EXAMINATION OF
CERTAIN PROCESSES, CONTROLS, AND TRANSACTIONS
OF THE CITY OF MANCHESTER

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December 20, 2006

The Honorable Daugh K. White, Mayor
City of Manchester
239 Memorial Drive
Manchester, Kentucky 40962

RE: City of Manchester Examination

Dear Mayor White and City Council Members:

We have completed our examination of certain processes, procedures, controls, and transactions of the City of Manchester (City). This examination was conducted as a result of concerns received by this office regarding certain practices and processes followed by the City.

Examination procedures included interviews with numerous City officials and employees, certain City Council and Clay County Tourism Council (Tourism Council) Members, a vendor of the City, the Certified Public Accountant (CPA) engaged by the City, and other government agency personnel. We also requested documentation from the City, the City's CPA, the Tourism Council, and other government agencies. Various documents examined and analyzed, include contracts, invoices, certain City bank and credit card statements, and City Council and Tourism Council meeting minutes.

Findings included in this report reveal:

- a lack of formal policies and procedures to govern certain financial activity;
- the City authorized and incurred the cost of paving private driveways;
- various areas of noncompliance with established state statutes;
- the City inappropriately reimbursed personal travel expenses;
- the City made loans to its employees and to a local business;
- City activity potentially violated the City's code of ethics; and,
- the CPA engaged by the City may lack independence required by audit standards.

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Detailed findings discussing these and other issues are presented in this report. We also offer our recommendations to strengthen the City's processes, procedures, controls, and compliance with state statutes.

Due to the findings resulting from this examination, we have referred this report to the Attorney General's Office, the City Attorney, the Governor's Office for Local Development, the Manchester Board of Ethics, and the Transportation Cabinet to consider whether further action is warranted.

We wish to thank you, in advance, for your consideration of the issues identified in this report.

Very truly yours,

Crit Luallen
Auditor of Public Accounts

Findings and Recommendations

The City did not adopt or implement formal policies and procedures to govern certain financial activity.

The City of Manchester, Kentucky (City) did not establish formal written policies and procedures to provide guidance and to ensure the proper management of certain City financial activity and programs.

According to those interviewed in the City Clerk's Office, the City adopted the local provisions of the Model Procurement Code (MPC), procurement policies established by Kentucky Revised Statutes (KRS) Chapter 45A. These provisions are similar to the procurement laws followed by the Commonwealth of Kentucky. Upon examination of the City's procurement code adopted on January 21, 1986, we found the City formally adopted the MPC only in relation to Community Development Block Grant (CDBG) funds, and not in relation to other City managed funds.

The lack of formal policies and procedures contributed to questionable City actions.

We also identified several other issues throughout this examination, which, in part, result from the City's lack of formal policies and procedures. These issues include:

- Insufficient supporting documentation for various payments, services, and loans;
- Use of City resources to pave private driveways;
- City's failure to pay a vendor an outstanding balance of approximately $54,000 for over 240 days, in violation of KRS 65.140;
- Use of City funds to reimburse questionable travel expenses; and,
- Use of City funds to provide loans to City employees and private companies.

Recommendations

We recommend that the City adopt and implement formal policies and procedures to establish:

- A transaction approval process to ensure the most efficient use of City resources and to ensure compliance with local, state, and federal laws and regulations.
- Clearly defined public services the City offers to its citizens. Further, policies should specify the procedures to be followed for citizens to request a public service.

- Accountability, timely payments, proper reporting of City finances, and the creation of a sufficient audit trail.
- That the City will prohibit making loans to its employees.
- Travel reimbursements that ensure employee travel practices are equitable and to maximize the economical benefit to the City.

The City authorized and incurred the cost of paving private driveways in November 2005.

In November 2005, the City employed a contractor to pave certain City streets. Upon completion of the project later that month, it was discovered that the City authorized the paving of a number of private driveways during the process. In a November 21, 2005 City Council meeting, as noted in a local newspaper article, the Mayor and a City Council Member addressed paving the private driveways. The Mayor stated that the owners of these private driveways had agreed to pay the City for the cost of paving prior to receiving the service.

During our discussions with the Mayor, the City Road Superintendent, and a City Council Member, we were told that the City paved approximately six or seven private driveways based on verbal arrangements with property owners. The arrangements were not formalized by a written agreement; and no documentation was provided to identify that this offer was made to all residents where paving was performed, the date the arrangements to pave private driveways were made, specific terms of the arrangements for this paving, or who, within the City, approved these arrangements.

The City invoiced in April 2006 a total of over $4,000 to 11 citizens for paving of private driveways.

