Auditor of Public Accounts
Mike Harmon

FOR IMMEDIATE RELEASE

Contact: Michael Goins
Michael.Goins@ky.gov
502.564.5841
502.209.2867

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, 2017. 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:

The fiscal court did not budget two funds: Two funds, the park dedicated fund and the Ten Commandments fund, were not included in the fiscal court's budget. In addition, receipt and disbursement ledgers were not maintained and reconciliations were not completed for these funds.

The county judge/executive did not include all funds in the budget as required by the Department for Local Government. Failing to budget and record all revenues and expenditures results in the Quarterly Financial Statement being understated.

KRS 68.240(1) states in part, "[t]he county judge/executive shall annually prepare a proposed budget for the expenditure of all funds, including those from state and federal sources, which are to be expended by the fiscal court in the next fiscal year." KRS 68.280 authorizes the fiscal court to amend the budget for "the expenditure of receipts unanticipated in the original budget by preparing an amendment to the budget[.]"

We recommend the county judge/executive present a budget which includes all funds of the county.

County Judge/Executive's Response: The Park Dedicated and the Ten Commandments Funds are now closed with the funds expended for their intended purposes. All funds are now included in budgeted items and are listed on financial statements.

Transfers were made before approval by the fiscal court: The county treasurer made 92 interfund transfers during Fiscal Year 2017. Out of the 92 transfers, only three received approval before being issued, two were posted as receipts to unbudgeted funds, 84 received approval after the transfer was issued, and three did not receive approval.

The treasurer is transferring funds based on receipt of the claims list and requests the fiscal court's approval after the transfer has been made.

The fiscal court's authority is being circumvented by the action of the treasurer, who is making the decision on how funds are to be used by transferring them to accounts he has selected to transfer funds to.

According to page 73 of the *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 being made, and the approval be clearly reflected within the fiscal court minutes.

County Judge/Executive's Response: We plan to minimize numbers of accounts in new budgets to resolve this issue.

The payroll revolving account was not properly reconciled: This is a repeat finding and was included in the prior year report as Finding 2016-002. The payroll revolving account did not reconcile to zero as of June 30, 2017, and the remaining balance could not be readily explained. The account balance as of June 30, 2017, was $61,117. Of this balance the county had outstanding checks of $1,300 and outstanding liabilities of $46,142; leaving an unexplained balance of $13,675 for Fiscal Year 2017. No evidence was found to indicate the payroll revolving account reconciliations were reviewed by another individual to ensure accuracy or completeness.

According to the 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 has not been able to determine the reason for the excess funds in the account. The county judge/executive stated he looks over the bank statements but has not signed or initialed them to show this review.

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 reconciliation 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: We agree with the ending balance in the payroll account, as these numbers are exactly what we show in our reconciliations. This fund has been out of balance for many years with no obvious explanation for the excess. We are looking to eliminate continued accumulation of funds in this account, further research explanation, and/or plan to close and reset the amount.

The fiscal court did not pay invoices timely and incurred penalties and interest charges: This is a repeat finding and was included in the prior year report as Finding 2016-005. The fiscal court incurred penalties and interest on disbursements, debt, and payroll. The following charges were discovered:

- Finance charges totaling $108 and late payment fees of $263 were assessed on seven credit card statements.
- Late payment fees totaling $1,080 were incurred on the 911 dispatch telephone equipment purchase.
- Late payment fees totaling $2,190 were incurred by two additional vendors.
- State payroll tax payments were assessed a total of $1,302 for late penalties and interest.

The payment of penalties and interest are due to invoices and payroll withholding not being remitted timely.

Since payments were not made before dates due, a total of $4,943 of funds were used to pay penalties and interest, which could have been used for other purposes.

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 by the vendor or by the vendor's subcontractor."

We recommend the fiscal court comply with KRS 65.140 by ensuring all invoices are paid timely. We also recommend the fiscal court ensure payroll taxes and mandatory reports are submitted to the federal government timely to avoid unnecessary penalties and interest.

