



City of Olive Hill Utility Rate Increases Fueled by a History of Fiscal Mismanagement

Background

On June 4, 1998, this office issued a report on the Audit Examination of the City of Olive Hill (City) for the Fiscal Year Ended June 30, 1997, making a number of comments and recommendations. On April 18, 2000, the Olive Hill City Council (City Council) approved ordinances adopting substantial flat rate increases in the City's utility rates based upon an external Utility Rate Analysis (Analysis) dated March 2000. The external Analysis cited operating losses and a lack of cash reserves as justification for the utility rate increases. This office initiated a special examination to determine whether recommendations made in the fiscal year 1997 audit were implemented and whether these previously identified issues had any bearing on the utility rate increases.

Summary

The City did not implement several previous audit recommendations. The failure to implement these recommendations, along with other incidents of fiscal mismanagement, increased by 40 percent the level of utility rate increases justified as needed in the Analysis. While the Utility Fund continues to subsidize the General Fund with transfers, the necessity for utility rate increases clearly illustrates that excess funds do not exist. Therefore, the transfers are contrary to KRS 96.200 and an opinion of Kentucky's highest court.

Additionally, the City misused restricted funds and state grant funds, violated debt reserve requirements, used a then former City Council member to bypass financial institution controls, and violated federal and state income tax statutes.

Audit Findings

The City disregarded several 1997 audit recommendations. The failure of the City to implement these recommendations resulted in the following findings:

- Net actual Utility Fund subsidies to the General Fund in the form of cash transfers, excessive rent charges, grant proceeds withheld from the Utility Fund, and General Fund expenses paid from Utility Fund revenues amounted to \$481,308 for the period from July 1, 1998, through June 30, 2000.
- Budget ordinances were violated when net actual Utility Fund subsidies to the General Fund exceeded

the amount budgeted by \$36,658 and \$45,000 for fiscal years 1999 and 2000, respectively.

- The Utility Fund Warrant account had a deficit bank balance on five occasions during fiscal year 1999, with overdraft amounts averaging \$20,052. Overdrafts in the General Fund Warrant account occurred on seven occasions during fiscal year 1999, with average overdraft amounts of \$1,354.
- Quarterly financial statements were not prepared or presented to the City Council until December 1999.
- The amended budget ordinance for the fiscal year ended June 30, 2000, published June 7, 2000, included appropriations that exceeded revenues by \$27,003 in the Utility Fund.

Other issues affecting the City's recent utility rate increases include:

- 12 restricted Utility Fund certificates of deposit (CD) totaling \$932,994 were liquidated between September 4, 1997, and June 30, 2000. The purposes of these CDs were restricted to customer deposits and utility systems maintenance and improvement. These proceeds were used in the following manner:
 - \$341,998 was used to prematurely retire a \$347,000 revenue bond on December 7, 1998, the same day another check for a recurring Utility Fund debt payment was returned for non-sufficient funds. The revenue bond was retired 26 months after the City Council's approval.
 - \$332,340 was used to make recurring Utility Fund debt payments. One transaction involved a transfer of \$89,998 from the Sewer Loan Reserve account into the Utility Fund Warrant account, where it was disbursed for a recurring debt payment. The transfer was completed by phone, contrary to the bank's requirement for written, multiple signatures, with the approval of then former City Council member Lottie Cook, an employee of the Commercial Bank of Grayson.
 - \$205,000 was used for capital projects not approved by the City Council. Of this amount, \$45,000 pertained to General Fund projects.
 - \$47,251 was deposited into the unrestricted Utility Fund Warrant Account where it remained on deposit as of June 30, 2000.
 - \$6,405 was forfeited in early withdrawal penalties.
- The City did not direct Community & Economic Development Associates, Inc. (CEDA) to include any consideration of operational efficiency or the potential

for cost savings in the Analysis. Had the possibility of reducing expenses been explored, the level of the Utility rate increase recommended might have declined. While identifying cost savings was not within the scope of this examination, our work identified overtime wages as a potential area for consideration. The current administration recognized that inefficiency in overtime wages existed and reduced average overtime hours reported per month by 63 percent, a \$4,479 or 11 percent average monthly gross wage reduction from 1998 to 2000.