While initially conducting this examination on-site in the City on April 13, 2006, no documentation existed of billings made to property owners, nor reimbursements made to the City by property owners for the paving of private driveways. Information regarding the property owners' addresses and amounts owed to the City for the paving work performed was not available. Subsequent to our initial on-site visit for this examination, on May 9, 2006, the City Clerk's office provided us with 11 City invoices totaling $4,066.85 sent to property owners for paving their private driveways. The City had sufficient information in November 2005 to invoice property owners for paving performed at their residences; however, the first invoice was dated April 21, 2006, illustrating a significant time lapse between the date services were rendered and the

date the City first attempted to collect the outstanding debt. The City was not able to provide an explanation for the extensive time lapse.

As of August 2006, the City has yet to collect over $1,200 for private paving.

The first payment made by a property owner was recorded by the City on April 17, 2006. This payment was made a week after our second site visit to the City and approximately five months after both the paving of the private driveways and the City's receipt of the paving contractor's invoice. As of May 9, 2006, the City reported collecting $2,809.50 or approximately 69 percent of the total balance due to the City. On August 15, 2006, the City reported receiving a partial payment of $25, making the total collected $2,834.50. The City Clerk's office provided deposit information to document the deposit of these funds into the City's general fund account.

Documentation identified a total of 34 private driveways paved.

As stated, the City sent 11 property owners invoices for paving private driveways; however, documentation provided to this office identifies that a total of 34 private driveways were paved or patched. The City provided no documentation that indicated an additional 23 private driveways were paved.

The practice of spending the City's public funds to pave private driveways appears to be contrary to Kentucky law. Section 171 of the Kentucky Constitution, and cases of Kentucky's highest court which have interpreted this section, prohibit as unconstitutional the expenditure of public funds for other than public purposes. In addition, according to Funk v. Milliken, 317 S.W.2d 499 (Ky. 1958), expenditures of public funds must be necessary, reasonable in amount, beneficial to the public, and not predominantly personal in nature. Expending the City's public funds to pay for paving the private driveways of only a few of the City's residents, is "predominantly personal in nature," is for other than a public purpose, and is improper. In addition, the City has not taken the necessary precautions to ensure repayment of these funds, and has allowed a significant period of time to elapse before making an effort to recoup the funds. Finally, the City has failed to protect public funds by not entering into formal written contracts with property owners, documenting the paving services provided, the dates of the services, and the terms of the agreements, along with authorizing signatures from the property owners and the appropriate City officials.

We are referring this matter to the Kentucky Attorney General's Office and the City Attorney for further review.

Recommendations

The City should continue to seek reimbursement from those individuals already invoiced who have not reimbursed the City for paving performed on their private property.

Furthermore, the City should identify from all available documentation or sources the private citizens who had paving performed on private property in conjunction with paving City roads.

We recommend the City identify the cost of paving private driveways associated with each of the additional 23 properties and aggressively seek reimbursement from these property owners.

The City should adopt a policy to prohibit arrangements for or compensation to a vendor for work performed for a private citizen. Any arrangements and payment for private paving performed by a vendor should be conducted by the private citizen directly with the vendor.

The City should ensure its expenditures of public funds are for public purposes, and are necessary, reasonable in amount, beneficial to the public, and not predominantly personal in nature.

The City failed to remit final payment to a vendor for over 240 days violating KRS 65.140.

As of May 9, 2006, the City Clerk's office reported an accounts payable of approximately $41,000 owed by the City to the paving contractor for the roadwork performed and invoiced in November 2005. In documentation obtained from the contractor it was discovered that the City had a $53,988.71 outstanding balance for over 120 days, as of July 17, 2006, payable to the contractor for services performed. Furthermore, these July 2006 records document the City's last payment to the contractor was received on November 29, 2005. As of August 15, 2006, the City had not remitted the funds received from property owners to the contractor for partial payment of the City's outstanding balance. The Deputy City Clerk stated that she had not thought to forward those funds from property owners on to the contractor.

Subsequent records obtained from the contractor document that on September 12, 2006, the contractor received payment in full, therefore eliminating this outstanding balance. Although payment for work performed has now been remitted to the contractor, the City maintained this outstanding balance for well over 240 days. This is a violation of KRS 65.140, which states, "unless 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." Based on interviews held with both City officials and the contractor, it is our understanding that no such written disapproval had been provided by the City. According to the City Mayor, on August 15, 2006, the vendor payment had not been made in full due to the City not complying with state statutes that require certain financial filings. A letter dated June 1, 2006, from the Governor's Office for Local Development (GOLD) to the City states "[t]his correspondence is to advise you that Municipal Road Aid payments to your city will be suspended until this report is completed, forwarded, and received by GOLD."

Recommendation

We recommend that the City comply with KRS 65.140 which states "…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."

The City violated state statutes requiring financial reporting and filing causing Municipal Road Aid funds to be suspended.

The City of Manchester is a fourth class city. KRS 91A.040(1) requires each city of the first through the fifth class to have an annual audit completed by February 1 following the end of the fiscal year. The City has not received its audit report for fiscal years 2004 or 2005.

