	669	-3.04%	\$30,141,466	2.74%
2003	663	-0.90%	\$31,014,116	2.90%
2004	642	-3.17%	\$30,791,029	-0.72%
2005	628	-2.18%	\$30,220,720	-1.85%
2006	623	-0.80%	\$31,978,718	5.82%
2007	625	0.32%	\$33,629,904	5.16%
2008	644	3.04%	\$35,266,253	4.87%
2009	668	3.73%	\$35,948,292	1.93%
2010	677	1.35%	\$37,535,471	4.42%
2011	672	-0.74%	\$39,887,917	6.27%
Comprehensive Percentage Changes		-20.28%		2.52%

Source: Auditor of Public Accounts based on information provided by MSD.

* Does not include expense reimbursements made to employees.

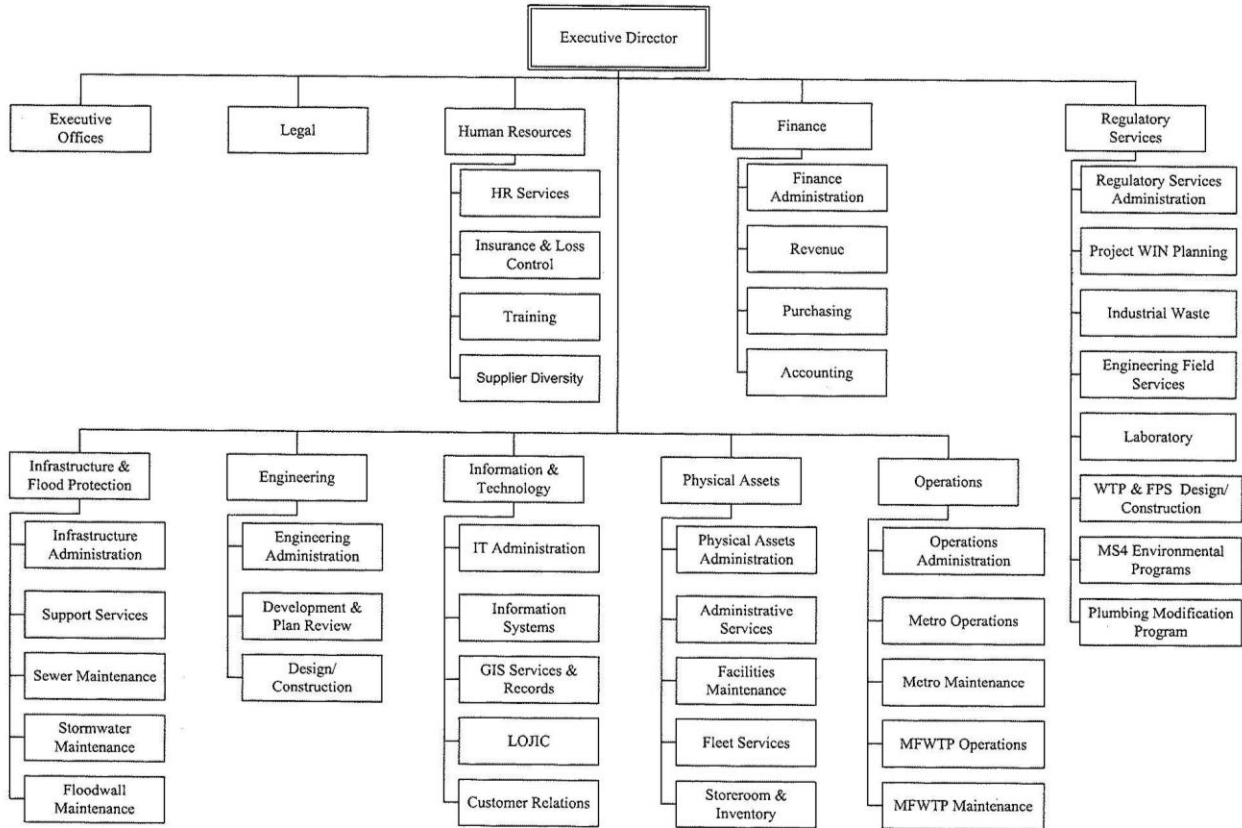
The large drop in staff as seen between FY 2000 and FY 2001 was in response to an internal decision to financially encourage certain employees to retire or otherwise leave MSD employment. To read more about this incentive, please turn to Finding 19.

Executive Staff

The Executive Offices Division is headed by the Executive Director of MSD. The remaining nine divisions are headed by at least one director, with the exception being the Operations Division which has two directors: 1) Director of Operations and Maintenance for Morris Foreman Wastewater Treatment Plant; and 2) Director of Emergency Response and Metro Operations. All of the division directors report to the Executive Director. The MSD organizational chart details areas covered within each division. Because the chart specifies areas of responsibility, not specific positions, it should be noted that both the Internal Auditor and the Controller report directly to the Finance Director and are not specifically identified on the organizational chart.

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Metropolitan Sewer District
Organizational Chart



Source: 2010 Comprehensive Annual Financial Report for MSD (p. 8).

While the Secretary-Treasurer and the Chief Engineer each are statutorily required to devote his or her entire time and attention exclusively to the services of the Board, the duties of the Executive Director involve both the MSD Board and the agency.

According to the MSD bylaws, the duties of the Executive Director are as follows:

- To provide for and be responsible for the management of all affairs of the District and act in such regard as Chief Executive Officer, and act as Secretary-Treasurer of the District;
- To promulgate and recommend policies for action by the Board of the District;

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- To enforce and administer all directives, policies, and resolutions of the Board of the District;
- To hire, promote, fire, lay off, discipline, set salaries and compensation of non-unit employees;
- To take all necessary and proper actions pursuant to any Collective Bargaining Agreement that may from time to time be in effect;
- To make recommendations to the Board of the District regarding actions to be taken by the Board, including awarding of contracts and expenditure of funds;
- To sign all contracts and other documents which the Board of the District authorizes;
- To exercise procurement functions as set forth in Board policies;
- To plan strategies for the comprehensive construction, maintenance, and rehabilitation of adequate sanitary sewers for the whole of Jefferson County;
- To plan, strategize, and prepare action plans in order for the District to provide comprehensive drainage programs for all areas within MSD's Drainage Service Area;
- To provide comprehensive reports on the operations and management of the actions of MSD employees to the Board of the District;
- To present to the Board reports, as needed and requested by the Board, of all MSD activities, objectives, and accomplishments;
- Assure that all of MSD's utilities are properly maintained, and comply with statutory and regulatory requirements, that all facilities maintain operating permits, and that the agency remains in compliance with all laws and regulations;
- Recommend that the Board maintain rates, fees, rentals, and charges for services of the District which will be sufficient for proper debt service coverage, payment of all accounts, operating expenses, and any and all other debt, and any amounts to discharge any charges required to be paid under any covenant adopted by the Board;
- To maintain adequate and timely communication with all elected officials having an interest in the operations of the District, and to timely and adequately respond to all inquiries and concerns of such officials, including the Mayor of Louisville Metro, councilmen, and Legislators, as well as the elected officials of other cities within Jefferson County;
- To attend any meetings or conference requested by any elected official or Board member, when necessary; and,
- Any other duties assigned by the Board or its Chairman.

In addition, when the position of the Secretary-Treasurer is vacant, the Executive Director will act as Secretary-Treasurer or may delegate the duties of that position to the Director of Finance. Likewise, when the position of Chief Engineer is vacant, the Engineering Director shall act as Chief Engineer, unless the Executive Director has been designated Chief Engineer by the MSD Board for the purposes of KRS Chapter 76. Consequently, the Executive Director may delegate the duties of Chief Engineer to the Engineering Director.

At this time, the Executive Director is serving as Secretary-Treasurer and the Design Manager within the Engineering Division is acting as Chief Engineer, due to vacancies in the positions of Chief Engineer and Engineering Director.

Findings and Recommendations

**Finding 1:
Governance
policies for the
MSD Board did
not address several
critical
responsibilities
necessary for
proper and
effective oversight.**

Policies applicable to the Board governance of MSD did not exist for several critical areas of responsibility necessary for proper and effective oversight of MSD. Auditors found no evidence of policies related to:

- Annual or new Board member orientation regarding fiduciary responsibilities as board members;
- Documentation of Board review of budget to actual expenditures in the meeting minutes;
- An independent procedure for reporting complaints and whistleblower policy;
- Independent reporting by the Internal Auditor directly to the Board;
- Documentation in the meeting minutes of annual Board review of MSD compensation policies, and executive staff salaries and bonuses; and,
- Review and approval of executive staff travel by the Board.

MSD's bylaws grant the Board the authority to manage, control, and conduct the business, activities, and affairs of MSD as prescribed by KRS Chapter 76. Such authority brings with it the responsibility to ensure the monies received for services provided are used in a responsible manner that serves the interests of the recipients of the services. The Board should ensure that the operating policies are consistent with, appropriate for, and supportive of the stated goals and objectives of MSD. Lack of assumption of such responsibilities weakens oversight and controls over the responsible use and safeguarding of public funds by MSD.

*Board Member
Orientation*

MSD Board members do not include MSD's operations or the Board member's legal and fiduciary responsibilities in their annual or new member orientation program; however, MSD does provide Board members an orientation binder with MSD's rules and regulations, Board bylaws, and other information. MSD Board members are provided a formal presentation by the Executive Director and other MSD directors at the annual meeting with all Board members.

Members of the eight person Board serve three-year terms without limitations. New appointees may not be familiar with the Board's fiduciary responsibilities or MSD's structure, and may not have an understanding of their responsibilities as Board members. It would be difficult for a Board member to effectively perform his or her duties, absent such a detailed orientation. New Board members, without a proper understanding of the organization or their responsibilities, may not ask pertinent questions or may be hesitant to enter into discussions.

*Detailed Budget to
Actual Expenditure
Review Not
Documented in
Meeting Minutes*

Detailed budget to actual expenditure reviews conducted by the MSD Board members were not documented in the MSD Board meeting minutes or Budget Committee minutes. Furthermore, no documentation existed that would indicate Board members or the Budget Committee conducted any periodic review of expenditures, or categories of expenditures, to evaluate whether those expenditures were reasonable and necessary, and to identify inappropriate, unusual, or excessive expenditures.

Per the Board Assistant, Board members receive a packet of information, usually four to five days before their meetings; which includes information about projects, payments, budgets, and any special directions for projects. Neither the Board minutes nor the Budget Committee minutes document an in-depth discussion of the financial information Board members have received and reviewed before approval. According to most of the Board members interviewed, they do not review the financial information at Board meetings. The Board does not receive line item budget to actual expenditure reporting and they do not compare expenditures to line item budgets.

A review of the minutes of MSD’s Board meetings and Budget Committee, confirmed very little discussion was involved concerning financial reviews. The purpose of the MSD Board is to “manage, control, and conduct the business, activities, and affairs of the district as prescribed by KRS 76” and “adopt an annual operating budget for revenues and expenditures and also an annual capital projects budget.”

For transparency, strengthened policies would require the budget categories or line items presented to the Board to provide sufficient detail to allow Board members to accurately identify the types of expenses being attributed to each category. If expenditures occur at an unexpected rate, or appear to be inappropriate or unusual, Board members should request additional detail to ensure that incurred expenditures are reasonable and necessary. Lack of this financial review oversight weakens the internal controls within the organization of MSD and the accountability over the use of public funds is reduced.

*No Independent
Procedure for
External
Complaints and No
Whistleblower
Policy*

Although MSD has an internal grievance policy for employees, MSD has not implemented an independent procedure for employees or others to report any concerns directly to the members of the Board. In addition, there is no process for individuals outside of MSD, such as citizens and contractors, to anonymously report concerns pertaining to potential fraud, waste, or abuse within MSD. MSD does not have an established whistleblower policy, and does not reference KRS 61.102 to notify employees of their protection from retaliation.

According to the MSD Policy Manual in Section 14, Grievance Procedures, employees are encouraged to communicate problems to their immediate supervisor or higher management whenever necessary, but the auditors saw no independent process to receive, analyze, investigate, and resolve concerns related to the organization, including anonymous complaints directly to the Board members.

None of the policies reviewed by the auditors referenced a whistleblower policy that would allow management, employees, contractors, and others to raise their concerns with respect to MSD. The policy should offer ways to report a concern, either to a manager, to a member of the executive staff, or through an employee hotline service.

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Without a written policy for employees or others to ensure the Board is aware of the concerns brought to management's attention, or to report potential violations of policy directly to the Board, the Board may be unaware of the environment within the organization and unable to ensure a proper follow-up to investigate reported complaints is performed. In order for the Board to be well-informed of employee and other concerns, the Board must be notified, independent of management, of certain complaints or allegations of policy violations.

Internal Audit Function

MSD does employ an Internal Auditor who performs audits, but there are no guidelines that direct the Internal Auditor to independently investigate and examine any issues as designated by Board members. Board members stated the Internal Auditor presents a work plan to them on an annual basis; however, it was determined that the Board is not made aware of all requested internal audits performed.

Board members believe the Internal Auditor would come to them directly, if necessary, to discuss concerns or issues and stated it is implied and understood that the Internal Auditor would address Board members directly. Auditors noted a work plan that is developed by the Internal Auditor and reviewed the reports submitted to the Board.

Without written guidelines or a policy for the Internal Auditor to independently investigate any Board concerns, the internal audit function is limited in its ability to be a direct administrative link to Board members.

Executive Director Salary/Bonuses and Compensation Policy

The Board and the Personnel Committee meeting minutes do not reflect a discussion or review of executive staff salaries and/or bonuses. According to Personnel Committee meeting minutes, the only committee meeting actions concerning personnel were when employees were recognized for gaining an "exceptionally achieves" during their performance reviews, which included the Executive Director.

There is no indication that the Board has direct knowledge of the annual salary and bonus of the Executive Director or executive staff, as nothing was documented in the Board meeting minutes. According to Board members interviewed, neither the annual compensation of, nor bonuses awarded to, the Executive Director or the executive staff are approved by the Board. The Board Chair does conduct an annual performance evaluation for the Executive Director, which in turn determines the amount of his annual bonus.

MSD does have a detailed personnel and compensation policy, but the MSD Board does not discuss or review this policy, instead the Board allows Human Resources to dictate and implement this policy without oversight. MSD's personnel policies cover benefits, evaluations, and salary adjustments and appear to be adequately documented; however, no requirement exists for the Executive Director or staff salary increases to be annually reviewed by the Board, or a designated committee.

Findings and Recommendations

During interviews, auditors were told that the employee compensation policy is set forth by Human Resources and has been in place for a long time. The policy states that the Human Resources Compensation staff will develop the employee pay grades and ranges. The policy does state that the “Compensation Program is subject to change by the Board and management of MSD based on financing and other considerations.” However, no Board or committee meeting minutes documented the discussion of the salary administration policy.

While MSD does have a detailed and equitable personnel and compensation policy, Board members have a responsibility to perform an annual review of the personnel and compensation for MSD staff. Salaries should be fair and equitable for all staff members.

Executive Staff Travel

Although MSD has established travel guidelines and procedural policies that define allowable costs, executive staff travel is not pre-approved and not reviewed after the fact by Board members. The MSD travel policy clearly defines the acceptable travel for employees, which must be pre-approved by the employee’s director. Expenses incurred by the employee during approved travel obligations may be reimbursed after the trip is completed or can be pre-paid, depending on the nature of the travel requirements. Employees are expected to use the most cost effective method and means for completing their trips.

The travel and related expenses of the executive staff are not specifically addressed in this policy. According to current and former MSD Board members interviewed, they stated the Board does not approve the executive staff’s travel plans or travel costs individually, other than inclusion in the operating budget, which is approved by the Board. The actual travel expenses incurred are not reported to the Board.

Effective policies that provide proper transparency and accountability should require Board members to pre-approve any travel plans and estimated costs of MSD executive staff. Such approvals should be documented in the minutes of the Board meetings. Subsequent to attending approved travel activities, executive staff should report amounts expended to the Board for approval. When travel expenses of executive staff are not reviewed by the Board, travel costs may exceed budgeted amounts and allow excessive spending.

Recommendations

We recommend the Board provide in their annual orientation training for new and returning Board members a clear understanding of MSD’s organizational structure and operations, their responsibilities as Board members, as well as their legal and fiduciary roles, and the purpose of the board on which they serve. In addition, the orientation should address ethical requirements of Board members and staff and any significant policy changes adopted by MSD during the previous year. We also recommend that the orientation be facilitated by a knowledgeable independent party, who can participate in and oversee the orientation training.

Findings and Recommendations

We recommend that the Budget Committee perform a regular review of budget to actual expenditures to monitor costs in each account and report to the Board. The name and number of budget categories should provide transparency and sufficient detail to allow Committee members to accurately identify the types of expenses attributed to each category. This review should be documented in the Board and Budget Committee meeting minutes. Periodically, the Budget Committee should receive and review a listing of expenditures with sufficient detail to question transactions as necessary.

We recommend the Board develop a whistleblower reporting policy by creating and documenting an independent process whereby employees and/or volunteers have the option to directly make the Board aware of concerns involving matters that specifically need Board oversight. We recommend the Board establish methods that allow for concerns to be reported directly to their attention by all staff, including anonymous concerns, and any complaints against executive staff. The Board should further develop a process by which concerns are brought to the attention of the Board and ensure a process exists to analyze, investigate and resolve issues brought to its attention. The internal audit function could be used to ensure that concerns brought to the Board are independently investigated and findings reported directly to the Board.

We recommend the Board adopt a policy to review and approve the salary and bonus incentives of the executive staff on an annual basis to ensure that the compensation paid is equitable to the responsibilities and duties of each position. We further recommend the Board annually review MSD's personnel and compensation policy, including the range of increases, by which salary increases and bonus payments are made to all staff. The salaries should be reviewed specifically by the Board to ascertain appropriate use of funds given the mission of MSD, and such review should be documented in the minutes. These actions should be documented in the meeting minutes.

We recommend the Board, or a designated committee of the Board, pre-approve executive staff travel, including estimated costs. The Board meeting minutes should document the review conducted by the Board. We also recommend the Board require a report of the actual travel expenses of executive staff, with Board approval, prior to expense reimbursement. The expense reports should sufficiently detail the expenses associated with meals, lodging, transportation, and entertainment of each trip, as well as the business purpose of each expense item.

Findings and Recommendations

Finding 2: Certain policies were not documented or sufficient to ensure accountability.

MSD’s policies and procedures related to purchasing card procedures, reimbursements to MSD, executive staff reimbursements, reporting lost or stolen financial information, and inventory controls of fixed assets were not sufficiently comprehensive to provide proper control and accountability needed for a public agency. Although MSD has implemented various policies and procedures in an attempt to provide control and oversight of its organization, several of the policies were limited and did not include necessary critical procedures.

Purchasing Card Procedure

Although not a formal policy, MSD has a written documented procedure for an employee’s use of purchasing cards. The purchasing card procedure allows authorized employees to make small-dollar, non-inventory purchases of materials and supplies. MSD’s purchasing card procedure covers the proper usage of the cards and lists examples of violations when using purchasing cards. Additionally, a list of merchants that are not permissible is made available to employees.

The MSD purchasing card procedure does not require a documented business purpose for expenses made using the purchasing cards and it does not address how MSD or the Board will handle employee’s repayment to MSD when improper and disallowed expenditures are found. The procedure also does not require Board members or a committee of the Board to review purchasing card expenditures of the Executive Director.

Effective policies that provide proper transparency and accountability will ensure employee purchases made with the MSD purchasing cards are monitored for unsupported charges or disallowed expenses. To ensure that any expenses made by an employee are monitored, a formal policy regarding proper business use of purchasing cards and reimbursement of funds when using purchasing cards for personal use is vital.

Reimbursements to MSD

MSD’s policies and procedures do not address the timing of when employees are required to reimburse MSD for any personal expenditure that may have been incurred. The review of the Board meeting minutes gave no indication that any review or oversight of the Executive Director’s purchasing card usage was conducted by the Board or a committee of the Board.

MSD’s purchasing card procedure covers the usage of the cards and requires documentation for support of the purchase(s), but the procedure does not require an employee to reimburse MSD when improper and personal usage is identified.

The MSD purchasing card procedure also does not address a timeframe for staff to reimburse MSD for a personal expense that may have been incurred, but does state that the purchase of items for personal use is considered a “policy violation.” The statement that personal purchases are not allowed and not providing consequences for the action provides little opportunity for enforcement or oversight of the policy.

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To ensure that any expenses made by an employee are monitored, a time requirement for reimbursement to MSD should be applicable to any purchasing card expenditures that are determined to be personal charges. Repayment of personal purchases to MSD should be detailed within the policy to allow for proper oversight of all expenses. Written policies regarding purchasing card usage is essential and should include steps for reimbursement to MSD if personal use of MSD purchasing cards is discovered. Board members or a committee of the Board should review all violations of purchasing card expenses in order to monitor the card usage.

Executive Staff Reimbursement

MSD policies and procedures do not require the Board or a Board committee to review business expense reimbursements requested by executive staff. MSD does have an Employee Business Reimbursement Form that all employees are required to complete and offers self explanatory directions. The form details the type of expense, purpose, and receipts that are required for approval.

The form does not require Board members or a committee of the Board to sign off on executive staff expenditures. Review of the Board meeting minutes gave no indication that any review or oversight of executive staff expenses was conducted by the Board or a committee of the Board. According to most of the Board members, there is no review by the Board or a committee of the Board concerning executive staff spending.

A written policy to go along with the Employee Business Reimbursement Form should require the proper completion of the form by executive staff and all MSD staff. The policy should include the acceptable documentation and steps for MSD management and Board members to follow when reviewing business expense reimbursements.

Reporting Lost/Stolen Financial Information

MSD does not have a written policy regarding the electronic backup of financial information, though there are written procedures to backup financial data. Policies regarding the electronic backup of financial information should be in written format. Without written policies for the electronic backup of financial information, transition or the absence of staff responsible for such policies could allow for pertinent financial information to be lost.

Inventory Controls of Fixed Assets

MSD had no written policies or procedures addressing fixed asset inventory requirements. MSD also has no written policies to address the reporting of missing business equipment. MSD did not conduct an annual or periodic inventory or physical accounting of MSD's fixed assets that is essential for proper accounting valuation and determining if equipment is missing.

Findings and Recommendations

MSD has a process for Finance employees to follow to determine when item(s) are added to the fixed asset system. The disposal of assets is documented by the use of MSD's disposal of assets form. However, the lack of maintaining inventory records and a periodic review of inventory allows for an asset to be misused, misplaced, damaged or possibly stolen without it coming to the attention of management. Good internal control over property requires an entity to account for furniture, equipment, or other items when purchased and to periodically perform a physical inventory.

Recommendations We recommend MSD strengthen their purchasing card procedure by making it a formal policy. We recommend the policy include information requiring a business purpose be documented and address how MSD or the Board will handle expenses that are considered improper or disallowed expenses. We also recommend the Board review purchasing card expenditures of the Executive Director.

We further recommend MSD include a procedure concerning reimbursement by an employee when a purchasing card is used for personal use in a formal policy. A timeframe when staff is required to reimburse MSD for any personal expenditure that may have been incurred should also be included in the policy. Currently, MSD does not use credit cards and therefore has no policy, but if credit cards ever become the preferred method of payment of goods, then we recommend a strong credit card policy should be developed.

We recommend policies be implemented to ensure that the Board or a designated committee of the Board review and approve all executive staff reimbursements and supporting documentation to ensure the reimbursements are for reasonable and necessary expenditures. Such reviews and approvals also will help ensure that duplicate payments are not made.

