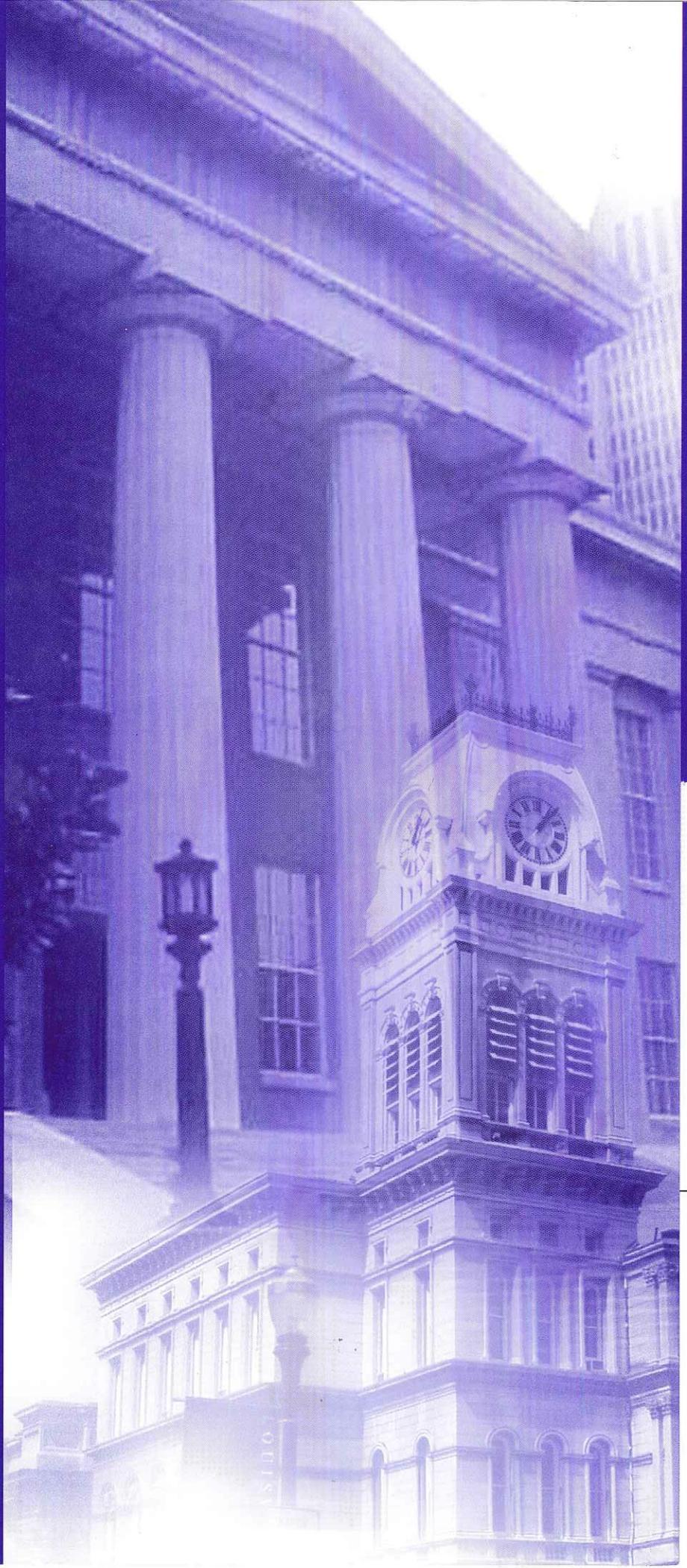




Jerry E. Abramson
Mayor

26 Member
Metro Council

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



Office of Internal Audit

Louisville Metro Government

Refreshment Expenditures

Audit Report

Office of Internal Audit

Louisville Metro Government

Refreshment Expenditures

December 2007



Louisville Metro Government

Refreshment Expenditures

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OFFICE OF INTERNAL AUDIT
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Transmittal Letter

December 28, 2007

The Honorable Jerry E. Abramson
Mayor of Louisville Metro
Louisville Metro Hall
Louisville, KY 40202

Subject: Audit of Louisville Metro's Refreshment Expenditures

Introduction

An audit of Louisville Metro's refreshment expenditures was conducted. This included expenditures for meals, food, snacks, soft drinks, coffee, and water. The primary focus of the audit was as follows.