- The City is not in compliance with reserve requirements of the note payable to the Kentucky Infrastructure Authority (KIA). A \$132,176.59 shortfall in required reserves was created when the City liquidated CDs restricted for the Utility Fund as noted above. The City notified KIA of this non-compliance on June 29, 2000, and obtained KIA's approval on how to remedy the situation. Additionally, funds restricted for sewer maintenance or replacement under this note were misused to make principal and interest payments on the Rural Economic & Community Development (RECD) revenue bonds in August 1997 and 1998.

Finally, other issues not directly related to the City's fiscal decline, but indicative of fiscal mismanagement during fiscal years 1999 and 2000, noted during our examination are as follows:

- The City violated Kentucky Revised Statute (KRS) 177.369(2) in fiscal year 1999 by withdrawing \$10,596 of restricted Municipal Road Aid funds to pay for General Fund operating expenses unrelated to the construction, reconstruction, or maintenance of urban roads or streets.
- The City violated Internal Revenue Code (IRC) §61 and KRS 141.010 by not including in gross wages reimbursements paid to City employees for health insurance premiums. Under City Ordinance 95-3 effective March 29, 1995, City employees may waive City health coverage, elect to be covered under an external health plan, and receive reimbursement for premiums paid. \$20,177 in insurance premium reimbursements were paid to City employees between July 1, 1998 and June 14, 2000. Excluding these reimbursements from gross wages also caused the City to violate IRC §3111 by not paying employers' taxes, and IRC §3402 and KRS 141.310 by not withholding income taxes on these reimbursements.
- Financial crises, rather than a financial plan, largely motivated inter-fund transfers during fiscal year 1999. 12 transfers totaling \$132,000 were initiated to cover overdrafts. Seven transfers totaling \$211,000 were initiated to prevent checks from being returned for non-sufficient funds. Additionally, three transfers

from the Utility Fund totaling \$14,548.77 were initiated to cover General Fund payroll expenses.

- Two new trucks were purchased for \$45,651 in January 1999 for use in Utility operations. These vehicles were paid for in cash at a time when cash flow problems existed, without any apparent consideration for financing options such as leasing.

Observations and Concerns

Our examination revealed a historical pattern of indifference to the appropriate financing of expenditures, potential conflicts of interests within the City Council, and inadequate financial oversight by the City Council allowing the Mayor to act unilaterally. Another concern relates to the recent utility rate increases, which to a large extent are due to management decisions questioned in this report. Once the cash reserves are replaced, a rate decrease may be possible without harming the financial condition of the utilities.

Briefing Report Scope and Methodology

Our special examination of the City was performed using the following procedures:

- Interviewing City personnel regarding transactions, policies, and procedures;
- Examining bank statements, budget ordinances, and other City documents to determine whether recommendations had been implemented; and,
- Examining the Analysis, bank statements and records, vendor invoices, and other City documents to determine whether previous and current issues noted had a bearing on the recent utility rate increases.



**SPECIAL EXAMINATION OF CERTAIN FINANCIAL
ACTIVITIES TRANSACTED BY THE
CITY OF OLIVE HILL**

**EDWARD B. HATCHETT, JR.
AUDITOR OF PUBLIC ACCOUNTS
WWW.KYAUDITOR.NET**

**144 CAPITOL ANNEX
FRANKFORT, KY 40601
TELE. (502) 573-0050
FAX (502) 573-0067**

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EDWARD B. HATCHETT, JR.
AUDITOR OF PUBLIC ACCOUNTS

August 15, 2000

Honorable Jack Colley, Mayor of Olive Hill
Members of the Olive Hill City Council
225 Roger Patton Drive
P.O. Box 1660
Olive Hill, Kentucky 41164

RE: Special Examination of Certain Financial Activities Transacted by the City of Olive Hill

Dear Mayor and Council Members:

This office performed a special examination of certain financial activities transacted by the City of Olive Hill. This examination was conducted as a follow-up to the recommendations offered in our audit of the City's financial statements for the fiscal year ended June 30, 1997. The examination was prompted, in part, by the City's recent decision to substantially raise its utility rates.