In addition to the annual audit requirement, the City is required under KRS 91A.040(4) to enter into a written contract with the auditor performing the annual audit, setting forth all terms and conditions of the agreement. During this examination, we made several requests to both the City and the City's Certified

Public Accountant (CPA) performing the fiscal year 2004 and 2005 audits for written contracts related to these audit periods. The City provided this office with a written contract for the 2004 fiscal year audit engagement; however, a written contract for the 2005 fiscal year audit engagement was not provided to this office by either the City or the CPA prior to the release of this report.

The City is at risk of losing future grant funding.

The City's fiscal year 2004 audit engagement contract was a sample contract available from the United States Department of Agriculture Rural Development (USDA). To qualify to receive a USDA loan and grant, the City was required to submit evidence that a financial audit of the City would be performed. The City did receive $1.7 million in USDA grant and loan funds to assist in a water line extension project.

In a letter dated January 10, 2006 to the Mayor, a USDA Area Director stated: "[i]n May, 2005 our agency sent a letter reminding the city that the annual audits/PSC Reports for the fiscal year ending June 30, 2005 would be due by November 30, 2005, as well as evidence of required insurance coverage. To date, this year-end report has not been received. We are requesting that you submit this information as soon as possible in order to be in compliance with your Loan Agreement. Availability of further funding from Rural Development will be dependent upon submission of any required documentation."

The City's 2004 audit engagement contract language was inadequate.

While examining the written contract obtained through the City for the 2004 fiscal year audit engagement, we found the contract failed to include a number of required elements as stipulated in KRS 91A.040(4). The contract failed to include language regarding the following statutory requirements:

> (b) The auditor shall include in the annual city audit report an examination of local government economic assistance funds granted to the city under KRS 42.450 to 42.495. The auditor shall include a certification with the annual audit report that the funds were expended for the purpose intended.
>
> . . . . . .

> (g) Any contract with a certified public accountant for an audit shall require the accountant to forward a copy of the audit report and management letters to the Auditor of Public Accounts upon request of the city or the Auditor of Public Accounts, and the Auditor of Public Accounts shall have the right to review the certified public accountant's work papers upon request.

KRS 91A.040(10) states, "[a]ny person who violates any provision of this section shall be fined not less than fifty dollars ($50) nor more than five hundred dollars ($500). In addition, any officer who fails to comply with any of the provisions of this section shall, for each failure, be subject to a forfeiture of not less than fifty dollars ($50) nor more than five hundred dollars ($500), in the discretion of the court, which may be recovered only once in a civil action brought by any resident of the city. The costs of all proceedings, including a reasonable fee for the attorney of the resident bringing the action, shall be assessed against the unsuccessful party."

The Mayor referred to the City's CPA to address the cause for the delay in obtaining the financial audits in a timely manner. The City's CPA noted a late start and the recent implementation of a new audit reporting standard, Governmental Accounting Standards Board (GASB) Statement No. 34 as the cause for the City's delay on issuing the financial audits within the time required by Kentucky law.

Further, KRS 65.905 requires that:

Statute requires a uniform financial information report to be completed.

> (1) Except as otherwise provided in subsection (2) of this section, each local government as defined in KRS 65.900 shall annually, after the close of the fiscal year, complete a uniform financial information report. The report shall be submitted to the Department for Local Government by May 1 immediately following the close of the fiscal year.
>
> (2) The final quarterly report filed by a county within fifteen (15) days after the end of the last quarter of the fiscal year, in accordance with KRS 68.360(2), shall be deemed the uniform financial information report for that county for purposes of compliance with KRS 65.900 to 65.925, if that quarterly report contains, at a minimum, all information required by KRS 65.910.

The last Uniform Financial Information Report (UFIR) the City filed with GOLD was for fiscal year 2003. The City has not complied with this requirement for fiscal years 2004 and 2005.

On June 1, 2006, GOLD informed the City that its Municipal Road Aid funding was suspended.

GOLD, in a letter dated November 29, 2005, stated that a review of its records noted that the City had not filed an audit/financial statement with GOLD since the June 30, 2003 reporting period. Subsequently, in another letter from GOLD dated June 1, 2006, the City was informed that "GOLD must suspend Municipal Road Aid payments to any city that does not submit the UFIR report as required by statute. This correspondence is to advise you that Municipal Road Aid payments to your city will be suspended until this report is completed, forwarded, and received by GOLD." The suspension of Municipal Road Aid funds was cited by the Mayor as the reason for not making timely payments to a contractor for the paving of City roads performed in November 2005.

This office will submit this issue to GOLD to inform it of the findings and recommendations associated with the City not complying with KRS 91A.040 and KRS 65.905.

Recommendations

We recommend the City file the required financial audits and UFIRs in accordance with KRS 91A.040 and KRS 65.905.

