CITY OF WILMINGTON
Performance Audit of Bad Debt
Internal Audit Review

July 30, 2019

City Auditor's Office

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Highlights

Why We Did This Audit

The Internal Audit Department (IA) performed an audit of Bad Debt (Policies & Procedures) in accordance with the 2017 Internal Audit Plan.

Methodology

The objectives were met by analyzing the CoW's CAFR statements for the audit period, reviewing GFOA best practices for Bad Debt; a review of City Code; testing of allowance for doubtful accounts financial transactions, and via discussions with personnel from Department of Finance.

<u>Audit Review Committee:</u>

Robert C. Johnson, Chair

Ciro Adams
Marchelle Basnight
Angelique Dennis
Bud Freel
Ronald Pinkett
Tanya Washington

Objective and Scope

IA conducted a Performance Audit of the City's Bad Debt Policies and Procedures. The audit objectives were to examine whether bad debt policies exist at the City of Wilmington and are guided by established government best practices and to determine if bad debt expense and write offs are accurate, reasonable, and supported by documentation. The scope of the audit included policies, practices, and financial transactions with effective dates from July 01, 2016 to June 30, 2018. IA believes that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We conducted our audit in accordance with Generally Accepted Government Auditing Standards ("GAGAS"). These standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives.

Background

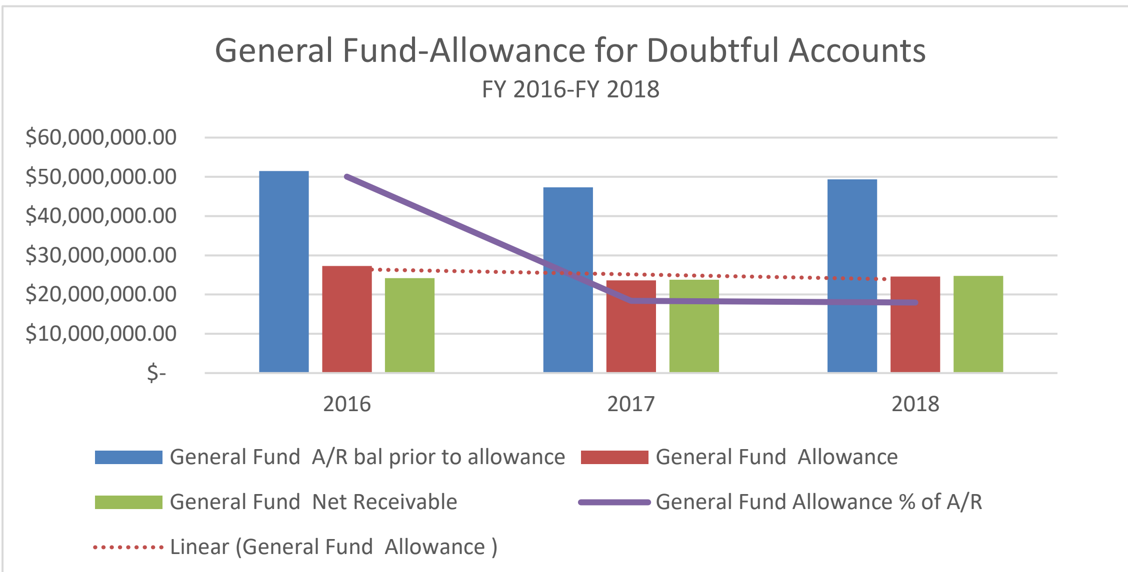
At the end of each fiscal year, the City of Wilmington (CoW) provides a report on the City's financial condition on the Consolidated Annual Financial Report (CAFR) as required by the Governmental Accounting Standard Board (GASB). Included in the statements is a presentation of the City's Accounts Receivable (A/R) which is adjusted to reflect the City's estimation of the amount of debt that will be uncollectible for the reported period. This estimation is called an "Allowance for Uncollectible Accounts", also otherwise referred to as an Allowance for Doubtful Debts.