Our report reveals that the City failed to implement several of our previous audit recommendations. Chief among these was the recommendation that the City cease subsidizing the operations of the General Fund through transfers and other payments from the Utility Fund. We note that these subsidies and other factors resulted in a utility rate increase substantially higher than would otherwise have been needed. Our report also discusses several other related findings and again offers recommendations for improving the fiscal management of the City.

We hope the City will implement these recommendations in order to improve the accountability of public dollars. We wish to thank the Mayor, the members of the City Council, the City Clerk/Treasurer, and the City Attorney for their cooperation during this examination.

Very truly yours,

Edward B. Hatchett, Jr.
Auditor of Public Accounts

EBHJr:kct

Findings and Recommendations

The Auditor of Public Accounts performed an audit of the City of Olive Hill's (City) financial statements for the year ended June 30, 1997. The report issued as a result of that audit included several audit findings and recommendations. In response to reports that Olive Hill's City Council (City Council) approved a significant increase in the City's utility rates, an examination was conducted to determine whether these audit recommendations were implemented. This examination revealed that audit findings were disregarded and that the City failed to implement any of the recommendations noted below:

- The City should cease subsidizing the General Fund with Utility Fund resources.
- All expenditures of the City should be authorized by the official budget ordinance as required by KRS 91A.030(1).
- Expenditures should not be made unless funds are available.
- The City should comply with KRS 91A.030(8)(b) and Section 157 of the Kentucky Constitution, which prohibit approval of an annual budget ordinance allowing appropriations to exceed revenues.

Additionally, the City failed to implement the recommendation that quarterly financial statements should be prepared by the Administration and presented to the City's legislative body as required by KRS 91A.030(11), until December 1999.

The 1997 audit findings and recommendations were disregarded

Our fiscal year 1997 audit reported that the City's Utility Fund provided \$263,551 of assistance to the General Fund, in the form of rental fees, cash "loans" never repaid, and use of Utility Fund revenues to pay for General Fund expenditures. These practices continued during the next three fiscal years.

The City continues to subsidize General Fund operations with Utility Fund resources, in violation of state law

The City's Utility Fund provided subsidies to the General Fund totaling \$481,308.08 for the period from July 1, 1997 through June 30, 2000. These subsidies took the form of cash "loans" never repaid, excess rental fees, grant proceeds withheld from the Utility Fund, and General Fund expenses paid from Utility Fund revenues.

According to the City's independent financial audit report, the Utility Fund loaned \$98,368 to the General Fund in fiscal year 1998. These loans were not repaid and were ultimately forgiven.

Utility Fund rental fees paid to the General Fund for occupancy of approximately half of the City Hall building were decreased from \$10,000 per month to \$5,000 per month beginning in fiscal year 1999. Information gathered from real estate professionals estimates that the market rate for this rental space should be approximately \$950 per month. Based upon this market rate, the General Fund overcharged the Utility Fund through June 30, 2000, as follows:

	<u>FY1998</u>	<u>FY1999</u>	<u>FY2000</u>
Rent Collected from Utility Fund	\$120,592	\$ 60,000	\$ 60,000
Rent at Market Value	<u>11,375</u>	<u>11,375</u>	<u>11,375</u>
Excess Rent Collected	\$109,217	\$ 48,625	\$ 48,625

Checks written to the General Fund for rental fees and sanitation receipts since April 1, 2000, were held uncashed by the current City administration. This was done to allow the Utility Fund Warrant account to increase its cash balance. This amounts to \$15,000 in rental fees and \$28,761 in sanitation receipts that were remitted but not deposited as of June 30, 2000.

The City's General Fund withheld state grant funds due to the Utility Fund

The City was awarded a \$188,860.25 Kentucky Heritage Land Conservation Fund (KHLCF) grant on July 21, 1998. The grant amount included over \$35,000 for transaction and land management costs. The City's purpose for seeking the grant was to purchase a parcel of land adjacent to the lake that serves as the City's water supply and to prevent livestock from accessing the lake. The grant funds were deposited in the General Fund Warrant account on July 31, 1998. The full payment of \$174,400 to purchase the land was made from the General Fund Warrant account on August 3, 1998; the land was capitalized as an asset of the General Fund. Payments totaling \$13,634 for appraisals and a survey, were made from the Utility Fund Warrant account in September 1998, while the remaining grant funds of \$14,460.25 were kept in the General Fund.