Further, we recommend that upon completion and filing of the required financial reports, the City notify GOLD in order to resume state Municipal Road Aid funding.

City funds were used to improperly reimburse personal travel expenses.

The City reimbursed the travel expenses for one City employee and paid a credit card charge for another employee's travel expenses that were personal in nature, and not associated with the performance of their jobs.

The City reimbursed travel expenses include charges for movies, liquor, and a gift shop purchase.

In March 2005, a City management employee attended a conference in Owensboro, Kentucky, incurring a bill that totaled $830.44. Of this amount, $189.36 consisted of expenditures for movies, liquor, beer, tips, and a gift shop purchase. In January 2005, the City pre-paid a portion of the travel expenses by making a payment directly to the vendor to compensate for the City management employee's four nights stay at the hotel. According to the City Clerk, the City typically made advanced direct payment for lodging to the hotel where an employee was staying to attend training or conferences.

It was determined that the City wrote two checks to the employee for travel expenses. The first check was written a week before the conference as a per diem payment in the amount of $125 paid directly to the employee, while the second check for $178.96 was written after the conference as reimbursement for additional charges not covered for prepaid per diem and hotel lodging. The City Clerk stated that the City advances an employee $25 a day for expenses associated with training or conferences that they are scheduled to attend.

The City overpaid a travel reimbursement by $285.46.

Further, the hotel portfolio documents that this employee stayed just three of the four nights at the hotel. However, the City had prepaid four nights of hotel lodging. The prepaid amount of the fourth nights lodging was applied to purchases made by the employee. As a result, the City overpaid the total travel expense by $285.46 and in effect paid the full amount of any personal purchases made by the employee. These purchases were:

- $9.99 for a hotel movie;
- $15.37 for a gift shop purchase;
- $96.10 for excess per diem charges;
- $133 in liquor and beer; and,
- $31 in tips associated with the cost of these beverages.

We confirmed with a hotel employee that charges coded for the purchase of liquor and beer is attributed to the purchase of these beverages and not to food or any other item.

It appears the City reimbursed the travel expenses of an employee's spouse.

A credit card receipt from a hotel restaurant submitted by the City management employee and signed by the employee's spouse documents that the employee's spouse joined the employee on the trip. The total amount the City reimbursed the employee for expenses associated with this trip included the credit card receipt signed by the employee's spouse.

Public funds should be used to reimburse City employees for legitimate travel expenses incurred for public purposes, not expenses incurred by friends or family accompanying the employee on the travel or for personal expenses. The City is responsible to its citizens and should provide proper governance and control to safeguard the use of public funds. Reimbursing a City employee for alcoholic beverages and personal gift items, among other things, is not for a public purpose, and is clearly a misuse of public funds, and a breach of the public trust. According to Section 171 of the Kentucky

Constitution, expenditures of public funds must be for public purposes, and according to the Funk v. Milliken case, must be necessary, reasonable in amount, beneficial to the public, not predominantly personal in nature, and supported by adequate documentation.

The City reimbursed an employee for personal phones calls made to hotels, limousine services, and a dating escort and introduction service.

In mid-April 2004, another City management employee, this one employed by the City's police department, traveled to Indianapolis, Indiana, for a conference. The hotel portfolio associated with this travel documents a number of phone calls made from this employee's hotel room to other hotels, limousine services, and a dating escort and introduction service. While each of the calls charged to the room was no longer than a minute and cost the City only $1.00 each plus six percent sales tax, totaling $15.90, our examination of the documentation does not indicate that the City made any review of the charges specified on the travel voucher to ensure proper use and management of public funds. In discussion with the Mayor and City Clerk, they were unaware of any personal charges associated with this reimbursement. The City paid the hotel portfolio charges in full when it paid the balance owed on the City's credit card in May 2004. These personal calls, made for other than public purposes, were improperly paid for with public funds.

In April 2006, this office asked the City to provide all statements from the initiation of each of the two City credit card accounts. The City was uncertain of the date when either of the two credit card accounts was initiated. We requested all statements for each credit card from July 1, 2003 through August 2006. Subsequently, we learned from the statement of one credit card that this account was opened in April 2004. The City was initially only able to provide a total of five credit card statements. A single statement, May 2004, for one account and four statements for the other credit account, April through June 2004, and August 2004.

City credit card statements identified approximately $3,400 of hotel charges that were not supported by documentation.

Further, we identified from City credit card statements provided to this office additional hotel charges in the amount of approximately $3,400; however, we were unable to examine those charges further due to the City not providing the requested supporting documentation. Charges for overnight accommodations included lodging in Gatlinburg, Tennessee; Indianapolis, Indiana; and Kentucky cities. In June 2006, the Deputy City Clerk stated that her office could not find any additional documentation.

