Auditor of Public Accounts
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Harmon Releases Audit of McCreary County Fiscal Court

FRANKFORT, Ky. – State Auditor Mike Harmon has released the audit of the financial statement of the McCreary County Fiscal Court for the fiscal year ended June 30, 2018. State law requires annual audits of county fiscal courts.

Auditing standards require the auditor's letter to communicate whether the financial statement presents fairly the receipts, disbursements, and changes in fund balances of the McCreary County Fiscal Court in accordance with accounting principles generally accepted in the United States of America. The fiscal court's financial statement 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 noncompliance with laws, regulations, contracts, and grants. The auditor must also comment on material weaknesses involving internal control over financial operations and reporting.

The audit contains the following comments:

Transfers were made before approval by the fiscal court: This is a repeat finding and was included in the prior year audit report as Finding 2017-002. The former county treasurer made 119 interfund transfers during Fiscal Year 2018. Of the 119 transfers, 118 received approval after the transfer was issued and one did not receive approval.

The former treasurer transferred funds before approval due to timing issues in an attempt to avoid late payment fees and penalties that would have incurred if he had waited until the next fiscal court meeting. By transferring funds before approval is received, the former treasurer circumvented the fiscal court's authority to decide how county funds are to be used.

According to page 73 of the Department for Local Government's *County Budget Preparation and State Local Finance Officer Policy Manual*, "all cash transfers require a court order." Additionally, the McCreary County Fiscal Court's Administrative Code states, "[t]he original appropriation shall be entered and all amendments and transfers authorized by order of the fiscal court."

We recommend that all transfers be approved by the fiscal court before the transfer is made. The approval should be clearly reflected within the fiscal court minutes.

County Judge/Executive's Response: We have consolidated most of our funds into the General Fund to minimize the need for transfers.

The payroll revolving account was not properly reconciled: This is a repeat finding and was included in the prior year audit report as Finding 2017-003. The payroll revolving account did not reconcile to zero as of June 30, 2018, and the remaining balance could not be readily explained. The account balance as of June 30, 2018, was $63,786. Of this balance, the county had outstanding checks of $366 and outstanding liabilities of $47,746, leaving an unexplained balance of $15,674 for Fiscal Year 2018.

According to the former treasurer, the payroll account has not been properly reconciled since before he was appointed. The balances at the end of the fiscal year have been carried forward since at least 2011 and he was not able to determine the reason for the excess funds in the account.

The unreconciled payroll account could cause the fiscal court to have insufficient funds to meet payroll requirements, cause the fiscal court's liabilities to not be properly paid, or cause liabilities to not be paid timely.

Per KRS 68.210, the state local finance officer has the authority to require a uniform system of accounts. The *County Budget Preparation and State Local Finance Officer Policy Manual* includes monthly bank reconciliations as a minimum requirement for all county officials. Since the payroll account is a "sweep account" only the funds necessary to pay employees and government agencies should be transferred from other county funds. Therefore, each month the account should reconcile to zero.

We recommend the fiscal court properly reconcile the payroll revolving account to a zero balance monthly. Additionally, we recommend payroll revolving account bank reconciliations be reviewed by an independent employee to verify accuracy and completeness.

County Judge/Executive's Response: Beginning in July 2018 we opened a new payroll account and that account is being reconciled monthly.

The occupational tax administrator did not deposit receipts intact daily: The occupational tax administrator does not deposit receipts on a daily basis. A test of all 56 fourth quarter occupational tax collection dates indicated that 40 did not clear the bank within three business days.

Per the occupational tax administrator, a limited budget restricts the hiring of additional employees, and working by herself, the administrator could not always make daily deposits.

The practice of making daily deposits reduces the risk of misappropriation of cash, which is the asset most subject to possible theft. Additionally, when deposits are not made timely, the risk that the bank account can be overdrawn increases.

Per KRS 68.210, the state local finance officer was given the authority to prescribe a uniform system of accounts. The minimum of requirements of handling of public funds as stated in the *County Budget Preparation and State Local Finance Officer Policy Manual* requires daily deposits into a federally insured banking institution.

We recommend the occupational tax administrator deposit receipts intact daily.

County Judge/Executive's Response: The Occupational Tax Administrator now makes deposits daily.