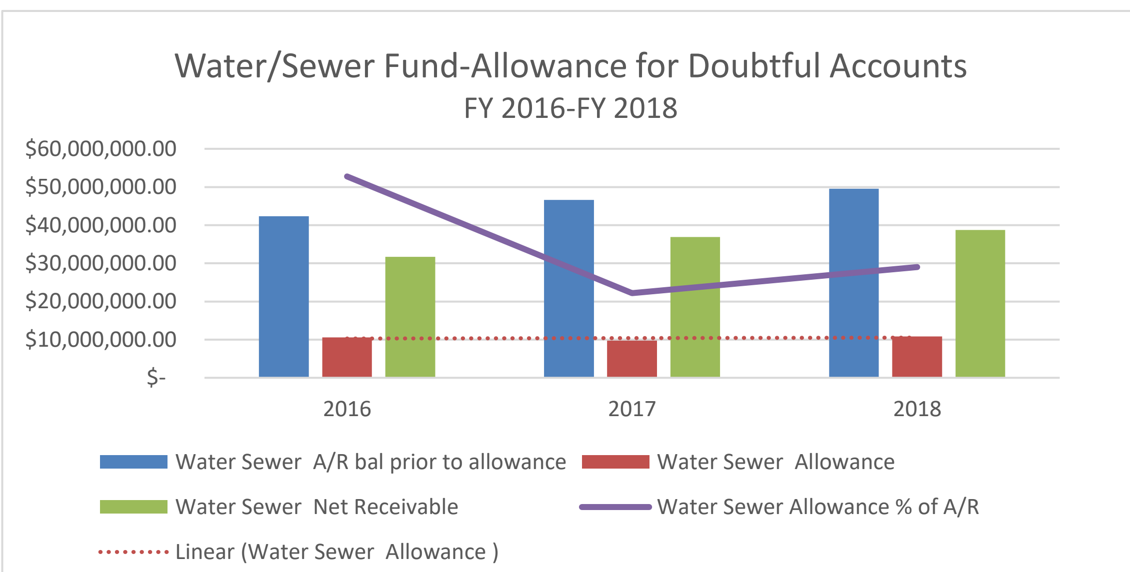
According to U.S. Generally Accepted Accounting Principles (GAAP), the allowance method is one of the two acceptable ways an entity can account for delinquent and unpaid customer accounts. An entity can decide to do their allowance by customer or by percentage of A/R, in which an entity estimates uncollectible accounts by determining the desired size of the Allowance. This typically requires the entity to look at their bad debt history and develop a percentage that reflects that experience. When the percentage of A/R allowance method is used, an entity uses an aging report to identify which customers owe and for how long the debt has been delinquent. Each entity sets its own determination of how long an account can be delinquent before it is flagged as a bad debt.

After an account is determined to be a bad debt, its value is no longer included as part of the entity's assets in their A/R. An adjusting journal entry must be prepared at the end of each accounting period to record the bad debt expense.

As of the date of this report, it has been the City's practice to not flag individual accounts but to calculate the estimated uncollectible amount based on the aggregate receivable for each type of revenue the City processes.
The other acceptable bad debt accounting method according to GAAP is the "direct line" method in which the actual debt is written off the books, also known as a "write-off". The only debt that the CoW write's off according to GAAP is Parking ticket citations and Red-Light fines.

Key Statistics:





What we found

<u>Key Findings</u>

Following are key issues that resulted in a process/area to be risk rated a three or four:

Risk Ranking:		**(See Attachment B for full rating definitions)**			
Process / Area	**Process / Area Owner**	**1 Strong Controls**	**2 Controlled Effectively**	**3 Controlled - Improvement Required**	**4 Significant Improvement Required**
Policies and Procedures	Brett Taylor Stephanie Collins				✓
Reconciliation	Brett Taylor				✓
Strategic Operations	Brett Taylor Roseanne Prado				✓
Review & Approval Process	Roseanne Prado			✓	