On August 15, 2006, we made a final request for credit card information and supporting documentation. As a result of this request, on September 14, 2006, this office received an additional seven credit card statements, although no additional supporting documentation, for one account that the City requested from the credit card services provider. However, for the other credit card account, the City provided this office no additional credit card statements. With many months of credit card statements missing and lack of supporting documentation, information pertaining to the credit card accounts remains incomplete and sporadic.

We are referring this matter to the City Attorney for further review.

Recommendations

We recommend the City review the travel expenditures cited in this finding and seek reimbursement of any improper payments made to or on behalf of a City employee.

We recommend the City establish, implement, and follow clear policies for travel or expense reimbursements that include a formal documented pre-approval process, the implementation of a travel request and reimbursement forms including documenting signatures to identify appropriate authorization and review of activity.

We recommend the City policy identify the process to approve a travel payment.

We recommend any policy adopted regarding travel and expense reimbursements be disseminated to employees and training be provided to those employees approving travel expenditures to ensure compliance with City policy.

We recommend a policy to include the requirement to provide invoices or other supporting documentation for expenditures exceeding a pre-determined dollar amount.

Finally, we recommend all documentation provided relating to travel expenditures be retained at a minimum until the financial audit is complete or to coincide with other documentation retention schedules maintained by the City.

The City made informal, interest free loans to its employees.

On several occasions in 2005, the City made interest free loans, in the form of pay advances, to City employees. These loans, though approved verbally by the Mayor, were not formally recorded or logged. The City did not require an employee to sign any documentation specifying the amount or terms and conditions of the loans. The Deputy City Clerk stated that she relied upon her memory to deduct the amount loaned to an employee in order to subsequently deduct this amount of the loan from the employee's pay check or checks. According to payroll documentation provided by the City, several pay advances totaling $1,175 were verbally authorized by the Mayor for four City employees. The City Clerk's office initiated deductions from future paychecks until each loan was repaid. The lack of loan documentation increases the risk that all loans were not identified or fully repaid. Further, this does not allow for proper financial disclosure and review of the transaction or scrutiny by the City Council.

The Mayor and Deputy City Clerk both stated that loans to employees were fully repaid and this practice was discontinued as of January 2006. However, without formal documentation this could not be verified.

We are referring this matter to the City Attorney for further review.

Recommendation

We recommend that the City prohibit the practice of issuing loans to its employees in any form, including salary advancements.

The City violated the Kentucky Open Meetings Law and an Administrative Regulation when loaning $6,600 of LGEA Funds.

On May 12, 2005, the City issued a check to a local company in the amount of $6,600. The Mayor described this transaction as a short-term loan and City records, in fact, record a repayment of this amount on May 16, 2005. The City's check was from the Local Government Economic Assistance (LGEA) Fund.

City Council minutes do not reflect the Council's pre-approval of this loan. The first mention of this loan in City Council minutes was made on August 15, 2005, when a Council Member asked the status of the loan. The City Clerk informed the Council that the loan was paid back to the City four days after the loan was made. According to the Mayor and City Clerk, the loan was to assist the company in meeting pending payroll obligations and, as such, the action could not await the next City Council meeting. According to the City Clerk, the

Mayor had called City Council Members to obtain their verbal approval of the loan. Voting by telephone is not permitted under Kentucky's Open Meetings Law, KRS 61.810, which states that "[a]ll meetings of a quorum of the members of any public agency at which any public business is discussed or at which any action is taken by the agency, shall be public meetings, open to the public at all times . . .." None of the exceptions listed in the statute to this requirement are pertinent in this instance.

The action purportedly taken by the City Council Members in verbally approving this loan, by way of telephone calls from the Mayor, is not only unlawful, but has no legal effect, as evidenced by Kentucky Attorney General Opinions 92-OMD-1688; 02-OMD-206; and 05-OMD-026. This loan of LGEA funds appeared to have been made improperly and unilaterally by the Mayor, without the vote of the City Council in an open meeting, as required by law. The Mayor stated that he and his brother jointly owned and leased the property on which the company resides that received the $6,600 loan from LGEA funds.

The LGEA program consists "of a system of grants to local governments to improve the environment for new industry and to improve the quality of life for the residents." KRS 42.455 and 109 KAR 10:010 require specific rules to be followed before any local public agency receiving LGEA funds may expend them, including holding a public hearing and the advertisement thereof.

The City did not hold a public hearing before loaning $6,600 in LGEA funds.

Our examination of the City disclosed no evidence that the City complied with 109 KAR 10:010 (a) by holding a public hearing on specific proposed projects the City expected to pay for with LGEA funds, including the loan to this company, (b) by giving the required newspaper notice of such a hearing, or (c) by making available for public inspection a summary of the proposed expenditures from the LGEA funds, including the loan to this company. Thus, the City's loan to the company violated the law.

The City did not enter into a written loan agreement.