- **Public Purpose.** Determining if the activity was in compliance with public purpose requirements for expenditures.
- **Federal Tax Issues.** Determining if expenditure activity complied with Federal Internal Revenue Service requirements in regards to taxable fringe benefits.
- **Procurement.** Determining if opportunities exist to improve the efficiency and effectiveness of the procurement of refreshment commodities.

Compliance with laws, policy, and other regulatory guidelines were included in this review. The objective was to obtain assurance that the risks are adequately mitigated through the internal control structure.

The examination was conducted in accordance with Government Auditing Standards issued by the Comptroller General of the United States and with the International Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors.

As a part of the review, the internal control structure was evaluated. The objective of internal control is to provide reasonable, but not absolute, assurance regarding the achievement of objectives in the following categories:

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

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

Scope

Louisville Metro's refreshment expenditures were reviewed. The audit period covered expenditures from July 1, 2006 through September 30, 2007. The population of refreshment expenditures was identified by Metro financial accounts and by suppliers of refreshments. The primary financial accounts identified were Food and Public Relations. Reviews of sample data were performed for transactions from the audit period. Activity reviewed included supplier payment documents, along with supporting documentation and Metro financial system postings.

The review assessed whether expenditure activity was in compliance with various requirements in Louisville Metro policies, procedures, and ordinances, Kentucky State guidelines, and applicable Internal Revenue Service regulations. The details of the scope and methodology of the review will be addressed in the Observations and Recommendations section of this report. The examination would not identify all issues because it was based on selective review of data.

Opinion

It is our opinion that the internal control structure for refreshment expenditures is weak. The internal control rating is on page 5 of this report. This rating quantifies the opinion regarding the internal controls. Issues noted include the following.

- **Policy.** Louisville Metro Government does not have an enterprise policy for refreshment expenditures, nor is public purpose defined in its enterprise policies and procedures. Each Metro department is responsible for the administration of its refreshment expenditures, including ensuring it is for a public purpose. Without a policy, Metro departments have very little guidance to use in determining if an activity is appropriate. As a result, there is inconsistency with what is considered appropriate refreshment expenditure activity.
- **Public Purpose Documentation.** For 51% (56 of 110) of the sample of refreshment expenditure transactions reviewed, the public purpose could not be determined based on the payment documentation. The Metro departments that authorized the refreshment expenditures were contacted. The departments were requested to provide additional information to justify the public purpose of the expenditures. All departments responded.
 - The Office of Internal Audit is not expressing an opinion as to the appropriateness of the public purpose justification provided by these Metro departments. Some of the activities appeared to be solely for the benefit of Metro employees. This

included refreshments provided for retirement and holiday parties as well as employee meetings.

- **Fringe Benefit Tax Issues.** It appears that the refreshment activity related to Metro employees qualifies as a de minimis fringe benefit under IRS regulations. Thus, it would be proper to exclude it from the employees' gross income since it is not taxable. However, the particular circumstances of the activity may impact the final determination. Therefore, the Office of Internal Audit is not opining on the appropriateness of the tax treatment for the 110 transactions reviewed.

Corrective Action Plan

The focus of this review was the Louisville Metro enterprise, not an individual department. Each Louisville Metro department is responsible for ensuring its refreshment expenditures are for a public purpose and comply with applicable regulations and requirements. To facilitate appropriate corrective actions, this report will be provided to all Louisville Metro departments. Each department should be accountable for reviewing its policies and procedures to ensure controls are effective in mitigating the risks. This includes implementing necessary corrective actions as well as recommendations contained in this report.

Since public purpose is the ultimate determining factor for the appropriateness of expenditures, it would be in Louisville Metro Government's best interest to issue guidance for departments. The guidance would allow Metro departments to determine if an activity would be an appropriate use of public funds. As the originator of Metro's financial policies, the Department of Finance would be the most logical department assigned the responsibility for issuing the guidance. Departmental input, as well as legal advice, should be included in the development of the public purpose guidance.

Formal responses from the Louisville Metro departments were not requested for inclusion in this report. However, future reviews of refreshment expenditure activity will determine the effectiveness of the departments' corrective actions. The Office of Internal Audit will be available to consult with the departments as necessary corrective actions are implemented.