The fiscal court did not have proper purchase and procurement procedures: This is a repeat finding and was included in the prior year audit report as Finding 2017-005. The fiscal court did not have proper purchase and procurement procedures as noted by the following deficiencies:

- Internal controls - The county does not have sufficient internal controls in place over the bid process. The finance officer relied upon the road supervisor to determine if invoices were paid correctly. Neither the finance officer nor the road supervisor realized that the vendor rounded haul cost per ton to the nearest dime. The finance officer, former county judge/executive, and former county treasurer all initialed blacktop/paving bills; however, invoices were not compliant with accepted bid pricing.
  - This resulted in the county overpaying $22,146 on three of the five blacktop/paving invoices tested. The other two invoices were underpaid by $25,148.
- Five regular disbursements were not paid timely.
- Six copier lease payments were not paid timely.
- Three health insurance invoices were not paid timely.
- Thirty invoices did not have a purchase order.
- One invoice tested did not have supporting documentation.

The above deficiencies are a direct result of the lack of adequate segregation of duties, improper accounting practices, and poor internal controls without sufficient management oversight.

The finance officer relies on the department heads to ensure that purchases are valid, meet bid requirements, and are calculated correctly. This could have resulted in significant overpayments, misappropriations, inaccurate financial reporting, or penalties being assessed. The authorized check signers rely upon the finance officer to ensure disbursements are valid before submitting them for approval. This reliance negated the compensating controls instituted to offset the lack of segregation of duties.

The state local finance officer, given the authority by KRS 68.210, requires in the *County Budget Preparation and State Local Finance Officer Policy Manual* all disbursements to be accompanied by a purchase order and sufficiently documented. KRS 65.140(2) states, "[u]nless the purchaser and vendor otherwise contract, all bills for goods or services shall be paid within thirty (30) working days of receipt of a vendor's invoice except when payment is delayed because the purchaser has made a written disapproval of improper performances or improper invoicing[.]" In addition, good internal controls dictate that proper supporting documentation is maintained to validate disbursements.

We recommend the fiscal court maintain supporting documentation, such as approved bid specifications, with the original invoices and purchase orders. We recommend all invoices be reviewed for correct billing such as accepted bid price and due dates. We recommend that the check signers ensure that all disbursements agree to the supporting documentation attached before authorization. We recommend the fiscal court pay all expenditures within 30 working days in compliance with KRS 65.140. Additionally, we recommend the fiscal court contact any vendor that was overpaid or underpaid to request a refund or submit any amount due.

County Judge/Executive's Response: We are working with our contractor to resolve this issue. There was an error in their spreadsheet. We will put some of the bills into our budget as recurring bills as a solution.

The fiscal court did not have sufficient internal control procedures over credit card disbursements: This is a repeat finding included in the prior year audit report as Finding 2017-011. The fiscal court has not implemented proper internal control procedures over credit card disbursements. Credit card disbursements had the following deficiencies:

- Five charges were based on a receipt with only a total instead of an itemized listing. Without an itemized listing the purchase may have included unallowable items.
- One charge was paid without supporting documentation to explain what the charge was or which department head purchased them.
- Twenty-eight of 46 credit card charges were not supported with a purchase order.
- The fiscal court is not paying invoices timely thereby accruing late fees and charges (ten late payments totaling $363 and six finance charges totaling $137).

The deficiencies noted above stem from a lack of adequate segregation of duties, improper accounting practices, and poor internal controls without oversight. The county treasurer and county judge/executive are relying upon the finance officer to ensure all invoices are valid without proper review of the supporting documentation before authorizing disbursement.

The lack of proper segregation of duties, improper accounting practices, and lack of oversight could result in misappropriation of assets, inaccurate financial reporting, or payment for personal purchases with public funds.

The state local finance officer, given the authority by KRS 68.210, requires in the *County Budget Preparation and State Local Finance Officer Policy Manual* that all disbursements be accompanied by a purchase order, within budgeted amounts, and sufficiently documented.

Additionally, good internal controls dictate that proper supporting documentation is maintained to support disbursements.

We recommend the fiscal court ensure proper accounting practices by implementing additional internal controls in the area of credit card disbursements, such as assigning an individual other than the finance officer to review all transactions to ensure that they have proper documentation before being submitted for approval to the fiscal court. We further recommend that the authorized check signers ensure credit card disbursements are properly supported before authorizing the disbursements.