County Judge/Executive's Response: Previous cash flow limitations prevented timely payments in some circumstances. Some bills were received late and since fiscal court meetings occur only once per month, some bills are paid after the 30 days. Most of the issues have been resolved with additional cash flow due to the increase in revenue with the occupational tax increase. Efforts will be made to minimize any issues.

The fiscal court did not have proper purchase and procurement procedures: This is a repeat finding and was included in the prior year audit as Finding 2016-001. The following deficiencies show the fiscal court lacks proper purchase and procurement procedures:

- Three invoices that were bid did not have sufficient documentation attached to support the payment.
  - These invoices were for asphalt resurfacing. Additional information such as haul tickets and mileage used to calculate haul cost had to be obtained from the road supervisor to verify the invoices were valid.
  - Although the net amount of difference was immaterial, all invoices for asphalt did not agree to the approved bid. The haul cost billed was rounded to the nearest dime (e.g., if the haul cost was calculated at $9.57, it was billed at $9.60, or if calculated at $9.51, it was billed at $9.50).
- Twelve invoices were not paid timely.
- Thirty-two invoices tested did not have a purchase order attached, issued, or approved.
- One invoice tested did not have supporting documentation.
- Three health invoices tested were paid late and did not have purchase orders.
- One invoice for $222 was paid twice.
- Of the three retirement reports tested, all three payroll reports showed more being owed to the County Employees Retirement System (CERS) than the CERS report showed was owed and subsequently paid (a combined variance of $485).

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 and allowed the fiscal court to spend $222 in error due to duplicate payments. Additionally, since the payroll reports generated are used to transfer fund to the payroll account, this is likely why the payroll account has an excess of funds and cannot be reconciled to zero.

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 haul tickets and approved bid specifications, with the original invoices and purchase orders. We recommend all invoices be accompanied by the signed haul ticket or packing slip showing receipt of the item purchased. Debt invoices should be accompanied by a payment or amortization schedule. We recommend that the check signers ensure that all disbursements agree to the supporting documentation attached before authorization. Furthermore, we recommend the fiscal court pay all expenditures within 30 working days in compliance with KRS 65.140.

County Judge/Executive's Response: Measures have been taken to prevent rounding of dollar amounts by the asphalt contractor relative to the bid price. Previously, service invoices and utilities and similar items did not require the issuance of a purchase order. Procedures are now in place to minimize these deficiencies.

The fiscal court did not comply with the United States Department of Agriculture (USDA) grant agreement: This is a repeat finding and was included in the prior year audit report as Finding 2016-006. Since 1994, the McCreary County Fiscal Court has utilized USDA grant funds 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 most recent USDA grant for this purpose was awarded to the McCreary County Fiscal Court during Fiscal Year 2013 in the amount of $75,000. In accordance with the grant agreement, the fiscal court was required to provide $20,000 in matching funds.

In June 2014, the fiscal court approved a new business loan in the amount of $50,000. The loan was to be made from $40,000 obtained from the USDA grant, and the remaining $10,000 coming from county matching funds.

The fiscal court paid the matching $10,000 from the county's Revolving Loan Fund, which is made up of prior revolving loan repayments. Due to poor accounting practices, the auditor was unable to determine if the prior repayments were from RBEG loans or from the earlier SMART loans.

Due to the fiscal court incorrectly considering any prior RBEG repayments as being unrestricted, the county's matching requirement for the grant was not met.

The grant agreement states, "[i]t is clearly understood that matching Revolving Loan Funds (RLF) will remain in perpetuity along with Rural Business Enterprise Grant funds that are likewise designated and referred to as the fund. The fund will contain a Federal Interest equivalent to the dollar amount invested."

Additionally, a USDA official confirmed to the auditors that any prior revolving loan repayments are restricted, and thus should not be utilized by the county as a source for their matching requirements. Loan repayments should be used to provide additional revolving loans.