The City continued to use Utility Fund resources to pay General Fund expenses

Four disbursements totaling \$26,464.06 from the Utility Fund Warrant Account were noted in fiscal years 1999 and 2000 to pay for General Fund expenses. The expenses were for insurance premiums of \$24,816.36 and \$1,647.70 for supplies. Supporting documentation for the insurance coverage clearly reflected that the above premiums apply to the General Fund. In all cases, the expenses were coded to General Fund expense accounts, while the cash came from the Utility Fund Warrant account.

The City misled the public regarding inter-fund transfers, and continued to violate state statute by disregarding its own budget ordinances

Our fiscal year 1997 audit reported that the City's General Fund expenditures for the fiscal year ended June 30, 1997, exceeded the amount budgeted by \$14,932.

KRS 91A.030(1) states that, "Each city shall operate under an annual budget ordinance adopted and administered in accordance with the provisions of this section. Notwithstanding any other provision of law, no city shall expend any moneys from any governmental or proprietary fund, except in accordance with a budget ordinance adopted pursuant to this section."

Budgeted subsidies from the Utility Fund to the General Fund are categorized on two line items in the official budget ordinances as Rent and Inter-fund transfers. The final budget ordinance for the fiscal year ended June 30, 1999, authorized inter-fund transfers from the Utility Fund to the General Fund of \$53,891. The actual net amount transferred from the Utility Fund to the General Fund during this period totaled \$90,548.77, exceeding the budgeted amount by \$36,657.77.

The final budget ordinance for the fiscal year ended June 30, 2000, did not include authorization for any inter-fund transfers from the Utility Fund to the General Fund. The actual net amount transferred from the Utility Fund to the General Fund totaled \$45,000. The budget ordinance process includes publication of the budget to inform the general public of the City's financial condition. Transferring funds in excess of those budgeted has the effect of improperly withholding information and misleading the general public as to the City's financial condition.

The City continued to mismanage public funds by making expenditures when funds were not available

Our fiscal year 1997 audit reported the City's Utility and General Fund Warrant accounts each had negative bank balances during one month periods by as much as \$39,615 and \$2,698, respectively.

On five occasions during four months of fiscal year 1999, the Utility Fund Warrant account incurred a deficit bank balance of as much as \$36,895.44, with an average overdraft amount of \$20,052. On seven occasions during three months of fiscal year 1999, the General Fund Warrant account incurred a deficit bank balance of as much as \$2,879.60, with an average overdraft amount of \$1,354.

The City continued to violate state statute by failing to prepare quarterly financial statements to be presented to the City Council

Our fiscal year 1997 audit reported the City's failure to prepare financial statements in violation of state statute.

KRS 91A.030(11) states, "Administration and implementation of an adopted ordinance shall be the responsibility of the executive authority of the city. That responsibility shall include the preparation and submission to the legislative body of operating statements which shall include budgetary comparisons of each governmental fund for which an annual budget has been adopted. These reports shall be submitted not less than once every three (3) months in each fiscal year."

The City did not prepare or present financial statements to the City Council until December 1999, even though the City's accounting package is capable of performing this function. Had the City Council insisted on being provided this financial information in a timely manner many of the issues cited in this report could have been prevented.

The City again violated state statute by passing an unbalanced budget ordinance

Our fiscal year 1997 audit reported that the City violated state statute by passing a budget ordinance containing appropriations that exceeded revenues by \$117,001 in the General Fund.

KRS 91A.030(8)(b) states, "No budget ordinance shall be adopted which provides for appropriations to exceed revenues in any one fiscal year in violation of Section 157 of the Kentucky Constitution."

The statute was again violated when an amended budget ordinance for fiscal year 2000 was adopted on June 7, 2000. This ordinance contained revenues of \$3,221,457 and total appropriations of \$3,248,460 for the Utility Fund, leaving a \$27,000 budget deficit.