We recommend MSD adopt written policies for the backup of electronic financial information. Moreover, policies should include a process to report any lost or missing financial information or records.

We recommend MSD adopt and implement property and inventory control policies and procedures to identify and account for all furniture, equipment, or other items valued over a certain specified dollar amount, with the specific dollar amount included in policy. Such policies and procedures should include recording of the following minimum information for each property item:

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- Name of individual in receipt of furniture/equipment;
- Description of furniture/equipment;
- Vendor name;
- Model and serial numbers;
- Acquisition date; and,
- Acquisition cost.

We further recommend such inventory policies and procedures include an annual, or periodic, physical inventory of all fixed assets. Dispositions of property should also be reflected in inventory accounting. The property inventory and control policy should be made available to all employees who have responsibility for property assets and should include sufficient detail to ensure accurate and appropriate accounting for property inventory. MSD should include its inventory and property control policies in its Policy Manual.

Finding 3: MSD lacked management oversight and enforcement of established policies.

MSD management has not consistently followed, nor has it required its staff to follow, policies and procedures established by the Board and management to provide fairness in its business practices, to manage risks, and to hold itself accountable to ratepayers.

In many instances, MSD has designed and drafted adequate policies and procedures to guide its staff in its day-to-day operations. The policies established by the Board are necessary to provide limits by which MSD personnel may make their decisions. The procedures are a means by which the organization can document institutional knowledge in the event of personnel turnover.

Policies and procedures are only effective if personnel are informed that such exist, are trained in how to implement the policies, are required to follow the policies, and are held accountable by management when violations of policy occur. Further, and perhaps most critical, management must lead by example and demonstrate significant respect for the established organizational policies and procedures.

As auditors conducted the examination of MSD, looking at the policies in place and testing various financial transactions and activity to determine MSD compliance with its established policies, we found multiple violations of various MSD policies and procedures at all levels within its organizational structure. We identified noncompliance in the following policy areas.

Procurement of Professional Services

While examining procurement processes, auditors found several instances of process violations. Auditors found services performed months before a contract was signed. We found MSD personnel procuring services without documenting the procurement method that would be followed in procuring the service. We also found that the wrong procurement methods were followed.

In most of those instances MSD management, including executive level management, was involved in the violations. For further information related to certain procurement issues, see Finding 20.

*Procurement of
Computers*

During the examination process, auditors also identified violations of the Electronic Communications Media Policy by MSD personnel. The MSD Chief Information Officer (CIO), was aware of MSD personnel purchasing computer equipment without going through the MSD Information Technology (IT) staff despite its policy that clearly requires, with few exceptions, that all purchases of computer software and equipment must be made by the MSD IT Division.

The discussion with the CIO occurred after auditors were attempting to locate the Administrative Services Manager's MSD issued laptop. While the CIO's database indicated that the Manager still had a laptop, we found that the Manager had purchased a newer laptop for himself and one of his staff members with MSD funds. In regards to purchasing the laptop himself, the Administrative Services Manager stated, "[w]ith my director's permission, we never purchase through IT because it takes them 2-3 months to get them to internal customers." He noted that the laptops were used for the telecommunications and security system and that the MSD IT Division did not support the related applications or equipment.

According to the Physical Assets Director, he had given his permission to the Administrative Services Manager years ago to purchase laptops needed by that department to support their job functions and stated that he had not discussed the issue with the CIO for some time. The Physical Assets Director stated that while this was the only department within his division that purchased their own equipment he believed there were others within MSD that had done so as well.

While auditors discovered that there was at least one other group within MSD who did not consistently purchase its computers through its IT Division, it is our understanding that these exceptions are for computer equipment used on the MSD industrial network and as such are the allowed exception per the MSD policy.

In addition to the laptop purchases by the Administrative Services Department, auditors found the Department had also purchased four wireless aircards through the use of MSD purchasing cards. Aircards are mobile or wireless modems that connect to standard cellular networks to connect laptops to the internet when internet access is not otherwise available. According to the CIO, these aircards should have also been purchased through MSD IT Division.

Findings and Recommendations

Education Reimbursements

One of the benefits available to MSD employees is its Education Assistance Program administered by the Human Resources Department, which reimburses MSD employees for education courses they take. Through testing a sample of MSD employee expense reimbursements for FY 2009, 2010 and 2011, auditors identified instances where MSD employees were reimbursed yet the reimbursements were made to the employees even after the policy requirements were not met.

Between July 1, 2009 and June 30, 2011, MSD paid \$238,722.89 to its employees for education expense reimbursements. In FY 2009, MSD paid \$49,244.98 in education reimbursements while that amount nearly doubled by FY 2011, as MSD paid out \$99,656.92 to its employees.

According to its policy, MSD will reimburse full-time and part-time employees through this program for “[a]ny courses undertaken to either maintain or improve an employee’s required job skills or prepare for advancement.” The policy establishes limits, such as a maximum eligible course load, maximum percentage that will be reimbursed, as well as a maximum amount of tuition and book costs that may be reimbursed. The policy also establishes deadlines for application to the program and for when the reimbursement requests must be submitted.

The following is a summary of the issues indentified by auditors while testing the education reimbursements:

- Several employee applications were approved after their class began.
- Three instances where no application for the program was found.
- Several instances where relevancy of the class to the employee’s job was missing or lacked detail. In some cases, the application just stated that the class was a requirement of a particular degree program.
- Three instances of an employee reimbursed beyond the annual book allowance.
- One instance of an employee reimbursed 100 percent for a pass/fail class, which the employee passed. The policy was to only reimburse a pass at 50 percent.
- Six instances where it appears MSD reimbursed for other than the allowed items, such as installment and deferral fees and in one case lodging during a field study class.
- One instance where employee was reimbursed \$40 more than they requested.
- Instances where support documentation was not provided for reimbursement.
- Several instances where reimbursement requests were made after the required three week period.

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- Several instances where the reimbursements were requested before the class was to end. In some of those cases, the reimbursements were made before the classes were reportedly ended.
- Instances of inadequate documentation provided by employees to Human Resources.

Employee Expense Reimbursements

MSD Employee expense reimbursements, excluding education expense reimbursements, totaled \$275,275.95 for the three-year period of FY 2009, FY 2010, and FY 2011. After selecting a sample from this population of expenditures to test, we again identified several instances where MSD's policies were not followed.

The most significant policy violation identified by auditors while testing this policy area was a single reimbursement of over \$11,000 paid to the MSD Regulatory Services Director in FY 2009. The reimbursement was for travel expenses the Director had accumulated over a three-year period. The MSD Travel Policy states, “[e]xpense reports are due within ten (10) business days of returning from your trip.”

According to the Regulatory Services Director, he had not taken the time to submit his multiple travel vouchers and had just submitted them all at once. He stated that the former Finance Director did discuss the reimbursement with him. The Regulatory Services Director acknowledged that it was after the allotted period of time for an employee to be eligible for reimbursement, but the reimbursement was made despite the violation of the MSD policy.

During the interview process, the Regulatory Services Director acknowledged currently having five outstanding travel vouchers, this time dating back to April 2011 and totaling approximately \$3,000. The purpose in submitting travel reimbursements for processing shortly after travel is to ensure that the expenditures are accounted for in the proper accounting period.

In several other cases, auditors found itemized receipts for meals but the invoices indicated that multiple meals were purchased. The policy requires individuals to be identified; however, according to those processing the reimbursements they were told to process the payment as long as the supervisor approved it. One individual stated that she questioned an employee about what appeared to be two meals on a single receipt. The employee seeking the reimbursement claimed they ate two meals. The employee processing the payment stated that the former Finance Director told her that as long as the supervisor approved it then it was okay to pay.

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The following is a summary of other issues identified by auditors during testing of employee expense reimbursements:

- Instances in which travel justification forms were not turned in with the reimbursement form.
- Reimbursements were allowed without having proper support or documentation, such as conference information, detailed receipts, or names of individuals attending meals.
- One instance where an employee was reimbursed a meal that included an alcoholic beverage.
- One instance where an employee was reimbursed for purchasing equipment once they had reached a training destination.
- Two instances where an employee was reimbursed based on a gas receipt rather than on mileage and there was no indication of a car rental.

Summary

Through testing of various policy areas, auditors discovered that MSD management has demonstrated a failure to adhere to its own policies. MSD executive management is leading by example and demonstrating to its employees that the policies established by the organization are optional business practices rather than boundaries within which to operate.

Management must be held to the same standards as its employees, it is not sufficient to simply put policies and procedures in place, they must also be consistently followed to be effective. As a governmental entity, MSD must provide proper governance over its business practices to ensure transparency and accountability.

Recommendations

We recommend the MSD Board discuss with its executive management the need for proper oversight and governance of its operations. Although it is not the Board's responsibility to oversee day-to-day business operations of the organization, the MSD Board is responsible to ensure strong leadership is in place and is working within the boundaries the Board has established.

We recommend the MSD Board require supervisory personnel to be re-trained on key organizational policies. The trainings should occur in-house at MSD facilities and could be conducted by MSD's own Human Resource Department staff or its Legal Department staff. Employee attendance for the training should be required and documented. Upon completion of training, MSD personnel should be required to sign an affidavit stating that they have been trained and understand their responsibilities as an MSD employee to abide by the policies and procedures of the organization. The statement should further acknowledge that the employee understands the consequences of not following the different policies.

Findings and Recommendations

We further recommend MSD hold its personnel accountable to the policies. If a violation of policy occurs, such as an employee not submitting a reimbursement request in a timely manner the employee should understand that a reimbursement will not be made. We recommend all levels of MSD management consistently follow and enforce adopted policies.

We recommend the Board evaluate the current MSD Education Assistance Program to ensure it is structured to provide the best benefit to the organization and the ratepayers.

Finding 4: MSD ethics policies for Board members, appointed executive staff members, and employees were not sufficient to address conflicts.

MSD revised its ethical policies for Board members, appointed executive staff, and employees during the APA’s period of review with an intent for improvement, but such policies still lack some significant provisions pertaining to certain ethical issues. The lack of strong, enforceable ethics policies allowed the potential for, as well as actual, conflicts of interest by certain MSD Board members, executive staff, and other employees. Although sanctions exist for employee violations of the ethics policies, no policies for investigating unethical activity of employees exist. Further, there are no policies detailing the investigation of unethical activity or criteria to impose sanctions or disciplinary procedures for violations by Board members, the Executive Director, or the Chief Engineer. Finally, no ethical policies exist for reporting improprieties directly to the Board.

Ethics Policies

During the APA’s period of review, MSD had policies in effect applicable to the ethical behavior of its employees that were documented in two policy manuals, as well as in one Board resolution. The latter document also includes limited ethical provisions applicable to MSD Board members and appointed executive staff. The Policies and Benefits Manual for Non-Unit (non-union) Employees (draft version 9-1-11), and the Policies and Benefits Manual for Unit (union) Employees (draft version 9-1-11), both contain sections entitled “Standards for Ethical Employee Conduct” that include identical guidelines for MSD employees to avoid conflicts of interest. The third MSD document providing ethical guidance, a resolution pertaining to a Conflicts of Interest Policy, adopted by the Board on November 10, 2003, and revised on March 28, 2011, applies, in part, to Board members and, in part, to employees. According to the resolution, the MSD Executive Director and the Chief Engineer are not considered employees, but rather are included under the definition of “Board Member.”

Standards for Ethical Employee Conduct

The Standards for Ethical Employee Conduct section of the Policies and Benefits Manuals, for unit and non-unit employees, is a compilation of various policies and procedures that mostly have been in existence for many years. Employees are required to sign an acknowledgment that they have received a manual and that they understand it is their responsibility to carefully review and become familiar with its contents. The newest updated version of the manual, which is still in draft form for unit employees, includes the following guidelines for MSD employees:

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- Display high standard of ethical behavior;
- Do not use position to provide special privilege to employee, to other individual or organizations;
- Be bound by any applicable occupational or professional standards of conduct;
- Avoid participating in decisions or deliberations bearing on business transactions in which a potential or actual conflict of interest exists;
- Keep confidential information confidential;
- Do not show favoritism between customers or vendors;
- Do not personally profit from MSD business (i.e. not use position to solicit customers for private business);
- No outside employment that conflicts with MSD employment;
- No acceptance of money, thing of value, or economic benefit in return for services rendered other than that provided by MSD for performance of duties;
- No acceptance of gifts, gratuities, favors or anything of monetary value, such as tickets or payment for sporting, recreational and charitable events, from anyone or who may have business with MSD except for food and beverages consumed on the premises at receptions or parties involving business clients, or insignificant items with a value of \$10 or less, or are strictly promotional in nature; and,
- Do not use MSD property for personal use or profit.

The Standards for Ethical Employee Conduct also include sections with guidance on:

- Employee Moonlighting requirements;
- Proper Use of MSD Assets; and,
- Political Activity.

While these provisions are sound guidelines for employees, the policies fail to address several other areas of conduct such as solicitation, service on outside boards and advisory commissions, investment/stock ownership, contracting or doing business with MSD, post-employment, financial disclosure, and acting as a representative of MSD before a business owned by a family member.

Resolution Adopting Conflict of Interest Policy

In addition to specific guidance for its employees, the MSD Board adopted the Conflict of Interest Policy resolution, mentioned above, to set forth standards for Board members, the MSD Executive Director, and the Chief Engineer in order to evaluate potential conflicts and assure the public that none exist. The resolution in effect from July 1, 2008 through March 27, 2011 included the following provisions:

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- All members of the Board shall disclose any known conflict of interest and shall avoid participating in any decision or advocating any subject matter before the Board in which the member or any member of the member's immediate family has a conflict of interest...
- This policy shall not prohibit a Board member, an organization which employs a Board member, or an organization in which a Board member has financial interest from pursuing a MSD purchase, contract or subcontract. However, such Board member must first inform the other Board members of his or her intent to participate in MSD purchase transaction.
- Board members who pursue or obtain a MSD purchase, contract or subcontract will not request any special treatment; and employees will not provide any special treatment to the Board member but will treat the Board member as he or she would treat any member of the general public.

Upon revision of the Conflict of Interest Policy resolution in March of 2011, the last two provisions stated above were removed, and the following provision was added:

- A Board member or an organization in which a Board member has financial interest shall not pursue a MSD purchase, contract or subcontract.

Both versions of the Conflict of Interest resolution include three provisions specifically for employees that also are included in the Standards for Ethical Employee Conduct section of the Policies and Benefits Manuals detailed previously.

Again, while the provisions in this resolution provide some limited guidelines for Board members, the Executive Director and the Chief Engineer, the policies fail to address many other areas of conduct such as outside employment, employment of relatives, use of official position to obtain a benefit, solicitation, acceptance of gifts, service on outside boards and advisory commissions, investment/stock ownership, post-employment, use of confidential information, honoraria, financial disclosure, political activity, and acting as a representative of MSD before a business owned by a family member.

The APA is aware that a committee of the Board also has recently reviewed, but not yet approved, a "draft ethics policy" specifically to be applicable to Board members. For purposes of this examination, the policies reviewed by auditors were those in effect during the period under review

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Statement of Financial Disclosure

Although MSD has a policy for both Board members and employees to disclose any known conflicts of interest, this disclosure is not required to be in writing. Furthermore, MSD has no requirement of an annual written statement of financial disclosure to be filed by Board members or executive management. Financial disclosure statements allow the public to determine whether individuals responsible for the management of public moneys possess any conflicts of interest or potential conflicts between their private interests and their employment/board member duties. Lack of such disclosure may reduce the public confidence in the integrity of those officers and employees responsible for the management of publicly funded entities.

Reporting Misconduct

Policies within the Policies and Benefits Manuals direct an employee who has been the recipient of misconduct to report the violation to his or her supervisor, any member of management, and/or to the Employee Relations Administrator or Human Resources Manager. Yet, no policy exists that allows employees or the general public the means to report illegal or unethical behavior directly to the Board as detailed in Finding 1 regarding Board governance.

High Ethical Standards

The citizens of Louisville and Jefferson County have a right to expect Board members, executive staff, and employees of a ratepayer funded sewer district to comply with high ethical standards of conduct in their administration of the district. Ethical standards of conduct applicable for Board members, the Executive Director, the Chief Engineer, management and other MSD employees, if enforced, serve to uphold the ethical behavior of such individuals. MSD's ethical provisions for employees, Board members, and appointed staff, allow improper exceptions for conflicts of interests and the acceptance of gifts, do not provide sufficient specificity regarding conflict situations, and do not address many of the standards that are required for such individuals to be accountable and ethical in their decision-making. Without expanded comprehensive policies, conflicts may still exist, and Board member and staff decisions may not be made impartially. Examples of situations where conflicts of interest occurred are detailed in Finding 5.

Recommendations

To remain independent in their decision-making regarding entities doing business with MSD, or seeking to do business with MSD, Board members, executive staff, and other employees should avoid any situations that are actual conflicts between their private interests and their duties on behalf of MSD, or that have the potential to present conflicts. Neither should they accept gifts and gratuities that compromise the impartiality of their decision-making on behalf of MSD, or that give the appearance that MSD actions are based on personal benefit, favors, or relationships, rather than objective decision-making.

Findings and Recommendations

We recommend the Board establish a comprehensive code of ethics, applicable to Board members, appointed executive staff members, and all employees. MSD may want to consider having someone skilled in establishing ethical standards for public employees and board members assist in the drafting of such policy standards. Upon adoption by the Board, the code of ethics should be incorporated into the two Policies and Benefits Manuals for employees (unit and non-unit), as well as any manual given to Board members during orientation. We recommend MSD provide initial training for Board members, appointed executive staff and employees on the code of ethics, as well as a review annually.

In developing a comprehensive code of ethics applicable to Board members, as well as appointed staff and employees, the following areas of conduct should be considered for inclusion:

- General standards of conduct;
- Contracting, subcontracting, having an agreement, or doing business with MSD;
- Use of official position to obtain financial benefit, privilege or advantage for self or others;
- Involvement in matters where an ownership interest exists;
- Use of confidential information;
- Use of MSD property, time, equipment;
- Solicitation;
- Acceptance of gifts and gratuities;
- Employment of relatives;
- Transactions with subordinates;
- Outside employment;
- Service on Boards and Commissions;
- Honoraria;
- Investment/ Stock ownership;
- Representation;
- Post-employment;
- Political activity; and,
- Financial disclosure.

In establishing a financial disclosure policy, we recommend the MSD Board members, as well as all executive team members, annually file with an appropriate committee of the Board, and by a specified date, a statement detailing financial interests held. Required information should be prescribed by an appropriate committee of the Board. The Board should consider including the following disclosures on the prescribed form:

- Name, business and home addresses, telephone number and e-mail address of the filer;
- Title of position or office whereby filing is required;

Findings and Recommendations

- Any other occupation of the filer or filer’s spouse;
- Businesses in which the filer or filer’s spouse hold a specified percentage of interest. The policy should numerically state the percentage of business ownership required to be reported;
- Sources of income to the filer, filer’s spouse, or filer’s immediate family members exceeding a specific amount (dollar amount should be specified in the policy);
- Real property owned by the filer, the filer’s spouse, or the filer’s immediate family, and its location;
- Creditor’s of the filer, the filer’s spouse, or the filer’s immediate family who are owed more than a specified amount. The policy should specify the dollar amount required to be reported; and,
- Sources of gifts over a specified amount, which should be stated in the policy, to the filer, the filer’s spouse, or the filer’s immediate family, except for gifts from family members.

The policy should further require an affirmative statement by the filer that he or she has no interest that would cause a conflict with his or her official duties. Sanction for noncompliance with the filing requirements also should be detailed in the policy.

To ensure compliance with the code of ethics adopted, MSD should develop and implement policies, procedures, and responsibilities regarding reporting, investigation, and resolution of allegations of ethical misconduct as detailed in the recommendations of Finding 1 regarding a whistleblower policy.

Finding 5: Several conflicts of interest existed that gave the appearance of improprieties by certain MSD Board and staff members.

MSD’s Policies and Benefits Manuals for employees and MSD’s Conflict of Interest Policy for Board members and appointed executive staff, were not effective in preventing conflicts of interest for Board members, executive staff, and other employees. Several instances of specific conflict of interest situations were identified that may have contributed to unfair business practices. It is impossible to determine if the vendors/contractors MSD used provided the best services at the best cost when relationships allowed the potential for favoritism and influence of independent decision-making.

MSD Board members, appointed executive staff, and employees should be independent and impartial in the actions they undertake and decisions they are called upon to render, making certain that such decisions are in the best interests of those who use the services of MSD in Louisville and Jefferson County. The selection of contractors and other vendors should be made without even an appearance of bias based on friendships or other relationships. It is the responsibility of the MSD Board to ensure that conflicts of interest do not exist and to set an example for employees.

Chapter 2

Findings and Recommendations

Conflict of Interest Situations

During our period of examination, based on information provided, auditors found several instances where conflict of interest situations existed for both Board members and employees, as detailed below:

Chief Engineer

Upon his employment, a recently resigned Chief Engineer took no action to abstain from involvement in matters related to the engineering firm he formerly owned. Ten days prior to his employment with MSD in 2008, MSD's now former Chief Engineer sold his ownership interests in an engineering firm which he had helped to establish in 2003. According to MSD's Board Legal Counsel, MSD policy did not require the newly hired Chief Engineer to abstain from immediate involvement with his former company as a part of his official duties. However, in both the November 10, 2003 and March 28, 2011 Conflict of Interest Policies passed by the Board and applicable to the Chief Engineer, they define "Conflict of Interest" as occurring "when the employee or Board member is in a position to affect significantly the business transactions of MSD with the organization in which the employee or Board Member has an interest. An employee or Board Member has an interest in an organization; ...ii. which employs, **has employed within the last 12 months** (emphasis added), or has an arrangement to comply, retain as a consultant, or pay a commission to that person or his immediate family..." In order to avoid any actual, or apparent conflict of interest, employees should abstain from involvement for a minimal period of time, at least 12 months in this case, in any matters pertaining to their former employers.

MSD's now former Chief Engineer also co-owned a business that was the landlord for one of his former engineering firm's office sites. The engineering firm had a year to year lease for the space. According to the former Chief Engineer, the payments by the engineering firm were market value of \$15 per square foot which was equal to the mortgage payment plus taxes. As MSD's Chief Engineer, he had involvement, including selection and oversight, in numerous MSD contracts with the engineering firm that leased space from the company he co-owned. Of the 18 contracts that MSD had with the engineering company that leased space from the former Chief Engineer's private business, the former Chief Engineer was directly involved in at least 12 of the contracts as documented by his signature on the Procurement Method Determination Forms, his designation as the Procurement Officer for the contract, and/or his signature on work orders under the contract. The contracts between the engineering company and MSD ranged in value from \$4,000 to \$2,800,000 and totaled \$4,488,357 over a three-year period. His involvement with contracts for a company that leased space from a business he co-owned presented a conflict between his personal interest in his private business and his duties on behalf of MSD.

Chapter 2
Findings and Recommendations

CIO

The sole officer of a consulting firm that did business with MSD during our period of examination and MSD’s CIO were married in December of 2010. Prior to and from the date of the marriage until or about June 30, 2011, the sole officer was supervised by MSD’s Project WIN Information Management Administrator, who reported directly to MSD’s CIO. The Project WIN Information Management Administrator also approved and signed the sole officer’s invoices. Between FY 2009 through 2011, MSD paid the sole officer of the consulting firm a total of \$328,200. Even though the CIO may have appropriately abstained from involvement in any supervision of the sole officer, the fact that he supervised the Project WIN Information Management Administrator caused her to be conflicted in her supervision of the sole officer of the consulting firm and her duty to act independently on behalf of MSD.