<u>Policies and Procedures</u>

1. The City lacks written, comprehensive policies and procedures pertaining to bad debt and revenue account write-offs:

   - The process for bad debt adjustments (also known as the allowance for uncollectible accounts) is not documented in the Accounting manual.
   - The policy and process for Estate settlement is not documented.
   - Bankruptcy policies and procedures are not specific in describing department actions to be taken for each type of revenue account and each type of bankruptcy filing. Except for instructing Delinquent Account staff to send a communication to the billing department, the procedures do not describe the removal of impacted accounts from accounts receivable.
   - The scope of policies and procedures pertaining to Delinquent Accounts, Property tax, and Water is inconsistent. While some policies describe payment arrangements, limitations, and allocation of delinquent payments, others do not. There are no written procedures that pertain to general billings.
   - Noncompliance still exists with a repeat FY14 internal audit finding, due to the lack of Policies and Procedures being created to ensure compliance with the Fair Debt Collection Act. In addition, the Delinquent Accounts process have not been updated since 2014.

2. There are no controls in place to ensure compliance with the Servicemember Civil Relief Act (SCRA) and City Code (CC) Sec 44-126-Time for performing certain acts postponed by reason of service in combat zones.

Reconciliation

3. No controls exist surrounding monitoring customer accounts for billing accuracy prior to year-end bad debt accrual adjustments. Although Accounting runs an aging report and uses it as the basis for its adjustments in the various tax and general billing accounts, there is no documented process in place to validate the data.

   For example, the Business License module in MUNIS creates billing invoices based on businesses licensed in prior years; however, business accounts are not annually reviewed and updated to reflect fluctuation in status (business closes, stops practicing business in the City, or moves outside of City limits). In addition, most general billing customer accounts are created and monitored by other City departments such as the instant ticketing and appeals process performed by Licenses & Inspection.

Strategic Operations

4. The City's Bad debt process does not completely follow the U.S. GAAP method of accounting for uncollectible debt:

   - The process for bad debt adjustments is based on a percentage of aged billings. The rationale for the percentages used are not documented and have not been reviewed for many years. Additionally, Management does not have a target for the City's Allowance for Uncollectible Accounts which should be used as the basis for adjustments. According to GAAP, the target balance in the allowance account should be a credit amount equal to the percentage of the estimation used.

   - While most revenue accounts are included in the allowance estimation for the balance sheet accounts, not all revenue accounts receive the bad debt adjustment to its A/R record, for example, lodging tax does not receive an A/R bad debt adjustment.

   - City Departments are deleting general bills such as instant tickets and vacant property fees without using a proper accounting method such as write-offs, to reflect the loss of revenue.

   - Bankruptcies are not recorded as a bad debt, instead once the bankruptcy is discharged, the unpaid bills are deleted from the system, preventing the recording of the uncollectible amount in the City's financial statements.

Review & Approval Process

5. Inconsistent and insufficient supporting documentation is being maintained for journal entries. During a review of journal entries surrounding five (5) parking citation write-offs and five (5) red light traffic ticket write-offs, the following exceptions were identified:

- Two journal entries failed reasonability testing because scanned, critical support documentation was illegible within the Tyler Content Management (TCM) system.

- One journal entry had a segregation of duty issue with journal entry approval.

Based on a review of 14 year-end allowance for uncollectible accounts adjustments the following exceptions were identified for accounts such as General Billings , Licenses and Inspection fees, Business License fees, Wage tax, and Property Tax:

- None of the allowance adjustments tested included documentation of a historical analysis of collection trends within three fiscal years, which is a bad debt best practice.

- Ten allowance adjustments had supporting documentation that did not clearly show the accounting steps taken to arrive at the final allowance calculation. The journal entries also contained extraneous documentation.

- Two allowance adjustments had segregation of duty issues with journal entry approval.

Additional Observations

<u>Financial Performance Analysis</u>

1. The City should monitor its financial performance using financial ratio analysis and comparing those measures to industry benchmarks and standards. Based on analytical results, 1) benchmarks should be developed for debt ratios, activity ratios, and other solvency indicators, and 2) the City should set relevant annual goals for bad debt management.

