

**EXAMINATION OF CERTAIN FINANCIAL
PROCESSES AND INTERNAL CONTROLS OF THE
KENTUCKY CORRECTIONAL INDUSTRIES**



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List of abbreviations/acronyms used in this report

ACCPAC	Kentucky Correctional Industries Accounting Software
CFO	Chief Financial Officer
Corrections	Kentucky Department of Corrections
CREFNO	ACCPAC Data Field – Payment Reference Made At Time Of Payment
KCI	Kentucky Correctional Industries
KSP	Kentucky State Police
MARS	Management Administrative Reporting System
MOA	Memorandum of Agreement
Treasury	Kentucky Department of the Treasury



CRIT LUALLEN
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November 15, 2004

John D. Rees, Commissioner
Department of Corrections
275 East Main Street, P.O. Box 2400
Frankfort, Kentucky 40602-2400

RE: Special Examination of Kentucky Correctional Industries

Dear Commissioner Rees:

We have completed our examination of certain financial processes and internal controls for the period July 2000 through May 2004 at the Kentucky Correctional Industries (KCI) as requested by your letter of May 4, 2004. Our examination revealed flawed business practices, lack of financial controls, and gross mismanagement by the former branch manager and previous administrators that led to the inability to conclusively account for all KCI receipts. Certain issues were identified that we are referring to the Kentucky State Police (KSP) for further investigation of potential criminal activity.

The scope and objectives of our examination were outlined in a Memorandum of Agreement (MOA) between our office and the Kentucky Department of Corrections (Corrections). The objectives of this examination were to:

- Perform procedures to determine whether a reliable process exists to reconcile payments made to KCI to customer invoices;
- Determine the amount of loss, if any, that resulted from the failure to deposit certain identified payments made to KCI;
- Evaluate the design and operation of KCI processes and controls for the receipt and deposit of payments made to KCI; and
- Report control weaknesses or other issues identified during our examination and offer recommendations to strengthen processes and controls, or address other issues as needed.

We also designed and performed specific tests to detect exceptions in the receipt and deposit processes followed by KCI.

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The scope and objectives of this engagement were approved by you and other KCI representatives. Two of the original objectives of this examination to reconcile data and determine any specific loss for a four-year period were modified, with your consent, because inconsistent processes followed by KCI made it impossible to properly complete all of the original objectives.

One objective of the original MOA was to determine whether all payments made to KCI have been properly accounted for from July 2000 through May 2004. Completion of this objective required a reconciliation of KCI's accounting software (ACCPAC) to the Commonwealth's accounting system, Management Administrative Reporting System (MARS).

Because of the high volume of transactions KCI processed during the examination period, it was unmanageable to perform a manual reconciliation of all transactions. We designed an approach to automate the reconciliation of individual payments entered into ACCPAC to individual payments KCI entered into MARS. To automate the reconciliation process, a data field unique to both accounting systems must exist. Because both ACCPAC and MARS were capable of capturing inter-account transaction document numbers, we were able to perform an electronic reconciliation of inter-account transactions that had a document number entered in both ACCPAC and MARS for fiscal years 2003 and 2004. This reconciliation yielded a \$177,000 variance between ACCPAC and MARS. In addition, 84 transactions were entered into ACCPAC with an incomplete inter-account document reference. These transactions were inappropriately identified as paid when they had not been entered into MARS for processing.

Because KCI failed to establish policies and procedures requiring employees to follow a uniform process for entering transaction data, non inter-account transactions were inconsistently entered or omitted from ACCPAC and MARS. This made it impossible to perform a complete electronic reconciliation.

We then attempted to manually reconcile all non inter-account transactions posted in ACCPAC to MARS. Due to the issues noted above, we were only able to reconcile a small percentage of non inter-account transactions. Because of the lack of unique data captured by both systems, we attempted to reconcile ACCPAC and MARS transactions using only the transaction amounts.