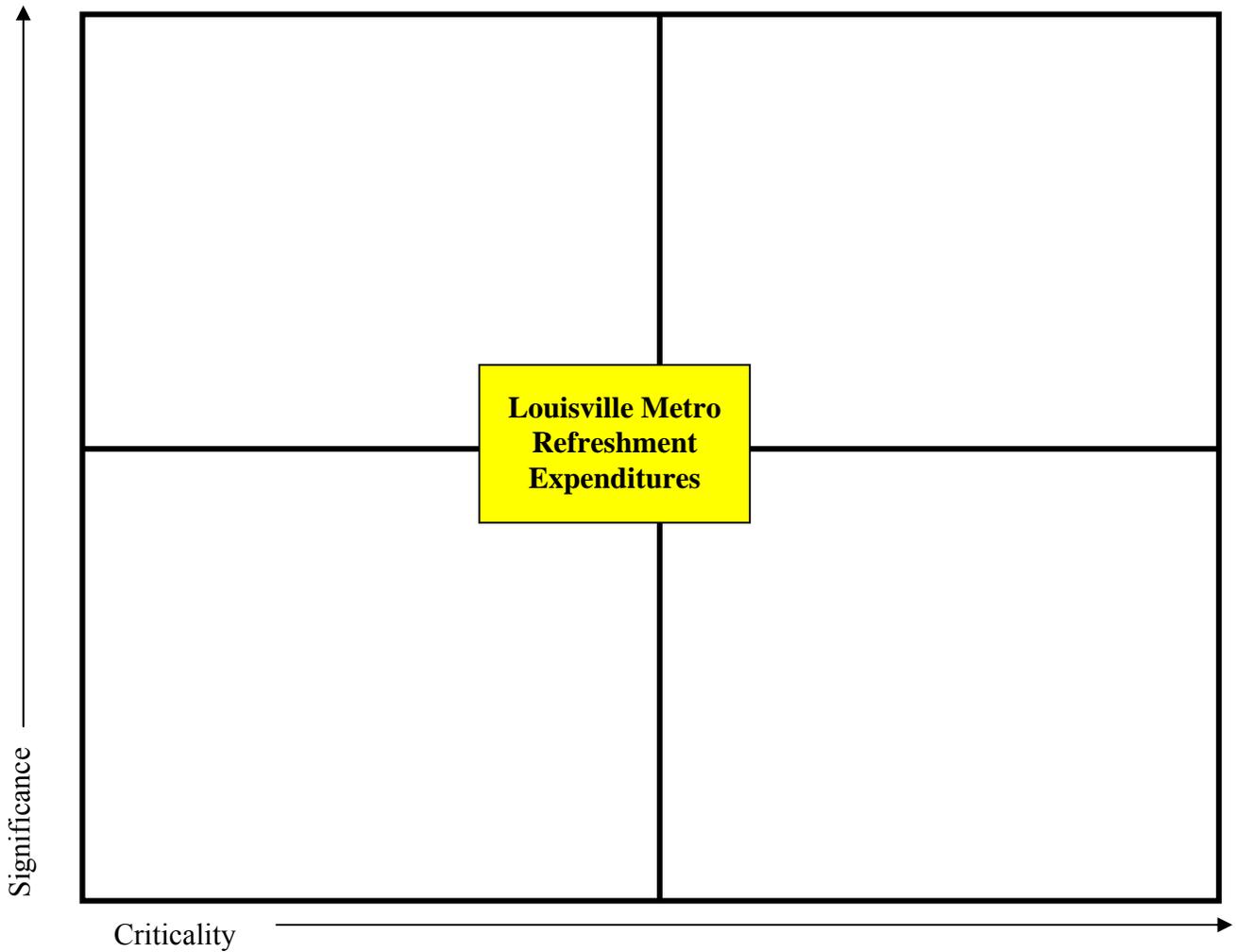
Sincerely,



Michael S. Norman, CIA, CFE, CGAP
Chief Audit Executive

cc: Louisville Metro Council Audit Committee
Louisville Metro Council Members
Department / Division Directors (e-file)
Department / Division Business Managers (e-file)
Louisville Metro External Auditors

Internal Control Rating



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

Background

Louisville Metro Government procures refreshments for use in various programs and activities. This includes activities such as providing nutritious meals to children at various sites during the summer; providing incentives for participants to continue in treatment programs which ultimately enhance public health and safety; and events and meetings in which the general public is invited to participate.

