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Edelen Releases Audit of Shelby County Fiscal Court

FRANKFORT, Ky. – State Auditor Adam Edelen has released the audit of the financial statements of the Shelby County Fiscal Court for the fiscal year ended June 30, 2014. State law requires annual audits of county fiscal courts.

Recent changes in auditing standards require the auditor's letter to communicate whether the financial statement presents fairly the receipts, disbursements and changes in cash and cash equivalents of the Shelby County Fiscal Court in accordance with generally accepted accounting principles in the United States. The report found that the financial statement of the Fiscal Court did not follow this format; however, the Fiscal Court's financial statement is fairly presented in conformity with the regulatory basis of accounting, which is an acceptable reporting methodology. This reporting methodology is followed for 115 of 120 fiscal court audits in Kentucky.

As part of the audit process, the auditor must comment on non-compliance with laws, regulations, contracts and grants. The auditor must also comment on material weaknesses involving the internal control over financial operations and reporting.

The audit contains the following comments:

The Fiscal Court's lack of adequate segregation of duties and weak internal controls allowed the payroll system to be manipulated and unearned payments to be made to two employees totaling $21,346. During fiscal year 2014, the Fiscal Court had a lack of segregation of duties and inadequate supervisory review over payroll processing. A former employee had the responsibility of recomputing hours paid from timesheets, calculating overtime and leave time, preparing supplemental payments and withholding payments, entering data into the retirement reporting system, inputting payroll information into the accounting system, preparing ACH files, preparing payroll checks and identifying and correcting errors. The person responsible for processing payroll was also able to set up new employees in the payroll system and change pay rates. During fiscal year 2014, the former employee increased the pay rate of her spouse (a county employee), added overtime to his timesheet, added overtime to her own timesheet, and used leave time when they had negative leave balances. The former employee also created a fictitious employee using her spouse's social security number. The fictitious employee, who had the same name as her spouse, was paid gross wages of $5,793 over four pay periods. These funds were deposited into the former employee and/or her spouse's bank accounts. The result of these actions caused gross wages of $625 to be overpaid to the former employee and gross wages of $9,300 to be overpaid to the former employee's spouse. The result is $15,718 overpaid in payroll and $5,628 paid directly by disbursement check (See finding 2014-002), totaling $21,346 in unearned payments received by the former employee and her spouse during the period reviewed.

These actions were possible because management did not implement a strong system of internal controls such as segregating duties or supervisory review. Further, the former employee had unlimited access to the payroll system allowing her to manipulate data by posting additional hours worked, altering pay rates and adding employees without detection.

Auditors noted the following issues with the former employee's payroll:

- She was paid four (4) times without a timesheet filed with the payroll reports
- Three (3) instances where her leave time used on timesheets did not agree to payroll stubs
- One (1) instance where her timesheet was not approved by a supervisor
- One (1) instance where she entered extra hours not worked and not approved resulting in an over payment of $625 in gross wages
- Seven (7) instances where sick leave taken during a period took her to a negative leave balance
- One (1) instance where vacation leave taken during a period took her to a negative leave balance

Auditors noted the following issues related to the former employee's spouse's payroll:

- Seven (7) instances where extra unapproved overtime hours were paid totaling 264 hours
- Six (6) instances where extra unapproved regular hours were paid totaling 72.25 hours
- One (1) instance where extra unapproved vacation leave was paid totaling 14.38 hours
- Three (3) instances where extra unapproved sick leave was paid totaling 32 hours
- Two (2) instances where the former employee changed her spouse's hourly rate resulting in overpayment
- Two (2) instances where the former employee's spouse carried a negative leave and/or sick leave balances

Additionally, numerous errors were made during payroll processing and retirement reporting. (See Finding 2014-003)

Good internal controls dictate segregating duties to ensure no one person has the ability to commit and conceal fraud or errors. Duties should be segregated between processing, posting, check-writing and reconciliation. Further, strong management oversight and review is necessary to help deter, prevent and detect overpayments, payment for time not worked, and processing errors. Employee access should be limited in a computer system to only the functions necessary for that employee to complete job duties. The ability to set up new employees and change pay rates should be limited to someone who does not have the ability to process payroll or create checks.