Recommendations

We recommend that the City take the following actions:

- Cease forgiving inter-fund “loans” and pass an ordinance prohibiting such forgiveness.
 - Revise rent charged to the Utility Fund for space within City Hall to reflect market rates and pass an ordinance requiring such valuation.
 - Record a General Fund account payable to the Utility Fund for reimbursement of the \$206,467 in excess rental fees collected since July 1, 1998, and establish a repayment plan.
 - Transfer the land asset acquired using KHLCF and the grant revenue from the General Fund to the Utility Fund Water Department.
 - Increase the General Fund account payable to the Utility Fund by \$14,460.25, representing the remaining KHLCF grant funds, and establish a repayment plan.
 - Increase the General Fund account payable to the Utility Fund by \$26,464.06, representing the General Fund expenses paid by the Utility Fund, and establish a repayment plan.
 - Ensure compliance with state statutes and its own budget ordinances.
 - Implement a procedure in consultation with its external auditors to prepare quarterly financial statements and present them to the City Council.
 - Ensure that future budget ordinances do not contain appropriations in excess of revenues in any funds.
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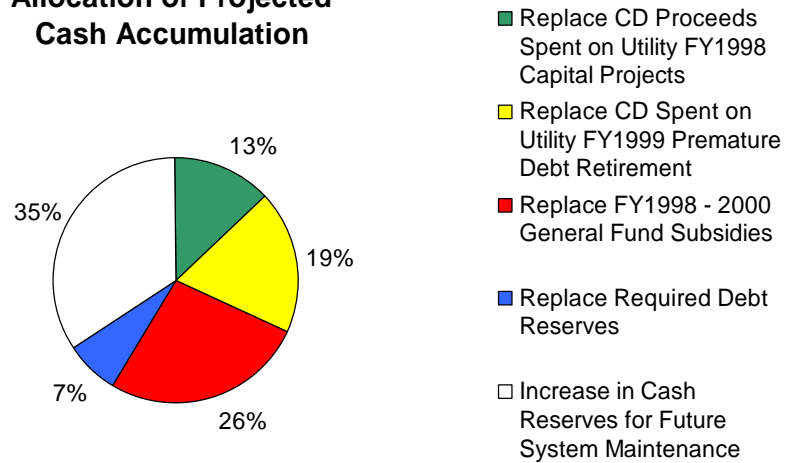
Utility rate increases could have been at least 40 percent lower if fiscal mismanagement had been avoided

In March 2000, a Utility Rate Analysis (Analysis) was presented to the City by Community & Economic Development Associates, Inc. (CEDA), a company providing grant and loan planning, packaging, and administration services. The Analysis recommended significant flat rate increases in all the utilities’ rates. These increases result in projected additional income of \$2,412,696 through June 30, 2004. Our examination revealed that \$590,233 of this additional income is required to make up the projected debt service shortfall. Our examination of the Analysis revealed that the remaining \$1,822,463 of additional income is

intended to accumulate cash reserves. The vast majority of these reserves must be accumulated because the City depleted reserves that were previously held.

The allocation of the projected cash accumulation can be summarized as follows:

Allocation of Projected Cash Accumulation



Overall, 52 percent of the projected cash accumulation would not be necessary if incidents of fiscal mismanagement, as detailed in this report, had not occurred. Had this additional revenue not been needed, utility rate increases could be reduced by 40 percent.

Given CEDA’s assessment of cash reserves necessary, it is clear that the funds taken from the Utility Fund to subsidize the General Fund were not of a surplus nature, but were in fact essential to meet Utility Fund requirements. The City’s position on this matter has historically been that transfers from the Utility Fund to the General Fund were allowed under statute. KRS 96.200 does allow, with certain restrictions, that

“the legislative body of any city of the third through sixth classes inclusive may, by ordinance, provide in what manner and for what purpose any profits, earnings or surplus funds arising from the operation of any public utility owned or operated by the city may be used and expended. The ordinance may be amended or repealed from time to time. Until such ordinance is enacted any surplus earnings shall be paid into the City treasury, to be expended for the general purposes of government in the city.”