We recommend the fiscal court provide their match in compliance with the USDA grant agreement and reimburse the revolving loan fund for the matching funds previously expended. This matter will be referred to the United States Department of Agriculture.

County Judge/Executive's Response: We were told by officials at the USDA at the time of this loan that once payments recycle through and are paid back to the revolving loan fund, they lose their federal identity. Additionally, the money in the revolving loan bank account includes monies from sources other than federal grants in the past. It was our understanding at the time that this was a proper use of that money since it was used for loans irrespective of whether there was a federal component or not. Our budget difficulties at the time did not grant us the latitude to use money from the general fund to support the revolving loan program.

Auditor's Reply: Fiscal court management is responsible for reviewing and adhering to all federal grant requirements. Fiscal court management should only comingle funds when permissible and accounting records are sufficient to clearly differentiate between the source and expenditure of the funds.

The fiscal court did not maintain accurate capital asset records: This is a repeat finding and was included in the prior year report as Finding 2016-007. The fiscal court is not maintaining accurate capital asset records. The audit adjustments to the fiscal court's beginning balances are due to prior year changes that were not adjusted timely. These adjustments along with audit adjustments to current year additions are a result of a lack of oversight in this area.

Management's lack of oversight caused capital assets records to be inaccurate. As a result of not maintaining an accurate list of capital assets, assets could be improperly stated, increasing the risk of material misstatement to the capital asset schedule, and assets can be insured that are no longer owned. The beginning balance for land was decreased by $76,300 from the prior year amount due to a prior year land donation that was not addressed. The beginning balance for other equipment was decreased by $2,721 for a generator that was replaced through the county's insurance policy in the prior year. Furthermore, the county failed to add six assets, totaling $126,697 purchased during the fiscal year to their asset listing.

KRS 68.210 gives the state local finance officer the authority to prescribe a uniform system of accounts. Per the *County Budget Preparation and State Local Finance Officer Policy Manual*, capital asset records are necessary for proper valuation.

We recommend the employee(s) in charge of capital assets maintain accurate records throughout the year of any purchases and retirements of assets and provide periodic updates to the fiscal court. Records should also be changed for any audit adjustments agreed to by management. Purchases should be approved and records should include the date the asset was acquired, a description of the asset, the vendor name, the amount, salvage value, and useful life. Invoices and supporting documentation for asset acquisition should be kept on file in a manner that allows retrieval of the original invoice for review and verification as needed by management and auditors. If possible, an inventory count at June 30 of each fiscal year should be conducted. We recommend the fiscal court provide the necessary oversight needed to ensure accurate and complete records are maintained.

County Judge/Executive's Response: Errors in the capital asset records were due primarily to tabulating on a calendar year versus a fiscal year. We have initiated measures to correct this.

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 2016-008. A lack of segregation of duties exists over accounting functions. The following issues were noted:

- The county treasurer prepares and deposits receipts, posts to the ledgers, prepares financial reports, and prepares the bank reconciliations.
- Items returned from the bank are handled by the county treasurer.
- The finance officer prepares a list of bills for the fiscal court's approval and prepares all checks

Per the county judge/executive, a limited budget places restrictions on the number of employees the fiscal court can hire. When faced with a limited number of staff, strong compensating controls should have been implemented to offset the lack of segregation of duties.

The lack of oversight could result in undetected misappropriation of assets and inaccurate financial reporting to external agencies such as the Department for Local Government.