Administrative Services Manager

MSD’s Administrative Services Manager used his official capacity to give MSD mowing business to private vendors with which he has private affiliations displaying favoritism in violation of MSD employee conduct policy. The Administrative Services Manager is authorized to hire private vendors to mow certain MSD properties. As such, the Administrative Services Manager procured services from a number of businesses with which he had close/personal relationships to provide the services. A total of \$530,981 was paid by MSD to eight related businesses, including MSD payments of \$338,503 to a high school friend of the Administrative Services Manager, who owns three of those businesses. The Administrative Services Manager conveyed to the auditors “that’s what you do in business – help each other out - help people you know.”

Table 5: Mowing Vendors

Administrative Services Manager Relationship to Vendor (Individual Owner)	Number of Vendors Owned by Single Individual Owner	Amount Paid to Vendors
High School Friend (FY 2007 – FY 2012)	Three	\$338,503
Pastoral Colleague (FY 2007 – FY 2012)	Two	118,010
Deacon in Church Pastored by Administrative Services Manager (FY 2009 – FY 2012)	One	8,450
Current Friend and Former Girlfriend (FY 2010 – FY 2011)	One	11,093
Long time Friend (FY 2005 – FY 2012)	One	54,925
Total		\$530,981

Source: Auditor of Public Accounts based on information provided by MSD.

Findings and Recommendations

MSD's Administrative Services Manager also used his official position to give himself a benefit by using an MSD computer improperly during work hours for his private communications business, his work as a pastor, and his spouse's private events business. This improper use of time and equipment for his private businesses during work hours is detailed in Finding 21.

*Director of
Emergency
Response/Metro
Operations*

MSD had agreements to remove and haul wastewater with a company that is owned by the father of the son-in-law of MSD's Director of Emergency Response/Metro Operations. Although the Director had no involvement in the procurement process or approving of invoices, he was responsible for the scope of work and as the division Director did authorize the execution of the initial contract with the company. The initial purchase order contract with the company was for \$156,000, with three renewals of \$80,000 each. Although there is not a direct family relationship between the contractor and the Director, this relationship could present a conflict for the Director.

Board Members

During the period of review, MSD had six different contracts/agreements with a computerized mapping company for which a then Board member and Chair served as President and Chief Executive Officer. The six contracts totaling \$597,411 were for in-house support of a senior spatial analyst, mapping and spatial analysis in relation to MSD efforts for green infrastructure mapping and flood pump station failure analysis, as well as, a GIS technician for the update and maintenance of MSD's sanitary drainage GIS data. The services were procured as non-competitive professional services agreements. The total expenditures paid by MSD to the mapping company under this contract from July 2008 through April 2011 totaled \$410,181. MSD also paid the company \$328,722 as a subcontractor. Although no MSD policies existed that prohibited such agreements by MSD and a company owned by a Board member, and the Board Chair was advised to abstain from Board action regarding the company, such action created an inherent conflict of interest for MSD employees in their procurement and administration of the contract.

During FY 2009 through 2011, MSD paid \$14,235 through a contract, \$1,750 as a small purchase, and \$70,848 through a subcontract, to a roofing company owned by a then Board member and Chair who served during the period under examination. Although no MSD policies existed that prohibited such agreements by MSD and a company owned by a Board member, and the contract was procured through competitive bidding, such action created an inherent conflict of interest for the MSD Board and member and for MSD employees in their procurement and administration of the contract.

Findings and Recommendations

Between August 2008 and December 2010 MSD paid a company co-owned by a then Board member \$16,350 for a subscription service on real estate trends. No contract or agreement existed for the subscription service. MSD employees responsible for the approval of this procurement are no longer employed by MSD and neither the former employees, nor any current MSD employees, have any recollection of how the subscription service was procured. The former Board member stated that he had invited MSD to attend a presentation on the services of the company. Although no MSD policies prohibited the procurement of such a service from a company co-owned by a Board member, such action created an inherent conflict of interest for MSD employees in their procurement and administration of the service.

During FY 2011 MSD paid \$24,677 for repair services on MSD equipment to a business owned by the sons of a then MSD Board member. Due to its cost, this service was not a procurement that was required to have Board approval, but nonetheless, it may have caused undue influence on MSD employees in their procurement and administration of this service.

During the APA's period of review beginning July 1, 2008, the spouse of the employee who served as MSD's Human Resources Director until December 31, 2008, was paid by MSD as a subcontractor \$69,550 for services rendered between July and December 2008. As an MSD employee, the Human Resources Director, through her spouse shared in the financial benefit of the subcontract held by her spouse with the agency by which she was employed, creating a conflict of interest for her. After the retirement of the Human Resources Director, the spouse continued to be paid as a subcontractor and also directly by MSD a total of \$266,987.

*Donations/
Contributions/
Sponsorships*

MSD gave numerous donations, contributions, and sponsorships to various organizations that were associated with Board members, executive staff and/or employees. See Finding 25 for more information on this matter.

Ineffective Policies

The limited ethical guidance provided in MSD's Conflict of Interest Policy for Board members and appointed executive staff, and in its Policies and Benefits Manuals for employees did not appear to be effective in prohibiting the conflicts of interest noted previously. The fact that Board members and employees, and related businesses, were not prohibited from holding contracts with or being vendors of MSD allowed inherent conflicts that created a climate of partiality and the appearance of influential decision-making, whether it existed or not. Without a comprehensive code of ethics, including a strong, detailed conflict of interest policy, that is enforced by management, actions and decisions taken by employees and Board members may not be made independently in the best interest of the citizens, and may give the appearance of preferential treatment.

Findings and Recommendations

Recommendations We recommend the MSD Board, within its comprehensive code of ethics, provide standards of conduct for conflicts of interest that prohibit Board members, appointed executive staff, and employees from the following:

- Having a primary contract, subcontract, or agreement with MSD, either directly, by a family member, or through a business which is at least five percent owned;
- Representing a person of business privately before MSD;
- Using his or her position to obtain a financial gain, a benefit, or an advantage for oneself, a family member, or others;
- Using confidential information acquired during his or her tenure to further his or her own economic interest or that of another person;
- Holding outside employment with, or accepting compensation from, any person or business with which he or she has involvement as part of his or her official position for MSD; and,
- Involvement in discussions and decisions pertaining to:
 - Persons or businesses from which he or she has accepted gifts or gratuities over a specified amount;
 - Matters involving businesses in which he or she has a direct or indirect financial interest of over five percent;
 - A former employer or previously owned company within the last 12 months;
 - Persons or businesses with which they have a partnership or financial ownership of over five percent;
 - Persons or businesses with which he or she competes privately;
 - Matters involving family members, or businesses owned by or employing family members; and,
 - Any other matter that presents a conflict between a personal interest and a duty to MSD and the citizens of Louisville and Jefferson County.

Board members, appointed executive staff, and other employees who abstain from involvement in discussions and decisions as recommended above should not be present during such discussions, and such abstention should be documented in writing and placed in the employee's personnel file or recorded in the minutes of a Board meeting.

To ensure compliance with the conflict of interest policies adopted, MSD should develop and implement policies, procedures and responsibilities found in Finding 1 regarding reporting and resolution of complaints.

Finally, we reiterate MSD's Policy and Benefits Manuals that state: "As public servants, employees must display a high standard of ethical behavior that ensures the public that employees do not use their positions to provide special privileges to themselves, to other individuals or organizations."

Findings and Recommendations

Finding 6: MSD’s primary legal services contract has been with the same attorney’s firm since 1984 while never being competitively negotiated or advertised.

MSD has not competitively negotiated or advertised its primary contract to provide legal services to the MSD Board, Legal Director, Executive Director, and act as “Bond Counsel” as needed. Since 1984, the same attorney has acted as the MSD Board Legal Counsel and that same attorney’s law firm (Firm) has received MSD’s contract to provide multiple types of legal services for an average annual amount paid to the Firm of \$1 million over the past three fiscal years. As the MSD Board Legal Counsel, this attorney reviews and approves all matters prior to their submittal to the MSD Board for action, along with all of the other outside legal services requested by MSD. Therefore, the attorney’s relationship with the MSD Board could impair the Board’s objectivity and independence related to advertising this contract to other law firms. Even though MSD Procurement Regulations give the Board the authority to waive any procurement requirement if it is in the best interest of MSD, a decision to continually authorize this contract with no request for proposals, competitive negotiations, or advertising is not a responsible action by the board of a public entity. Without advertising this contract, public confidence in the entity may be diminished and a concern exists that MSD is overpaying for legal services.

In a Resolution adopted on April 2, 1984, the MSD Board documented their desire to have its Board Legal Counsel review and approve all matters including resolutions, agenda items, and all other documents prior to their submittal to the MSD Board for action. This resolution gives the MSD Board Legal Counsel significant authority with the Board. See Finding 7 for additional information. Contracting with this attorney’s firm since 1984 for the majority of all other external legal services appears to be a conflict and waiving procurement requirements for this contract should not be acceptable.

The MSD Procurement Regulations related to Professional Services contain the statement that the “Board may choose to waive any or all requirements under this section if deemed to be in the best interest of MSD and select the person(s) or firm(s) best qualified to perform the required service.” Following this statement is a requirement that “[w]hen the Executive Director determines in writing that the procurement of engineering and other professional services is governed by these regulations, then the Executive Director shall use one of the following methods to obtain the services;”

1. Competitive negotiations;
2. Executive Director selects the vendor from a pre-qualified list; and,
3. Non-competitive negotiations.

While there are methods that could have been used to negotiate this contract, the Board authorized this contract without requiring any of the three actions be taken. In addition, there is no requirement in the regulations that the MSD Board justify why this contract is in the best interests of MSD.

Findings and Recommendations

This contract has provided the Firm with an average of \$1 million annually for all the services provided by the Firm. The contract terms make it difficult to determine whether excessive legal fees were charged. See Finding 9. The legal services contract requires that the Firm divide their monthly billing into three sections based on the type of legal work performed. Based on these billings, the amounts paid to the Firm for four different types of services can be accumulated. The following table illustrates the amount received by the Firm for each of the service types for FY 2009, 2010, and 2011.

Table 6: Amounts Paid to the Firm for Legal Services by Type

Legal Service Category	FY 2009	FY 2010	FY 2011	Totals
Litigation for MSD Legal Counsel	\$582,578	\$608,487	\$667,353	\$1,858,418
Litigation related to EPA Cases	68,616	29,194	24,085	121,895
MSD Board Legal Counsel Services	21,044	35,200	35,569	91,813
Co-Bond Counsel	165,000	535,000	275,000	975,000
Totals	\$837,238	\$1,207,881	\$1,002,007	\$3,047,126

Source: Auditor of Public Accounts based on information provided by MSD.

By combining multiple legal services, as well as MSD Board Legal Counsel services, into one contract, it is difficult for the MSD Board to be objective and maintain their independence due to their relationship and substantive history with this attorney. Separating each category of legal service into separate contracts would allow for a more independent and objective process in procuring legal services.

Competition, transparency, and accountability are maximized when an outside service is publicly advertised and the proposals received are judged on the basis of established criteria and awarded based on the recommendation of an evaluation committee made up of selected staff. These procedures promote public confidence in the contracting process and that the public entity is not overpaying for services.

Recommendations

We recommend that MSD designate this contract as an applicable professional services contract that should be periodically advertised and competitively negotiated to ensure MSD's best interests are met. Due to the multiple types of legal services that can be assigned to this Firm and attorney, the contract should be separated based on the type of legal services needed. An analysis should be performed to determine the need for outside legal services. Based on the results of the analysis, a separate request for proposals should be developed for advertising each type of service and an evaluation committee should be created to evaluate the responses using specific criteria. The evaluation committee should consist of staff members that are informed and knowledgeable regarding the services needed by MSD. We recommend the Board consider whether Board Legal Counsel should be independent of all other legal services.

Findings and Recommendations

**Finding 7: Board
Legal Counsel
given approval
authority in MSD
Board process.**

Through authority granted by the MSD Board, the Board Legal Counsel could potentially hinder the Board's control and intervene in the managerial process. A MSD Board resolution issued in 1984 provides the Board Legal Counsel an approval and oversight role over all matters coming before the Board. Specifically, the resolution states that Board Legal Counsel, "shall review and approve all matters including resolutions, agenda items, and all other documents prior to their submittal to the MSD Board for action." This approval authority over all matters prior to their submission to the Board could be used to subvert Board control and keep certain items or issues from being brought before the Board if the Board Legal Counsel refused to approve such items for the agenda. This could include the review of the Board Legal Counsel's contract, which is identified as a potential conflict in Finding 6. This would limit both the Board's authority to determine items they wanted to review and discuss, and management's ability to present items to the Board seeking approval or input. The preemptive review process also limits the ability of the Board and MSD management to control the costs of the services provided by the Board Legal Counsel and duplicates work performed by internal staff.

No indication has been given that the Board Legal Counsel has ever used the approval authority to deny certain items from being presented to the Board by MSD staff. Instead the authority granted by the 1984 resolution appears to primarily be used as a legal review procedure so that the Board Legal Counsel may be aware of issues in advance for Board meetings and provide opinions on issues being presented to the Board. It is uncommon to provide an outside attorney with approval authority over an internal process of a public agency, and does not preclude Board Legal Counsel from denying agenda items in the future. Also, the matters to review prior to Board meetings are at the discretion of the Board Legal Counsel. This limits control of these services by MSD and duplicates certain work performed by internal staff.

MSD currently maintains an internal agenda committee made up of four MSD staff members. This committee determines those items that need to go before the Board, produces the agenda, and ensures any necessary supporting documents have been compiled into an information packet for Board members. This committee works closely with the MSD Legal Director, who performs an internal review and makes recommendations to the committee. According to the requirements of the 1984 resolution, the agenda and packet are then sent to the Board Legal Counsel for review and approval, effectively inserting the third party contractor into the managerial process.

According to the invoices submitted by the Board Legal Counsel, review of the Board agenda may take up to an hour per Board meeting. Further research conducted or memos derived from the agenda items and Board packet can take additional time, as can internal discussions among attorneys in the Board Legal Counsel's firm. At a partner rate of \$130 per hour, this work can incur thousands of dollars in legal fees each year for services that appear to already be provided by salaried staff.

Findings and Recommendations

While it may be necessary for Board Legal Counsel to provide a second opinion to the Board on certain items, this does not appear to require preemptive research. Initial research and data collection is already conducted by MSD staff and the Legal Director during the regular managerial process. Should additional information be required, it should be those salaried staff that produce further research. If a secondary opinion by Board Legal Counsel is needed on the work being conducted or produced by staff, it should be done at the specific request of the Board, the Executive Director, or Legal Director during a meeting. Authorizing the Board Legal Counsel the discretion of determining which issues to research and review removes the MSD Board's and MSD management's ability to limit the services being provided by the outside contractor and the costs incurred by MSD.

Recommendations We recommend the MSD Board rescind the 1984 resolution that requires a review and approval of all matters by the Board Legal Counsel prior to presentation to the Board. Secondary reviews by Board Legal Counsel of issues or documents presented to the Board should be performed only upon request by the Board, Executive Director, or Legal Director and only for the specific incidence of the request. We recommend the Board not make a blanket request of the Board Legal Counsel to review all documents or issues of a certain type.

Finding 8: Legal services contract lacks centralized oversight.

The MSD internal Legal Director does not have appropriate levels of control and monitoring authority over the primary outside legal service contract. Currently, the contracted law firm acts as Board Legal Counsel, MSD's litigation representation, EPA Consent Decree representation, and co-bond counsel. Each of these four services has a separate oversight authority within MSD that is responsible for reviewing invoices and approving the expenses. This removes the legal experience and expertise of the Legal Director from the process of reviewing all aspects of outside legal services. It has also allowed for the influence of other reviewing authorities to potentially interfere with the authority of the Legal Director. This has resulted in weakening the authority of the Legal Director, who is employed to provide internal legal expertise and is directly responsible for ensuring the legal compliances and defenses of MSD.

According to the legal services contract, any work completed by the contracted law firm in the capacity of Board Legal Counsel is to be reviewed and approved by the Board. All litigation services are to be reviewed and approved by the MSD Legal Director. Any services related to the EPA Consent Decree are to be reviewed and approved by the MSD Executive Director. Also, while not specified in the legal services contract, the services provided related to co-bond counsel are reviewed and approved by the MSD Finance Director.

Findings and Recommendations

Currently, the Legal Director receives a billing invoice from the MSD Board Legal Counsel that includes charges for all litigation and Board Counsel services. While the contract with the Board Legal Counsel states the Legal Director is to only review and approve the litigation services, the Legal Director reviews both services prior to seeking the review and approval of the Board Chair for Board related matters. The Legal Director does not receive any of the Board Legal Counsel invoices for the services related to the EPA Consent Decree or work performed as co-bond counsel.

By segregating the review and approval process of a single legal service contract into four parts, it precludes the ability of one central authority reviewing the invoices to ensure there are no duplicate or otherwise questionable billings. It also removes the legal experience and expertise of the Legal Director from the oversight of all aspects of a legal contract. As the internal legal representation of MSD, the Legal Director should have the authority and responsibility of reviewing all legal billings prior to payment. Additional review and approval authority could still remain with other MSD authorities as needed.

The approval authority of the Legal Director over those legal services assigned by the contract should also not be interfered with by other authorities within MSD except through a formal protest procedure. As an example, in May 2007, the Board Legal Counsel presented MSD with an invoice that included a charge for an outside expert from Texas. The cost of the expert was for a total of \$937 for the expert to renew a professional license in the state of Kentucky. The Legal Director originally rejected this expense stating that MSD should not have to pay for professional licensure of experts. Shortly after the denial of the expense, according to the Legal Director, the Board Chairperson at the time made contact requesting that the expense be paid.

The action of the Board Chair would not be in keeping with the oversight process described within the legal services contract giving the Legal Director final approval authority over litigation services. It would also not be in keeping with the contractual requirement that Board Legal Counsel obtain the MSD Legal Director's approval before incurring expenses in excess of \$500 for all expert witnesses.

As the primary oversight body, the Board has ultimate authority over the actions of MSD; however, this does not give individual Board members unilateral authority to influence the established oversight process of the legal service contract. Such interactions have since given both a real and perceived message by the Board that the Legal Director does not have full control over the litigation services portion of the primary legal services contract. This weakened the authority of the Legal Director and may have kept the Legal Director from questioning other costs incurred by Board Legal Counsel for fear of unsupportive Board members.

Findings and Recommendations

To avoid future issues with legal service oversight, MSD must empower the Legal Director to properly oversee legal service contracts with the authority to both question and deny charges if needed. The MSD Legal Director must be recognized as the internal legal representative of the company, while the Board Legal Counsel remains a third party entity with a contract that should be enforced by MSD staff with legal expertise. The Board may retain oversight of the Legal Director's actions through the development of a formal protest procedure for vendors to contest denied charges, where it may be reviewed and discussed in an open and transparent manner.

Recommendations MSD should ensure that the internal Legal Director is responsible for legal contract compliance and reviewing all invoices associated with legal service contracts. The MSD Legal Director should regularly report on legal service expenditures and any related issues to the Board. Final approval authority for Board Legal Counsel services should remain with the Board to ensure an independent counsel, but all other legal services may have final approval by the Legal Director. Due to departmental budgetary oversight, other MSD authorities may still need to retain final payment approval.

MSD should also develop a formal procedure for vendors to protest a denial of certain expenses and request in writing an additional review of those expenses by a secondary authority. For legal service contracts, such a secondary review may be conducted by the Executive Director, the Board, or a designated Board committee. The final decision of the secondary review should be documented in writing with an explanation as to the final decision.

Individual Board members should refrain from attempting to influence the management process of MSD in a unilateral manner. Requests for changes to management should be made during Board meetings or meetings of Board committees and have the support of a majority of the members.

Finding 9: MSD's legal services contract terms are not well defined and are silent as to settlement procedures and conflict of interest disclosures.

MSD's legal services contract terms are not well defined and could result in MSD not maintaining sufficient control over the amount spent for contracted legal services. Aggravating this issue is that multiple types of legal work are included within one contract, which is discussed further in Finding 6. While the contracted firm (Firm) is relied on to abide by the ethics of the legal profession, the contract is silent as to MSD's expectations regarding legal settlements and the disclosure as to whether the Firm represents any clients with a potential conflict of interest with MSD. A contract with an outside entity should be clear in its expectations, designate a point of contact to oversee the terms of the contract, and include controls to govern the amounts allowed to be billed. Without these criteria, MSD cannot effectively and efficiently control the costs and use of this contract.

The legal services hourly contract rates are \$130 for partners, \$109 for associates, \$41 for paralegals, and \$21 for law clerks. These rates are slightly higher than the maximum rates allowed by Kentucky state government contracts for legal services that are \$125 for partners, \$100 for associate, and \$40 for paralegals. However, the contract did not specify that the Legal Director establish the number of attorneys that could charge the partner rate nor did it require justification for charging more than one attorney partner rate for a specific case. Further, the contract does not specify a not-to-exceed amount that can be charged to a specific case after which prior approval must be obtained before making additional charges.

According to MSD's Legal Director, it was assumed that only those that had significant experience would be charging the partner rate. In 2007, MSD conducted a review of billings that concluded that the partner rate was frequently charged by more than one attorney assigned to the case. The Firm explained that its attorneys are classified mainly as equity or non-equity members, and since the contract does not specify a rate for this classification, the partner rate is used.

The contract also allows the assignment of legal work based on the requests of multiple individuals. According to the contract, the Firm is to render "legal advice concerning legal matters when requested by the MSD Board, its Chairman or Officers, or by MSD's Legal Counsel." Another section of the contract states that "[a]ll assignments will be made by MSD's Legal Counsel unless otherwise provided by the Board, in which event the Board Chairman will confer directly with the Firm and will be responsible for verifying the accuracy of the bill rendered in connection with such assignment." In general, there is no designated person to monitor or control the costs incurred with this contract.

Prior approval of expenditures in addition to the billing of hours is only required by the contract for those costs related to expert witnesses. The contract states that the "Firm agrees to obtain the approval of MSD's Legal Counsel before incurring any disbursement for expert witnesses or extraordinary matters in excess of Five Hundred Dollars (\$500.00)." However, another section of the contract states that "[f]ees charged by such expert witnesses and investigators must be approved by MSD prior to their payment." Therefore, in one place, the contract requires prior approval from the MSD Board Legal Counsel, while another gives the authority to MSD in general and it is not clear as to how "extraordinary matters" should be interpreted.

For all other expenses, the contract does not discuss prior approval and simply allows for reasonable and necessary expenses. According the contract, the "Firm shall be reimbursed for all of its reasonable actual out-of-pocket expenses incurred as a direct and necessary incident to the performance of the professional services performed pursuant to this Agreement, including transportation expenses (less than first class rates for air travel when available) and other travel expenses such as meals and lodging."

Findings and Recommendations

Regarding settlement offers that may occur while the Firm is in the process of litigation, the contract is silent as to MSD's expectations and the issue of including non-disclosure requirements in a settlement. Settlements are a significant legal issue that can establish precedent and should be addressed by MSD within the contract for legal services. The contract should make it clear that, as a public agency, a settlement agreement with MSD is subject to the open records requirements stipulated by KRS 61.870, unless KRS 61.878 allows for a specific exemption that this information is to remain confidential and is not subject to release.

As for reporting any conflicts of interest, there is no requirement that the Firm disclose any actual or potential conflict between the Firm's clients and MSD. This information is needed by MSD so that a knowledgeable decision can be made as to whether MSD should use the Firm in litigation. Without this disclosure, the decision as to any conflicts of interest is made solely by the Firm.