We recommend the fiscal court implement a strong internal control system by segregating duties, limiting access in the payroll system, and reviewing payroll reports timely to ensure accuracy. We further recommend the fiscal court seek reimbursement for the overpayments from the former employee and her spouse.

County Judge/Executive's response: Duties have been segregated and internal controls strengthened.

The Fiscal Court lacks adequate segregation of duties and should improve internal controls over disbursements. During fiscal year 2014, the Fiscal Court had a lack of segregation of duties and inadequate supervisory review in the disbursements process. One former employee had the ability to procure goods and services, write purchase orders, use credit cards, pay invoices, post transactions, and write checks with little management oversight or review. Further, this former employee could create and change vendor information in the accounting system. This former employee prepared, approved and wrote checks to herself and her spouse totaling $5,628 during fiscal year 2014 and the first half of fiscal year 2015. There was no valid supporting documentation for these payments. In addition, this former employee made numerous errors during disbursements processing that went undetected by the county's internal control system.

Management lacked established, consistent policies and procedures for internal controls over disbursements. No supervisory review was performed to ensure all payments made were for valid purchases. The purchase order system in use acted as more of a purchase documentation system. Purchases were made before purchase orders are written, as evidenced by the dates on receipts being earlier than the dates on the purchase orders. Purchase orders were not consistently used for every disbursement. There was no system of tracking checks to ensure checks were not used and signed between batches.

As a result of the weaknesses, auditors noted the following issues during disbursements testing:

- Purchase orders were often prepared, completed, issued, and approved by the former employee. Many of these appeared to have the County Judge/Executive's name or initials written on the approval line by someone other than him.
- Sufficient supporting documentation was not available for every purchase. Some payments were made from copies of invoices and some payments had no invoices or no purchase order attached.
- One fuel bill tested did not include the purchase receipts that would identify the department or vehicle purchasing the fuel. That fuel bill was overpaid by $753.
- A vehicle purchased only had the dealer's quote attached to the purchase order as supporting documentation. The original invoice was later obtained by auditors from the department that ordered the vehicle.
- Payment was made for vehicle service from an estimate instead of an original invoice. The invoice was later obtained by auditors from the department.

- Invoices were paid over 30 days past the date of receipt, resulting in late charges, interest, and late fees. We noted $771 paid during the fiscal year to one utility due to late payments and interest and late charges totaling $281 paid due to late credit card payments.
- Three instances of overpayments were noted in the sample tested, two to the same vendor. Numerous overpayments were noted in the testing of credit card transactions, including one for $1,300 that paid several charges more than once.
- One bill was paid for a different amount than the amount on the bill list approved by fiscal court.
- Payments were made for employee travel and training that included extra charges for "spouse registration" and a "family suite." While it is the policy of the fiscal court to have employees or magistrates reimburse the county for these extra charges by billing the employee or magistrate, there was no documentation available to indicate the bill was prepared or reimbursement received.
- Two payments were made to a contractor totaling $23,241, which exceeds the county's bid requirement of $20,000, but the work was not bid.
- $475 in food and picnic items were coded to "misc supplies" without further documentation of the purpose of the purchase.
- A personal purchase made by the former employee of box springs at Walmart.com totaling $195 using the county Visa credit card.
- Payment made to Visa from a hotel reservation confirmation page that was never charged to the credit card, resulting in an overpayment on the credit card statement.
- A check written to Walmart for $1,071 with no supporting documentation and was not found to have been credited to the county's Walmart credit card. The signatures on this check do not appear to be valid signatures of the County Judge Executive and County Treasurer. Eight other checks written to Walmart totaling $632 were also not found to have been credited to the Walmart credit card.
- The former employee wrote checks to herself and her spouse without supporting documentation or approval, as noted below. The signatures on all of these checks do not appear to be valid signatures of the County Judge/Executive and County Treasurer. Two of the checks were processed by changing the vendor name in the accounting system to her spouse's name, printing the check, then changing the vendor name back to the actual vendor so that the check register and disbursements ledger would show the original vendor as the payee.
- Two disbursement checks written directly to the former employee total $ 632
- Five disbursement checks written to the former employee's spouse total $4,996

Management has a responsibility to design and implement internal controls that provide reasonable assurance of safeguarding resources against waste, fraud, and abuse. Good internal controls provide reasonable assurance that the recording, processing, and reporting of data is properly performed and that if errors or fraud occur, detective controls will bring these to management's attention. Management should be sufficiently involved with day to day operations, by providing strong oversight and review, to mitigate the risks inherent in certain accounting areas. Incompatible duties should be segregated to assure that no one person has the ability to commit and conceal fraudulent activity or to process errors that go undetected.

