



Town of Palm Beach

Internal Audit Report
Construction in Process Accounting
July 2010

Town of Palm Beach

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I. Executive Summary

Crowe Horwath LLP (Crowe) performed an internal audit of the Town's accounting function for a sample of construction projects from a time period spanning October 1, 2008 to March 31, 2010. The overall objective was to review the controls over the accounting for construction and capital projects for the time period identified. We reviewed selected policies and procedures with the Town's personnel, and in some instances tested certain detailed records and technical configurations.

REPORTING METHODOLOGY

In this report, we provide a summary of our results and recommendations as well as management's responses. To assist you in analyzing our recommendations, we have provided our suggestions for corrective action based on the finding's exposure to loss or increased regulatory scrutiny, as follows:

High – Requires *immediate* remedy and, if left uncorrected, exposes the Town to significant or immediate risk of loss, asset misappropriation, data compromise or interruption, fines and penalties, or increased regulatory scrutiny.

Moderate – Requires *timely* remedy and, if left uncorrected, may expose the Town to risk of loss or misappropriation of company assets, compromise of data, fines and penalties, or increased regulatory scrutiny. These issues should be resolved in a timely manner, but after any high priority issues.

Low – Should be addressed as time and resources permit. While it is not considered to represent significant or immediate risk, repeated oversights without corrective action or compensating controls could lead to increased exposure or scrutiny.

Best Practice – Represents operational efficiencies or improvements for consideration by management based on industry best practices and Crowe's experiences.

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SUMMARY OF RESULTS

The table below displays the number of recommendations identified through our procedures, categorized by priority.

Risk Rating	Total
High	1
Moderate	1
Low	1
Total	3

Best Practice	3
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Detailed observations and recommendations are provided in Section II – Results and Recommendations. The most significant issues identified during our assessment include the following:

- **Review of Construction in Process Accounts**
- **Capital Project Accounting Policies and Procedures**
- **Accounting for Infrastructure Capital Assets**

In addition to the items summarized above, other items are also documented in Section II that do not represent significant risk at this time, but offer opportunities for the Town to further strengthen controls and processes.

Thank you for this opportunity to report the results of our procedures. We also wish to thank the various Town personnel for their cooperation and assistance.

II. Results and Recommendations

Below are the results and recommendation of our procedures performed.

Finding # 1: Review of Construction in Process Accounts
Risk Rating: High

We noted that a “Capital Improvement Program” is approved by the Town Council on an annual basis. The Program is broken down into several areas such as Storm Water, Sanitary etc. Although individual projects are allocated by separate line items, there are also program line items that are for “general improvements”. It should be noted that if additional significant projects are identified, there may be transfers from the “General” line item to the specific project (this is done by the approval of the Director of Public Works after going through the required approvals).

As of September 30, 2009, there was \$2,649,947 and \$2,121,279 capitalized for sewer and drainage general improvements, respectively. Per discussion with the Assistant Finance Director, the Finance Department is unaware of the composition of the items that currently comprise the detail in the construction in progress accounts as to whether they should be expensed or capitalized. The rationale for this per inquiry appears to be that the Finance Department may not have sufficient resources available to enable these accounts to be fully analyzed and reconciled to the detail required on a periodic basis.

The risks of including the general improvement accounts under CIP expenditures are as follows:

- Expenditures that are not significant enough to meet the Town’s definition of a capital asset are being capitalized, as opposed to being expensed as incurred.
- There could be multiple smaller projects included in the general improvements that would make individual tracking of each difficult. As a result, it would be difficult to determine when to the asset is placed into service and should be transferred to capital assets and depreciated
- The Town is potentially overstating assets by a significant amount.

Recommendation

We recommend that the Town perform the following:

- Prior to the end of the Town’s financial year, the Finance department should perform an analysis of each general ledger account related to CIP, specifically the general improvement general ledger (GL) accounts. The analysis needs to include all expenditures incurred dating back to capitalization start date, along with details of which project the expense relates to and when the capital asset (if applicable) was or is intended to be placed into service. If the expenditure was not determined to be a capital asset, this should be identified to be expensed. This analysis needs to be performed in conjunction with a member of the Public Works Department.
- Once the analysis is completed, the Town should consider the materiality of the items that should have been previously expensed or that should have been placed into service and depreciated and the impact that these items have on previously issued audited financial statements.
- In the future, we recommend that GL accounts should not be used that are general in nature. If expenditures are related to specific projects, a separate GL account code should be used. Alternatively, a supplemental schedule that reconciles the individual transactions processed through

the general account should be performed quarterly and on an annual basis the appropriate adjustments should be made based on review between the Finance Department and the Director of Public Works.

Management's Action Plan

The Finance Department has begun the process of analyzing the sewer and drainage general ledger accounts. A spreadsheet detailing each purchase order and invoice that ties to the expenditures in each account is being prepared and will be reviewed with a representative from the Public Works Department to determine which items need to be capitalized. After the analysis of the two general accounts is complete, the remaining line items will be analyzed to determine capitalization levels. This process will be completed for incorporation in the FY2010 financials. The vacant position in the Finance Department has been authorized to assist with this ongoing reconciliation process.