This contract and its terms have not been modified since at least 2004, which is the first contract year that was included in our review. The loose contract terms and lack of requirements related to settlements and conflicts of interest provide few controls with which MSD can control the costs and use of this contract.

Recommendations We recommend that MSD amend its contract for legal services to ensure that MSD adequately controls the costs and responsibilities of the outside legal firm. Revisions should address the following areas:

- Specifically, define the experience requirements for billing at the partner or associate rates. The contract should require a justification if the partner rate is used by more than one attorney on the case. For optimal monitoring by MSD, the contract should require a written determination for each assigned case as to the expected number of attorney partners, associates, and paralegals, etc. This determination should also include a not-to-exceed amount to be paid to the Firm for the assigned case. The Firm must obtain written prior approval to exceed the maximum amount specified.
- Separate the types of legal work into individual contracts to improve monitoring efforts.
- Designate the MSD Legal Director to assign contracted legal work as needed.
- Require prior approval of any costs other than for time spent on a case by a Firm attorney from the Legal Director. This includes any costs related to travel, meals, expert witnesses, mock juries, and other costs incurred not related to the Firm's time costs.
- Include a term that specifies the settlement process that should be followed by the Firm.
- Include a term that requires the Firm to disclose any actual or potential conflict of interest between MSD and any of the Firm's other clients.

Findings and Recommendations

Finding 10: MSD spent \$2.1 million for co-bond counsel services with no documented justification.

Between June 4, 2009 and August 24, 2011, MSD paid its bond counsels a total of \$2.1 million for legal services to issue bonds with a total par value of \$1.75 billion. The legal fees for each bond transaction were paid in equal amounts to two firms, each of which has served MSD as bond counsel consistently since 1997. MSD officials, including its former Finance Director, could not provide a clear understanding as to the duties performed by each bond counsel, the need for co-bond counsel, and the process through which the financial team, including the co-bond counsel, were selected.

Background

MSD has been using the same outside firms on its finance team to assist in issuing its bonds since 1993, except in 1995 and 1996. The finance team consists of an outside financial advisor, legal counsel to the financial advisor, two bond counsels, and the MSD Finance Director.

Auditors made inquiries attempting to gain a historical understanding of the selection process followed to procure the services of the various team members and how it was determined that the same parties would continue to serve when MSD issued bonds. Auditors quickly learned that MSD had no institutional knowledge or historical information to answer these inquiries. The former MSD Finance Director, who retired on June 30, 2011, stated that the firms serving MSD were in place when he began work at MSD in July 2000 and that he had no knowledge of how their services were originally procured. Other MSD personnel, including the MSD Legal Director and the MSD Controller, who is currently serving as the interim MSD Finance Director, were also unable to provide any insight as to the selection of these firms.

Because of the lack of institutional knowledge, auditors asked the outside financial advisor about the selection of the bond financial team members. The MSD financial advisor stated that his company served as financial advisor to Jefferson County in the early 1990s and that the company was hired by MSD after a former Jefferson County Finance Director was hired by MSD to serve as its Finance Director. The financial advisor stated that the former MSD Finance Director's primary goal was to "create a legal/financial platform that would allow MSD to carry out a capital improvement program that would extend over many years to provide sewer service throughout the county." In 1993, to create that platform MSD adopted a Master Bond Resolution. According to the financial advisor, the 1993 resolution is the underlying contract for all of MSD's bond issues.

The legal counsel to the MSD financial advisor is a former member and chair of the MSD Board and currently performs work as a subcontractor to the MSD Board Legal Counsel. According to the financial advisor, the former MSD Finance Director in 1993 was creating the financing team and he assumes it was in the context of establishing that team that the former Finance Director asked his firm to retain this individual as the firm's counsel.

The financial advisor stated that hiring this individual for legal services was his decision and procurement of his services was never made a stipulation for his firm to act as financial advisor to the district. The fees of the legal counsel to the financial advisor are included in the financial advisor's fees to MSD. On average those fees are approximately \$15,000 to \$20,000 per bond issue.

Bond counsel services for each bond transaction is performed by two separate firms, who for the purpose of this finding will be referred to as co-bond counsel A and co-bond counsel B. Co-bond counsel A has served as the MSD Board Legal Counsel since 1984. As for the specific services performed by co-bond counsels, there was no historical documentation available detailing this information.

*Current Selection
Process*

The finance team does not change from year to year. According to all team parties, the financial advisor and co-bond counsel selections are approved by the MSD Board by passing each bond resolution. The resolutions, in addition to authorizing the issue of bonds on behalf of MSD, include a list of parties authorized to provide the financing services and legal opinions associated with the bonds.

When a bond issuance is anticipated by the financial advisor and the MSD Finance Director, the financial advisor determines the required principal amount of the bond issue, including all the costs associated with the issue. As part of this process, the financial advisor contacts all parties he believes will be used to issue the bonds. Co-bond counsel B then drafts a resolution to be presented to the Board for approval. According to co-bond counsel B, the bond resolutions they have drafted for MSD over the years have all contained similar provisions. The draft is submitted to the MSD Finance Director for review and approval before the resolutions are presented at a MSD Board meeting for adoption.

Based on this information, it appears that the MSD Finance Director is the initial decision maker on behalf of the district; however, the former Finance Director did not know why two firms were hired as co-bond counsel and stated that both firms "had an extensive historical knowledge of MSD operations and bond issues so I'm assuming that is why they were both retained." By this statement, it appears that the former MSD Finance Director is uncertain as to specifically why MSD hires co-bond counsel.

In discussing the selection process with the Executive Director and some of the current and former Board members, who served on the Board at the time many of these bond issues were approved, they stated that they relied upon the recommendation of the former Finance Director in the selection of firms involved in the bonding process.

According to the Government Finance Officers Association (GFOA), a best practice for selecting bond counsel, as approved by the GFOA Executive Board on February 22, 2008, is for counsel to be selected using a competitive process and to review the relationships periodically. A request for proposals (RFP) or request for qualifications (RFQ) permits issuers to compare firm's qualifications and to select a firm or firms that best needs the needs of the type of financing undertaken. Another best practice adopted by GFOA relating to the sale of bonds recommends issuers select financial advisors through a competitive process and to periodically review those relationships.

*Services Provided
by Co-Bond
Counsel/Fees*

A bond counsel is to provide an opinion to affirm that the bonds have been legally authorized, that all necessary procedures have been followed to issue the bonds, and that the bonds are tax exempt under law. It is permissible for an organization to use one or two bond counsels in association with a single bond issuance. The determination is made by the client after considering a number of factors including the complexity of the issuance, counsel expertise, par value of the bonds, and market conditions.

In discussing MSD's use of co-bond counsel in association with its bond issuances, current and former MSD Board members interviewed had differences in their understanding of MSD's need for the services of co-bond counsel. Further, statements made to auditors by the former MSD Finance Director and current interim MSD Finance Director indicate the client itself was uncertain regarding the need for and the actual services provided by the co-bond counsel.

The current Board Chair stated that it was his understanding that it was advisable to have co-bond counsel when handling such high value bond issues. He initially stated that his understanding came from the former Finance Director, who retired from MSD in June 2011, and that the reason was sufficient "enough for me to accept." However, in a subsequent conversation with the Board Chair, he stated that his understanding for the need for co-bond counsel was provided from the MSD financial advisor who had recently made a presentation to the MSD Board. One former Board member stated that he also understood the need for co-bond counsel services was due to the large amount of funds involved and that MSD would want the most advice possible when dealing with that amount of money.

One former Board member thought perhaps the use of co-bond counsel services had something to do with MSD's Women Business Enterprise and Minority Business Enterprise goals, while another thought perhaps there were two different scopes of work being performed by each bond counsel and one firm could not do all the work. Two other Board members stated the co-bond counsels were who the former Finance Director and MSD had always used and provided no explanation as to why co-bond counsels were necessary.

Findings and Recommendations

In discussing the services provided by co-bond counsels with the former Finance Director, he stated that co-bond counsel B prepares the preliminary bond resolution that is presented to the MSD Board and supplies an opinion on the bonds, while co-bond counsel A prepares the ordinance and any other information presented to Louisville Metro Council. The current interim MSD Financial Director gave a similar description of the work performed by both co-bond counsels.

When asked whether bond counsel services could be provided by one bond counsel, the former Finance Director stated one firm could certainly do all the work and that MSD did not need two law firms. The former Finance Director had discussed the possibility of a sole bond counsel with co-bond counsel B on more than one occasion, and was told during the most recent of those discussions that their firm could provide all the bond services, if requested by the client.

The Co-bond counsel B acknowledged having a discussion with the former Finance Director before he left in June 2011, but also stated that there were no further discussions with anyone at MSD concerning the topic. The former Finance Director stated that he had discussed the potential of a sole bond counsel with MSD officials, including the MSD Board Chair and Vice-Chair prior to his retirement from MSD; however, neither the Chair nor the Vice-Chair recalled such a conversation.

Auditors asked during separate interviews with co-bond counsel which firm should MSD select if it decided to use a single bond counsel. Co-bond counsel B stated, “I can’t comment on that. That’s the client’s decision.” Co-bond counsel A stated that he believed his firm would be the most logical choice because of his expertise with MSD.

In discussing the co-bond counsel services and fees with co-bond counsel B, auditors were told that they would be contacted by the financial advisor, advised of the anticipated bond transaction, and then would be asked to provide an individual quote for their anticipated fee.

Co-bond counsel B stated that the bond issue is discussed internally by the firm and after considering the complexity of the specific bond issue, the amount of time it would take to do the work, the amount of documentation needed and the risk involved in signing an opinion letter, the firm would give the financial advisor a quote for legal services. Co-bond counsel B stated that their fee was based on their estimation of what was needed to perform their work and that fees were determined independently from co-bond counsel A.

Co-bond counsel A issues an opinion that in addition to co-bond counsel B's opinion also includes the work the firm performs in presenting resolutions before Louisville Metro Council. Co-bond counsel A stated that the opinions provided determine the bond rates. When asked how performing the additional work done by Co-bond counsel A would affect their fee, co-bond counsel B stated that the fee would likely not change.

Contrary to what auditors were originally told by co-bond counsel B, co-bond counsel A stated that he and co-bond counsel B work together and present a fee to MSD. He said it would be unfair to charge differently and that they work together to negotiate a fee. Eight days later, co-bond counsel B contacted auditors and stated that "[t]he liability of co-bond counsel providing the same opinion is identical and one would therefore expect their fees to be identical."

As a point of interest, auditors observed that the invoices from the co-bond counsels were completely identical including the invoice language, information, form, format, and font. Co-bond counsel A stated that "[e]verything we do as co-bond counsel is coordinated; however the service were not the same and MSD was always aware of the various service performed by each firm." Co-bond counsel B stated that they had never seen any of co-bond counsel A's invoices and could not account for why the invoices were identical.

Though multiple criteria is considered when establishing the legal fees paid associated with a bond issue, the following two tables provide the legal fees paid by MSD and other public utilities as a percent of the par value of bonds issued by public utilities. As evidenced by the information in the tables, bond counsel legal fees paid by MSD are a higher percentage than other listed utilities. In addition, the Commonwealth of Kentucky paid an average of approximately .02 percent for 25 bond issues with a par value totaling over \$3.7 billion. However, legal fees for bond issues vary as evidenced by an April 15, 2010 issue by the state, which was over .04 percent.

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Findings and Recommendations

Table 7: MSD Bond Counsel Fees from July 2008 through August 2011

Description of Issue	Par Value of Bonds Issued	Number of Bond Counsel	Name of Bond Counsel	Bond Counsel Fees	Bond Counsel Fees %
Series 2009A Revenue Bonds	\$76,300,000	Two	Co-bond Counsel A Co-bond Counsel B	\$90,000 \$90,000	.24
Series 2009A Bond Anticipation Notes	\$226,300,000	Two	Co-bond Counsel A Co-bond Counsel B	\$125,000 \$125,000	.11
Series 2010A Bond Anticipation Notes	\$226,300,000	Two	Co-bond Counsel A Co-bond Counsel B	\$125,000 \$125,000	.11
2009 Revenue Bonds	\$225,800,000	Two	Co-bond Counsel A Co-bond Counsel B	\$135,000 \$135,000	.12
2009 Build America Bonds	\$180,000,000	Two	Co-bond Counsel A Co-bond Counsel B	\$150,000 \$150,000	.17
Series 2010A Build America Bonds	\$330,000,000	Two	Co-bond Counsel A Co-bond Counsel B	\$150,000 \$150,000	.09
Series 2011A Bond Anticipation Notes	\$226,340,000	Two	Co-bond Counsel A Co-bond Counsel B	\$125,000 \$125,000	.11
Series 2011A Revenue Bonds	\$263,360,000	Two	Co-bond Counsel A Co-bond Counsel B	\$150,000 \$150,000	.11
Total/Average	\$1,754,400,000			\$2,100,000	.12

Source: Auditor of Public Accounts based on information obtained from MSD.

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Table 8: Other Entity Bond Counsel Fees from July 2008 through August 2011

Entity	Description of Issue	Par Value of Bonds Issued	Number of Bond Counsel	Name of Bond Counsel	Bond Counsel Fees	Bond Counsel Fees %
Louisville Water Company (LWC)	Series 2009A and 2009B	\$202,930,000	Two	Co-bond Counsel 1	\$192,956	.10
				Co-bond Counsel 2	\$14,441	
LWC Total		\$202,930,000			\$207,397	.10
Lexington-Fayette Urban County Government Sewer Division (LFUCG)	2009 Series A Revenue Bonds	\$35,960,000	One	Bond Counsel *	\$32,364	.09
	2010 Sewer Refunding Issue	\$13,860,000	One	Bond Counsel *	\$12,474	.09
LFUCG Total/Average		\$49,820,000			\$44,838	.09
Sanitation District 1 of Northern Kentucky (SD1)	2010 Series A	\$75,000,000	One	Bond Counsel	\$54,504	.07
	2010 Series B	\$42,310,000	One	Bond Counsel	\$37,119	.09
SD 1 Total/Average		\$177,815,000			\$303,677	.08

Source: Auditor of Public Accounts based on information obtained from LWC, LFUCG and SD1.

* Issued RFPs.

Note: SD1 information provided in the table above does not include the 2010 Series C&D bond issue that had legal fees totaling \$212,054. SD1 has a cap on Bond Counsel Fees of not to exceed \$61,500 per issue. However, the Board of Directors approved additional compensation for additional work to attain the Recovery Zone Allocations from counties across the Commonwealth.

Recommendations We recommend the MSD Board formally adopt a policy to select bond counsel and a financial advisor through a competitive selection process using either a RFP or RFQ. This competitive process should assist in determining those most qualified to perform the services, while also provide an opportunity to control the costs of issuing bonds. If co-bond counsel is desired, justification for co-bond counsel should be provided to the Board for its review and approval. The RFP or RFQ should state the services desired, the length of the engagement, the evaluation method, the selection process, and a cost proposal to provide services. If co-bond counsel is being engaged the RFP, RFQ, or engagement letter should specify the roles and responsibilities and tasks assigned to each firm to minimize potential duplication of work and costs. MSD should ensure proper oversight of legal counsel to ensure work is progressing and coordinated as required by the RFP, RFQ, or engagement letter.

Findings and Recommendations

We further recommend the MSD Board be fully apprised of the RFP, RFQ, and engagement letter for procuring services, the method used to select bond counsel and financial advisor, the tasks to be performed by counsel and financial advisor, their fees and other bond issue costs.

Finding 11: The lack of a policy development process results in duplication of work and potentially unnecessary legal fees.

MSD lacks a defined process for the initiation and development of policies, which has resulted in duplicative work and potentially unnecessary legal fees. Policies at MSD may be created or revised through a variety of avenues. The MSD Board or the Executive Director may request that MSD staff develop or revise policies. Staff may also begin this process internally and bring new or revised policies to management for discussion and to determine whether if it should be brought to the Board. Further, the Board or Executive Director may also request the MSD Board Legal Counsel to produce policies. There is no specification for which of these methods should be, or may be, employed in the policy development process. This can allow for certain individuals, including staff or the Board Legal Counsel, to work toward developing the same policy at the same time, without the knowledge of the other parties work.

Based on interviews with MSD Board members, MSD staff, and the Board Legal Counsel the process to develop recently proposed ethics policies are an example of the confusion that can arise when no defined procedure exists. According to MSD legal staff, they began drafting new ethics policies with the intention of presenting the proposed policies to the Board. Staff stated that the members of the Policy Committee of the Board were aware of their work. At the same time, the Board Legal Counsel drafted ethics policies for the same purpose to also present to the Board. Neither party stated they were aware of the others work until the end of the process.

It is the position of the Board Legal Counsel that the work performed on the ethics policies was at the request of certain Board members. Upon interviewing Board members, one stated that the entire Board had requested Board Legal Counsel to perform the work, though no record of the request exists in the Board minutes. The Chairman of the Board Policy Committee stated that he thought it was a cooperative effort between Board Legal Counsel and internal legal staff. It would appear that confusion from many parties resulted in duplication of services by internal staff and Board Legal Counsel, and may have resulted in unnecessary legal fees.

Findings and Recommendations

At a partner rate of \$130 per hour, Board Legal Counsel fees can nearly double the hourly costs in the development of policies when compared to the average hourly rate paid for internal legal staff of approximately \$73 per hour when including estimated benefits. While the experience and expertise of outside counsel may be required in the development of certain policies, the most efficient method should be considered first. Should outside legal expertise be required, it should only occur at the direct request of the Board or Board Policy Committee during a meeting, or the Executive Director or Legal Director at other times. As the client, MSD should determine when services are needed by the Board Legal Counsel. This allows MSD to control costs and ensure that there is no duplication of work between internal staff and a third party contractor.

Recommendations MSD should develop a policy or process by which policies are to be initiated and developed and subsequently brought before the Board. This should include who has the authority to initiate policy development and who has the authority to authorize the expense of Board Legal Counsel to assist in the process. When making an initial request for a new or revised policy, use of internal staff should be considered first, when possible, to ensure the most cost effective methods of policy development are used. A determination for the need of outside legal expertise should be made in consultation with the internal legal staff.

Finding 12: The Louisville Green Corporation bylaws specify by name the President and the special legal counsel.

The bylaws drafted for the Louisville Green Corporation in 2005 by the MSD Board Legal Counsel, specify by name who will be the President and who will be employed as special legal counsel. Instead of referring to a position title or including a provision that the corporation may employ or contract for independent counsel, the actual names of MSD's Executive Director and the MSD Board Legal Counsel are used in this document. To avoid the need to amend bylaws, this document should not contain individual's names and should only include fundamental items that will not change. Specificity related to a position or detailed duties should be accomplished through policy manuals or board resolutions. By specifying the actual names of individuals, an appearance exists that the attorney was ensuring that his personal interests were represented and not those of his clients when he drafted these bylaws. Further, this circumvented a transparent, competitive process to select the legal counsel for Louisville Green.

According to the Rules of Professional Conduct for Kentucky lawyers, a conflict of interest exists if there is a significant risk that the representation of the client will be limited by a personal interest of the lawyer. The Supreme Court of Kentucky issued these rules to govern the conduct of lawyers licensed in Kentucky. Specifically, Kentucky Supreme Court Rule 3.130(1.7) prohibits a lawyer from representing a client if the representation involves a concurrent conflict of interest. This rule states that:

Findings and Recommendations

A concurrent conflict of interest exists if 1) the representation of one client will be directly adverse to another client; or 2) there is significant risk that the representation of one or more clients will be materially limited by the lawyer’s responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

While these bylaws can be amended, the Louisville Green bylaws stipulate that changes can only be made if six of eight board members agree. This stipulation validates the reason that specificity in drafting bylaws should be avoided because needed changes can be difficult to make.

Recommendations

We recommend the Louisville Green Board amend its bylaws to remove specific names of individuals. The Louisville Green bylaws should be free of any redundant or unnecessary terms that may complicate the governance of this corporation. Further, we recommend the Louisville Green Board select a legal counsel through a transparent, competitive process as similarly recommended in Finding 6.

Finding 13: MSD Board provides inadequate investment oversight and lacks sufficient information.

MSD invests hundreds of millions of dollars from bond proceeds in a proprietary investment program through a third-party investment management firm that provides MSD with limited reporting on investment holdings and the investment process. This lack of investment information provided by the investment management firm combined with no known inquiries into the details of the investment program by the Board means that the fiduciary body of MSD does not know the level of investment risk and cannot ensure whether investments are secure through compliance with MSD policies or other regulations.

Based on a review of the financial information presented to the Board by MSD staff and discussions with certain MSD Board members, knowledge of the investment program details are limited. Monthly financial statements provided to Board members by staff contain a single line item disclosing the “investment income” of MSD. In addition, Board members receive a quarterly financial report that contains a page showing the current value of investment holdings by category. Neither of those reports identify which of the holdings or what part of the income is derived from the Yield Enhancement Program, which is the primary investment program at MSD. They also provide no information on the program activities or strategies. This is not in keeping with Section 7.03 of the MSD Investment Policies, which requires that the Executive Director to submit a semi-annual report to the Board to include investment activities, portfolio performance, risk characteristics, and investment strategies. It is not clear why this report is not presented to the Board.

Interviews with Board members revealed that some members are not familiar with the actual process undertaken by the investment management firm regarding the Yield Enhancement Program, did not know that the program is proprietary in nature, and in some cases, did not know of the program in general. This indicates that the risk factors of the investment program have never been made fully available to the current Board members, which would allow the investment process to undergo a proper review by the primary fiduciaries of MSD.

This appears to have been caused, in part, by the Board failing to request investment information, which may be due to the program providing MSD with a return on these types of investments significantly higher than may be reasonably expected and therefore, the perception that it does not need further scrutiny. MSD investment income levels for each of the last two years have exceeded \$30 million. Such returns may have encouraged a lack of inquiry due to the investments profits realized by MSD.

A further lack of providing investment information to the Board also appears to be due to the investment management firm's claims of a proprietary program and its unwillingness to share details of the investment process in an open format, such as a Board meeting. According to interviews, the presentation of the investment program to the Board was performed by the former Finance Director. The exact information presented to Board members at this initial proposal is unknown. In order to protect the proprietary nature of the program, it does not appear any program details were given to the Board. While such proprietary claims may be normal operating procedure for the private sector, transparency in public agencies dictates that the process be evaluated in a more open and forthright manner.

Considering funds invested in just one investment category of the Yield Enhancement Program has been as high as \$431 million in March 2011, there is a potential for substantial loss to MSD if an investment management firm and the investment practices are not properly reviewed. Prior to investing such large funds, the Board should be certain that the risk levels of the investment program match the expectations of the agency and can ensure that the funds used to provide such a necessary public service are protected. It must also ensure that the investment program is providing the greatest benefit to MSD for the proceeds being invested.

Through review of investment program documentation, interviews with MSD staff, contractors, Board members, and in consultation with other governmental investment entities, auditors have determined a number of factors that should have been revealed to the Board for consideration prior to investment in the Yield Enhancement Program.

Findings and Recommendations

Potential for Loss of Funds

The greatest risk that must be considered by a public board in reviewing an investment program is the safety and security of the funds being invested. MSD invests the proceeds obtained through the issuance of bonds in order to offset the interest that must be repaid on those bonds. These investments are purposefully restricted by the bond requirements in order to minimize the risk to the funds. This is why most investments are restricted to federal government securities and money market funds.

According to documents provided by MSD, the Yield Enhancement Program does invest in government securities, but in order to enhance the immediate yields of those investments the investment management firm must employ a buying and selling tactic that it considers a proprietary process. According to the investment management firm, this provides for a greater return on the investments than the basic interest rate of the security. It appears that this tactic has been successful for the investment management firm, but this tactic introduces a greater risk to the investment practice that does not exist through the basic and more conventional program of investment in government securities. It does not appear that the Board was ever informed of this additional risk and that current MSD staff may not understand the elevated risk of the investment process.