We were able to identify certain transaction amounts posted in MARS that also appeared in ACCPAC. However, due to inconsistent data entry, obvious data entry errors, and multiple transaction amounts entered in ACCPAC being accumulated into a single transaction amount entered into MARS, we were unable to perform a complete reconciliation of data within these systems. In attempting to reconcile transactions within these systems, we identified transaction discrepancies totaling \$202,000. It appears that these discrepancies are the result of data entry errors and other weaknesses identified above.

As a result of our examination, we cite several internal control weaknesses at KCI including:

- Inadequate segregation of duties;
- Negotiable instruments not restrictively endorsed;
- Untimely deposits;
- Remittance advices not included with sales invoices;
- Lack of management reviews and reconciliations;
- Inconsistent data entry; and
- Outdated written policies and procedures.

Accordingly, we have made recommendations to improve each of these concerns including:

- Recommendations to improve business processes to ensure sufficient management oversight;
- Recommendations to improve accountability by suggesting a process to facilitate a reconciliation of transactions entered into ACCPAC and MARS; and
- Recommendations to improve securing and consistent processing of receipts.

The results of our examination are presented in the attached detailed report. We thank you, the KCI fiscal officer, and all Corrections personnel for the cooperation and assistance received during the course of this examination.

Very truly yours,



Crit Luallen
Auditor of Public Accounts

Background

KCI discovered unprocessed checks totaling over \$346,000.

Kentucky Correctional Industries (KCI) is a self-supporting division of the Kentucky Department of Corrections (Corrections) that employs hundreds of inmates in the production of goods and services in Kentucky's major penal institutions. In recent years, KCI sales have exceeded \$11 million annually.

In April 2004, KCI discovered approximately 250 checks and loose cash totaling over \$346,000 in a manager's office. These checks had accumulated over four years. Most of these checks represented payments for KCI sales. Unprocessed credit transactions totaling over \$31,400 were also discovered in the office. As a result of this discovery, the manager's employment was terminated, a director was reassigned, and the Kentucky State Police (KSP) was notified.

On May 4, 2004, Corrections requested our office to "scrutinize the financial integrity of [KCI], as well as to examine existing internal control mechanisms." We then began an examination of certain financial processes and internal controls at KCI.

We interviewed key personnel and examined flowcharts and other documentation to gain an understanding of KCI's receipt and deposit processes.

We interviewed the current KCI fiscal officer and examined flowcharts prepared by KCI to gain an understanding of the design and operation of internal controls for the receipt and deposit processes at KCI. We gained an understanding of both the current internal control processes and the controls in place before KCI implemented changes in May 2004. We did not perform certain interviews due to another pending investigation.

Generally, the processes involved in executing and recording KCI sales include the following:

- Receive customer orders that are subsequently recorded in ACCPAC, the accounting software used by KCI;
- Generate sales orders and transmit these orders to the KCI warehouse or appropriate KCI plants;
- Fill orders and deliver the ordered products;

- Generate and transmit invoices and create accounts receivable in ACCPAC;
- Receive and log invoice payments; and
- Transmit deposit items to the Kentucky Department of the Treasury (Treasury) and record receipt information in ACCPAC and in the Commonwealth's accounting system, Management Administrative Reporting System (MARS).

Upon payment of an existing invoice in ACCPAC, the customer account receivable is credited for the amount of payment. If an invoice has not yet been generated, the payment is deposited and the account is credited upon generation of the invoice. The latter process occurs when orders are received from private citizens or entities. These orders must be pre-paid upon receipt of the order. In these instances, an invoice is not generated until receipt of goods by the customer. The pre-payment is deposited and a deferred revenue liability exists for KCI. Once receipt of goods is documented by KCI, the invoice is generated and the corresponding account receivable and deferred revenue are decreased for the amount of payment.

An accounts receivable report is generated by ACCPAC on a monthly basis. This report lists all accounts with a balance due payable to KCI. The fiscal officer reviews the report.