A segregation of duties over various accounting functions, collecting receipts, preparing bank deposits, 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: Our limited budget and resulting minimal workforce prevent us from hiring additional employees to enable optimal remediation of this issue. We will, however, *continue to have oversight by multiple employees where possible. We are aware of the need to have oversight in all transactions and will work diligently to ensure strong controls.*

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 2016-009. 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 34 loans, totaling $1,586,345 from Fiscal Year 1994 through Fiscal Year 2017. The following issues were noted for Fiscal Year 2017 as a result of reviewing the program:

- The fiscal court made an attempt to collect payment on 12 inactive loans originally totaling $568,082 by way of refinancing. The loans were refinanced to a 1 percent interest rate and had their principal balances lowered dependent on their payment history. According to the 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.
- According to the 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 was now retired.
- 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 2017.

Due to weak controls and inadequate monitoring over the revolving loan program, the fiscal court has forgone the ability to support viable businesses 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 nonpaying 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: This is a recurring audit finding and we are diligently working to remedy this issue. We have worked with our present, as well as previous county attorneys to identify collectable and uncollectable loans from the past. The Fiscal Court during 2016 authorized an option of refinancing any of the collectable loans, providing financial benefits to loan holders who complied. All but 3 of the collectable loan holders took advantage of the offer and refinanced to get their loans in compliance and up-to-date. The remainder are being pursued with legal action (currently in progress).

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 2016-003. The fiscal court did not have sufficient internal controls over payroll as shown by the following deficiencies:

- Of the 20 employees tested:
  - Four employees did not have a timesheet to substantiate hours worked or health and retirement benefits received.
  - Six employees had a timesheet listing hours worked, but no evidence of supervisor approval.
  - One employee received a vacation leave payout, which is allowed under the county's administrative code; however, the county judge failed to approve this payout, which is required.
- Magistrates received health insurance and retirement benefits but no timesheets or affidavits were found to justify the county paying these benefits.
- The coroner received health insurance and retirement benefits but no timesheets or affidavits were found to justify the county paying these benefits.

The lack of properly designed internal controls creates the possibility that employees will receive wages or benefits not actually earned and that discrimination will occur, such as one individual working part-time hours receiving full-time benefits while other part-time individuals receive no benefits. Additionally, the fiscal court believed magistrates and constables, as elected officials, were exempt from submitting timesheets.

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[.]"

We recommend the fiscal court strengthen their internal controls and ensure compliance with the county's administrative code by requiring any individual receiving a paycheck from the fiscal court to submit a signed timesheet. Those timesheets should be approved by the employee's supervisor or by the county judge/executive. As elected officials, magistrates and the coroner 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: We changed salaried employees to hourly during the year and now require timesheets for those hourly employees. We still maintain that the elected offices of magistrate, jailer, coroner, constables, etc. are not required to present time sheets for their work. Supervisors always sign their employees' time sheets. I, the Judge/Executive, sign all supervisors time sheets as they are presented.

Auditor's Reply: The recommendation that magistrates and constables submit an affidavit of hours worked is not a statutory requirement; however, it is a good practice to show they have met the full-time criteria for retirement benefits.

The fiscal court did not have sufficient internal control procedures over credit card disbursements: This is a repeat finding and was included in the prior year audit report as Finding 2016-004. The fiscal court has not implemented proper internal control procedures over credit card disbursements. We noted the following deficiencies with credit card disbursements:

- Four charges were paid without supporting documentation to explain what the charges were or which department head purchased them.
- Three food charges were based on a receipt with only a total instead of an itemized listing; without an itemized listing the purchases may have included unallowable items.
- None of the disbursements were accompanied by a purchase order.

All credit card statements showed evidence of approval with initials by the county treasurer or the county judge/ executive even with the deficiencies noted above.

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 make every effort to maintain strong controls over credit card purchases, making sure all receipts are attached to statements. All credit card purchases are made with the Judge/Executive's approval. We will make every effort to improve compliance by users of the credit card to provide sufficient itemized documentation to support all charges.

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

###

The Auditor of Public Accounts ensures that public resources are protected, accurately valued, properly accounted for, and effectively employed to raise the quality of life of Kentuckians.

Call 1-800-KY-ALERT or visit our website to report suspected waste and abuse.