While the Yield Enhancement Program has been able to generate significant returns for MSD, this is, in part, due to the nature of the recent market and interest rate environment. The investment management firm is currently able to buy government securities and then sell them at a premium when interest rates drop on newly issued securities. By buying securities with a long term maturity rate, the investment management firm is able to capture higher interest rates associated with those long term investments and then selectively time the sale of these securities to maximize returns in the short term.

The risk associated with this practice occurs when the market rises and interest rates increase. If MSD has purchased a security with an interest rate lower than the new market rate, it would not be possible to sell without a significant loss. Also, the current securities being bought through the Yield Enhancement Program are long term, which may not meet the short term liquidity needs of MSD. The purpose of investing bond proceeds by public agencies is to enable those agencies to earn some amount of interest on temporarily excess idle funds while also ensuring adequate liquidity for future debt service obligations. Since the investments are made in longer term maturity securities, MSD is then at risk of not having immediate access to the invested funds for these payments, unless the investments are sold at the market rate available at that time. It is for this reason that governmental units such as the Commonwealth of Kentucky rarely hold bond proceeds related investments with maturities longer than five years. It is also why the MSD Investment Policies prohibit securities purchased with Revenue Fund proceeds from having a maturity beyond five years. Policies further require that investments from Capital Fund proceeds cannot have maturities beyond three years.

While the Yield Enhancement Program appears to have brought MSD an excellent return on investments, it does not appear that the program was entered into with full disclosure to the Board of all program risks and is not in keeping with MSD investment policy. A certain level of risk could have been disclosed through a legal opinion letter that was obtained by MSD staff at the recommendation of the investment management firm. The opinion letter outlines the practices of the investment program and provides some indication of the risks. While the language does not explain the full risks of the program, it would at least have provided Board members some indication that the risk level was greater than typical investments in government securities. This was never shared with the Board due to concerns that the proprietary program may become subject to discussion in an open meeting. Among others, this letter was addressed to the Board Legal Counsel; however, the Board Legal Counsel stated he is not familiar with the Yield Enhancement Program or the name of the investment firm that manages it.

The primary purpose of the legal opinion letter is to certify that the Yield Enhancement Program does not violate certain federal government securities investment rules. It opines that the program does not violate these rules; however, based on a review of the investments made under the program and the speculative nature of process, a separate independent source should evaluate the program. This would be a precautionary measure to ensure that MSD investment practices are within acceptable guidelines set forth by federal regulatory bodies.

*Program
Management Fees*

Based on interviews, it is also unclear if Board members understand the full extent of the fees being paid to the investment management firm and the financial advisor for management of the Yield Enhancement Program. MSD currently pays a 15 percent program manager fee on all investment returns. This fee is currently divided between two firms. The investment management firm receives ten percent and determines which securities will be purchased under the programs and the timing of any purchases and sales. The firm MSD considers to be its financial advisor receives five percent and monitors the funds MSD has available for investment.

Program management fees are realized when a profit is made through the sale of MSD holdings. Because sales are made often under the Yield Enhancement Program and the sales have historically made a profit, program management fees paid by MSD are extensive. The following table contains the fees paid to both the investment management firm and the financial advisor.

Findings and Recommendations

Table 9: Program Management Fees for the Yield Enhancement Program

Fiscal Year	Financial Advisor	Investment Management Firm
FY 2009	\$1,209,652	\$2,041,414
FY 2010	1,473,141	2,946,382
FY 2011	1,066,838	2,133,675
Totals	\$3,749,631	\$7,121,471

Source: Auditor of Public Accounts based on information provided by MSD.

The management fees for the Yield Enhancement Program seen in the table are more reflective of a higher risk investment practice, such as a hedge fund, than a low risk government securities program. According to the financial advisor and documents provided by MSD, the Yield Enhancement Program is not a hedge fund or other sophisticated investment program. Instead, it appears the investment management firm is merely managing a securities program in a manner that has more risk than normal government securities investment practices. For this reason, it is unclear why MSD would be expected to pay such a high management fee to the investment management firm. Also, it is unclear why the financial advisor receives a portion of the large management fee. See Finding 14 for further discussion of the financial advisor’s role in the investment program.

The management fee can also have a significant impact on the investment returns of MSD. While the Yield Enhancement Program has provided MSD with returns, it has never been compared to the potential returns of investment options with a lower management fee. Due to the management fee being based on realized profits of the investment program, it is in the best financial interests of the investment management firm to achieve as much of an immediate return on the investment to ensure a consistent revenue through fees. While this also provides MSD more funding to reinvest, the management fee erodes that amount remaining for MSD to invest.

Because the Yield Enhancement Program is based on the sale of securities with interest rates higher than those currently on the market, the reinvested funds reasonably must eventually be invested in a newer security with the lower market rate. Since the sale of the higher rate security nets a premium for MSD it provides more to be invested at that lower rate and should be nearly equal, but because the 15 percent fee is paid, the reinvested amount is much lower. This can mean that MSD earns a lower rate of overall return than they would have had they held the higher rate security for a longer term.

Findings and Recommendations

Had MSD followed the requirements of its current Investment Policy, a sufficient amount of information about the investment program would have been made available to both MSD Board members and staff. It would have also provided for an open and transparent procurement process at the initial stages of approval. Currently, section 3.01 of the Investment Policy requires that MSD publicly solicit Request for Proposals (RFP) for all investment services. The requirements for the RFP would have given all stakeholders at MSD a better understanding of the program details and ensured that the management fees are competitive.

It appears to have been the practice of the MSD Board to rely on staff and the financial advisor to determine appropriateness and risk levels of MSD investment programs. Particularly the former Director of Finance has been cited as the primary oversight authority and contact point for such activities, but he has not held a position with MSD since June 30, 2011. In addition, the financial advisor has no contract with MSD, so he has no contractual obligation to act in the interests of MSD. As Finding 14 also states, the financial advisor, due to the personal benefit he receives through fees, has a conflict of interest in his ability to provide advice concerning the Yield Enhancement Program.

The MSD Board must receive sufficient information about its investment programs in order to properly ensure funding is secure and compliant with all applicable policies and regulations. MSD policies already require regular investment reporting and the fiduciary duty of Board members dictates that they should request such information if not given to them. Regardless of the proprietary claims of an investment firm or the perceived returns of the program, MSD Board members and staff cannot be lax in enforcing good governance standards of transparency and openness.

Recommendations MSD should, at a minimum, follow current Investment Policy and provide the Board with detailed semi-annual reports as to the holdings of the investment program, investment activities, risk levels of the program, and program strategies. However, we recommend the policies be updated and investment reports be provided to the Board, or to a Board investment committee as recommended in Finding 16, on a monthly basis. Board members should request such information if not provided by staff.

MSD should follow the requirements of the current Investment Policy and annually solicit Request for Proposals for investment services that contain all required details of the investment management firm and the services being provided. In the interests of transparency, MSD should not enter into a proprietary investment program that does not disclose all details of the program to the Board members.

Findings and Recommendations

Finding 14: MSD financial advisor has conflict of interest.

The financial advisor used by MSD to provide independent evaluations and recommendations for investment opportunities also acts as a program manager for the primary MSD investment program and receives substantial fees based on the gains of those investments. Having a management role in the investment program and receiving fees based on the program profits creates a conflict of interest for the financial advisor and calls into question his ability to act in an independent nature on behalf of MSD.

As discussed in Finding 10, MSD has regularly obtained the services of a single financial advisor since 1993 without a competitive process to provide advice and consultation for a variety of services, including the MSD investment portfolio, bond issuance, and other debt related services. The purpose of hiring a financial advisor to assist with investments is to provide MSD with an independent expert that understands the complexities of investment strategies and can act as a representative in the financial markets on behalf of MSD.

MSD does not currently have a specific contract with the financial advisor that outlines the consulting services to be provided, though he is considered the designated advisor to MSD. Instead services are obtained as needed for items such as bond issuance, where fees are paid based on the individual agreements of each transaction. As detailed in Finding 13, services related to the MSD Yield Enhancement Program are established in a collective agreement between MSD, the financial advisor, and an investment management firm. These fees are based on the yields generated from the investment returns, allowing the financial advisor to share in the profits.

The funds invested in the Yield Enhancement Program by MSD are generated from bond proceeds. According to the financial advisor, this program was first initiated in 2004 when he was approached by an investment management firm with a program that it claimed was proprietary and would provide for a greater yield on the proceeds of the bonds issued by MSD. The financial advisor brought the program to MSD and recommended the investment opportunity. MSD approved the investment program and entered into an agreement with the investment management firm and the financial advisor, paying a 10 percent program manager fee on all investment gains. The financial advisor and the investment management firm are named collectively as the Program Managers for the investment program, with the fee evenly divided between the two.

According to the financial advisor, federal regulatory changes required a change to the Yield Enhancement Program, so it was modified in 2008 and a new agreement was made with MSD. The new agreement continues to name both the investment management firm and the MSD financial advisor as the Program Managers. The Program Manager fee for the new agreement increased to 15 percent of any investment gains, with the investment management firm retaining 10 percent and then paying five percent to the financial advisor.

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The Yield Enhancement Program agreement states that the Program Managers collectively have the authority to arrange for program transactions on behalf of MSD and directly authorize the purchase or sale of money market funds or State and Local Government Series obligations (SLGS). While the program management role of the MSD financial advisor is not specifically described in the agreement, he has stated that he determines and monitors the MSD funds that are available to maximize the amount for investment in the program.

Over a three-year period, the financial advisor has been paid more than \$4.6 million in fees for services provided to MSD. The fees for the Yield Enhancement Program are particularly lucrative. The following table contains the payments made to the financial advisor by MSD from FY 2009 through FY 2011 for both the Yield Enhancement Program and advisory services related to bond and other debt services.

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Findings and Recommendations

**Table 10: MSD Investment Related Fees Paid to Financial Advisor
FY 2009 – FY 2011**

Invoice Date	Advisory Services Fee	Yield Enhancement Program Fee
FY 2009		
10/6/2008		\$27,736.22
10/16/2008		54,238.52
11/18/2008		188,944.56
12/18/2008		93,222.66
1/15/2009		144,571.88
2/12/2009		354,725.81
2/25/2009	\$75,000	
3/13/2009		130,237.54
4/9/2009		19,572.07
5/15/2009		147,200.43
6/4/2009	95,000	
6/12/2009		49,202.08
FY 2009 Totals	\$170,000	\$1,209,651.77
FY 2010		
8/14/2009		3,644.49
8/21/2009	215,000	
9/18/2009		123,354.64
10/23/2009		649,380.91
11/23/2009	140,000	
12/3/2009		40,055.37
12/21/2009		538,228.54
1/8/2010		9,575.60
2/26/2010		3,691.01
3/22/2010		11,010.71
4/13/2010		23,668.94
5/17/2010		2,648.21
5/26/2010	90,000	
FY 2010 Totals	\$445,000	\$1,473,141.05
FY 2011		
7/15/2010		183,828.79
8/19/2010		316,272.43
8/23/2010		42,071.21
9/20/2010		16,151.29
11/1/2010		11,516.48
11/23/2010		47,353.54
11/30/2010	165,000	
2/16/2011		7,031.02
3/2/2011	95,000	
3/22/2011		27,623.10
4/12/2011		118,010.36
5/13/2011		120,789.38
6/14/2011		176,190.07
FY 2011 Totals	\$260,000	\$1,066,837.67

Source: Auditor of Public Accounts based on information provided by MSD.

Findings and Recommendations

As a Program Manager to the MSD investment program and as a recipient of fees based on the investment yields, the financial advisor appears to have entered into an arrangement more similar to a partnership with the investment management firm rather than an independent party advising on the interests of MSD. By receiving fees from the profits of the program, the financial advisor is no longer just representing the interests of MSD but his own as well. This can result in a lack of independence, and as a manager within the program, may cause the financial advisor to allow a greater investment risk on behalf of MSD in exchange for a greater potential profit.

In addition, MSD currently lacks a contract with an independent financial advisor that is unrelated to any investment program, including with the firm that it considers its financial advisor. This means that no firm has a contractual fiduciary duty to represent the best interests of MSD. Also, as seen in Finding 15, MSD lacks sufficient staff to properly navigate financial markets and investments. Without an independent experienced financial advisor, MSD cannot ensure that the program has been effectively evaluated to meet the needs of MSD in both return expectations, as well as the risk to bond proceeds.

Financial advisors should be retained through a contract that is exclusive of any investment program and based solely on the advisory and consulting services that are to be provided by the individual or firm. Based on consultation with other governmental investment entities, investment consultants should be obtained through an open procurement process seeking firms free from connections or conflicts with investment firms. Fees should be a single agreed upon rate based on the total investment pool being managed. This provides for an independent financial advisor loyal only to the interests of MSD with all management and consulting duties specifically stated within a contract.

Recommendations MSD should undergo an open procurement process on a periodic basis for an experienced financial advisor to provide advice and consultation related to the investment portfolio of MSD. This contract should be separate from other financial services such as the issuance of bonds, which may be negotiated on a per transaction basis. The contract should require the financial advisor to be free of conflicts with any investment firm doing business with MSD. All fees for an investment consultant and advisement contract should be a single fee based upon the amount of funds to be invested and the type of investments that are expected by MSD.

Findings and Recommendations

Finding 15: MSD does not have financial staff or Board members with background or specific experience in the types of investments and other related financial activities undertaken at MSD.

MSD does not have staff or Board representation with sufficient financial expertise to adequately understand and analyze the various financial programs and activities undertaken by MSD at the direction of its external investment management firm and financial advisor. Without the expertise and ability to understand and evaluate such programs, MSD’s assets may be exposed to unnecessary risk and MSD may not be assured of receiving the most competent, compliant, and economical financial advice.

MSD uses an investment management firm and a financial advisor to oversee a variety of investment and financial management programs. The amount of MSD funds available for investment that are under the control of the investment management firm and financial advisor at any one time can range from approximately \$100 to \$400 million. The programs and financial instruments used by these entities are designed to maximize MSD’s investment opportunities and also to help MSD manage interest rate exposure on the various bond issues.

The Yield Enhancement Program, in which MSD’s available bond proceeds have been invested, was deemed proprietary by the investment management firm used by MSD. Per an agreement with this investment firm and the MSD financial advisor, MSD is paying a total of 15 percent of the income earned on the investment program. Those fees totaled \$11.7 million for FY 2009, 2010, and 2011.

Prior to August 2009, MSD entered into several interest rate swaps upon the advice of its financial advisor. Swaps are a financial tool that allow the exchange of fixed or variable interest rates between two parties that, when properly designed and implemented, can assist MSD in effectively managing interest rate exposure resulting from the many bond issues required to fund the various MSD capital programs. MSD, as of fiscal year ending 2011 has interest rate swaps with a face value in excess of \$1 billion. Due to market fluctuations, MSD had an unrealized fair market value loss of \$78,445,000 at the end of FY 2010 that was reduced to an unrealized fair market value loss of \$55,808,000 at of the end of FY 2011. A strategy with such risk and significant financial implications identifies the need for strong Board oversight.

MSD's former Finance Director was the primary MSD contact with the investment management firm and financial advisor, and was the single individual at MSD who was most knowledgeable of, and actively involved in, the investment and financial management programs. The former Finance Director retired from MSD in June 30, 2011 and took a similar position outside the state. The MSD Executive Director appointed the MSD Controller as interim Finance Director until such time as a replacement for the Finance Director could be hired. We requested documentation that the Executive Director authorized the former and interim Finance Director to engage an external investment management firm on behalf of MSD; however, no documentation was provided. During the course of the examination, any questions posed by the auditors to MSD staff regarding specific details of the investment programs or financial activities almost always resulted in those questions being forwarded to, and the answers being provided by, the MSD financial advisor and/or the former Finance Director.

Upon reviewing the background and experience of the current MSD Board, it is apparent that the current MSD Board does not include any members with specific identifiable financial expertise relative to the types of investment activities and programs used by MSD. Further, the MSD Board has no investment committee nor does the Board Budget Committee receive detailed investment information or specifically monitor the MSD investment activity or programs. The lack of Board expertise and a committee to oversee investment activity increases the risk that investment activity and programs will not adhere to MSD investment policies. For example, investment policies state, "[o]n a cycle of not less than annually, and at the Board's discretion, the Executive Director will publicly solicit Request for Proposals (RFP) for investment services which will be prepared in compliance with MSD's Procurement Policy." Had there been more investment expertise on the Board, additional oversight may have avoided this violation of the Investment Policy.

Recommendations We recommend that MSD ensure that the finance staff include a person or persons with strong financial and investment knowledge and experience to enable investment and financial strategies to be based on the knowledge and understanding of such activities by MSD staff and not solely on the advice of third party advisors.

We further recommend that MSD Board membership include at least one professional who is particularly knowledgeable in investment and financial management activities commensurate with the types of activities in which MSD may engage. In addition, we recommend the MSD Board create an investment committee whose members are responsible for the oversight of investment activity and programs. The committee should include, at a minimum, one professional who is particularly knowledgeable in investment and financial management activities.

We recommend the investment committee receive detailed reporting of MSD's investment portfolio, all investment activities, programs, trends, and strategies. The investment committee should have a thorough understanding of existing investment policy, and propose additional policies as deemed necessary. The committee should question staff and financial advisors regarding investment activity and programs to evaluate compliance with investment policies.

Finding 16: MSD has insufficient policies regarding investment and other financial activity.

MSD has not updated its Investment Policy since it was adopted on February 27, 1995. Further, no policy has been developed to address the use of interest rate swaps. An entity's policies should be comprehensive and define the roles and responsibilities related to major financial activities including the investment of funds or other financial tools. MSD has increased its investment activity over the years, and has also entered into an extensive number of interest rate swaps that have had a profound impact on the liabilities of MSD.

KRS 66.480 provides MSD with the authority to invest and reinvest its funds. This statute requires that a governing body subject to its requirements adopt a written investment policy by January 1, 1995. MSD's Investment Policy does address key issues required by KRS 66.480; however, the policies are not comprehensive and do not fully reflect the current investment activity of MSD. The Investment Policy does not address external financial advisors and the role they should play in the investment process. However, MSD has used a financial advisor for many years who MSD paid over \$4.6 million for those services.

In addition, the Yield Enhancement Program discussed in Findings 13 through 15 is considered a proprietary investment program that potentially employs an investment process beyond the basic investment activity envisioned in the current Investment Policies. Considering investments in this particular program can range from \$100 million to over \$400 million, policies must reflect the processes by which funds are allowed to be invested and how that process will be evaluated and monitored to ensure the proper handling and security of those funds. Current policies do not appear to envision the type of investment practice employed under the Yield Enhancement Program.

MSD also has interest rate swaps with a total face value in excess of \$1 billion and a fair market value loss of \$78,445,000 at the end of FY 2010. Due to market conditions, that loss was reduced to \$55,808,000 at the end of FY 2011. This fair market value and the related income statement recognition of the change in fair market value will fluctuate from year to year as a result of changes to the underlying interest rate projections used to calculate the fair market value. Financial strategies with such significant monetary and financial reporting implications and risks highlight the need for pertinent policies and stronger Board oversight.

Findings and Recommendations

Recommendations We recommend that MSD undertake a comprehensive review of its Investment Policy to strengthen Board oversight and to determine what changes are needed to ensure this policy fully addresses the actual investment activities conducted by MSD. In addition, these policies should address the use and monitoring of external financial advisors and provide detailed guidelines related to their use.

Further, we recommend MSD develop policies related to interest rate swaps that include the following:

- Objectives for the use of interest rate swaps;
 - Conditions for the use of interest rate swaps;
 - Guidelines as to the terms and conditions of any MSD swap agreement;
 - Criteria related to the use of interest rate swap counterparties;
 - Evaluation and management of interest rate swap risks; and,
 - Terminating interest rate swaps.
-

Finding 17: MSD lacks a formal process for initiating, performing, reporting and distribution of its internal audits.

The MSD internal audit function is governed by its Internal Audit Charter, which was formally adopted in July 2008. The Charter describes the internal audit mission and scope of work, including its responsibilities and authority within the organization. While the purpose of this Charter is to establish the basic groundwork for internal audit, it is not designed to provide the details of a formal process to be followed by internal audit in accomplishing its mission and scope of work. MSD has not established a formal process for initiating, performing, reporting, and distributing internal audits.

To accomplish the mission of the internal audit function as outlined in the MSD Internal Audit Charter, the Internal Auditor must rely upon professional judgment and past interactions with MSD management and Audit Committee members to determine the appropriate processes to follow. The lack of formal procedures potentially limits the involvement of the Audit Committee and can cause confusion regarding the audit process among Audit Committee members, management, and the Internal Auditor.

An example of such a situation occurring is the April 2008 MSD Internal Audit of the contract with the MSD Board Attorney. In that instance, the Executive Director made a request for work to be performed and the former Internal Auditor performed audit services without reporting the request for work to the Audit Committee or the Board. According to the former MSD Internal Auditor, after performing her audit work and drafting her findings she presented the draft findings to the Executive Director for a management response.

The former Internal Auditor left approximately two months after first sharing the report with the Executive Director. She never received a response prior to leaving MSD and consequently did not formally issue the report to the MSD Audit Committee. Typically, the former Internal Auditor issued reports by sending them electronically to the Board Assistant who would then distribute the report to Audit Committee members.

Due to the lack of formal procedures, MSD has provided no guidance to its internal audit function as to the will and desire of the Audit Committee or Board if such circumstances occur. Subsequent to the Audit Committee's approval of the annual work plan, the Internal Auditor is not required to inform or obtain approval from the Audit Committee to initiate audits requested by management or others. No requirement is established regarding the appropriate length of time to wait for a management response to an audit report draft or what action to take if management does not respond to the draft report. In addition, a process is not in place specifying who reviews and approves the draft report prior to the draft being sent to management for a response. Further, no process is established for the Audit Committee or the Board to accept or approve final internal audit reports. Finally, the distribution of the final report is not specified.

Recommendations We recommend the MSD Audit Committee develop and approve procedures for the internal audit function. The adopted procedures should state the process for the Internal Auditor to follow in initiating an audit, including the process for the Audit Committee to be informed of and approve or authorize any audit requests not already on the annual audit plan made by management or other parties. The adopted procedures should also state the acceptable time period for the Internal Auditor to allow management to respond to a draft audit report. The adopted procedures should specify that the Auditor is to inform the Audit Committee if management fails to respond to the draft report within the specified time period and the process to follow to release an audit report when management fails to respond. The procedures should require the Internal Auditor to inform the Committee when a draft audit is completed for the Audit Committee to review and approve the draft report prior to forwarding the report to management for response. Finally, procedures should require the Audit Committee, after reviewing and approving internal audit reports, to ensure internal audit reports are presented to the full MSD Board for ratification.

Findings and Recommendations

**Finding 18:
Oversight of MSD
internal audit
function primarily
performed by
executive
management;
MSD Audit
Committee is not
sufficiently
engaged with
Internal Audit.**

Despite an Internal Audit Charter stating the Chief Internal Auditor “reports functionally to the Audit Committee and administratively to the Budget and Finance director,” MSD’s internal audit function is primarily directed and supervised by MSD’s executive management. The current structure of MSD and the lack of engagement by the MSD Audit Committee with its Internal Auditor indicate the MSD Board failed to support an independent internal audit function.