Further, no written agreement existed between the City and the company regarding any terms of the loan. Though the company provided the City a check to hold prior to the City releasing funds to the company, lacking such an agreement, the City would have had little recourse pursuing collection of the loan in the event of non-payment by the company.

We are referring this matter to the City's Board of Ethics to determine whether loaning funds to this company violated the City's code of ethics. In addition, the apparent violation of the Kentucky Open Meetings Law will be referred to the Kentucky Attorney General's Office.

This issue will also be referred to the City Attorney for further review.

Recommendations

We recommend that the City Mayor and Council conduct public business in open meetings as required by KRS 61.810.

Further, we recommend that the City comply with the specific rules established for the use of LGEA funds as required by KRS 42.455 and 109 KAR 10:010.

In addition, we recommend that the City enter into an appropriately authorized written contractual loan agreement with an entity prior to the proceeds of the loan. The contract should clearly state and define the terms and conditions of the loan agreement, including any penalties for the failure to make complete timely payments to the City.

The City conducted business with City employees and officials creating potential ethics code violations.

Records provided by the City show the City paid $22,159.02 from January 1, 2005, through December 31, 2005, to a company incorporated by a management employee of the City's Police Department. According to the Mayor, the purchases were made directly by the City Police Department and the responsibility for receipt of the goods was left to the City's Police Chief. The Mayor noted that all payments are presented before the City Council for approval, and the City Council had on one occasion given specific approval to purchase merchandise from the management employee's private business, even after the City Council had been notified by the Police Chief that he thought the City's Ethics Code prohibited the City from buying from any City employee.

Despite potential ethics code violations, City Council approved purchase with City employee's business.

The minutes of the City Council meeting of March 10, 1997, document that the Police Chief believed that the City's Ethics Code prohibited the City from purchasing items from an employee; however, the Police Chief stated that he had already placed an order to purchase hats from the employee's business. A motion was made and carried by the City Council to proceed with the purchase.

In August 2006, we requested documentation of any additional purchases made by the City from this business associated with the management employee in the Police Department since the first of this year. The City provided documentation of two additional purchases, the first made on June 23, 2006, and the next on July 19, 2006. The total of these two purchases is $3,624.80.

City purchases may violate the City's ethics code.

All of these purchases appear to be violations of Section 6(A) of the City's Ethics Code in effect at the time, which states that "[n]o officer or employee of the city or any city agency shall directly or through others undertake, execute, hold, or enjoy, in whole or in part, any contract made, entered into, awarded, or granted by the city or a city agency . . .." None of the three exceptions to this prohibition listed in Section 6 appear to be applicable in this case.

Furthermore, Section 27 of the Ethics Code lists penalties for violations of the Ethics Code that are found by the Board of Ethics, to include civil fines not to exceed $100, forfeiture by the officer or employee to the City of an amount equal to the economic benefit or gain which the officer or employee is determined by the Board to have realized as a result of the violation, and removal, suspension, demotion, or other disciplinary action by the City against the violating officer or employee.

The City hired two of its employees to perform backhoe and excavating services.

In a separate incident involving other City employees, during interviews with an employee in the City Clerk's office and the Mayor, we were informed that the City hired a company owned by two City employees to perform backhoe and excavating services for the City. According to the Mayor, the City had to seek out the services of a vendor because the City did not own the necessary equipment to complete the work. Through review of documentation submitted by the City, we identified two payments, made on November 11, 2004, and January 13, 2005, totaling $1,150.00 to the company owned by the City employees. These transactions also appear to be prohibited by the City's Ethics Code.

Finally, certain City expenditures were identified as made payable to the spouse of a City Council Member. These payments were for work performed on a Clay County Tourism Council (Tourism Council) project in which the City agreed to act as a fiscal agent to obtain federal grant monies through the Kentucky Transportation Cabinet (KYTC). The Tourism Council Project is known as the Manchester B Project.

The objective of the Tourism Council project is to restore a building located on a primary access corridor for the purpose of housing the Clay County Historical Society who will operate a tourism information and welcome center and a history museum in the newly restored building. The 2005 grant agreement between the City and KYTC is for $30,000 obtained through a federal program entitled the Transportation Equity Act for the 21st Century (TEA-21). The funding is provided on a reimbursement basis, meaning that the money is expended and then requests are made, through the City to KYTC, for reimbursement of these funds.

The Tourism Council is the subrecipient of the TEA-21 grant funds, which is overseeing the restoration project. The Tourism Council is comprised of individuals within the community who, according to the co-chairman, is merely a dedicated group of volunteers and is not a formally instituted organization.

A grant recipient, member, officer, or employee shall not receive any direct or indirect benefit from grant proceeds.