KCI implemented internal control changes in May 2004.

Before KCI and Corrections implemented internal control changes in May 2004, the former administrative branch manager (former manager) received all incoming checks for payment of invoices. A daily cash receipts log or other transmittal listing was not prepared to document the checks received for each day. Checks were not restrictively endorsed by KCI upon receipt.

The cash receipts were then forwarded to a separate employee in the fiscal branch for input into ACCPAC and MARS. The employee also prepared the transmittal document to be forwarded to Treasury.

Cash receipt documents were prepared at the discretion and judgment of the former manager. No formal policy was followed at KCI for preparing and depositing incoming checks. According to the fiscal officer, KCI prepared about two to three cash receipt documents per month.

If a payment was received from an agency or individual before ACCPAC had generated the billing invoice, the check or other negotiable instrument was held by KCI and not deposited until the invoice was generated by the ACCPAC system. This delay could have been months from receipt of check by KCI until actual deposit. The checks or negotiable instruments were maintained in the desks of KCI employees and were not stored in a secure vault.

Findings and Recommendations

Inadequate segregation of duties had significant impact on KCI financial processes.

A properly designed internal control structure separates one individual from having control over two or more of the following duties and responsibilities of a transaction or operation: authorization, custody, recordkeeping, and reconciliation. Ideally, different employees would perform each of the four control functions. However, limited resources prevent KCI from assigning each function to a separate employee. In the absence of properly segregated duties, compensating controls should be in place.

The former KCI manager possessed the ability to authorize, record, and reconcile transactions. Further, the manager maintained custody of checks or other negotiable instruments received by KCI. During the scope of this examination, no compensating controls were in operation to reduce the risk of one person performing these functions. In May 2004, KCI implemented compensating controls that included providing transaction documentation to Corrections' management, independent of the cash receipt process, for review.

KCI has also hired a new fiscal branch employee to assume specific duties to further segregate financial control procedures. Hiring a new fiscal employee allows KCI the opportunity to segregate duties among its staff by assigning responsibilities consistent with a strong internal control structure.

Recommendations

We recommend that KCI continue to provide transaction documentation to Corrections' management for independent review. Further, we recommend that KCI's Chief Financial Officer (CFO) be responsible for the reconciliation duties and perform an additional independent review of financial activity reports.

Negotiable instruments were not restrictively endorsed by KCI upon receipt.

KCI did not restrictively endorse checks or other negotiable instruments upon receipt. A restrictive endorsement on checks or other negotiable instruments deters the potential for theft or other loss. Even though Treasury does not require state agencies to restrictively endorse checks or other negotiable instruments at the agency level, Treasury encourages agencies to restrictively endorse checks received before forwarding the checks or negotiable instruments to Treasury for deposit.

Recommendations

We recommend that KCI restrictively endorse checks immediately upon receipt. The endorsement should be made by the individual assigned to open incoming mail.

Deposits were not made on a timely basis.

Before May 2004, KCI prepared cash receipt documents for depositing incoming cash receipts at the sole discretion of the former manager. The lack of a formal policy led to KCI only preparing two to three cash receipt documents per month for transmittal to Treasury for deposit. Furthermore, incoming checks were not adequately secured by the former manager from the time of receipt by KCI to transmittal to Treasury for deposit.

In May 2004, KCI began forwarding cash receipts to Treasury on a daily basis for deposit. In addition, a cash receipt document is prepared for each check or negotiable instrument received by KCI.

Recommendations

We recommend that KCI continue to forward cash receipts to Treasury on a daily basis for deposit. We again recommend that the negotiable instrument be restrictively endorsed.

A remittance advice is not included with sales invoices.

KCI does not include a remittance advice with its sales invoices. A remittance advice is the part of a sales invoice sent to a customer that should be returned with the customer's payment. At a minimum, a remittance advice should include the customer's name, account number, invoice number, and purchase amount.