It is our understanding through interviews with the current and former MSD Internal Auditors, each of the auditors reported to the former MSD Finance Director with little direct contact with the Audit Committee. Both auditors received annual performance evaluations completed by the former Finance Director with no known input by the Audit Committee or Committee Chair. Further, the funding for the Internal Auditor position and expenses of the internal audit function are included as part of the overall Finance Administrative Office under the Finance Division, not a separate and distinct budgeted line item.

For the past several years, MSD decided to have no cost of living adjustment; therefore, the annual performance evaluations, bonuses, and promotions are the main impetus for an increase in MSD employee compensation. Since the Internal Auditor’s evaluations have historically been performed by executive management, the compensation of the Internal Auditor is directly impacted by management that she is responsible to audit. This conflict in reporting and oversight impairs the independence of the internal audit function and could directly or indirectly influence the work of the Internal Auditor resulting in a lack of objectivity when reviewing MSD management actions.

MSD management could also apply influence or control over the internal audit function through control of the funding available through the budget or expenditure approval processes. MSD budgetary discussions occur at meetings of the MSD Finance Committee and the full Board. The budget that is reviewed, discussed, and approved by these bodies does not clearly define the amounts that are budgeted for the Internal Auditor, as those funds are included within a larger cost center under the Finance Division. Because funding for the Internal Auditor falls under the Finance Division, spending by the Internal Auditor was approved by the former Finance Director and currently by the MSD Executive Director in the absence of a full time Finance Director.

The MSD Internal Auditor stated that she has discussed her annual funding needs directly with the former Finance Director during the budget development process, but not with the Audit Committee or full Board. In order for the Audit Committee to provide oversight of the internal audit function, the Committee should be involved in budget discussions and recommend the funding budgeted for internal audit. MSD executive management’s ability to restrict or limit funding for internal audit could impact its ability to operate effectively.

The MSD organizational charts, in effect, between July 1, 2008 and June 30, 2011, do not indicate any affiliation between the MSD Board and the MSD Internal Auditor despite the Internal Audit Charter and the Audit Committee Charter stating that the Internal Auditor functionally reports to the Audit Committee. According to the former Internal Auditor, the MSD organizational charts sometime prior to 2008 included a reporting line for the Internal Auditor position to the Executive Director and the Budget and Audit Committee. She was not certain if the reporting line to the Committee existed after the position was moved to report to the Budget and finance Director instead of the Executive Director in or around calendar year 2000. An organizational chart should clearly provide the lines of authority in an organization. By not including a reporting line from the Internal Auditor to the Audit Committee, the organization diminishes the authority of the internal audit function and gives the appearance that it is not independent from MSD management.

The Internal Audit Charter states that the Internal Auditor will present an annual work plan to the Audit Committee for review and approval as well as provide periodic updates. Audit Committee minutes for meetings held during the examination period, July 1, 2008 through June 30, 2011, document the Internal Auditor's presence at Committee meetings; however, the majority of the presentations documented in the minutes were made by the now former Finance Director and external auditor.

According to the current MSD Internal Auditor, she has made three presentations to the Committee over the last three years, twice to present her annual audit plan and one other time, in March 2010, to present the Committee with an overview of audit committee and internal audit roles in an organization and recent MSD audit results. MSD Audit Committee meeting minutes document only two presentations to the Board, once on March 22, 2010, to update the Audit Committee on previous audits conducted by MSD and on June 28, 2010, to present the draft audit plan for FY 2011. The auditor's work plan for FY 2011 while clearly presented to the Audit Committee was not formally approved by the Committee. Further, the Audit Committee is not receiving sufficient periodic updates from the Internal Auditor.

The infrequency by which the Internal Audit Committee has been meeting could make it difficult for the Internal Auditor to provide sufficient periodic presentations to the Committee. According to its bylaws, the Committee is to at least meet twice a year. During the three-year period the Committee has met 8 times, each meeting was held an hour prior to the morning Board meetings, with an average meeting time of 29 minutes, and meeting minutes reflect the primary focus of these meetings was to discuss the annual financial statement audit performed by an external CPA firm.

Findings and Recommendations

While both the current and former MSD Internal Auditors expressed comfort with reporting to the former Finance Director, stating they did not feel any undue influence and believed he valued the internal audit function, both expressed a desire for more direct interaction and discussion with the Audit Committee. The current MSD Internal Auditor stated that while she does get some verbal acknowledgement from Audit Committee members she has not had much in-depth discussions with Committee members regarding her audits or the internal audit function at MSD.

The MSD Audit Committee Chair acknowledged that there is little discussion of internal audit results. The Committee Chair stated that the Committee should make more use of the MSD internal audit function and the Committee hasn't used the Internal Auditor's talents to the fullest of her abilities. The Committee Chair noted that the Committee should ask the Internal Auditor more questions and the Committee needs to better perform their job.

According to the Audit Committee Charter the committee has the responsibility to "[r]eview with management and the chief Internal Auditor the charter, plans, activities, staffing, and organizational structure of the internal audit function." During this examination, we found little indication that the MSD Audit Committee has fulfilled this responsibility. In order for the internal audit function to be fully effective the Audit Committee and the Board must ensure it is engaged sufficiently to full this responsibility and to ensure independence of its Internal Auditor.

Recommendations We recommend the MSD Audit Committee perform the annual evaluation of the Internal Auditor.

We recommend the MSD Audit Committee approve and recommend to the full Board an annual budget for the Internal Auditor based on the approved internal audit work plan. The Internal Auditor should request directly to the Audit Committee the amount of funds estimated as necessary to conduct those audits. Once approved by the Audit Committee, the annual budget for the Internal Auditor should be ratified by the full Board to be included in the MSD budget by the Finance Director.

We also recommend the MSD Board revise the Audit Committee Charter to include within the Committee's responsibilities the performance of the annual evaluation of the Internal Auditor and the budgeting for the expenses of the Internal Auditor.

We recommend the MSD Board revise the organizational chart of MSD to include a direct reporting line from the Internal Auditor to the Audit Committee of the Board.

We recommend the MSD Audit Committee consistently approve the annual MSD internal audit work plan as required under the Internal Audit Charter. Further, the Board should revise the Audit Committee Charter language to agree with the language in the Internal Audit Charter as the current Committee Charter only states the Committee is responsible for reviewing the work plan.

Findings and Recommendations

Additionally, we recommend the MSD Internal Auditor provide routine status updates on audits to the Audit Committee. This will foster continued communication between the Internal Auditor and Audit Committee members. It will allow the Internal Auditor to discuss any problems that may be encountering on an audit with the Committee in a more timely manner and will allow the Committee an opportunity to discuss any concerns they may have with the thoroughness of a particular audit or regarding other areas of the organization that they may wish to ask her to investigate.

Finally, we recommend the MSD Audit Committee consider holding quarterly meetings to ensure continued direct communication with the Internal Auditor.

Finding 19: MSD provided compensation benefits that could be considered excessive for a public entity.

MSD executives received bonuses, deferred compensation, and retirement increases that appear excessive for a public entity. While these actions may have been approved by the MSD Board, the public could consider these actions to be excessive and unnecessary costs incurred by MSD. The former and current executive directors received deferred compensation trust funds, 180 employees in 1999 and the current Executive Director in 2003 received payments to purchase retirement service credits, and significant salary increases and bonuses were provided to executives and other employees during our audit period.

Former MSD Executive Director received two deferred compensation agreements that resulted in total payments of \$175,000.

MSD's former Executive Director was hired May 1, 1984, and received two deferred compensation agreements before he retired on May 31, 2002. The first Deferred Compensation Agreement was for the period starting July 1, 1994. MSD agreed to set aside \$20,000 per year for a five-year period to retain this employee in this position. In 1999, the former Executive Director received a lump sum payment of \$100,000 and immediately entered into a second deferred compensation agreement starting on July 1, 1999 for the stated purposes to induce continued employment. This agreement established a true "trust" account from which the employee would receive payments on a deferred basis. MSD agreed to pay \$25,000 per year into a trust fund until June 2004 and then pay out the account's assets according to a payment schedule. When this employee retired on May 31, 2002, prior to completing the agreed upon five-year period, MSD had deposited \$75,000 that the employee received in a trust account.

Early Retirement Incentive Plan in 1999 cost MSD over \$10 million.

On March 8, 1999, the MSD Board authorized a voluntary Early Retirement Incentive Plan. This plan offered an incentive payment equivalent to the approximate cost of five years service credit with Kentucky Retirement System for employees who had twenty or more years of service within Kentucky Retirement System on or before March 31, 1999. This payment was made to the employees and it was up to them as to whether they actually purchased any service credits with Kentucky Retirement System. In exchange for this payment, the employee had to sign a written, irrevocable declaration of early retirement from MSD. Even though MSD can terminate its relationship with "at-will" employees at any time with or without notice, the following were provided as the reasons that MSD was offering this incentive were as follows:

Findings and Recommendations

- the recent action by the 1998 Kentucky Legislature permits eligible employees in the Kentucky Retirement System Plans to purchase up to a maximum of five (5) years of otherwise non-purchasable years – commonly referred to as non-qualified time or “air” time,
- to reduce staff levels beyond what is occurring by attrition,
- to reduce payroll costs without forcing layoffs,
- and to assist in the transition from employment to retirement status.

This plan resulted in 180 early retirees at a cost of over \$10 million per MSD’s audited financial statements. The plan made payments to employees that ranged from \$24,893 to \$137,699. There were 16 employees in this plan that were paid in total over \$1 million to retire even though they already had 27 years with MSD and were eligible to retire. Based on interviews with the current personnel, it was not known if a cost-benefit analysis was conducted to establish the financial or employee turnover goals that were anticipated by this plan. However, auditors requested any analysis that was performed and no such documentation could be provided. Without understanding MSD’s goals, the determination as to whether this plan was successful in meeting the needs of MSD cannot be evaluated.

MSD’s current Executive Director was paid an additional \$540 per week for five years totaling \$129,600 to purchase retirement credits.

When the current Executive Director began employment for this position on January 13, 2003, a Retirement Compensation Agreement was also executed for the stated reason of providing incentive and rewarding the Executive Director’s success at MSD. Beginning on March 1, 2003 until February 29, 2008, this employee was paid \$540 per week as a bonus as long as a “Fully Achieves” status is given during the annual performance review. This agreement specified that this money was to be used to purchase retirement credits with the Kentucky Retirement System. Also included in the Retirement Compensation Agreement is a clause that states:

Should Employee be removed by the Mayor from his position, as Executive Director for MSD, he will, with no break in service, be reappointed by the MSD Board to his previous position of Community Relations and Emergency Response Director, at no less than a rank of Grade 22.

In total, MSD provided the Executive Director with \$129,600 to purchase retirement, but this purchase has also provided additional potential pension benefits of \$380,048 based on lifetime projected payout of pension benefits. Through the cooperation provided by Kentucky Retirement Systems under the provisions of KRS 61.685, it was confirmed that the Executive Director purchased five years of retirement under a payment plan that began on April 2003 and ended March 2008. The following table illustrates the effect this purchase had on the monthly and lifetime benefit payments that this employee will receive as a result of this purchase. This information is based on the assumed retirement age of 65 with no further salary increases.

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Table 11: Illustration of Pension Benefits for the MSD Executive Director

Participant	Amount Paid by MSD for Retirement Purchase	Projected Monthly Pension Payment Without Retirement Purchase	Projected Monthly Pension Payment with Purchase	Additional Monthly Benefit from Retirement Purchase	Projected Lifetime Benefit of Retirement Purchase
MSD Executive Director	\$129,600	\$9,620	\$11,342	\$1,723	\$380,048

Source: Auditor of Public Accounts based on information provided by MSD and the Kentucky Retirement System.

MSD gave the current Executive Director a Deferred Compensation Agreement worth \$200,000 to stay with MSD through January 2013.

On January 28, 2008, the current Executive Director entered into a Deferred Compensation Agreement with MSD. MSD agreed to deposit \$40,000 per year until January 2012. The amounts are to be paid out to the employee according to a payment schedule of 10 percent of the account’s market value starting on January 1, 2013 until January 2022. If the Executive Director leaves that position prior to the five-year period that ends in January 2013, MSD will cease payments and the employee will forfeit all amounts contributed unless the termination was the result of death, disability, or retirement.

Former Human Resources Director received a 45 percent salary increase to stay at MSD from August 1, 2008 until December 31, 2008.

The former Human Resources Director received a pay increase of \$27,580 at the direction of the Executive Director. According to the Executive Director, this action was approved by the MSD Board but documentation of this approval was not found. This increase was an incentive for the employee to remain in this position from August 1, 2008 through December 31, 2008. Per the Executive Director, this employee had announced a retirement date of August 1, 2008 that was thought to be a retirement deadline to ensure a more generous retirement benefit formula. Due to personnel turnover at the same time due to this supposed deadline, the Executive Director thought that this retirement would be detrimental to the Human Resources Division. Therefore, the Executive Director increased this employee’s salary by 45 percent as incentive to remain and train the replacement for this position. This action was taken without the Executive Director confirming the issue of whether the retirement formula was more generous in August versus December with the Kentucky Retirement System, which in fact turned out not to be the case.

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While this employee did work during this period, the employee’s personnel file does not document that this increase occurred or that the employee was given any responsibilities to train the incoming Human Resources Director. The only documentation that supports the authorization of this increase is an email from the Executive Director to the Finance Director stating, “[p]lease set her salary range at highest number within the range (grade 27).” This email resulted in another email from the Finance Division to Payroll that the amount that needs to be paid “from 8/1/08 thru 12/31/08 is \$27,580.80. Please divide this evenly for the remaining weeks of the year.”

MSD provides performance awards and pay increases at the six month period for new hires and an annual performance award and pay increases in March regardless of how long the employee has been with MSD.

MSD conducts a six month performance evaluation for new hires and an annual performance evaluation in March. This situation can result in large pay increases for employees even if they have not been employed by MSD for a full year. These evaluations can result in lump sum payments and a percentage increase to the employee’s annual salary.

As an example, the Chief Safety/Security Officer was hired on June 2, 2009 at the annual salary of \$85,010 and, in less than a year, this individual’s salary increased to \$89,544 with additional lump sum bonuses of \$5,177. According to this employee’s personnel file, the Executive Director completed a six-month performance appraisal on March 4, 2010, which was eight months after initial employment. As a result of this evaluation, this employee received a 3.01 percent salary increase and a bonus of \$2,550. One month later when all employees received an annual review, this employee was evaluated again and received a 2.26 percent salary increase and a bonus of \$2,627. While MSD policies allow for this situation, the increases and bonuses appear excessive for an employee with less than a year of experience with the agency.

MSD paid out over \$1.5 million for lump sum performance bonuses in the past three years.

In calendar years 2009, 2010, and 2011, MSD paid out a total of over \$1.5 million in lump sum performance bonuses to employees. This amount does not include the percentage increase to the employee’s salary as a result of the performance evaluations. The following table illustrates the amount of lump-sum bonus payments made per year, the number of employees receiving a bonus, the average payment, and the highest and lowest amounts received by an employee.

Table 12: Lump Sum Bonus Payments Per Year

Calendar Year	Total Amount of Bonuses Paid	Number of Employees Paid Bonuses	Average Amount of Bonus	Highest Bonus Paid	Lowest Bonus Paid
2009	\$511,720	251	\$2,039	\$7,105	\$364
2010	\$507,973	248	\$2,048	\$6,699	\$396
2011	\$534,946	254	\$2,106	\$7,760	\$323

Source: Auditor of Public Accounts based on information provided by MSD.

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Two Executives Received Performance Salary Increases and Bonuses that Restored a Publicized 10 Percent Wage Reduction.

In December 2008, an email was sent to all MSD employees from the Executive Director about the need to reduce the budget for calendar year 2009. The Executive Director's email stated that there will not be any cost of living increases, no salary adjustments, no travel costs unless critical, only emergency overtime, and that the Executive Director and the Chief Engineer will take a ten percent wage cut. The reason for the cuts was due to the economic downturn. This email did not address performance bonuses or pay increases related to performance evaluations.

While these two officials did take a 10 percent pay cut, both received lump sum performance awards and pay increases tied to their evaluations that year. When these amounts are factored in, the Executive Director had only a 1.8 percent reduction in his salary and the Chief Engineer's wages actually increased by 3.8 percent during the calendar year 2009.

As illustrated in the previous table, performance bonuses totaling over \$500,000 were paid out by MSD in calendar year 2011, which does not include the performance increases provided as a percentage of the employees' salaries. Therefore, salary increases related to performance can significantly affect MSD's payroll costs.

Recommendations

We recommend that MSD review its various methods of providing compensation to executives and other staff and ensure that its compensation structure and programs are fair and equitable to executives and staff and is in the best interests of the public it serves. Expenses incurred by a public entity should be scrutinized due to the public nature of the business. Alternative measures should be evaluated to reduce staffing and a cost-benefit analysis of any retirement buyout considered by MSD so that the Board is aware of the potential costs involved and the goals that should be achieved by additional compensation costs. In addition, the policy providing six-month and annual salary increases and bonuses to new employees should be reconsidered because this policy could provide an excessive increase in compensation to an employee that has not been with MSD a complete year. Furthermore, all forms of compensation, including performance salary increases and bonuses, should be considered if MSD wants to control or freeze its payroll budget.

Finding 20: MSD did not comply with procurement guidelines when procuring certain professional services.

In several cases, MSD contracted for professional services without following its own internal procurement requirements or those in the Model Procurement Code, KRS Chapter 45A, applicable to state agencies for the procurement of personal services. Furthermore, MSD policies allowed the MSD Board to waive all requirements in the regulations if deemed to be in the best interest of MSD.

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Procurement Regulations

MSD’s Procurement Regulations, adopted on September 27, 2010 and revised on January 20, 2011, list provisions for the procurement of professional services for services such as lawyers, engineers, accountants, plumbers, electricians, or mechanics, where the cost exceeds the small purchase maximum prescribed by the regulations. When the cost of professional services is expected to cost less than the small purchase maximum, MSD is to follow the “Small Purchase Procedures” as defined in the regulations.

“Small purchases” include those that do not exceed \$20,000 in aggregate per year, per item or product. Purchase may not be parceled, divided, or split over a period of time for the sole purpose of meeting the dollar limitation for small purchases. Additionally, MSD has in writing a separate Small Purchase Procedures document, which was last revised on July 10, 2010. The Small Purchase Procedures document separates levels of purchases into four categories with the following requirements:

Table 13: Small Purchase Procedures

Dollar Amount of Purchase	Direct Pay	Purchase Order Required	Three Quotes Required	Procurement Regulations must be followed
Under \$1,500	x			
Over \$1,500		x		
Between \$5,000 and \$20,000		x	x	
Exceeds \$20,000		x		x

Source: Auditor of Public Accounts based on information provided by MSD.

When the anticipated amount to be paid for a professional service exceeds \$20,000, and the Executive Director determines in writing that the procurement of the professional service is governed by the Procurement Regulations, then the Executive Director uses a Procurement Method Determination Form (PMDF) to document one of the following methods to obtain the services:

- Competitive negotiations;
- Selection from a pre-qualified list; or,
- Non-competitive negotiations.

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Negotiations with the offeror(s) are conducted by the Procurement Team, which includes representatives from the following MSD divisions: Finance, Diverse Works, Legal, and Engineering. Upon completion of negotiations, the Procurement Team prepares a written summary of the selection and negotiation process. The Procurement Regulations require all professional agreements to be in written form, be approved by Board Legal Counsel, and be submitted to the Board along with a summary of negotiations. No contract may have an indefinite term, and those that extend beyond one year require annual contract extensions.

Procurement Regulations also allow that “the Board may choose to waive any or all requirements under this section if deemed to be in the best interest of MSD and select the person(s) or firm(s) best qualified to perform the required service.” Such an exception is not provided in the state’s Model Procurement Code, in KRS Chapter 45A, where guidance is provided for the selection of procurement of professional services. Such guidance in KRS 45A.695 has the following requirements relating to the procurement of professional services through “personal service contracts:”

- (1) Not begin work until a contract is entered into;
- (2) Complete a proof of necessity;
- (3) Give adequate notice for the service need through a request for proposals (RFP); and,
- (4) The award is to be made by the agency head based on evaluations factors set forth in the RFP.

Although MSD has contract requirements, there are no specific requirements for “personal services.”

In addition, KRS 45A.735 authorizes local public agencies, including special districts, to adopt the provisions of KRS 45A.740, 45A.745, and 45A.750 pertaining to the procurement of architectural and engineering services. The APA found no evidence that MSD has adopted such provisions.

Procurement Violations

In its examination of MSD’s procurement of professional services, the APA found violations of its Procurement Regulations and Small Purchase Procedures policies. Table 14 details the professional service secured and the amount MSD paid for the service. Further explanation is provided detailing the procurement violations.

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Table 14: Examples of Professional Service Procurement Deviations

Description of Professional Service	Background of Individual Providing Service	Amount Paid in FY 2009	Amount Paid in FY 2010	Amount Paid in FY 2011	Total Amount Paid
Consultant services for team-building	Former State Senator		\$44,750		\$44,750
Green infrastructure and educational support	Former MSD Employee		13,358	19,013	32,371
Creating easement plats, surveying, inspection services, appraisals, and valuation	Former MSD Engineering Tech	122,377	100,933	117,830	341,140
Independent investigator	Jefferson Circuit Court Retired Judge		10,868	11,025	21,893
Legal services	MSD Contractor since 1996	18,333	20,122	1,710	40,165
Totals		\$140,710	\$190,031	\$149,578	\$480,319

Source: Auditor of Public Accounts based on information provided by MSD.

Former State Senator

According to interviews, MSD paid a former state senator for services that were procured by circumventing in-house procurement requirements and prior to a contract being signed. MSD’s Executive Director directly obtained the consulting services of a former state senator with whom he was a long-time friend. At the time, the Executive Director believed there were communication problems at the director level and instructed him to be at staff meetings to offer advice in communications, as well as provide team-building training. The Human Resources Director disagreed and believed that the work could have been done in-house. No contract existed for his services until after his work was performed. Per a review of expenditure detail, the former state senator was paid \$19,750 for consulting on December 23, 2009 and \$25,000 on March 24, 2010, totaling \$44,750 in FY 2010. The contract for his services appears to have been entered into on April 1, 2010 listing a maximum of \$49,500 to be paid, purportedly at the rate of \$350 per hour. Work should never be performed before a contract is signed. This places the agency under unnecessary risk.

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Procurement regulations provide that small purchases should not exceed \$20,000 in aggregate annually; thus the consulting service provided by the former state senator should have been procured under the Professional Services section of the MSD's Procurement Regulations. The auditors found no PMDF or any other documentation showing the method of procurement for this service: competitive negotiations, prequalification, or non-competitive negotiations. In addition, no documentation of the Board waiving the requirement and judgmentally selecting the individual was provided. After the former state senator provided services, MSD then issued an RFP for additional team-building and communication services, but later pulled the RFP before any services were procured. The reasons conveyed to the auditors for pulling the RFP were inconsistent.

Former MSD Employee

MSD procured the services of a former MSD employee for planning, outreach, and technical support shortly after she resigned from MSD in 2009 due to personal reasons. The specific services to provide were for green infrastructure and educational support with assistance in program development, research of new technologies, and conceptual plan development. According to the initial belief of the Regulatory Services Director who was responsible for the procurement, this service was procured as a professional service, but he was unable to locate a PMDF for the service. He believes it was lost or misfiled and offered to prepare another PMDF for the service stating that. However, later the Regulatory Services Manager conveyed that he could not say whether the service procured was a professional service since the vendor had no certifications that would be highly recognized.