County Judge/Executive's Response: We have instructed all employees who use the credit card that all purchases must be approved by the Judge/Executive and all purchases must have an itemized receipt.

The fiscal court did not segregate duties over accounting functions: This is a repeat finding and was included in the prior year audit report as Finding 2017-008. A lack of segregation of duties exists over accounting functions. The following issues were noted:

- The former county treasurer prepared and deposited receipts, posted to the ledgers, prepared financial reports, and prepared the bank reconciliations.
- Items returned from the bank were handled by the former county treasurer.
- The finance officer prepares a list of bills for the fiscal court's approval, prepares all checks, and makes adjustments to the appropriations ledger.

According to the former county judge/executive, a limited budget places restrictions on the number of employees the fiscal court can hire. The lack of oversight could have resulted in undetected misappropriation of assets and inaccurate financial reporting to external agencies such as the Department for Local Government (DLG).

A segregation of duties over various accounting functions, collecting receipts, preparing bank deposits, and preparing reports and reconciliations, or the implementation of compensating controls, when needed because the number of staff is limited, is essential for providing protection from asset misappropriation and inaccurate financial reporting. Additionally, proper segregation of duties protects employees in the normal course of performing their daily responsibilities.

To adequately protect against undetected misappropriation of assets and inaccurate financial reporting, we recommend the fiscal court separate the duties involving collecting and depositing of receipts, and preparation of reports and reconciliations. If this is not feasible due to limited number of staff, strong oversight over these areas could occur and involve an employee that is not currently performing any of those functions. Additionally, the county judge/executive could provide this oversight and document it on the appropriate source documents.

County Judge/Executive's Response: Due to limited staff it is not possible to segregate all duties. We have implemented procedures to ensure stronger controls in most areas.

The fiscal court did not have sufficient monitoring or internal controls over the revolving loan program: This is a repeat finding and was included in the prior year audit report as Finding 2017-009. Since 1994, the McCreary County Fiscal Court has utilized United States Department of Agriculture (USDA) grants to run a Rural Business Enterprise Grant (RBEG) program. The program is designed to encourage new employment opportunities within the county by providing low cost financing to new businesses. The fiscal court has made 35 loans, totaling $1,601,345 from Fiscal Year 1994 through Fiscal Year 2018. The following issues were noted for Fiscal Year 2018 as a result of reviewing the program:

a. The fiscal court made an attempt to collect payment on an inactive loan originally made in the amount of $25,000 by way of refinancing. The loan was refinanced to a 1 percent interest rate and had their principal balance lowered dependent on their payment history. This also occurred in Fiscal Year 2017 to 12 inactive loans totaling $568,082. According to the former county judge/executive, the prior payments made on these loans were converted to all principal. Due to records the fiscal court maintained in regards to payment history not being complete, the new beginning balances could not be verified for accuracy.
b. According to the former county judge/executive, the decision to refinance the inactive loans was discussed and approved by the USDA. However, the auditor was informed the approval was not in writing, and the official at the USDA involved with the discussion is now retired.
c. The grant agreement requires the fiscal court to report the status of the loans to the USDA semi-annually. However, the fiscal court did not submit a report during Fiscal Year 2018.

Due to weak controls and inadequate monitoring over the revolving loan program, the fiscal court has forgone the ability to support viable business within the county that could have produced additional jobs and revenue for the taxpayers.

Section 52 of the Kentucky Constitution prohibits the fiscal court from forgiving debt in which the amount can be precisely determined and which is not in dispute.

Adequate monitoring and properly designed and implemented internal controls could allow early detection of possible non-paying borrowers. In addition, good internal controls dictate accurate records are maintained to support the activity of the program.

The grant application states "[r]ecords will include an accurate accounting of any principal repayments, interest, or other proceeds generated by the loan fund and will document expenses paid for with interest, or other proceeds generated by the loan and will be documented for the grant audits."

We recommend the fiscal court properly monitor the activities of the revolving loan program. Additionally, we recommend the fiscal court comply with the requirements of the loan application and ensure that all loans are properly made, documented, collected, and reported. This matter will be referred to the United States Department of Agriculture.

County Judge/Executive's Response: We will pursue legal actions on delinquent loans. Our loan program has new and stricter requirements.