This statute appears to allow cities to use utility funds of a surplus nature only for general governmental purposes. Therefore, KRS 96.200 does not authorize the City's subsidization practices. Additionally, in Electric Plant Board of City of Mayfield v. City of Mayfield, 185 S.W.2d 411 (1945), Kentucky's highest court ruled that a fourth class city may only use profits from city operated utilities to supplement the city's general fund, after funds sufficient to cover operating, maintenance, and sinking fund requirements have been set aside. Clearly, the City has not set aside funds sufficient for these purposes.

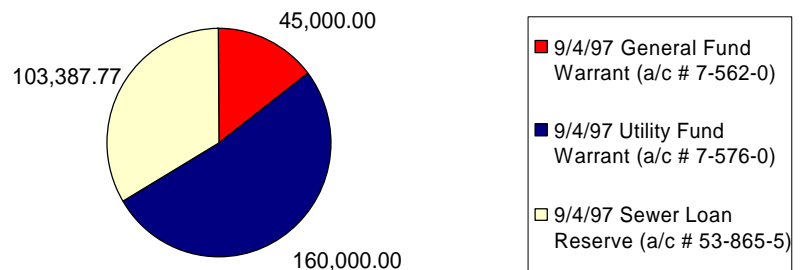
Restricted certificate of deposit assets were misused and poorly managed, depleting Utility Fund reserves

As of June 30, 1997, the Utility Fund held \$28,090 in cash and \$1,099,363 in restricted cash and certificate of deposits (CDs). A total of \$932,994 in restricted CDs was liquidated between September 4, 1997, and June 30, 2000.

On September 4, 1997, a \$311,594.65 CD classified in the City's financial statements as Utility Fund restricted cash and investments payable to the "City of Olive Hill Depreciation Reserve Fund" was liquidated. A note written by the Mayor in office at that time indicates that this CD was transferred to cover costs of a building program approved by the City Council. However, City Council meeting minutes did not contain approval of the projects, but rather presented the projects as a "list of goals" with cost estimates. The minutes also did not contain any information on how the projects were to be funded.

Proceeds from the liquidation of this CD, less \$3,206.88 in early withdrawal penalties paid, were deposited as follows:

Allocation of CD # 62-0017106 Proceeds



Deposits to the General and Utility Fund Warrant accounts correlate closely to the estimated costs from the “list of goals” for each of the funds. Three of these “goals” were for the sole benefit of the General Fund:

<u>“Goal”</u>	Estimated <u>Cost</u>	Identified <u>Cost</u>
Sidewalk construction	\$ 20,000	\$ 2,947
Planning Commission appropriation	12,000	12,000
Amphitheater construction	<u>10,000</u>	<u>17,360</u>
TOTAL	\$ 42,000	\$ 32,307

Four “goals” exclusively benefited the Utility Fund:

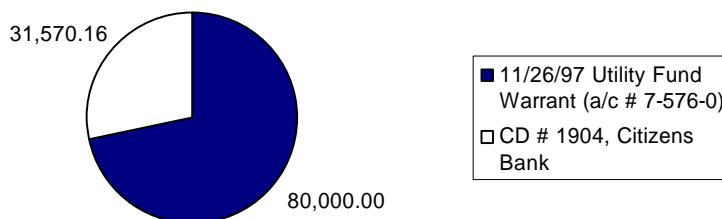
<u>“Goal”</u>	Estimated <u>Cost</u>	Identified <u>Cost</u>
Water pumping station	\$ 20,000	\$ 0
Purchase sewer cleaning machine	25,000	20,550
Purchase new backhoe	25,000	27,250
Maintenance building construction	<u>100,000</u>	<u>86,752</u>
TOTAL	\$170,000	\$134,552

Actual costs of these projects could not be readily determined because of the use of City employee labor on a number of the projects. City labor costs for the projects were not tracked and cannot be separately identified.

The proceeds from liquidating the CD that were deposited in the Sewer Loan Reserve account effectively replaced \$96,500 that was transferred from the Sewer Loan Reserve account to the Bond Interest Redemption Fund account on August 8, 1997. This transfer was completed to cover a \$102,606.87 check written from the Bond Interest Redemption Fund account on August 7, 1997, to make a recurring payment on the Rural Economic & Community Development (RECD) revenue bonds.