MSD paid \$13,358 to the former employee for her services in FY 2010 and \$19,013 in FY 2011, both within the limit for small purchases. The Procurement Regulations state that all purchases between \$5,000 and \$20,000 require a purchase order and a minimum of three quotes to be obtained. Although this procurement could have been procured as a small purchase, no quotes were obtained as required. Two purchase orders were found for the procurement of the service, but neither had authorizing signatures.

Former MSD Engineering Tech

MSD procured the services of a company of which the sole officer is a former MSD Engineering Tech III for work related to creating easements plats, surveying, inspection services, appraisals, and valuation. The former MSD Engineering Tech's original employment with MSD was from February 1989 through January of 1993. MSD paid his company \$122,377 in FY 2009, \$100,933 in FY 2010, and \$117,830 in FY 2011. MSD had eight separate Professional/Technical Services Agreements with the company beginning August 22, 2005 through August 1, 2011. For three of the eight agreements, no PMDF was prepared. For the remaining agreements, the PMDF's document the agreements were procured using non-competitive negotiations, and all were approved after the dates of the agreements. According to an MSD employee responsible for the agreements, the PMDF and the agreement are usually prepared at the same time. According to MSD policy, the PMDF should be completed and approved prior to any negotiations of contracts or agreements.

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Retired Jefferson Circuit Judge

MSD procured the services of a retired Jefferson Circuit Judge to investigate certain personnel employee grievances. The Executive Director procured his services and negotiated the terms of his agreement. The MSD Legal Director believes this procurement was made a small purchase, as the intent was to use his services on a limited as-needed basis, although the Executive Director believed his services were procured as a professional service. Nevertheless, no PMDF was found documenting the method of his procurement, nor were any bids or quotes obtained. MSD paid the former judge \$10,868 in FY 2010 and \$11,025 in FY 2011. As stated above, small purchases between \$5,000 and \$20,000 require a minimum of three quotes.

MSD Contractor since 1996

MSD paid an attorney for legal services \$18,333 in FY 2009, \$20,122 in FY 2010, and \$1,710 in FY 2011 on an as needed basis for MSD closings of flood plain property acquisitions. The only written contract with the contractor was in 1997. The auditors found no PMDF completed for the work performed. Procedures for the procurement of professional services were not followed. Additionally, MSD wired millions of dollars into an escrow account for MSD property closings handled by the attorney.

The money was wired to a separate escrow account pending disbursement for the payment of a particular property and unpaid taxes, liens, and other related costs associated with the closing. The MSD Legal Director stated that she should have negotiated an escrow agreement directing the handling and disbursement of wire transferred funds and also should have used an escrow instruction letter.

MSD provided training on procurement requirements in 2009 for managers, supervisors, and some directors, but such training is not periodically provided to staff. Employees conveyed to the auditors that staff knowledge and training on procurement requirements was not adequate.

Recommendations

We recommend MSD implement procedures to ensure compliance with all procurement policies, particularly those pertaining to professional services. Employees responsible for procurement should be sufficiently trained on those policies.

Further, we recommend MSD adopt the provisions in the Model Procurement Code in KRS 45A.740, 45A.745, and 45A.750 pertaining to the procurement of architectural and engineering services.

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We recommend:

- Procurement Method Determination Forms be completed in a timely manner in accordance with procurement policies and used to document the method by which the agency intends to procure a service. It is a checkpoint to ensure the agency is utilizing the correct procurement method and should not be overlooked or completed after the contract is signed or services are provided;
- MSD centrally maintain all procurement records; and,
- MSD only approve payments that have a signed Purchase Order.

Finally, we recommend that MSD's policy of allowing the Board to waive any or all requirements related to the procurement of professional services be repealed.

Finding 21:
Employee usage of
MSD computer
appears to violate
policy.

While attempting to address a MSD procurement issue involving procurements made by the MSD Administrative Services Manager during the audit period, auditors found a significant number of personal user data files stored on the MSD server through a shared network directory designated to the Administrative Services Manager's user profile. While incidental and occasional personal use of MSD Electronic Media is permitted for reasonable activities, it must be minimal according to the MSD Electronic Communications Media Policy.

The MSD Electronic Communications Media Policy specifically states that personal use must not involve, among other things, "storing files of an excessive number or size." Based on auditor's review, it appears that dozens of user data files, such as those found in Word and PowerPoint, were personal files stored on the MSD server under the Administrative Services Manager's profile.

Most of the personal files were related to his outside employment, while others were affiliated with the Administrative Services Manager's family and a private business he co-owns. The created, modified, and accessed dates and times of various personal files reflect dates and times that according to his supervisor would be considered normal work hours between 8:15 a.m. and 5:00 p.m. This provides an appearance that the employee conducted personal matters during work hours rather than performing his official duties.

After witnessing the extent of personal use by the Administrative Services Manager, auditors requested and obtained a copy of the employee's Receipt of Electronic Communications Media Policy acknowledgement on file in the employee's personnel file. Through signing this form the Administrative Services Manager acknowledged that he understands that he is "responsible for adhering to the policies and practices" and because the policy may be modified he understands that his "regular review of the policy is required." The employee signed this acknowledgement on June 13, 2000. The Electronic Communications Media Policy was last updated on December 22, 2008.

Findings and Recommendations

Recommendations We recommend MSD provide an updated training to its staff regarding MSD policies, including its Electronic Communications Media Policy. MSD should require staff to sign-in for the training and maintain the sign-in sheets in accordance with its record retention policy. We further recommend MSD require its personnel to periodically sign an acknowledgment to be placed in the employee's personnel file, when its Electronic Communications Media Policy is updated.

Finding 22: MSD had no formal records retention policies or records retention training for its employees.

Upon employment, MSD employees were not provided information and training on records retention requirements for the public records created at MSD. No formal policies on records retention procedures are included in the Policies and Benefits manuals for MSD employees. Further, no records retention system for e-mail exists to assure that recorded information of MSD's functions, decisions, procedures, and essential daily transactions, is retained, regardless of format.

Kentucky law requires that local agencies and special districts retain public records, including books papers, maps, photographs, discs, software, e-mails, databases, and other electronically generated records, as long as legally and operationally required. MSD's current records retention program was created in 1990 and is under the direction of MSD's Administrative Services Manager.

The APA obtained and reviewed MSD's overview of its records storage and retrieval processes, as well as its retention schedule. Although the overview provides general guidance on retention, and the retention schedule is quite comprehensive, neither the overview, nor records retention policies and responsibilities of individual employees were formally communicated to MSD employees. According to the Administrative Services Manager, directors and managers did not want to be trained, and thus training on records retention procedures and responsibilities was "upon request only." He relied on employees to communicate to other employees the retention requirements. Employees were not given a copy of the retention schedule to read or review upon employment, although they were told it was available on-line.

Policies for the retention of e-mail at MSD are documented within MSD's Electronic Communications Media Policy and are not under the direction of the Administrative Services Manager. Regarding e-mail retention, MSD's Electronic Communications Media Policy provides the following:

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Retention of E-Mail – MSD’s users are responsible for the appropriate disposition of e-mail messages. MSD’s mail system should not be used as “filing cabinet” to store messages for an indefinite length of time. Users must review and follow the detailed procedures, as they are made available and updated, to take the necessary steps to preserve important and permanent e-mail as records. As technology progresses to archive e-mail in an appropriate and useful manner, MSD intends to provide its users with such tools.

Although the above policy states that MSD will provide its users with a tool to preserve “important and permanent e-mails records,” MSD has not yet developed or implemented an e-mail retention policy or system that assures archival of those necessary records. Based on information provided during interviews, for two years MSD has been in the process of drafting a records retention archival policy for electronic records. Without such a policy and system that assures the archival of such e-mail records, e-mail records may be deleted, which by law are required to be retained.

Recommendations To ensure MSD retention schedules and related systems and processes are being effectively carried out, we recommend MSD formally adopt records retention policies to be included in the Policies and Benefits manuals for employees. Such policies should detail employee responsibilities over retaining required books, papers, maps, photographs, discs, software, e-mails, databases, and other electronically generated records. We further recommend an archival policy and system be drafted and adopted specifically regarding proper e-mail retainage. Policies should also include training requirements.

Once such policies are adopted by MSD, we recommend that all employees be formally trained on all records retention requirements, including the proper retention of e-mail communications. Upon employment, all new employees should be trained on records retention responsibilities to assure proper retainage of records. MSD also may want to consider having employees sign an acknowledgement that they have read and understand the records management policies.

Findings and Recommendations

Finding 23: MSD accounting system coding errors led to misclassified expenditures and failure to issue 1099 forms to its contractors.

Auditors identified accounting system coding errors, both in the classification of MSD expenditures and its vendors. These coding errors led to the misclassification of certain expenditures between capital projects, between MSD and Louisville Green, Inc., and led to a failure by MSD to issue any 1099s to certain vendors prior to 2009. A 1099 is a federal tax form to report non-salaried income.

While testing a sample of MSD capital projects, auditors found MSD personnel had applied certain capital project expenditures totaling \$61,522.06 to the wrong MSD capital project. In two of the three instances identified during testing, the instances occurred between capital projects that were originally initiated as one project but, early within the project, separated into two projects to reduce the size of the overall project and allow for local competition through a competitive bid process. After auditor's questioned the expenditures, MSD personnel made the necessary corrections to correct the errors.

Auditors also identified direct vendor payments made as small purchases coded in error. A \$1,937.80 contribution was made towards a private tribute event in honor of a former MSD Human Resource Director that was charged to Maintenance and Repairs under the Physical Assets Division. While there is disagreement among MSD personnel as to who knew about this expenditure at that time, see Finding 25 for further detail, it was clear that this expenditure went to benefit a private individual and could not be considered an expenditure for maintenance and repairs of any MSD facilities or assets.

As auditors examined MSD legal expenditures for the period July 1, 2008 through June 30, 2011, we found MSD had not properly coded approximately \$700 of legal expenditures to the proper entity. The MSD Board Legal Counsel also serves as the Louisville Green Board Legal Counsel. Legal billing for services provided as Louisville Green Board Legal Counsel were sent to MSD through a standard billing from the MSD Board Legal Counsel. In 2008 and again in 2010, MSD simply included the small amount billed for services performed as the Louisville Green Board Legal Counsel to MSD legal services.

Finally, auditors found that MSD personnel incorrectly coded the reporting status of several vendors within their system and as a result MSD did not issue these vendors 1099s prior to 2009. The error was found in 2009 by the Accounts Payable Coordinator when assuming this function. The errors are believed to have occurred due to the vendors being established in the MSD accounting system by MSD personnel without first obtaining a required W-9 form. The vendors not receiving a 1099 include several of those whose service was incorrectly procured as discussed in Finding 5.

Findings and Recommendations

While the exact number of affected vendors is not known, the MSD Accounts Payable Coordinator estimated that the number of vendors receiving a 1099 subsequent to identifying the errors doubled. The Accounts Payable Coordinator thought that there were approximately 60 1099s issued in 2008 and about 125 after the coding errors were identified and corrected. After identifying the errors, MSD did not correct the situation by issuing 1099s to its vendors for previous years.

The Accounts Payable Coordinator has created a new procedure regarding W-9's to prevent this type of error from occurring in the future. While it is important for the MSD Finance Department personnel to be aware of and to follow the procedure, it would be beneficial for MSD to develop a policy regarding financial processing activity including the reporting of W-9 information so that all those involved in the procurement of services are aware of MSD requirements.

Recommendations We recommend MSD Finance Department be more diligent in ensuring expenditures are coded to the proper projects and cost categories. Further, because the MSD Finance Department personnel partially rely on the department managers and directors to assist them in identifying the appropriate codes to use when entering the expenditures into the accounting system, we recommend the MSD Finance Department review expenditure cost center and classification information provided by those approving the expenditure and question the information that does not appear reasonable or appropriate.

We recommend the MSD Finance Department require all necessary financial forms, including W-9s, prior to entering the vendor into the MSD accounting system.

Finally, we recommend MSD develop a policy that addresses financial processing activity involving the reporting of W-9 information. The policy should be presented to the MSD Board Policy Committee for approval prior to implementation. The policy should then be posted and distributed to all required personnel to ensure complete institutional knowledge of the newly created and adopted policy.

Finding 24: MSD has not reviewed the computer-based overhead process used to allocate departmental cost to capital projects.

MSD uses a mainframe computer-based process to allocate overhead costs between departments and from departments to maintenance and capital projects. MSD's failure to review the allocation process since its inception in 1999 raises concerns as to the accuracy and applicability of the process to the current MSD structure. Any such misallocation of costs could have a significant impact on financial statements resulting in the over or under allocation of costs to capital projects. Per the current MSD Controller, in the three years that she has been with MSD there has not been a review of the methodology or percentages used in the process.

Findings and Recommendations

The allocation process is a three step computer-based procedure, run on a monthly basis that performs the allocation of cost in three distinct stages. Those stages are referred to as Assessment 1, 2, and 3.

Assessment 1 allocates the total monthly administrative cost of the Corporate Overhead Divisions to Maintenance and Operations Corporate Overhead Clearing Accounts (41.79 percent), Engineering Corporate Overhead Clearing Accounts (56.84 percent), and LOJIC Corporate Overhead Accounts (1.37percent). The departments whose costs are fully allocated in this step are Finance, Human Resources, Physical Assets, IT, IS, GIS, Customer Service, Legal, and Executive Office. The allocation to the receiving departments is based on the total year-to-date actual accumulated costs of that department as a percentage of all the departments to whom costs are allocated. The departmental costs of LOJIC (Louisville and Jefferson Co. Information Consortium) are not allocated in Assessment 1.

Assessment 2 distributes the cost allocated to the corporate overhead clearing accounts in Assessment 1 to the various operating department cost centers, and also directly to any capital projects that may be open and chargeable per specific work orders. This cost allocation is based on the ratio of the total of the individual operating departmental cost to the total of the monthly actual costs of all the operating departments. Any costs allocated to capital projects in this assessment are also based on the total actual costs charged to that project in the month.

Assessment 3 distributes 100 percent of the Engineering department cost and the total of certain other departmental cost centers to open capital projects based on the ratio of accumulated individual project cost to the total accumulated cost of all projects.

While the use of a computer-based system to allocate costs to capital projects may be an efficient and accurate means of allocating costs to capital projects, there may be many factors that could affect and alter the logic or rationale for such automated processes. Changes in, or realignment of departmental responsibilities structure, changes in accounting application of capital and operating costs, and the addition or deletion of department cost centers are examples of changes that might impact the methodology and resultant accuracy of the cost allocation process.

Recommendations We recommend MSD review the allocation process on a regular basis and ensure that the process is fundamentally sound and complies with the commonly accepted accounting basis for capitalized project cost.

We also recommend that MSD review the allocation process annually and document that the process has been reviewed and approved by the appropriate administrative and executive staff.

Findings and Recommendations

Finding 25: MSD made questionable expenditures for parties, donations, travel, training, and other items.

A review of MSD financial records lead auditors to identify MSD funds spent on various questionable items, such as a private tribute party, donations to various organizations, holiday parties, and other miscellaneous items. As a public agency, the MSD Board is responsible for ensuring that funds are used in the most efficient and effective manner possible aligned with its mission and in the best interest the ratepayers that it serves. As such, the benefit of these types of questionable expenditures should be reexamined by the MSD Board and Executive Management.

Retirement Tribute

On December 22, 2008, MSD paid an invoice in the amount of \$1,937.80, through its Physical Assets Division. This expenditure is associated with a private tribute event for the former Human Resource Director, who was retiring from MSD at the time. This event was hosted by the former Human Resource Director's husband but MSD shared some of the expense. According to MSD personnel who attended the tribute event, attendees purchased tickets to the event from the former Human Resource Director's husband.

The invoice paid by MSD for contributing to this private tribute was signed as approved by the Administrative Services Manager. The invoice was not addressed to MSD, but rather to the business office of the former MSD Human Resource Directors' husband. According to the Administrative Services Manager he was assisting the former Human Resource Director's husband in coordinating the tribute event, along with perhaps two or three other MSD employees, and was not anticipating an invoice from the hotel where the event took place. He further stated that he did not know how the invoice came across his desk for payment.

The Administrative Services Manager stated that he asked his supervisor, the Physical Assets Director, about the expense and was reportedly told by his supervisor that he himself had talked to the Executive Director about the expense and that it could be paid.

According to the Executive Director, he used his personal funds to pay the former Human Resource Director's husband approximately \$40 to \$50 per ticket for him and his wife to attend the private tribute. He stated that he was unaware that MSD shared in the cost of this retirement tribute. He noted that there were only about six to eight MSD employees that attended the tribute.

Although there are conflicting statements as to who was aware of the expenditure and when, this is clearly a personal expense that should not have been partially offset using MSD funds.

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Findings and Recommendations

Vendor Payment

While examining the invoices associated with the work of certain companies, auditors identified on one vendor invoice the home address of the MSD Chief Safety and Security Officer, indicating that the vendor had performed work at this residence on behalf of MSD. The invoice, dated September 9, 2010, in the amount of \$550 was from a company's affiliated with the Administrative Services Manager's high school friend.

In discussing the matter with the Administrative Services Manager he stated that the Chief Safety and Security Officer had obviously just used the vendor and this invoice erroneously got paid by MSD. He stated that it was an error by the vendor in billing MSD for the work and it was his responsibility to have approved the invoice and as such he took responsibility for missing the error.

During an interview with auditors, the Chief Safety and Security Officer stated that he had never met this vendor, had not requested this vendor to perform work on his property, and was not aware of the vendor invoice to MSD until it was recently brought to his attention by the MSD Executive Director.

The Chief Safety and Security Officer stated he had discussed with the Administrative Services Manager, about a year ago, a problem he had with a mouse in his home and the need for about a one-half bucket full of dirt to fill in a hole next to his home. He noted that the Administrative Services Manager offered to have someone fill in the hole and that he had no idea who actually performed the work. The Chief Safety and Security Officer believed the work performed at his residence would have only cost approximately \$9.00 and that he had offered to pay the Administrative Services Manager for the work performed. He was told, however, not to worry about it and that the Officer did not owe him anything for the work.

The questions surrounding this vendor invoice, along with the known personal affiliation of the Administrative Services Manager with this vendor and the inconsistency between the responses by the Administrative Services Manager and the Chief Safety and Security Officer to those questions, concerned auditors. Not only does it appear that MSD incurred a personal expense for one of its employees through use of an MSD vendor, but it also draws the question of potential overbilling by this MSD vendor.

Board Legal Counsel Travel

During review of billing statements submitted to MSD by its Board Legal Counsel's firm during the examination period, auditors identified two restaurant invoices, totaling \$472.81, with no details of the items purchased or those attending the meals were provided. Further the restaurant charges were presented by the firm in its billing as overnight accommodations for the Board Legal Counsel for the nights of November 2, 2009 and November 3, 2009, when in fact other portions of the billing statement support that the Board Legal Counsel returned on November 3, 2009 from this trip.

The trip to New York, NY, was taken by MSD officials, including the former Finance Director and the MSD Board Legal Counsel, to meet with a bond rating agency to negotiate credit analysis. After the same trip, the former MSD Finance Director included within his travel expense reimbursement a detailed restaurant receipt totaling \$153.47 for lunch on November 3, 2009. As already detailed in Finding 3, the former Finance Director provided MSD a detailed receipt but did not provide the required details to identify those attending the meal.

In the case of the billing statement provided by the MSD Board Legal Counsel's firm to MSD, the contractor should be held to the same policy requirements as MSD employees. MSD should not reimburse for meals without requiring a detailed receipt and names of the individuals for whom the expenditure was incurred. While MSD documentation indicates there were five MSD representatives traveling on this trip, the documentation from the Board Legal Counsel does not provide sufficient details to determine the appropriateness of this expenditure.

Donations

According to MSD financial records it has expended in total over \$509,000 in contributions and donations during FY 2009, 2010, and 2011. While auditors found some of the donations and contributions may relate to MSD's Consent Decree or mission, a direct relationship to its purpose or mandate was not consistently found.

In some cases, the contributions and donations were made to organizations with which Board members or employees were affiliated such as the Louisville Urban League, MSD Retirees Club and MSD Employees Association. In other cases the contributions and donations were made to organizations that had no remote affiliation with MSD, its mission, or its Consent Decree such as the Louisville Orchestra, Women 4 Women Inc, Dress for Success Louisville and the Louisville Aids Walk. See Exhibit 2 for a full listing of all MSD donations made during FY 2009, FY 2010, and FY 2011.

According to the MSD Executive Director, he is responsible for making the final determination for donations that are made by the organization. MSD does not have a policy regarding donations and the Executive Director stated that it was a MSD practice to make donations before he came into the executive director position. He stated that he has tried to cut back on the extent of the spending in this area over the years. MSD financial reports show that contributions were as high as \$261,688 in FY 2006, in contrast to the \$166,063 MSD expended in FY 2011.

While attempting to reduce the spending in contributions and donations, the Executive Director stated that he has been lobbied by others, including MSD Board members, to reinstate funding to different organizations; however, the Executive Director stated that he never felt pressure from any Board member to make a contribution or donation.

Findings and Recommendations

According to the Executive Director some of the contributions and donations are to support green initiatives. An example of such an annual contribution is one made to an organization funded by Louisville Metro and through private donations, for beautification of the City of Louisville. The Executive Director stated that contributions to that organization over the last two years, totaling \$40,000, could count towards the Consent Decree, as MSD is required to participate in green initiatives as part of that decree.

Through interview with another MSD employee, we learned that one of the high dollar contributions made each year is to partner with the Louisville Water Company to pay costs of water and sewer for needy residential customers. In that case, there is clearly a relationship to MSD's mission and a benefit to its customers.

Current and former MSD Board members we interviewed stated that the spending on contributions and donations are seen as good-will to the community. While the Board is not presented with a list of all organizations for which contributions and donations are made by MSD they do approve a certain amount each year when approving the MSD budget.

While not all contributions and donations made by MSD are completely unrelated to its mission, and perhaps its Consent Decree, other donations made by MSD are not essential and should be re-evaluated by its Board to determine the necessity of such spending. For transparency and full disclosure of MSD donations and contributions, a complete listing should be presented to the Board.

Holiday Parties

MSD annually hosts a Veterans Day celebration and a Holiday Extravaganza for MSD employees, Board members, and their families. On average, for FY 2009, 2010, and 2011, MSD annually spent a total of approximately \$14,000 on these parties.

Over the last three fiscal years MSD spent a total of \$9,754 on its Veterans Day celebration. This celebration began in 2005 as the result of an employee suggestion. The celebration includes a catered breakfast for attendees and a plaque for MSD employees and Board members that want to take part in the recognition celebration who identify themselves as serving or having served in the armed forces. MSD employees and Board members who have received a plaque in the previous year will be presented with another item such as a pin and hat for their service.

MSD spent a total of just over \$31,000 for the Holiday extravaganza for the last three fiscal years. The Holiday Extravaganza includes a catered lunch for attendees and other activities such as games and sketch artists.

These holiday party expenditures are personal in nature with no direct benefit to MSD ratepayers, and are not a necessary business expense.

Chapter 2

Findings and Recommendations

Conference

Auditors tested over \$150,000 in employee expense reimbursements for travel and training. While most travel and training examined was related to an employee's job duties or area of responsibility, auditors identified one particular conference that could not be associated with an employee's job duties or a general need for the employee to attend the conference. The conference in question, the National Black MBA Association Conference, was attended by the same MSD employee each of the three fiscal years of our examination period.

The annual conference was held in Washington, D.C. and in September 2008, cost MSD a total of \$2,580, including airfare. In FY 2010, the same employee flew to the annual conference in New Orleans costing MSD a total of \$1,811 for that conference. Finally, in FY 2011, the employee flew to Los Angeles for the annual conference for a total cost of the trip of \$2,096.