Good internal controls dictate that adequate supporting documentation and purchase orders be maintained for all disbursements. All vendor invoices, receipts, and statements should be maintained and agreed to corresponding purchase orders and reports. KRS 65.140(2) requires all bills for goods and services to be paid in full within thirty (30) working days of receiving a vendor invoice. KRS 424.260 states when the county purchases, makes a contract, lease, or other agreement involving an expenditure of more than $20,000, they must advertise for bids.

KRS 68.210 gives the State Local Finance Officer the authority to prescribe a uniform system of accounts. In the Instructional Guide for County Budget Preparation and State Local Finance Officer Policy Manual, purchase guidelines are prescribed by the State Local Finance Officer, including:

> 1. Purchases shall not be made without approval by the judge/executive (or designee), and/or a department head.
> 2. Purchase requests shall indicate the proper appropriation account number to which the claim will be posted.
> 3. Purchase requests shall not be approved in an amount that exceeds the available line item appropriation unless the necessary and appropriate transfers have been made.
> 4. Each department head issuing purchase requests shall keep an updated appropriation ledger and/or create a system of communication between the department head and the judge/executive or designee who is responsible for maintaining an updated, comprehensive appropriation ledger for the county.

To improve internal controls over disbursements, we recommend the Fiscal Court take the following actions:

- segregate duties to ensure no one person has the ability to create, approve, and process transactions without sufficient management oversight and review,
- review and update the purchase order system in use to ensure state guideline are met,
- update and communicate the purchase order and credit card policy to all staff,
- require all original invoices, receipts, statements and other supporting documentation to be maintained and reconciled to corresponding purchase orders and bill lists for all disbursements,
- pay only from original invoices, not estimates, quotes, copies, or email confirmations,
- ensure all invoices are processed and paid within 30 days of receipt to avoid unnecessary late charges, interest, and finance charges,
- update and communicate the policy to staff concerning reimbursement for excess charges during training events for spouses and other family members,
- account for all checks in numerical sequence by maintaining a check register or other check log system for both the County Judge/Executive and Treasurer that tracks the last check signed, to prevent signing of checks by unauthorized personnel,
- limit vendor creation and vendor file changes to authorized personnel,
- provide the county’s tax id information to all vendors to avoid paying sales tax.

The fiscal court should also investigate the payments made to Walmart that were not credited to the county’s account.

County Judge/Executive's response: Duties have been segregated and internal controls strengthened.

The Fiscal Court should strengthen internal controls over payroll processing to ensure employee retirement information is accurately entered into the County Employee Retirement System and agrees to supporting payroll documentation. The fiscal court has elected to participate in the County Employees Retirement System (CERS), pursuant to KRS 78.530 administered by the Board of Trustees of the Kentucky Retirement Systems. This is a cost sharing, multiple employer defined benefit pension plan, which covers all eligible full-time employees and provides for retirement, disability and death benefits to plan members. Employees are classified as full time or part time and hazardous or non-hazardous.

During fiscal year 2014 this data was manually entered into the CERS reporting system for each employee by the former employee discussed in findings 2014-001 and 2014-002.

During our reconciliation of the county's payroll system to the (CERS) reporting system we noted the following:

- Not all county employees on county payroll reports were consistently reported to the retirement system.
- One county employee holding a Hazardous position and a Non Hazardous position was only entered in retirement system one time at Hazardous classification.
- Employee names and salaries were copied from May with three pay periods into June with two pay periods making salary totals for June be overstated.
- Sometimes new employees were not entered into the system timely or at all.
- Salaries were not adjusted for raises in the system timely.
- There was not review of the manually entered data to ensure accuracy and completeness with the payroll system reports.
- Supporting documentation for data manually entered was inconsistently maintained.

Management has not established a policy for adequate supervisory review of the data entered into the retirement system to be compared to data from the payroll system for accuracy and completeness.