Section 16 of this agreement between the City and KYTC states, "[n]o member, officer, or employee of the CABINET or the RECIPIENT during his tenure or for one year thereafter shall have any financial interest, direct or indirect, in this AGREEMENT or the proceeds thereof as identified in KRS 45A.340. The CABINET and the RECIPIENT shall comply with the requirements of the Executive Branch Code of Ethics KRS Chapter 11A."

A City Council Member received indirect benefits from grant proceeds.

The City is merely a fiscal agent with no direct decision making ability. However, the spouse of a City Council Member, who is also a Tourism Council Member, received payments from these grant funds for roofing and wiring work performed for the Tourism Council's Manchester B Project. As a member of the Tourism Council, the City Council Member participates in the decision making process. In effect, the City Council Member, through the payment provided to her spouse, is in a position to indirectly benefit from these TEA-21 grant funds in violation of the agreement stated above.

We are referring these matters to the City of Manchester Board of Ethics for its determination as to whether further consideration is warranted. In addition, the issue pertaining to TEA-21 grant funds identified above will be referred to the KYTC Office of Special Programs.

Recommendations

We recommend the City review its ethics code to ensure that it complies with all requirements of the code, including not doing business with City employees.

The CPA performing City audits may lack independence required by audit standards.

Government Auditing Standards (GAS) (2003 revision), Chapter 3.03, the general standard relating to independence, states, "[i]n all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, should be free both in fact and appearance from personal, external, and organizational impairments to independence." Further, GAS 3.07d states that personal impairments include "concurrent or subsequent performance of an audit by the same individual who maintained the official accounting records when such services involved preparing source documents or originating data, in electronic or other form; [or] posting transactions (whether coded by management or not coded) …"

The City's CPA provides multiple services for the City.

Through discussions with the City's CPA, who was retained to audit the City, we have identified a number of issues we believe would cause a third party to reasonably question the CPA's independence as an auditor of the City. The CPA retained to conduct the fiscal year 2004 and 2005 audits for the City is also engaged by the City to perform water billing services, and to assist in the collection of water billing receipts. In addition to these potential conflicts, the CPA acknowledged that he is related to a high-ranking City official.

It was explained by the CPA that the work performed by his firm on behalf of the City is done at a reduced cost. Currently, the City pays the CPA $100 an hour for audit services, and $0.75 per water bill generated by his office. The CPA stated that a lot of work by his office has to be done prior to auditing the City's finances and that the time it takes to do this and audit the books is in excess of what he charges the City. The CPA stated at one point he recommended the City hire an accountant to prepare its financial records for audit. He stated

that if another CPA was hired to perform services for the City it would significantly increase the City's cost over what he currently charged. In addition, he stated that during an audit of the water rates by the Public Service Commission (PSC) performed approximately 15 years prior, he was informed at that time that other companies performing the same billing process were charging $1 per water bill, indicating that the City could incur a greater cost for this service elsewhere.

According to the CPA, City officials decided in the Fall of 2005 to withdraw the water billing services from the CPA and assume the responsibility internally. Through an interview with another individual, it was explained that this decision was made because the City felt it had the personnel on staff to handle this responsibility. When referring to the City's decision, the CPA stated that he believed the City was firing him and he voiced discontent with the manner in which he had first been informed of the City's decision. The CPA explained that he had first been informed of this decision by reading about it in the local media.

The City's CPA claimed water utility data to be his personal property.

Once approached by City officials, the CPA agreed to return the water billing computer software package to the City, the software package having been paid for by the City, which allowed the CPA to use the package to account for the City's water billings. However, the CPA claimed that the data entered into the software, which constitutes the City's water billing account information, is his personal property because it was entered into his computers by his staff and would be provided to the City at a cost. The CPA pointed out that the City had not entered into a written contract with him or his firm that specified the terms of the agreement including ownership of transaction data for water billing services to be performed. During an interview with the CPA, he stated that he would have been more willing to work with the City on this transition if City officials had handled the situation differently and approached him before the decision to terminate his services related to the water billing was released to the media.

The City's CPA offered the City alternatives for processing water utility payments.

The CPA believed it would take the City a significant amount of time to re-establish the account information, noting that it had taken his office some time to establish the account information when the CPA first assumed the responsibility years prior, and that the water utility customer base was significantly less at that time he took over the billing process than it is currently. The CPA offered City officials these options:

- to leave the responsibility of the water billing with his firm;
- to assume the software package without the account information; or,
- to assume the software package and pay a fee for the account information.

The minutes from an October 17, 2005 City Council meeting show the CPA asked the City Council what they were going to do about the water billing. A motion was made and passed by the City Council to rescind the motion made on September 19, 2005, and keep the water billing with the CPA. The motion carried four in agreement with the motion, two voted against the motion, and one abstained.

In discussing the CPA's independence, the CPA noted that he had considered his independence in years past and believed that he was independent of the City and, as such, could perform the services for the City. After additional consideration, the CPA asked our office for guidance on the issue. At that time we recommended the CPA contact the State Board of Accountancy (Board) and request a formal opinion from that Board, as it has the authority over such matters.