Due to the lack of a remittance advice, KCI is sometimes unaware of which sales invoices to credit when customer payments are received. This creates inefficiencies as staff must search all outstanding invoices for the customer to identify which invoices comprise the payment amount. A customer may also make a single payment for multiple invoices. Without a remittance advice associated with each purchase made, KCI employees must, through trial and error, determine the specific invoices being paid.

Recommendations

We recommend that KCI send remittance advices along with sales invoices mailed to its customers. Ideally, remittance advices should be the only documents forwarded to the accounting office for crediting customer accounts. The payments received and the daily spreadsheet log for each payment should be forwarded to an individual separate from the posting function. However, we recognize the limited number of staff at KCI available to perform the posting and depositing functions. In the absence of fully segregated duties, we recommend that KCI management perform regular systematic reviews of posting and depositing activity.

Management did not perform reviews and reconciliations of KCI financial reports.

Certain checks received by KCI were not deposited over four years. According to the fiscal officer, the former manager was responsible for periodically reviewing accounts receivable reports. As indicated previously, the former manager also maintained custody of incoming checks from customers. The former manager had complete oversight of the cash receipts process. Because management reviews and reconciliations were not performed prior to May 2004, the undeposited checks and related outstanding accounts receivable were not detected for a considerable length of time.

Currently, the fiscal officer reviews an accounts receivable aging report on a monthly basis. This report is sorted by 30-day time intervals up to 120 days and identifies all accounts with outstanding balances within each time interval.

Recommendations

We recommend that KCI continue to produce accounts receivable aging reports for management. KCI should investigate items outstanding longer than 30 days. Ideally, the report should be distributed to an individual not involved in the cash receipts transaction process, such as the CFO, and others for review.

Data entry errors and other weaknesses resulted in a \$177,000 variance between ACCPAC and MARS transactions.

We performed an automated reconciliation between accounts posted as paid in ACCPAC and deposit information entered into MARS. Specifically, for fiscal years 2003 and 2004 we reconciled all payment transactions in ACCPAC made through inter-accounts to deposit transactions entered into MARS. Inter-account payments are transfers of funds between state agencies.

Our electronic reconciliation identified a \$177,862.11 discrepancy between ACCPAC and MARS. The majority of the discrepancy appears to be due to incomplete data entry or consists of transaction amounts posted as paid in ACCPAC with an inter-account reference number that did not match a corresponding inter-account reference number in MARS. Other discrepancies are identified due to inconsistent data entered in ACCPAC. Details of these discrepancies will be provided to the agency for their further review.

Recommendations

We recommend KCI continue to attempt to reconcile the discrepancy between ACCPAC and MARS. To facilitate the reconciliation process in the future, we further recommend that KCI require the transaction reference number be entered in ACCPAC. Transaction data from ACCPAC and MARS should be reconciled monthly. The reconciliation should be performed, or at least reviewed, by someone not involved in routine daily operations. Monthly, the CFO should review amounts entered in ACCPAC and reconcile the amounts to data also entered in MARS. This process could be automated as recommended in the following comment.

KCI does not enter data consistently in ACCPAC and MARS.

In the past, KCI captured data in ACCPAC that was also entered in MARS. However, because it was difficult for KCI personnel to track payments from customers into ACCPAC, KCI began entering the customer check number into ACCPAC instead of the deposit documentation data entered in MARS. While this change allowed KCI personnel to quickly retrieve customer payment information, it compromised KCI's ability to ensure that all payments from customers were posted correctly and timely in MARS.

KCI also assigns multiple customer numbers to the same customer. This occurs because sales people use various names to describe the same customer and ACCPAC allows the same vendor to be added with different name variations. For example, the Department of Corrections may be entered as Dept. of Corrections, Corrections Department, or Corrections Dept., etc. Each variation is assigned a separate customer number even though the vendor may be the same.