Lack of proper internal controls increases the risk incorrect information will be processed by the CERS reporting system for employee contribution and county match and that these errors will not be identified or corrected which could impact the county and the employees as listed below:

- Gross salaries understated in CERS system resulting in
    1. Employees being under-credited in retirement contribution
    2. Employees being under-matched in retirement contribution
    3. County not paying enough to retirement for employee contribution and county match
    4. Employee withholdings and maybe county match remaining in the payroll clearing bank account

- Gross salaries overstated in CERS system resulting in
    1. Employees being over-credited in retirement contribution
    2. Employees being over-matched in retirement contribution
    3. County over paying to retirement for employee contribution and county match
    4. Paying overstated retirement bill overdraw payroll clearing bank account

After our initial work in this area, management requested a comparison of payroll reports to retirement data for the period September 2011 through December 2014. We have provided the county with detailed information based on this review. Our analysis of that time period for each employee found a net underpayment by the county of $48,146 made up of $8,819 in employee contribution and $39,228 in employer match due to inaccurate data entered into CERS reporting system. This can have a potentially significant effect on current employees' retirement balances as well as impact the benefits paid to those employees that retired recently.

Good internal controls dictate adequate supporting documentation and an established policy requiring consistent review for verification of the accuracy and completeness of data reported.

KRS 61.680(6) states, "any member of the Kentucky Employees Retirement System or County Employees Retirement System who is working in more than one (1) position covered by the same retirement system, shall have his wages and contributions consolidated and his retirement account administered as a single account. If part-time positions are involved, an accumulation of all hours worked within the same retirement system shall be used to determine eligibility under KRS 61.510(21)." KRS 61.510(21) defines eligibility as those "positions that average one hundred (100) or more hours per month, determined by using the number of months actually worked within a calendar or fiscal year."

Employers are required to include all employees in CERS reporting system per regulation in 105 KAR 1:140. Employer's administrative duties. Section 1. (8) Each employer shall report employees who are not regular full-time employees as defined by KRS 61.510(21) and 78.510(21), but shall not remit employer or employee contributions for those employees unless required to do so pursuant to KRS 61.680(6),

We recommend Fiscal Court strengthen controls over payroll by establishing policies and procedures to ensure data entered accurately into the retirement system and is reviewed for accuracy and agreement to the payroll system by someone other than the person doing the data entry.

County Judge/Executive's response: Internal controls strengthened and HR software purchased to enabling stronger supporting payroll documentation

The Fiscal Court should implement a capital asset inventory policy and maintain complete and accurate capital asset schedules. The county has not put procedures in place to ensure asset additions or asset retirements and asset disposals are accurately documented during the fiscal year. The auditor noted annual inventories are requested from the departments however there is no review or reconciliation of the inventories to the capital asset schedule to ensure accuracy. Further, the county has included an asset on the capital asset schedule not titled to the county.

This is a repeat comment from the prior year as this has been an ongoing issue with the county not taking action to ensure compliance with the Department for Local Government's policy documented in the County Budget Preparation and State Local Finance Officer Policy Manual. The Department of Local Government (DLG) requires counties to maintain records for fixed assets including infrastructure, buildings, land, vehicles, equipment and other items purchased or received exceeding capitalization threshold determined by the fiscal court.

Not maintaining an accurate list of assets could result in new assets not being insured and retired assets not being removed from insurance. Further, the capital asset schedule included in the financial statements could be materially incorrect.

Good internal controls over compliance dictate adequate supporting documentation be maintained for assets and the capital asset schedule be updated regularly throughout the year to ensure accurate information is recorded.

In order to strengthen controls over capital assets and infrastructure, we recommend the fiscal court implement a capital asset inventory policy, conduct annual inventories and require departments to submit completed inventory sheets to the County Judge/Executive's office. The submitted inventory should then be reconciled to the capital asset schedule. If the Judge/Executive's office finds that notifications of new or disposed capital assets are not submitted from departments timely, a compensating control could include review of the fiscal court minutes, as they typically document purchases and disposals.

County Judge/Executive's response: Software has been purchased and implemented to facilitate and maintain complete and accurate asset schedules.