This issue will be referred to the City Attorney for further review.

Recommendations

We recommend that the City contact the State Board of Accountancy to request a formal written opinion associated with this audit engagement prior to the CPA continuing to perform the City's financial statement audit.

We recommend that when outsourcing services, such as water utility billings, the City should enter into formal written contracts reviewed by legal counsel detailing the services to be provided, the responsibilities of both parties regarding these services, and specific contract language to address all terms and conditions of the contract including the termination of the contract by either party.

We further recommend that the City review all services the CPA provides for the City to ensure the City is employing the most efficient and effective means to accomplish these duties.

Finally, we recommend the City have its legal counsel review the question of the ownership of the City's water utility billings, adjustments, and other associated transactions.

Former City officials remain as authorized signatories for City bank accounts.

Bank signature cards for nine of the City's 30 bank accounts included the signature of one, and in some cases two, individual(s) formerly affiliated with the City's operations. The bank signature cards were obtained by the City Clerk's office in May 2006 upon request by this office.

The City Clerk identified the two individuals as being a former Deputy City Clerk and a former City Council Member. The City Clerk stated that she was not aware that these individuals' names remained as authorized signatures, until the requested documentation was provided by the City's bank. The City Clerk subsequently stated that she believed the signatures had now been updated; however, documentation to substantiate this statement was not provided to our auditors.

Although the exact last date of service for each individual was not known, the City Clerk's office estimated that the former City Council Member has been out of office for four years while the former Deputy City Clerk has been out of that position for three to five years. These estimations indicate a significant time lapse between the last date of service and the date the City identified the discrepancy.

City tax dollars were placed at undue risk.

By not updating the bank signature cards immediately after the termination date of a previously authorized signor, the City allowed continued access by those individuals to thousands of taxpayer dollars. Proper safeguards over City funds should be in place to ensure such access is not available to previous City personnel.

Recommendations

We recommend the City contact its banking institution(s) to ensure all authorized signatures are current.

In addition, we recommend the City implement procedures to ensure the signature cards are updated immediately upon the termination of an individual who was formerly authorized to sign on City accounts.

Lastly, we recommend the City keep a copy of all updated signature cards on file for quick reference in case questions arise as to whether an employee is an authorized signer to a City account.

CITY OF MANCHESTER RESPONSE

City of Manchester

City Hall
239 Memorial Drive
Manchester, Kentucky 40962

December 15, 2006

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

Dear Crit Luallen,

This letter is in response to the report of the examination of the City of Manchester. Upon review of the report findings, there are issues I would like to address.

In the finding that the City authorized and incurred the cost of paving private driveways in November 2005, it stated that according to vendor documentation there were a total of 34 private driveways paved. The city has no documentation of an additional 23 private driveways being paved or patched because we did not pay to have an additional 23 private driveways paved or patched.

In the finding that former City officials remain as authorized signatories for City bank accounts, it stated that documentation of updated signature cards had not been provided to the auditors. All signature cards have been updated and have already been provided to the auditors.

The City of Manchester will continue to review the findings and take the necessary steps to comply with the recommendations your office has provided in it's examination.

Sincerely,

Daugh K. White
Mayor

AUDITOR'S REPLY

Documentation submitted to this office identifies that 34 private driveways were paved and the cost of this paving was included in vendor invoices to the City for road paving. The City ultimately paid the full amount of the vendor invoices for paving. The City then invoiced 11 citizens a total of $4,066.85 for paving private driveways and as of August 15, 2006, the City had collected $2,834.50. The cost of paving an additional 23 private driveways was not invoiced to those who had driveways paved and resulted in the City paying for paving private driveways.

In reference to the request for updated signature cards for City bank accounts, our records document that May 17, 2006, was the last date this office received updated signature cards from the City.

CLAY COUNTY TOURISM COUNCIL RESPONSE

CLAY COUNTY TOURISM COUNCIL
MANCHESTER, KENTUCKY
DECEMBER 14, 2006

Brian Lykins, Director
Office of Crit Luallen
Auditor of Public Accounts

Dear Mr. Lykins:

This correspondence is in response to your audit findings pertaining to the Manchester B Project.

The council regrets any faultfinding issues pertaining to this particular project and is working with Mr. Shane Tucker, Department of Transportation to rectify any mistakes found. We can assure any and all persons this was an innocent happening on our part. Through our consultations with Patrick Kennedy, Historical Preservation Office, who was an advisor in the beginning of the project, we thought proper procedures were being followed. In addition, we received no notice from the city that we were in violation of said agreement.

On behalf of the Clay County Tourism Council, I appreciate the opportunity to respond to your report.

Sincerely yours,

Faye Gregory

Faye Gregory, Co-Chairman
Clay County Tourism Council