The Commonwealth of Kentucky requires that tax collections, and expenditures with taxes, be for a general public purpose. Louisville Metro's operating procedures place the responsibility for ensuring public purpose on the individual departments (and employees) authorizing the activity.

Refreshment activity is a high risk area. Refreshment commodities are consumable, transferable, and convertible which increase the risk of misuse. Also, refreshment activity can be misperceived even when it is used as part of programs / activities in which the public purpose is easily identifiable.

This was a scheduled audit.

Summary of Audit Results

I. Current Audit Results

See Observations and Recommendations section of this report.

II. Prior Audit Issues

The Office of Internal Audit has not previously conducted reviews focused solely on Louisville Metro's refreshment expenditure activity.

III. Statement of Auditing Standards

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

IV. Statement of Internal Control

An understanding of the internal control structure was obtained in order to support the final opinion.

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

The examination did not disclose any instances of irregularities, any indications of illegal acts, and nothing was detected during the examination that would indicate

evidence of such. Any significant instances of noncompliance with laws and regulations are reported in the Observations and Recommendations section of this report.

VI. Views of Responsible Officials / Action Plan

The focus of this review was the Louisville Metro enterprise, not an individual department. Each Louisville Metro department is responsible for ensuring its refreshment expenditures are for a public purpose and comply with applicable regulations and requirements. Therefore, views of responsible officials are not included in this report.

To facilitate appropriate corrective actions, this report will be provided to all Louisville Metro departments. Each department should be accountable for reviewing its policies and procedures to ensure controls are effective in mitigating the risks. This includes implementing necessary corrective actions. Future reviews of refreshment expenditure activity will help determine the responsiveness, appropriateness, and effectiveness of the departments' corrective actions.

Observations and Recommendations

Scope and Methodology

Louisville Metro's refreshment expenditures were reviewed. This included expenditures for meals, food, snacks, soft drinks, coffee, and water. The primary focus of the audit was determining if the activity was in compliance with public purpose requirements for expenditures. Compliance with Federal Internal Revenue Service requirements in regards to taxable fringe benefits was also considered. The efficiency and economy of the procurement of refreshment commodities was also reviewed.

The audit period covered expenditures from July 1, 2006 through September 30, 2007. The population of refreshment expenditure activity was identified by Metro financial accounts and by suppliers of refreshments. The main accounts identified for this review were Public Relations (#521352) and Food (#531611).

A sample of refreshment expenditures was selected from the population for review. Judgmental sampling techniques were used to select the sample. Care was used so that the sample did not include only activity with a higher probability of compliance issues. The sample was also intentionally selected to represent a broad coverage of Metro departments.

The review consisted of examining the supplier payment documents, along with supporting documentation and Metro financial system postings for the transactions in the sample. The review assessed whether expenditure activity was in compliance with various requirements including Louisville Metro Government policies, procedures, and ordinances; the Kentucky Constitution; Kentucky Revised Statutes; Kentucky Administrative Regulations; and Federal Internal Revenue Service tax code. The review would not reveal all issues because it was based on selective review of data.

Observations

Issues were noted with Louisville Metro refreshment expenditures. As a result, the internal control structure is weakened and its effectiveness impaired. The observations are as follows.

- #1 - Refreshment Expenditures Policy
- #2 - Documentation of Public Purpose
- #3 - Fringe Benefit Tax Issues
- #4 - Commodity Procurement Efficiency and Economy

Details of these begin on the following page.

#1 - Refreshment Expenditures Policy

Louisville Metro Government does not have an enterprise policy for refreshment expenditures nor is public purpose defined in its enterprise policies and procedures. Therefore, Metro departments have very little guidance to use in determining if an activity is appropriate. As a result, there is inconsistency among Metro departments with what is considered appropriate refreshment expenditure activity.

Recommendations

Applicable Louisville Metro departments should take corrective action to address the issues noted. Specific recommendations include the following.