While assigning multiple customer numbers to one customer may not have a direct impact on KCI's ability to process and deposit payments received, it is an inefficient practice and could impact the accuracy of financial reports generated from ACCPAC and deter a detailed reconciliation of activity.

Recommendations

We recommend that KCI add an additional field or sub-field in ACCPAC that allows the same unique data for a specific transaction to be entered into ACCPAC that is also entered into MARS. KCI management should perform periodic reconciliations of transactions posted in ACCPAC to transactions posted in MARS. To expedite the process, we recommend that KCI automate the reconciliation of ACCPAC and MARS transactions. This can be accomplished by extracting relevant KCI transactions from MARS into a file using Seagate Info or Crystal Reports. An extract file of ACCPAC transactions for the same period should be created. Both extract files should be imported into Access and sorted by the transaction reference numbers. The two files should then be merged into a single file matching the unique data. Those transactions that do not create a match should be investigated.

Further, we recommend that KCI instruct and require its sales staff to complete sales orders using the master listing of existing customers and customer numbers to eliminate assigning new customer numbers to already existing customers.

KCI's written policies and procedures are outdated.

KCI has established written policies and procedures for processing cash receipts and accounts receivable. However, the policies and procedures are outdated, having not been modified since possibly the late 1980s. The policies do not reflect current KCI operations.

Recommendations

We recommend that KCI update its policies and procedures manual for all its internal operations. This update should include changes already made by KCI as well as the recommendations offered in this report. Further, the policies and procedures manual should be readily accessible to each employee.

KCI has deposited over \$338,000 of payments discovered in the former manager's office.

KCI personnel discovered approximately 250 checks, loose cash, and unprocessed credit transactions from customers in the office of the former manager in April 2004. The total amount of checks, cash, and credit charges was \$377,751.86. KCI immediately began the process of cataloging the payments. KCI also contacted vendors and researched all available supporting documentation in order to properly deposit these payments.

We verified that KCI has deposited \$338,241.34 of the \$377,751.86 of unprocessed payments discovered in the former manager's office. In addition, \$34,908.67 was identified either as duplicate payments from customers or payments received by KCI that should have been routed to other state agencies. As of September 2004, KCI continues its efforts to recover the remaining undeposited amount of \$4,601.85. These payments could not be processed by banks due to the time period elapsed between the original date of payment and discovery of the payments in April 2004. KCI has notified these customers and requested payments be sent to KCI.

Recommendation

We recommend that KCI continue to pursue payment from customers whose original checks cannot be processed by banks due to the time period elapsed since the original date of payment.

We designed and performed audit procedures to detect irregular transactions.

In addition to the audit procedures identified above, we performed specific testing procedures designed to detect exceptions of the normal receipting, depositing, and accounting processes. Specifically, we tested transactions posted in ACCPAC with unusual transaction references posted in the CREFNO column, which provides payment reference information.

Normally, the CREFNO column contains transaction references to supporting documentation also posted in MARS. For our testing purposes, we sorted the transactions in ACCPAC from fiscal years 2003 and 2004 and selected those transactions posted with unusual transaction references in the CREFNO column.

KCI identified 84 transactions totaling \$39,338.53 in ACCPAC with unusual CREFNO references. These transactions were posted as paid in ACCPAC but were not entered into MARS and no corresponding deposit was made on or near the date of posting. When it was identified that these transactions were not invoiced, KCI initiated inter-account transactions to collect the amount due. Subsequently, we were able to trace 79 of the 84 transactions identified totaling \$38,707.25 to deposit documentation provided by KCI or to MARS information. Based on the information in MARS and supporting documentation provided by KCI, we were unable to reconcile five of the 84 transactions totaling \$631.28.

In addition to the transactions identified by KCI, we identified 58 transactions with unusual CREFNO references totaling \$28,825.50. We were able to trace 23 of the 58 transactions identified totaling \$4,328.44 to referenced information in MARS. Based on information provided in ACCPAC and MARS, we were unable to determine whether the remaining 35 transactions totaling \$24,497.06 were entered in MARS and corresponding deposits were made.