On November 26, 1997, a \$111,570.16 CD classified in the City’s financial statements as Utility Fund restricted cash and investments payable to the “City of Olive Hill” was liquidated. Proceeds from the liquidation of this CD were deposited as follows:

Allocation of CD # 1761 Proceeds



The proceeds deposited in the Utility Fund Warrant account from this CD were used to make a recurring payment on the note payable to the Kentucky Infrastructure Authority (KIA).

In early December 1998, six CDs classified in the City's financial statements as Utility Fund restricted cash and investments payable to the "City of Olive Hill" totaling \$341,998.39 were liquidated, and the proceeds were deposited in the Utility Fund Warrant account. These proceeds were then used to retire the 1985 RECD revenue bond principal balance of \$347,000 more than 25 years prior to maturity. The 1973 RECD revenue bonds, with a principal balance of \$21,000, were also retired in December 1998, more than one year prior to maturity.

This debt retirement was approved by the City Council on October 8, 1996, but was not carried out until 26 months later. The objective, according to City Council meeting minutes, was to realize interest savings that could be used to service debt for a water plant upgrade. The minutes did not specify the source of the funds to be used for the debt retirement. The check for the premature debt retirement was written December 7, 1998, from the Utility Fund Warrant account. On the same day, a check written from the same account for the recurring payment on the KIA note payable was returned for non-sufficient funds.

On August 9, 1999, a \$330,384.79 CD classified in the City's financial statements as Utility Fund restricted cash and investments payable to the "City of Olive Hill Depreciation Reserve" was liquidated. A portion of the proceeds, \$77,200, was deposited in the Utility Fund Warrant account, which was used to make a recurring payment on the RECD revenue bonds. After payment of \$1,640.50 in early withdrawal penalties, the remaining proceeds of \$253,728.63 were reinvested in another CD for the Utility Fund.

The CD for \$253,728.63, payable to the “City of Olive Hill (Depreciation Reserve Fund),” was subsequently liquidated on December 1, 1999. A portion of the proceeds, \$71,752.28, was deposited in the Utility Fund Warrant account, which was used to make a recurring payment on the KIA note payable. After payment of \$1,557.84 in early withdrawal penalties, the remaining proceeds of \$191,142.89 were reinvested in another CD for the Utility Fund, which remained on deposit as of June 30, 2000, according to the Commercial Bank of Grayson. This remaining CD is also payable to the “City of Olive Hill (Depreciation Reserve Fund).”

On January 28, 2000, a \$35,118.19 CD classified in the City’s financial statements as Utility Fund restricted cash and investments payable to the “City of Olive Hill - Customer Deposit Account” was liquidated. All proceeds were deposited into the Utility Fund Warrant account, where they remained on deposit as of June 30, 2000. City officials questioned the need to maintain funds in the customer deposit account sufficient to refund 100 percent of the deposits and interest owed.

On June 28, 2000, a \$12,132.97 CD classified in the City’s financial statements as Utility Fund restricted cash and investments payable to the “City of Olive Hill” was liquidated. All proceeds were deposited in the Utility Fund Warrant account, where they remained on deposit as of June 30, 2000.

The City failed to consider any potential for cost savings when enacting recent utility rate increases

At the City’s direction the Analysis essentially calculated the rate levels necessary to cover the present cost and debt structure, without exploring any potential cost savings. While the scope of this examination did not include identifying potential cost savings, excessive overtime costs were noted in the water and sewer plants. The two supervisors at these plants reported approximately 455 and 688 overtime hours between July 1, 1998, and December 31, 1998. This is an average of 17 and 25 overtime hours reported per week, respectively. Each supervisor also reported more than 40 overtime hours in a single pay period on one occasion during this period. The current City administration noted the excessive overtime earlier in fiscal year 2000 and took steps to reduce the overtime. As of June 30, 2000, overtime gross wages as a percentage of total gross wages were reduced by 55 percent. This was accomplished through a 63 percent reduction in overtime hours. This equates to an 11 percent or \$4,479 overall reduction in average monthly gross wages paid between 1998 and 2000.