- ✓ Each Louisville Metro department should review its policies and procedures related to refreshment expenditures. The goal should be ensuring the risks are properly mitigated through the use of internal controls. The policies and procedures should address the types of allowable refreshment expenditures and the documentation required to substantiate public purpose.
- ✓ Since public purpose is the ultimate determining factor for the appropriateness of expenditures, it would be in Louisville Metro's best interest to issue guidance for departmental use. The guidance would help Metro departments determine if an activity would be an appropriate use of public funds. The guidance could provide broad acceptable categories of activities, as well as when to pursue a legal opinion, and the appropriate level of documentation.
- ✓ As the originator of Metro's financial policies, the Department of Finance would be the most logical department assigned the responsibility for issuing the public purpose guidance. Departmental input, as well as legal advice, should be included in the development of the public purpose guidance.
- ✓ For purposes of this review, several authoritative sources¹ were consulted for guidance. The following criteria were developed to use in determining whether refreshment expenditures met the public purpose requirement.
 - Necessary for the operation of Metro government / for the furtherance of a public purpose (e.g., Metro program, relevant to Metro Government's public health and safety activities, official duties of Metro employee).
 - Benefits the public-at-large / general good and welfare of the citizens of Louisville Metro (not a select few / individuals).
 - Not predominantly personal in nature.
 - Enhances economic development for the Louisville Metro area.These criteria could be used as the foundation for developing guidance for the Louisville Metro enterprise.
- ✓ Ultimately, the determination of public purpose is a legal opinion. If there is any doubt about the appropriateness of an expenditure, Louisville Metro departments should obtain a formal legal opinion.

#2 - Documentation of Public Purpose

Criteria

As noted in Observation #1, Louisville Metro Government does not have an enterprise policy regarding refreshment expenditures nor is public purpose defined. Therefore, several sources¹ were consulted in order to develop criteria for assessing refreshment expenditure activity. The criteria are as follows.

- Necessary for the operation of Metro government / for the furtherance of a public purpose (e.g., Metro program, relevant to Metro Government's public health and safety activities, official duties of Metro employees).
- Benefits the public-at-large / general good and welfare of the citizens of Louisville Metro (not a select few / individuals).
- Not predominantly personal in nature.
- Enhances economic development for the Louisville Metro area.

Results

Using the above criteria, a sample of 110 refreshment expenditure transactions was reviewed. The purpose was to determine if the activity was in compliance with public purpose requirements. The following issues were noted.

- For 56 cases, or 51% of the sample, a determination of the public purpose could not be made based on the payment documentation and / or the description in the Metro financial system. Examples of the missing documentation include the following.
 - Recipients of refreshments, such as the citizen group name, or program name.
 - Purpose of, and persons attending, events in which tickets were purchased with Metro funds.
 - Purpose of providing refreshments and activities at locations other than Louisville Metro Government facilities.
- For the 56 cases, the Metro departments that authorized the refreshment expenditures were contacted. The departments were requested to provide additional information to justify the public purpose of the expenditures. All departments responded.
 - The Office of Internal Audit is not expressing an opinion as to the appropriateness of the public purpose justification provided by these Metro departments. Some of these were for activities that appeared to be solely for the benefit of Metro employees. This included refreshments provided for retirement and holiday parties as well as employee meetings.
 - Metro's financial system was reviewed in an attempt to identify if employee reimbursements were made for some of these activities. None were located in the financial system, nor did the payment documentation refer to employee reimbursements.

Recommendations

Applicable Louisville Metro departments should take corrective action to address the issues noted. Specific recommendations include the following.

- ✓ The public purpose of all expenditures should be sufficiently documented. This is especially critical when the public purpose of the expenditure is not inherently obvious.
- ✓ If the public purpose of a proposed activity is questionable, Metro departments should obtain a legal opinion before authorizing it. The legal opinion should be documented and included with the payment documentation sent to Metro Finance.
- ✓ Enough documentation should be provided to allow a reasonable person to determine the public purpose of expenditures without assistance. Additional explanations should not be needed from the Metro department that authorized the activity. The documentation should be included with the payment records sent to Metro Finance for processing.
- ✓ Metro departments may want to consider using an internal purchase document form for certain types of expenditures (e.g., refreshments, public meetings). This type of form helps provide information regarding the public purpose of the activity, and can be included with the payment documentation sent to Metro Finance.
- ✓ Beneficiaries of refreshments should be documented. This does not need to include specific individual names; rather it can be the nature of the recipients (e.g., program name, volunteer group name).
- ✓ Public funds should not be used to purchase refreshments solely for the benefit of Metro employees. This includes items such as coffee and soft drinks for the employees' consumption at their respective worksites. Employees should purchase these types of items with their personal funds. Any exceptions should be properly documented.