We are referring the 84 and 35 transactions, totaling \$63,835.59, identified above to the KSP for further investigation of potential criminal activity.

Recommendations

We recommend that KCI continue its efforts to ensure all amounts posted as paid in ACCPAC are deposited in the most expeditious manner possible. In order to ensure that a complete and accurate reconciliation can be performed, we also recommend that KCI enter data unique to a specific transaction into both ACCPAC and MARS. The data must be consistently and accurately entered into ACCPAC and MARS to be of value.

DEPARTMENT OF CORRECTIONS' RESPONSE



Ernie Fletcher
Governor

Commonwealth of Kentucky
Department of Corrections
P.O. Box 2400
Frankfort, KY 40601
Phone: 502-564-4726 or Fax: 502-564-5037

John D. Rees
Commissioner

November 1, 2004

The Honorable Crit Luallen
Auditor of Public Accounts
105 Sea Hero Road, Suite 2
Frankfort, Kentucky 40601-5404

Dear Auditor Luallen:

In response to the State Auditor of Public Accounts' Examination of Certain Financial Processes and Internal Controls of the Kentucky Correctional Industries (KCI), we have instituted or have in process the following actions to correct the mismanagement by the former branch manager and the lack of financial controls.

First, the branch manager of KCI was dismissed and her immediate supervisor was reassigned. We have hired a new Director and Chief Financial Officer. The Director has extensive experience in prison industries and also has an accounting background. The CFO is from the private sector with over 25 years experience in handling all facets of the accounting process.

We have addressed the internal control weakness concerning segregation of duties in the area of cash receipts with the following changes in procedure. The Director's Administrative Specialist retrieves checks from the daily mail and restrictively endorses the checks (For Deposit Only / KCI). The checks are given to the CFO who adds them to a check log and then forwards them to the Fiscal Manager for review. The Accounts Receivable (AR) Specialist next receives these items to process and forwards to the Kentucky State Treasurer with a cash receipt transmittal form. This process will be performed on a daily basis. The checks being processed are stored in a secured safe located in the AR Specialist's office.

To alleviate concerns of management review and reconciliation, the CFO will compare his check log to the cash transmittal form to ensure accuracy. He will also confirm that the deposit has reached the Kentucky State Treasurer. For independent review, the above documentation will be forwarded to an Internal Policy Analyst at the Department of Corrections Central Office. The CFO will also review on a daily basis a centralized accounts receivable aging report of all the different plants in KCI. This report is presently being constructed by our software vendor and is to be implemented within two weeks.

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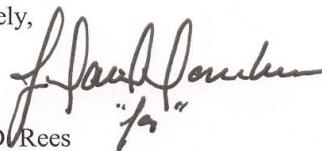
To assist our Accounts Receivable Specialist in determining where to credit payments, we will begin to send remittance advices along with sales invoices mailed to our customers. With our growing amount of non-state agency business this could be a valuable enhancement.

We understand the weakness cited concerning inconsistent data entry. In response, we are now using a common data field in MARS (State accounting system) and in ACCPAC (KCI accounting system) that includes the same information for a specific cash receipt transaction. This will allow these transactions to be reconciled with each other.

Along with the above procedures, modification and development of all written accounting policies at KCI is now underway. We note these have not been modified since the 1980s and do not reflect our current operations. However, it is our belief that with the current staffing levels, we have the necessary personnel to ensure proper segregation of duties.

The Department of Corrections would like to take this opportunity to thank your staff for their hard work and especially Director Brian Lykins for his assistance during this examination.

Sincerely,

A handwritten signature in black ink, appearing to read "John D. Rees". The signature is written in a cursive style with a large initial "J" and "R".

John D. Rees
Commissioner

cc: Lt. Governor Stephen B. Pence, Secretary
Cleve Gambill, Deputy Secretary
J. David Donahue, Deputy Commissioner