2. In addition, the City should monitor all revenues for timeliness and accuracy of payments, including those of non-billed transactions such as the franchise fees and property tax assessments for Delmarva and Comcast. For such fees, an allowance method should be determined based on a historical analysis of estimated revenues (based on contractual and codified fee rates and experience) vs actual revenues received.

<u>Data Integrity</u>

3. During testing it was noted that customer bills and payment histories for non-tax and/or utility related charges such as vacant property fees and instant ticket fines, are being deleted from the financial system as part of the Bankruptcy and Sheriff Sale processes. Although this audit did not include testing at the individual customer account level, it is recommended that when drafting the comprehensive Bad Debt and Write-Off policy, the Department of Finance include a policy and procedure that is applicable to bills generated by other departments. Furthermore, the system capability to delete open receivables from the general ledger should be restricted to authorized personnel involved in the Accounting function. This limitation should be in MUNIS as well as in other applications that send financial data to MUNIS such as the SharePoint system utilized by Licenses and Inspections.

4. The City should develop a billing standard that is utilized by all departments within the City, specifically those departments that create bills and account payable notes in MUNIS. The billing standard should have one universal method for recognizing ownership of a liability, whether it is by parcel identification number, customer number, or another unique identifier. Having this measure in place will simplify the City's collection processes and ensure debt can be accurately traced, monitored, and recovered.

5. Although testing did not specifically review the validity of individual parking citations that receive reductions on fine amounts, it was noted that the total reduction amount per reporting period is considered by the Department of Finance when archiving (writing-off) citations. Therefore, management should determine whether proper controls are in place for citation adjustments, ensuring that adjustments are approved, accurate, and appropriate.

Management Responses to Audit Recommendations

Summary of Management Responses

Recommendation #1 Management should write a current Bad debt and Write-off policy that follows Government Financial Officer Association (GFOA) best practices: describe why and how to write off delinquencies in each of its revenue accts, the write-off amount and age thresholds, approval authority, and specific accounting procedures.

Management should ensure the Delinquent Accounts policy and procedure manual is updated to include the following:

- Criteria for payment arrangements or their limitations (maximum number allowed, thresholds, etc.)
- Controls in place to ensure compliance with City Code Sec 44-126 "Time for performing certain acts postponed by reason of service in combat zones.", the Servicemember Civil Relief Act, and the Fair Debt Collection Practices Act
- A description of the actions to be taken by Finance staff to completely remove the liability from accounts receivable once a sheriff sale has been processed and a balance remains on the account.
- Identify third parties involved in the collection process, their role, and authority level.

Agree

Management response & action plan: Of the 19 sections of the Delinquent Accounts Manual, 8 sections have been updated since 2014. The Delinquent Accounts procedures manual will be reviewed in its entirety prior to the anticipated completion date.

This will be the focus for the 1st Quarter of FY 2020. A new Delinquent Accounts Administrator has been hired and will be dedicated to a full review of the manual. The Director, Deputy Director and DAD staff will be reviewing threshold requirements for each area of delinquencies (96-hour shutoff, sheriff sales, bankruptcies, write offs, percentage of collection performance on the part of third-party collectors, payment arrangements, bad debt, etc.)

Recommendations from Audit will be included in the revisions and be properly vetted through our Admin Board.

Once the manual has been vetted and approved, meetings will be held with the staff to review the manual in its entirety for compliance going forward

Completion Date: September 30, 2019

Recommendation #2 The department should draft a policy and procedure to ensure compliance for the Servicemember Civil Relief Act and include all accounts owed by the customer that would qualify such as water/sewer, property taxes, L&I fees and parking citations or red-light tickets. Within the MUNIS system, the department should make a practice of flagging qualified accounts and regularly monitoring them for change in servicemember status.

Agree

Management response & action plan: The Delinquent Accounts procedures manual will be reviewed in its entirety prior to the anticipated completion date. Recommendations from Audit will be included in the revisions and be properly vetted through our Admin Board.