General Ledger accounts that are general in nature will not be used in the future. As each bid award is approved by Town Council, new projects will be established with budget transfers from the general line items to a specific project. A supplemental schedule that reconciles the individual transactions processed through each account will be performed on a quarterly basis starting with the quarter ended December 31, 2010.

**Individual(s) Responsible: Jane Struder, Finance Director, Paul Brazil, Public Works Director
Due Date: December 31, 2010**

Finding # 2: Capital Project Accounting Policies and Procedures
Risk Rating: Moderate

We noted that there is currently no formal written accounting policy and procedure related to Capital Project Accounting. We were provided with a draft document that describes the current practice for Capital Project Accounting, however this was an informational document that was drafted to provide us with additional insight that would assist us with our procedures.

In addition, there were no periodic reconciliations performed on capital project general ledger accounts and no identified process owners or specified reviewers.

Recommendation

We recommend that the Town finalize the Capital Project Accounting Policy and Procedures, which should include the following:

- Specify the process and other employees responsible for the process and related internal controls.
- In addition to identifying the related processes, documenting the key controls that reduce the risk of material misstatement. For example, in the draft that was provided, one process that was identified was "A determination is made prior to establishing account numbers, as to whether the project is to be capitalized/depreciated or expensed as supplies maintenance". This process should be supported by a key control, such as "Prior to the creation of project account number, the Assistant Finance Director or designee and Public Works Project Manager will review each project phase in accordance

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with the Town's Capital Asset Policy to determine if that phase of the project should be capitalized or expensed. This process shall be documented and signed off as approved by the Finance Director.

- The policy should specify the development and use of a "Capital Project Request Form" in conjunction with the annual budget development process and for inclusion in the budget document. An example of this form was provided by the Finance Department but was not currently being utilized on any project. The purpose of this form is to enhance the information flow between the Finance Department and other departments within the Town.

Management's Action Plan

A Capital Project Accounting Procedure will be drafted by Finance, reviewed by the Public Works Director and approved by the Town Manager. The procedure will identify related processes and document the key controls that reduce the risk of material misstatement. Two forms will be developed as a part of this procedure. The first form will be prepared during the annual budget process and will be included in the Town's budget document. The second form will be prepared when projects are submitted to the Town Council for approval to identify the project budget including contingency, phases as they relate to accounting for acquisitions, disposals and depreciation for infrastructure accounting.

**Individual(s) Responsible: Jane Struder, Finance Director, Paul Brazil, Public Works Director
Due Date: October 1, 2010**

Finding # 3: Accounting for Infrastructure Capital Assets
Risk Rating Low

We noted that all infrastructure assets are maintained in excel and depreciation is recorded to the General Ledger based on this schedule.

The schedule is prepared annually by the Assistant Finance Director and is not reviewed or approved by any other employee. Upon obtaining the schedule for infrastructure assets, we also noted the following:

- Asset additions under each major category of infrastructure are added under one item (i.e. "2009 Additions") as opposed to individual projects. As a result, future disposals are not able to be accurately determined in terms of carrying value.
- On an annual basis, the Assistant Director of Finance obtains a listing of the current year disposals from the (former) Assistant Director of Public Works. The disposals are based the Director's estimates and are calculated based on the materials used during the current year additions (i.e. quantity and current price). Once the total disposals have been calculated, there will be a reduction in cost and accumulated depreciation for the same amount. Due to the significant lives on the various classes of infrastructure, it is unlikely that the assets would be fully depreciated, although due to this treatment all disposals are treated as if they had no carrying value.
- There is no depreciation calculated on current year additions due to the date during the year that assets are placed into service (one time per year at September 30).

Recommendation

We recommend that the Town perform the following going forward:

- Separate schedules are maintained for each component of infrastructure that reconciles back to the total additions for the year. Each separate schedule should break down the total additions into separate smaller projects.
- Disposals for each year are calculated based on the actual cost and accumulated depreciation through the month of disposal. A loss on disposal should be recorded on disposed assets with a residual carrying value.
- Additions should be depreciated from the date placed into service. The analysis of when a fixed asset is placed into service should be identified as opposed to one date each year.

Management's Action Plan

The Finance Department will be researching the best method to track infrastructure activity. Additional training will be scheduled during November 2010 on the Project Accounting Module for the Town's current financial software to determine if the module will provide the required infrastructure information. In addition, Finance will survey area municipalities and work with the Town's current annual auditors as a part of the evaluation process. Our goal is to establish a cost effective method of achieving the objectives stated in Crowe's recommendation above. The procedural improvements in response to this finding will be implemented by September 30, 2011.