#3 - Fringe Benefit Tax Issues

The taxability of refreshments provided to employees was reviewed. The issue focused on whether the Federal Internal Revenue Service considers refreshments as a taxable fringe benefit. The concern was that Louisville Metro Government was inadvertently creating a tax liability for its employees through refreshment expenditures. This issue is compounded when the public purpose of the refreshment expenditure is not adequately documented (see Observation #2).

Various Internal Revenue Service documents were reviewed, and staffs from the Jefferson County Attorney's Office and the Kentucky Auditor of Public Accounts were consulted. The following excerpt is from the IRS Publication *Frequently Asked Questions for Government Entities Regarding De Minimis Fringe Benefits*.

What is a de minimis benefit?

In general, a de minimis fringe benefit is one for which, considering its value and the frequency with which it is provided, is so small as to make accounting for it unreasonable or impractical. This would include such items as:

- Controlled, occasional employee use of photocopier
- Occasional snacks, coffee, donuts, etc.
- Occasional tickets for entertainment events
- Holiday gifts
- Occasional meal money or transportation expense for working overtime
- Group-term life insurance for employee spouse or dependent with face value not more than \$2,000
- Flowers, fruit, books, etc. provided under special circumstances

In determining whether a benefit is de minimis, you should always consider its frequency and its value. An essential element of a de minimis benefit is that it is occasional or unusual in frequency. It also must not be a form of disguised compensation.

Is there a set dollar limit on the value of de minimis benefits?

No. Whether an item or service is de minimis depends on all the facts and circumstances. In addition, if a benefit is too large to be considered de minimis, the entire value of the benefit is taxable to the employee, not just the excess over a designated de minimis amount. The IRS has ruled previously in a particular case that items with a value exceeding \$100 could not be considered de minimis, even under unusual circumstances.

It appears that the refreshment activity related to Metro employees qualifies as a de minimis fringe benefit under IRS regulations. Thus, it is not considered a taxable fringe benefit and can be excluded from the employees' gross income. However, the particular circumstances of the activity may impact this determination. Therefore, the Office of Internal Audit can not opine on the appropriateness of the tax treatment for the 110 transactions reviewed.

Recommendations

Louisville Metro departments should be aware of the potential tax implications of refreshment activity. If there is any doubt about activity, legal guidance should be obtained.

#4 - Commodity Procurement Efficiency and Economy

There may be an opportunity for Louisville Metro Government to improve efficiency and economy in the procurement of some refreshment commodities. This applies to commodities that appear to be procured on a routine basis. Examples include coffee, groceries, ice, and water. The use of departmental, as well as enterprise, procurement contracts for these types of commodities may increase efficiency and economy. However, some refreshment commodities may be related to special events, or more incidental in nature. If so, purchasing contracts may not be practical or efficient.

Recommendations

Metro departments should assess the feasibility of using purchasing contracts for their refreshment commodities. The feasibility should include the frequency and quantities of purchases. The overall cost may be decreased if several departments pool their activity into one contract.

Footnotes

¹ Authoritative sources consulted for developing the public purpose criteria included the following:

- Louisville Metro Ordinances – Chapter §37
- Kentucky State Constitution - Section 156b, 171, 179
- Kentucky Revised Statutes – Chapter §45A; Chapter §67C
- Kentucky Auditor of Public Accounts - “*Review of City of Louisville Selected Areas of Expenditures and Administrative Policies*” September 1994 Report.
 - Kentucky Administrative Regulations KRS 1:070 - Technical Audit Bulletins 93-001, 93-002
 - Court Case - Funk v. Milliken 317 S.W. 2d 499 (Kentucky 1958)
- Kentucky Auditor of Public Accounts – Staff
- Kentucky Office of Attorney General – Opinion OAG 99-5
- Federal Tax Code - Title 26, Subtitle A, Chapter 1, Subchapter B, Part III, Section 132
- Jefferson County Attorney’s Office – Staff