Once the manual has been vetted and approved, meetings will be held with the staff to review the manual in its entirety for compliance going forward.

Completion Date: September 30, 2019

Recommendation #3 The Department of Finance must work with the Department of Licenses & Inspection and the Fire Marshal's Office to create an annual process of reviewing and reconciling customer account records for accuracy and data integrity, ensuring that duplicate or dormant accounts and receivables have been removed from the system.

Agree

Management response & action plan: The Mayor's Office has authorized the Department of Finance to cross-tabulate its databases to determine if there are any opportunities to use the Business License program to ensure payments in other areas, such as property taxes, and vice versa. In addition, we will be using State databases and skip trace data from third parties to examine business license and other database accounts to identify who and how to collect.

In addition, the Billing Division will be using this data to update accounts (as well as returned mail and bounced checks) to determine correct addresses, names, etc. To get the data into a correct baseline state will require some time.

Once scrubbed the database will be continuously improved and updated. We are contemplating introducing Six Sigma process principals to continuously update the database.

Completion Date: December 31, 2019

Recommendation #4 The City should make a practice of having monthly or quarterly (based on billings) soft closing so that bad debt can be accurately reflected.

Management should review the current percentages used for A/R estimates of uncollectible debt and analyze accounts receivable to determine if the percentages are reasonable based on account history. During this review, Management should set a target amount for the Allowance and at the year-end true up, ensure estimates are in-line with the goal.

Agree

Management response & action plan: The Department of Finance will be performing soft closings at the end of each quarter and a soft closing for June 30, 2019 (FY 2019). During this time, the Department will examine the percentages of uncollectible debt, set its baseline, and perform a quarterly true up against that baseline.

It will take some time to establish an uncollectible allocation against each account. Keep in mind that there are 4,400 accounts with delinquencies over 365 days. This will be performed over the course of the next quarter. The Delinquent Accounts Division is looking at each account to determine collectability. The Department will use the Auditor's recommendation for items such as bankruptcies and sheriff sales as bad debt categories. Once each account is identified and categorized, it will be reconciled with the uncollectible percentages for each business area and Fund for inclusion in the CAFR.

While individual departments will be informed and involved when needed, the Department of Finance reserves the right to determine collectability since other departments are not involved with the collection of debts in an organized manner. The DAD unit will structure its approach to be focused on business areas (L&I tickets, property taxes, etc.) to ensure that the amounts collected and written off are aligned by business area.

The authority to write off debt will be confined to the Director or Deputy Director or a proxy authorized by the Director.

Completion Date: September 30, 2019

Recommendation #5 To increase readability and minimize the storage burden for large, internal data sets that tie into the final write-off or allowance calculation, where appropriate, the totals page of the data set should be scanned, and an accounting summary page should be used to clearly capture the amounts used in the calculation relative to the adjustment required.

Supporting detail for each transaction should be consistent according to a written Bad debt and Write Off policy (see recommendations in Finding #1).

On an annual basis, a historical analysis should be performed to identify collection trends, comparing estimations to actuals. Following the analysis, the allowance percentages should be appropriately adjusted, documented and attached to the journal entry.

Journal entries created by Management must be reviewed and approved by another member of management to ensure there is appropriate segregation of duty and approval of bad debt transactions.

Agree

Management response & action plan: The Department of Finance will be performing soft closings at the end of each quarter a soft closing for June 30, 2019. During this time, the Department will examine the percentages of uncollectible debt, set its baseline, and perform a quarterly true up against that baseline.

It will take some time to establish an uncollectible allocation against each account. The Delinquent Accounts Division, in conjunction with the Accounting staff, Deputy Director and Director, will look at each account to determine collectability. This will be performed over the course of the next quarter.

Once a baseline on the status of accounts is in place, this will be an ongoing process and the Deputy Director or Director will review and approve the bad debt calculations each quarter.

Completion Date: September 30, 2019

Audit Team
Yvette R. Johnson, Senior Auditor
Tamara Thompson, Audit Manager