Individual(s) Responsible: Paul Brazil, Public Works Director; Jane Struder, Finance Director and Cheryl A. Somers, Asst. Finance Director
Due Date: September 30, 2011

Finding # 4: Employee Access Rights to Eden Modules
Risk Rating: Best practice

We tested the various employee access rights to the Eden modules on a sample basis. Although it appeared that the majority of access rights were appropriate for the employee's job responsibilities, there were instances where exceptions were noted. For example, an Accounting Clerk (Linda Jones) has access to the Accounts Receivable module in Eden, even though it appeared that Accounts Receivable is not part of her job profile.

Recommendation

Management should complete a full review of user access for all members of the Finance group and employees should be provided access to those modules that are appropriate for their job responsibilities. For instances where some employees need access to other modules for cross-training or cross-cover purposes, this should be documented as to the reason for the access provided.

Management's Action Plan

Each year on an annual basis, the Office of Information Systems runs a report of user access to all of the Eden Systems and provides this report to the Finance Director. The Director reviews the report, makes any necessary changes, and responds to the Information Systems Manager regarding any actions that need to be taken. This is part of the existing Information Systems Technologies Policy. When it is completed again this year (and in future years) as part of the Town's annual audit, the Finance Director will include in her review specific consideration of Crowe's concerns as stated in this finding and recommendation.

Individual(s) Responsible: Spencer D. Wilson, Information Systems Manager, and Jane Struder, Finance Director

Due Date: September 30, 2010

Finding # 5: Information Systems Security Policy

Risk Rating: Best Practice

We noted that the Information Systems Security Policy was first implemented in January 1993 and was last revised on September 30, 2005. It has been almost five years since the policy has been updated, and the Town has been through a major systems conversion to Eden during this period.

Recommendation

Management should consider reviewing the Security Policy to determine if the Policy needs to be revised and updated.

Management's Action Plan

During the summer of 2010, the Office of Information Systems updated the existing Information Systems Security Policy as well as several other policies. All of these policies have been combined into a single Information Systems Technologies Policy which was completed on July 30, 2010. This new all inclusive policy covers all aspects of work, procedures and security within the Office of Information Systems. This new policy will be updated annually to make sure the policy keeps pace with the changes in technology as well as other changes within the Town.

Individual(s) Responsible: Spencer D. Wilson, Information Systems Manager

Due Date: Completed July 30, 2010

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Finding # 6: Information Systems Utilization and Communication
Risk Rating Best Practice

From discussions with members of the Finance Department, we noted the following issues:

- The project accounting module of the Eden accounting system was not being reconciled to the general ledger and the full capacity of the project accounting module was not being effectively utilized.
- There were concerns expressed that the Finance Department was not being as efficient as possible in the processing of transactions, especially items such as processing purchase orders with multiple budget line items.
- The period end closing procedures appeared to be delayed through a lack of coordination and communication with the various departments involved. The general ledger has remained left open for a significant amount of time so that all invoices could be included in the correct fiscal year to ensure that fund balances are correctly rolled over.

Recommendation

We recommend the following:

- Employees of the Finance and Public Works departments should consider engaging the services of Eden consultants for guidance and additional training on the system's capabilities. The consultant would first determine how the system is currently being used and determine what efficiencies can be gained, especially by the use of the project accounting module. It is imperative that both departments be involved in the training to ensure that both departments are aware of what each department requires from the accounting system and how best to achieve the desired results.
- The period end closing procedures should be reviewed to determine the point at which communication between various departments needs to take place, the process owners and the controls that are in place to ensure that deadlines are met. Specifically related to obtaining invoices in a timely fashion, at year end the Public Works department should review a listing of open purchase orders and from this list, contact vendors to ensure that invoices are going to be received in a timely fashion to ensure that the period end closing of the general ledger can be achieved in an efficient manner.

Management's Action Plan

EDEN has been contacted regarding additional training on the project accounting module which is tentatively scheduled for November 2010. Employees involved in accounting for capital projects in the Public Works and Finance Departments will be trained on the system's capabilities.

Open purchase orders as of July 2010 have been reviewed by each Department and many balances have been liquidated. In mid-September an additional updated schedule of open purchase orders will be provided to the Departments to determine the status of purchase orders and if invoices need to be provided by vendors for services rendered.

Individual(s) Responsible: Jane Struder, Finance Director, and Paul Brazil, Public Works Director
Due Date: November 30, 2010

III. Summary of Scope

The specific procedures performed were based on the concepts of selective testing. Although our testing was performed in some areas without exception, we can provide no assurance that exceptions would not have been detected had procedures been changed or expanded.

It should also be recognized that internal controls are designed to provide reasonable, but not absolute, assurance that errors and irregularities will not occur, and that procedures are performed in accordance with management's intentions. There are inherent limitations that should be recognized in considering the potential effectiveness of any system of internal controls. In the performance of most control procedures, errors can result from misunderstanding of instructions, mistakes in judgment, carelessness, or other factors. Internal control procedures can be circumvented intentionally by management with respect to the execution and recording of transactions, or with respect to the estimates and judgments required in the processing of data. Controls may become ineffective due to newly identified business or technology exposures. Further, the projection of any evaluation of internal control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions, and that the degree of compliance with procedures may deteriorate.