The fiscal court did not have sufficient internal controls over payroll: This is a repeat finding included in the prior year audit report as Finding 2017-010. The fiscal court lacked sufficient internal controls over payroll as shown by the following deficiencies:

- Of the 16 employees tested:
    - The former treasurer did not have a timesheet to substantiate hours worked or health and retirement benefits received. The former treasurer did not meet any of the four criteria to be exempted as an executive or salaried employee per Kentucky Administrative Regulations (KAR).
    - Three employees had timesheets listing hours worked, but no supervisor approval was evidenced.
        - Two of the three were jail employees; therefore, auditor reviewed timesheets for all transport officers for the pay periods tested. The Jailer did not approve any of his employees' time sheets for the two pay periods tested.
    - Three employees were paid for 'Guard Duty' or 'On Call Time' which was not approved in the fiscal court salary schedule. No evidence found in the fiscal court minutes of the salaries being approved separately.

- One individual submitted a timesheet showing three hours overtime but was not paid for that time. Per the individual's pay stub, this person was considered 'Salaried'. However, the individual did not meet any of the four requirements to be exempted as an executive or salaried employee per KAR.
- Magistrates and constables received health insurance and retirement benefits but no timesheets or affidavits were found to justify the county paying these benefits.
- Of the six insurance invoices tested, one employee received dental benefits yet no premiums were withheld from the employee's pay.

According to the former county judge/executive, he believed he had instituted sufficient controls to prevent the deficiencies. He also stated that he believed the former treasurer and other employee were considered salaried.

The lack of properly designed internal controls increased the possibility of employees receiving wages or benefits not actually earned, such as an individual working part-time hours receiving full time benefits while other part-time individuals receive no benefits. Additionally, discrimination occurred since one employee received free dental benefits when other employees did not.

Internal control procedures that are properly designed and implemented allow employees to detect misstatements in a timely manner while preventing misappropriation of assets or inaccurate financial reporting. An individual who is independent of the recording and disbursement process should approve employee timesheets.

The county administrative code SECTION 5.9 Classification of Employees (A)(1) defines a full-time employee as "[a]n employee who works 40 hours per week on a regular scheduled basis."

SECTION 5.24 (b) requires timesheets to "be signed by employee and supervisor in order to be considered valid and compensation authorized."

And the county administrative code SECTION 5.37(a) states "[a]ll full time employees of the County shall be provided with a health and hospitalization insurance coverage plan as provided by the Fiscal Court." In addition, KRS 78.510(21) defines regular full-time positions as "all positions that average one hundred (100) or more hours per month, determined by using the number of hours actually worked in a calendar or fiscal year[.]"

Furthermore, according to OAG 79-448, "Section 3 of the Kentucky Constitution is unequivocal on the point that public emolument to any person must be based on the consideration of public services. By the strongest implication this means 'public services actually rendered.'" Without timesheets it cannot be determined if services were actually rendered.

803 KAR 1:070 Section 2 lists "General Rule for Executive Employees. (1) The term 'individual employed in a bona fide executive capacity' in KRS 337.010(2)(a)2 shall mean an employee: (a) Compensated on a salary basis at a rate of not less than $455 per week, exclusive of board, lodging, or other facilities; (b) Whose primary duty is management of the enterprise in which the employee is employed or of a customarily recognized department or subdivision thereof; (c) Who customarily and regularly directs the work of two (2) or more other employees; and (d) Who has the authority to hire or fire other employees[.]"

We recommend the fiscal court strengthen their internal controls and ensure compliance with the county's administrative code, KAR, and the Kentucky Constitution by making sure all classifications of employee pay are approved by fiscal court, by ensuring all employees who sign up for additional health benefits are paying for those benefits, and by requiring any individual receiving a paycheck from the fiscal court to submit a signed timesheet to substantiate payment received. Those timesheets should be approved by the employee's supervisor or by the county judge/executive. As elected officials, magistrates and constables are not required to maintain timesheets. However, we recommend they submit an affidavit of hours worked to ensure proper credit for retirement and to support county paid benefits.

County Judge/Executive's Response: Treasurer now does a timesheet. We still maintain that Magistrates, jailer, coroner, constables are not required to do timesheets. Supervisors and the Judge/Executive sign all timesheets.

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

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