While the employee's supervisor, the Director of Regulatory Services, explained to auditors the importance of MSD's presence at certain industry conferences and meetings, he acknowledged that the conference in question was not directly related to the employee's job duties. According to the Director of Regulatory Services, the employee was allowed to attend the conference annually as it seemed to help with the employee's interpersonal relationships with coworkers. He acknowledged that the necessity of the conference may be questionable and stated that it was unlikely that the employee would be allowed to attend that conference again this next year.

Although most conferences and travel by MSD employees may have an appropriate business purpose or connection to their job duties, auditors questioned the need for frequent travel by MSD employees. Given current economic conditions, MSD, like all other governmental agencies, must carefully scrutinize and minimize such travel and associated expenses where possible.

Office Plants

Between July 1, 2008 and June 30, 2011, MSD spent approximately \$42,600 on office plants. The expenditures, coded to MSD Physical Assets Facilities Maintenance, are for container plants provided to MSD for its offices and maintained by the vendor. The vendor is paid monthly to periodically trim and water these plants. This type of spending appears unnecessary.

Recommendations

We recommend MSD refrain from spending funds for activities and items that do not provide a clear benefit to its ratepayers or help fulfill MSD's mission. We recommend MSD management carefully evaluate each discretionary expenditure to ensure funds are efficiently and effectively used in keeping with its mission.

We recommend MSD consider seeking reimbursement of the amount it contributed to the private tribute from the MSD employee who authorized the payment with obtaining the appropriate approval from the Executive Director.

Findings and Recommendations

We recommend that the MSD Board closely scrutinize its expenditures for contributions and donations. If a contribution or donation is being considered, it should have a clear and documented connection to MSD's mission or must be needed to meet a requirement of its EPA Consent Decree. Further, we recommend all contributions and donations under consideration by MSD be presented to the full Board for approval to ensure Board awareness and management accountability MSD.

We recommend MSD no longer use public funds for Holiday parties and celebrations.

We recommend MSD closely scrutinize travel and conferences, particularly of out-of-state travel. We recommend MSD management also closely scrutinize the number of employees allowed to attend a single conference or meeting. Further, the MSD Board should approve out-of-state travel after being provided with estimated travel costs. Subsequent to the travel, the actual travel expenses should be reported to the Board.

Finding 26: MSD uses the Internal Revenue Service's (IRS) commuting valuation rule to calculate the taxable value of assigned vehicles regardless of the employee's compensation levels.

MSD calculates the taxable benefit of an employer assigned vehicle using the same method for all employees, but this method is not appropriate for all employees. According to MSD's Employee Benefits policies, MSD employees are taxed for the benefit of a take-home vehicle using the IRS Commuting Valuation method. However, this method cannot be used to determine the taxable benefit for certain employees that meet the definition of a "control employee" per the IRS Taxable Fringe Benefits Guide. Using an inappropriate method to calculate this benefit could result in an understatement of taxable benefits reported to the IRS.

When an employer assigned vehicle is used for both business and personal purposes, the value of the personal use must be calculated to determine the taxable amount of this benefit. The IRS Taxable Fringe Benefit Guide (Guide) allows the use of the commuting valuation rule for assigned vehicles, except for "control employees." This Guide states:

Personal use of a vehicle by a "control employee" cannot be valued using the commuting valuation rule (\$1.50 rule). A control employee in a governmental organization is either an:

1. Elected official, or an
2. Employee whose compensation is at least as great as a Federal government employee at Executive Level V.

The annual rate of pay for Level V positions within the executive branch of the Federal government ranged from \$143,500 to \$145,700 between 2009 and 2011.

Findings and Recommendations

During the audit period, four MSD employees grossed an annual salary that exceeded the Federal Level V salary. Therefore, based on the IRS's guidelines, these four MSD employees would be defined as control employees and the commuting valuation rule should not be used to value the personal use of an employer vehicle. The IRS prescribes other valuation methods that can be used for controlled employees.

Recommendations We recommend that MSD comply with IRS guidelines to ensure that the personal benefit of an assigned vehicle is valued appropriately for tax purposes. The MSD policies should be amended to reflect how controlled employees will be determined and the method that will be used to calculate the taxable benefit of assigned vehicles.

Finding 27: The MSD Board allowed a corporation under its authority to administratively dissolve before conveying the corporation's property to MSD.

In the 1990s, MSD agreed to accept responsibility over a local area subdivision's wastewater treatment plant that, in exchange, conveyed its stock to MSD. The MSD Board was then named the Board of this organization. While MSD still assumes responsibility for the facility and surrounding property, the MSD Board allowed the corporation under its authority to administratively dissolve before formally conveying the corporation's property to MSD.

During the examination auditors had identified the P-B Corporation (Corporation) as an entity that was affiliated with former MSD Board members and the former Executive Director. After requesting information regarding this corporation from the MSD Legal Director, auditors were informed that the Corporation was responsible for the oversight of a wastewater treatment facility for a local area subdivision. In November 2003, the Corporation was administratively dissolved by the Kentucky Secretary of State's Office for failure to file the required annual reports.

The Legal Director discovered through her research that the former Executive Director had taken responsibility for filing the annual reports to the Kentucky Secretary of State's Office and after he left MSD the appropriate filings were no longer made. It is believed that this was allowed to occur because only the former Executive Director was involved in submitting the paperwork for this organization. Auditors question the need for the former Executive Director to be solely responsible for filing legal paperwork as it appears to be a routine legal matter that could be handled by in-house legal staff.

The Legal Director stated that the wastewater treatment property is still in the name of the Corporation and that MSD will need to reinstate the Company so the property can be properly conveyed to MSD. The attorney stated that reinstatement should be a simple process; however, the Legal Department was not aware of the issue until auditors raised the question.

Findings and Recommendations

Recommendations We recommend the MSD Legal Director take the necessary actions to address the situation regarding the dissolved corporation and its related property.

We also recommend the MSD Board and its Executive Management evaluate its processes to ensure tasks undertaken by employees are reasonably aligned with their job responsibilities. While it is not inappropriate for the former Executive Director to have filed annual reports on behalf of the Corporation, it is more reasonable and allows for better continuity for the MSD Legal Department to perform that function.

EXHIBITS



CRIT LUALLEN
AUDITOR OF PUBLIC ACCOUNTS

Auditor of Public Accounts
Recommendations for Public and Nonprofit Boards

Revised 3/4/10

The Auditor of Public Accounts, as a result of recent investigations, makes the following recommendations to assist public and nonprofit Boards in designing and implementing internal controls. These recommendations should assist Board members in providing appropriate financial oversight. The following is a brief summary of various financial policy areas that Board members should consider. After each control area is considered, a policy should be developed to address the specific business model of the organization.

1. The Board should have a well defined, clear mission statement to serve as a platform for policies, operational plans, and resource allocations that further the interest of its organization’s members.
2. The Board should facilitate the development of an annual orientation program and manual for new and returning Board members to ensure an understanding of the Board’s structure, operations, and their legal and fiduciary responsibilities. An explanation of the budget and accounting structure, as well as revenue and investment information should also be included. If possible, the orientation should be facilitated by a knowledgeable, independent party, such as a Board attorney or consultant.
3. The Board should ensure that its organizational structure maintains a flexibility that allows for multiple sources of information. The Board should request reports from individuals having responsibility for various program areas rather than from just the chief executive.
4. The Board meeting minutes should document the exact nature of the financial reviews conducted by the Board. Any issues that result from these reviews and action taken to resolve the issues should also be documented.
5. For Boards who fall under the open meetings law, sessions closed to the public should be entered into in accordance with KRS 61.810. Any conclusions or decisions reached during a session closed to the public must be documented in the Board meeting minutes as stated in KRS 61.815, clarified in OAG 81-387.

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6. The Board should establish an independent process to receive, analyze, investigate, and resolve concerns related to the organization including anonymous concerns. Employees, business associates, customers, or the general public may have significant, beneficial information that they are uncomfortable reporting directly to the Board. A toll-free complaint number or an advertised email and postal address for feedback would allow the transmission of this information. In addition, where applicable, the Board's policy should include a reference to Kentucky law (KRS 61.102) notifying employees, as defined in KRS 61.101, of their rights to protection against retaliation for reporting violations to certain authorities. A whistleblower policy should be adopted and distributed to employees. The policy should include reporting procedures and management's responsibility to address issues reported.
7. An internal audit function could be used to ensure that Board concerns are independently investigated. The individual designated to perform internal audits should be given the authority to investigate and examine any area designated by the Board and the responsibility to report the audits findings directly to the Board.
8. A Board audit committee should appoint and compensate the audit firm and ensure the rotation of the lead audit partner and the audit partner reviewing the audit, as required by the Sarbanes Oxley Act (SOX) for companies with publicly traded stock. The Board should also consider whether rotating audit firms would be beneficial given the facts and circumstance of the organization. Further, if possible, the Board audit committee should be comprised of at least one member who has an understanding of generally accepted accounting principles and financial statements, experience with internal controls and in preparing or auditing financial statements, and an understanding of audit committee functions, as suggested in Section 407 of SOX. In addition, reviews of internal controls should be conducted to ensure that controls are functioning as designed or needed. The review of internal controls could be conducted by an internal auditor, Board designee, or included in the engagement of an auditing firm. Any concerns noted by the Board should be disclosed to the auditor and included in the audit scope for review.
9. The Board should adopt a code of ethics that includes standards of conduct for its Board members, officers, and employees related to business conduct, integrity, and ethics. The policy should include the requirement to sign a form stating that the individuals have received and understand the code of ethics. The code should include statements regarding moral and ethical standards, confidentiality, conflicts of interest, nepotism, gifts, honoraria, and assistance with applicable audits and investigations. Violations of the code of ethics should be reported to the Board or designated committee of the Board.
10. The Board should adopt a financial disclosure policy for Board members and executive management. A policy should also be developed requiring Board members and executive management to disclose any conflicts of interests. The disclosure form should be completed by a specified date and returned to the appropriate committee of the Board.

11. The Board should establish and approve a detailed, equitable personnel and compensation policy. The policy should include that the Board or a designated Board committee annually review the salary increases and bonus payments made to all staff. This review should be documented in the Board meeting minutes.
12. The Board should define and document all employee benefits in a fair and equitable manner. Benefits received that result in taxable income should be properly accounted for and accrued to each applicable employee. Employee benefits should also be reviewed to ensure they provide a reasonable business purpose. Also, membership fees to organizations or associations should provide a reasonable business benefit.
13. The Board should approve the compensation package of the organization's primary executive and be aware of the compensation provided to other Executive Staff. In determining the compensation for the primary executive, the Board should consider the organizations financial resources, current economic conditions, employee performance, and salary data for similar positions at relevant organizations within the region.
14. The Board should ensure a well-defined employee evaluation system is implemented within the organization to consistently assess employee performance. The results of the employee's evaluation should be used for employee advancement or salary adjustments.
15. The Board should adopt policies to ensure all forms of employee leave are properly approved and accurately recorded.
16. The Board should have sick and vacation leave policies that address the accrual, use, and the payment to employees for any unused sick, vacation, or compensatory time.
17. The Board policy should include a transparent, competitive selection process for the procurement of goods and services. The policy should outline the circumstances under which quotes or competitive bids are required and the process to be followed. The Board should have policies that require a formal contract for purchases over a specified amount and that all contracts over a specified dollar amount require Board approval.
18. A review of budget to actual expenditures should be performed regularly by the Board or a designated Board Committee to monitor costs in each account. The name and number of budget categories or line items should provide transparency and sufficient detail to allow Board members to accurately identify the types of expenses being attributed to each category. If expenditures occur at an unexpected rate, additional detail should be requested to ensure that incurred expenditures are reasonable and necessary.
19. At least quarterly, the Board or a designated Board committee should receive and review a listing of payments that includes, at a minimum, the payee, dollar amount, and date of each expenditure. This review would assist in identifying inappropriate, unusual, or excessive expenditures.

20. Executive management traveling out of state should present their plans and estimated costs to the Board for prior approval. The approval of these activities and associated costs should be addressed at the Board meetings to ensure proper documentation in the minutes. Subsequent to attending approved conferences or activities, the amount expended should be reported to the Board.
21. To minimize and control the cost of travel, a travel expense policy should be developed that specifically defines the allowable costs related to lodging, meals, entertainment, personal mileage reimbursement, rental cars, and airfare. The travel expense policy should state the invoice requirements for the reimbursement of certain expenditures such as taxi fees, tips, parking, or tolls. The policy should provide examples of expenditures that are to be paid for by the employee, such as costs incurred by family members or the attendance at events not approved by the Board. This policy should explicitly state that expenses not in compliance with the travel expense policy would not be reimbursed or paid by the Board.
22. In lieu of credit cards, the Board should consider the following:
 - The use of purchasing cards that would allow the Board to restrict the types of purchases that can be made on the card based on industry codes. Casinos, specialty retail outlets, and food and beverage establishments are examples of these restrictions. The amount spent on a single purchase can also be restricted through the use of a purchasing card.
 - Reimburse employees personal credit card charges when the use is necessary. Procedures and supporting documentation requirements should be developed to facilitate this type of reimbursement.
23. If the use of credit cards is needed, the Board should implement the following oversight controls:
 - A Board member or committee of the Board should be assigned to review, at a minimum, credit card statements of Executive Staff prior to payment.
 - Credit card charges should be supported by detailed receipts, documented business purpose, and supervisory approval. The employee should be responsible for the timely payment of any unsupported credit card charges or disallowed expenses.
 - Policies established by the Board should ensure that all review procedures are performed in a timely manner to avoid late fee and finance charges.
24. Expenses classified as gifts or entertainment should be documented to include the name and title of the person(s) involved and a description of why the expense was needed and how it relates to business operations.
25. A policy related to reimbursements made by employees to the organization should be developed to ensure that any expenses that should be paid by an employee are monitored. This policy should include the timeframe allowed for making the reimbursement and the alternative actions that will be taken if reimbursement is not made.

26. Business expense reimbursements requested by executive management should be reviewed by the Board or a designated Board committee to ensure supporting documentation is provided. This documentation should be retained to ensure that duplicate payments are not made to the employee.
27. Specific marketing goals should be developed to monitor the success of any business promotions approved by the Board. Marketing expenditures incurred should be coded to that goal so that Board members will know the expenses involved in a specific marketing promotion. Further, documentation should be maintained detailing the recipients of promotional prizes including tickets, trips, or merchandise.
28. A Board policy should be developed to address the authorization process to purchase vehicles and the method used to dispose of vehicles. The use and assignment of vehicles owned by the organization should be addressed within this policy. In addition, the practice of providing a vehicle should be reviewed and monthly vehicle allowances considered. The policy should include following the IRS guidelines for personal use of a vehicle.
29. The personal use of business equipment should be addressed within Board policy to determine when appropriate. The policy should require that equipment being used inappropriately or that is missing should be reported directly to the Board.
30. The Board should establish a policy detailing the process to report lost or missing financial information or records. To avoid lost or stolen financial information, electronic images of financial records should be created and retained, if possible.
31. A formal policy should be developed that identifies what equipment is a fixed asset and should be included as inventory. Once this designation has been made, the existing inventory listing should include the following identifying information related to each piece of equipment:
 - The name of the individual in receipt of equipment;
 - Description of equipment;
 - Vendor name;
 - Model number;
 - Serial number;
 - Acquisition date; and,
 - Acquisition cost.

Once the inventory listing has been validated, any acquisitions and dispositions of computer equipment that fall within the fixed asset policy should cause an appropriate update to the inventory listing.

32. An information system policy should be developed that explicitly defines a user's responsibilities as they relate to information system resources and applications. These policies should cover, at a minimum:

- Securing of user id and password;
- Protection against computer virus or mal-ware infection;
- Legal notice at logon indicating system is to be used for authorized purposes only;
- Securing unattended workstations; and,
- Securing portable devices, such as laptops, Blackberries, cell phones, etc.

Donations And Contributions Made By MSD By Fiscal Year

Exhibit 2

Vendor Name	FY2009	FY2010	FY2011
100 BLACK MEN OF LOUISVILLE	\$ 1,000	\$ 1,500	\$ 1,500
ADELANTE HISPANIC ACHIEVERS	--	1,500	--
AFRICAN AMERICAN HERITAGE	--	1,500	--
ASSOCIATION OF COMMUNITY MINISTRIES	--	25,000	--
BOY SCOUTS OF AMERICA	600	--	600
BPW RIVER CITY	1,500	--	1,500
BRIGHTSIDE	40,000	20,000	20,000
BROWN COMMUNITY DEVELOPMENT CTR	500	--	--
BUSINESS FIRST OF LOUISVILLE	280	320	360
CENTER FOR INFRASTRUCTURE RESEARCH	25,000	--	--
CENTER FOR WOMEN & FAMILIES	2,000	2,000	2,000
DRESS FOR SUCCESS LOUISVILLE	1,000	500	1,000
DUES/FEES/SUBSCRPTN *	(5,500)	(750)	--
EDGE OUTREACH INC	--	10,000	--
FAMILY SCHOLAR HOUSE	750	750	750
FOUNDATION FOR OHIO RIVER EDUCATION	--	10,000	5,000
FRANKFORT AVENUE BUSINESS ASSOC	--	--	20,000
GREATER LOUISVILLE INC	11,025	20,000	27,950
HIGHLANDS COMMUNITY MINISTRIES	--	1,000	--
JCPS TREASURER	10,000	--	--
KENTUCKIANA MINORITY	3,000	--	--
KENTUCKY ALLIANCE	400	400	--
KENTUCKY CENTER FOR AFRICAN	2,500	--	1,500
KENTUCKY COMMISSION ON HUMAN	--	5,000	--
KENTUCKY ENGINEERING FOUNDATION	--	--	250
KENTUCKY SECTION ASCE	--	--	250
LCCC INC	600	600	750
LIVING LANDS & WATERS	10,000	10,000	--
LOU CONVENTION & VISITOR'S BUREAU	--	--	750
LOU METRO DEPT OF NEIGHBORHOODS	750	--	--
LOUISVILLE / JEFFERSON COUNTY	--	600	500
LOUISVILLE AIDS WALK	--	1,500	1,000
LOUISVILLE DEFENDER	225	--	--
LOUISVILLE DOWNTOWN MGMT DISTRICT	980	980	980
LOUISVILLE METRO FINANCE & BUDGET	750	--	--
LOUISVILLE METRO HUMAN	635	--	--
LOUISVILLE REGIONAL SCIENCE FAIRS	--	10,000	10,000
LOUISVILLE SCIENCE CENTER	5,000	--	--

Donations And Contributions Made By MSD By Fiscal Year

Exhibit 2

Vendor Name	FY2009	FY2010	FY2011
LOUISVILLE URBAN LEAGUE	4,500	4,000	4,500
MSD EMPLOYEES ASSOCIATION	--	--	4,523
MSD RETIREE'S CLUB, INC.	3,000	3,000	3,000
NAACP FREEDOM FUND	1,000	500	--
NAWBO	450	--	--
ONE SOUTHERN INDIANA	1,200	1,500	1,500
JUNIOR ACHIEVEMENT	100	--	--
ORSANCO	10,000	--	--
PROJECT ONE INC	5,000	4,000	2,000
RUBBERTOWN COMMUNITY ADVISORY	3,000	3,150	3,300
SALT RIVER WATERSHED WATCH	8,000	8,000	8,000
SHERRIE HALL	375	--	--
THE LINCOLN FOUNDATION INC	--	--	1,000
THE LORD'S KITCHEN	--	1,000	--
THE LOUISVILLE ORCHESTRA	2,500	--	--
THOMSON-HOOD VETERANS CENTER	--	500	500
TRI-STATE MINORITY SUPPLIER	--	3,000	3,000
UNIVERSITY OF LOUISVILLE	60	25,000	25,100
VOLUNTEERS OF AMERICA	--	3,000	3,000
WOMEN 4 WOMEN INC	500	500	500
WOMEN OF VISION AND PURPOSE	500	--	--
YMCA BLACK ACHIEVERS	3,500	3,500	7,500
YMCA SAFE PLACE SERVICES	2,000	2,000	2,000
Total Contributions	\$ 158,680	\$ 185,050	\$ 166,063

Source: Auditor of Public Accounts based on information provided by MSD.

* DUES/FEES/SUBSCRPTN is an account within MSD's accounting system. Rather than reclassifying specific transactions within the MSD system from contributions to dues, fees and subscriptions, MSD personnel have created a transaction netting these amounts from contributions.

METROPOLITAN SEWER DISTRICT RESPONSE



Louisville and Jefferson County Metropolitan Sewer District
700 West Liberty Street
Louisville Kentucky 40203-1911
502-540-6000
www.msdlouky.org

December 14, 2011

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

Subject: Report on Examination of Certain Policies, Procedures, Controls, and Financial Activity of Metropolitan Sewer District

Dear Ms Luallen:

On behalf of the Louisville and Jefferson County Metropolitan Sewer District (MSD), please accept this letter in response to your draft report of the Examination of Certain Policies, Procedures, Controls, and Financial Activity of Metropolitan Sewer District, which was received by MSD at the close of business on December 7, 2011.

On behalf of the MSD Board members and staff, we would like to express our appreciation to you and your staff on the professional and thorough manner in which this examination was conducted and on the preparation of the draft examination report.

Your report describes several opportunities for improvement at MSD, which have been taken under serious advisement by Board members and staff. It is our goal to operate this agency in a manner that is transparent, ethical, responsible, and efficient while keeping our customer needs and satisfaction our number one priority. In order to improve our operations, we have already started to implement several recommendations including the following:

- MSD's recent draft ethics policy for Board members and appointed staff members is being revised to include your specific recommendations, and a Policy Committee meeting will be scheduled for January 2012 to discuss this policy.
- To ensure MSD retention schedules are effectively carried out, staff has obtained a copy of a records retention policy that members of the auditing staff recommended be used as a guide. Staff has been reviewing this policy for the purpose of drafting a comprehensive records retention policy that will include retention and archive of email.
- In addition, we have already eliminated certain donations and contributions from our current budget, and MSD staff has been asked to review the budget for activities and items that do not provide a clear benefit to ratepayers or in fulfilling MSD's mission.
- Lastly, MSD policies are currently being amended to include the appropriate valuation methods to calculate the taxable value of assigned vehicles.



Beneficial Use of Louisville's Biosolids
www.louisvillegreen.com

December 14, 2011
Page 2

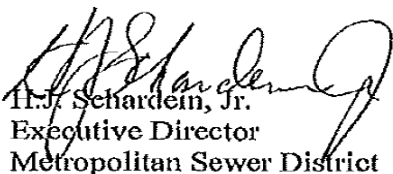
We are in general agreement with all the recommendations provided in your report, and understand the positive effect implementing them will have on our operations. To ensure there are no missed opportunities for improvement, we are putting together a corrective action plan to study and follow your recommendations. Our plan will outline the corrective actions we intend to make, as well as the timeline for implementation. As corrective actions are discussed in detail, we may find it necessary to make additional corrections, or tailor your recommendations to better meet our operational, regulatory, or legal concerns. Our corrective action plan, along with any implementation concerns, will be communicated to your office within 60 days of the issuance of your final report.

I would like to thank your staff again for their thorough identification of opportunities to improve MSD operations. These corrective actions will allow us to meet the needs of our customers in a more accountable, ethical, and efficient manner.

Sincerely,



Arnold J. Celentano, P.E.
Chairman
Metropolitan Sewer District Board



H.J. Schardein, Jr.
Executive Director
Metropolitan Sewer District

cc: Honorable Greg Fischer
MSD Board Members
Brian Lykins, Executive Director, Office of Technology and Special Audits