The Fiscal Court should reconcile the payroll revolving bank account and resolve the negative account balance. The fiscal court uses a clearing bank account for payroll processing. Deposits are made into the bank account from the county's general, road, jail and EMS funds to pay for salaries, taxes, the county's matching portion of taxes, retirement, and health insurance, and other payments to benefit vendors. The account should reconcile to zero every month because the total amount deposited into the account should be completely paid out that same month. The fiscal court has not completed regular, accurate reconciliations for this bank account, resulting in a negative reconciled balance at June 30, 2014 of ($110,942). The balance is due to the cumulative effect of various errors made in payroll processing, including:

- failure to deposit two of the clerk's payments for retirement and health contributions;
- overpayment/underpayment of the county's retirement matching contribution to the county retirement system;
- payment of the monthly health insurance invoice before completing a reconciliation, resulting in a difference between the amount due and the amount paid;
- overpayment of benefits and withholdings to vendors
- various other errors noted in calculations/payments

Good internal controls require timely, accurate reconciliations to ensure all funds are properly accounted for and to prevent misappropriation of funds and/or inaccurate financial reporting.

We recommend the fiscal court reconcile the payroll revolving bank account to zero every month. A reconciliation should also be performed of the health insurance invoice to withholdings and county match before the transfer is made to the clearing account. Differences noted in the reconciliation should be tracked as reconciling items. To address the current negative account balance, the fiscal court should complete a current month reconciliation and determine the ending balance in the account. If the balance is still negative, a cash transfer from the county's funds to the payroll revolving bank account should be made to bring the bank account balance to zero. The reconciliation should be performed by someone other than the person responsible for payroll processing, to ensure an adequate segregation of duties.

County Judge/Executive's response: Account reconciled and balanced.

The Fiscal Court should improve controls over credit card purchases. During expenditure testing of credit card purchases we noted the following:

- purchase orders without original receipts or invoices
- purchase orders without approval signatures from department heads
- purchase orders prepared from receipts after purchase
- payments made from credit card statement balances not matched to purchase orders
- purchase orders not paid within 30 days of receipt

We further noted in several instances the supporting documentation (i.e. cash register receipts) were not maintained or reconciled to the statements and payment was made based on an outstanding statement balance.

The lack of consistent documentation increases the risk for fraud or error. By not consistently requiring purchase orders prior to using credit card for purchase and matching purchase receipts or invoices to purchase orders, the Fiscal Court's finance personnel cannot perform a complete, knowledgeable review of documentation before payment of the expense.

Documentation of all expenditures should be included in the overall payment package for approval by fiscal court. An annual review by the fiscal court of the administrative code is required by KRS 68.005 during the month of June. KRS 65.140(2) requires all bills for goods and services to be paid in full within thirty (30) working days of receiving a vendor invoice. It continues to state that if payment of invoices exceeds thirty (30) days, a 1% interest penalty should be added.

Strong internal controls dictate procedures in place to reconcile monthly receipts submitted by employees to the credit card statements.

We recommend the fiscal court implement control procedures to ensure purchase orders are prepared prior to purchases using a credit card; purchase receipts are matched to the purchase order; and credit card receipts are reconciled to the credit card statements on a monthly basis.

We further recommend full documentation of credit card purchases be provided to fiscal court members with the list of expenditures to be approved.

County Judge/Executive's response: Internal controls improved over credit card purchases.

The Fiscal Court should have an agreement with the depository institution to pledge or provide sufficient collateral to protect deposits. On June 30, 2014, $40,653 of the Fiscal Court's deposits of public funds at US Bank was uninsured and unsecured. According to KRS 66.480(1) (d) and KRS 41.240(4), the depository institutions should pledge or provide sufficient collateral which, together with Federal Deposit Insurance Corporation insurance, equals or exceeds the amount of public funds on deposit at all times. The Fiscal Court should require the depository institution to pledge or provide collateral in an amount sufficient to secure deposits of public funds at all times.

We also recommend the Fiscal Court enter into a written agreement with the depository institution to secure the County's interest in the collateral pledged or provided by the depository institution. According to federal law, 12 U.S.C.A. § 1823(e), this agreement, in order to be recognized as valid by the FDIC, should be (a) in writing, (b) approved by the board of directors of the depository institution or its loan committee, which approval must be reflected in the minutes of the board or committee, and (c) an official record of the depository institution.

County Judge/Executive's response: This has been executed.

The audit report can be found on the auditor's website.

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