Recommendations

We recommend that the City take the following actions:

- Ensure that all restricted CDs reflect the applicable restriction and fund ownership on the face of the certificate.
- Ensure that any actions involving the City’s investments and bank accounts, such as liquidating investments and opening or closing accounts, are performed with the permission of the City Council through a resolution.
- Ensure that City Council approval of capital projects is documented in a resolution that includes identification of the financing source for such projects.
- Ensure that the status of previous resolutions is documented in City Council meeting minutes until such time as the resolution is carried out.
- Ensure that restricted funds are used only for the purpose for which they are restricted.
- Attempt to identify cost savings that have recently been or could potentially be realized and quantify their impact on future operating costs.
- Reevaluate the utility rate increases put into effect July 1, 2000, considering identified cost savings and the latest audited financial information available, and revise downward, if appropriate.

Debt agreement and statute violations were attributable to fiscal mismanagement

Examination of bank statements and City documents revealed that acts of fiscal mismanagement, including misuse of restricted funds, misuse of state grant funds, inappropriate treatment of certain employee reimbursements, and poor cash management occurred during fiscal years 1999 and 2000. These acts resulted in the violation of the KIA note payable restrictions, federal, and state statutes.

The City used a then former City Council member’s position with the Commercial Bank of Grayson to bypass account restrictions and misuse restricted funds, resulting in a violation of reserve requirements

The City holds a Sewer Loan Reserve account on deposit in the Commercial Bank of Grayson. This account is restricted under the KIA note payable agreement to provide maintenance and replacements to the sewer distribution system. According to records of the Commercial Bank of Grayson, this account requires multiple signatures for disbursements. However, on August 10, 1998, \$89,998 was transferred into the Utility Fund Warrant account by means of a telephone transfer. This transfer was approved by then former City Council member Lottie Cook, an employee of

the Commercial Bank of Grayson, whose initials appear on the deposit slip. The transferred funds were then used to make a recurring payment on the RECD revenue bonds. This transfer reduced the Sewer Loan Reserve account balance below the reserve requirement, thus violating the KIA note payable agreement. As of June 30, 2000, the City has a \$132,176.59 shortfall in its reserve funds for this note. The City notified KIA of this non-compliance on June 29, 2000, and obtained KIA's approval regarding the steps to be taken to remedy the situation.

Restricted state grant funds were misused to subsidize General Fund operations

The City receives funds from the state under the Municipal Road Aid program, which are deposited in the Road Aid account. KRS 177.369(2) states that these funds are to be expended "solely for the purpose of construction, reconstruction, and maintenance of urban roads and streets set forth in KRS 177.365." During fiscal year 1999, the City incurred expenses totaling \$44,404.17 for expenditures that qualify under this statute. All of these expenses were incurred by the end of August 1998.

During fiscal year 1999, two transfers from the Road Aid account occurred. On July 21, 1998, \$30,000 was transferred from the Road Aid account into the General Fund Warrant account. This timing correlated closely with the largest payment to the road work contractor of \$33,709.20 on July 23, 1998, which was made from the General Fund Warrant account.

On January 7, 1999, \$25,000 was transferred from the Road Aid account into the Utility Fund Warrant account. The transfer slip indicates that the transfer was a loan repayment from the General Fund to the Utility Fund. This transfer slip also bears the initials of Councilwoman Cook. The second transfer caused the amount of funds taken from the Road Aid account to exceed the expenses allowed under state statute by \$10,595.83.

Mistreatment of certain benefits paid has resulted in some City employees receiving tax-free compensation

City Ordinance No. 95-3, enacted March 29, 1995, authorizes the reimbursement of insurance premiums paid by full-time City employees for external health coverage. For instance, if a City employee elects to waive coverage under the City's health plan and instead is covered under his/her spouse's health plan, the City reimburses any premiums paid by the employee for his/her entire family's coverage.

These reimbursements are actually compensation but have been treated as accounts payable disbursements. The reimbursed amounts were not included in employee gross wages, in violation of Internal Revenue Code (IRC) §61 and KRS 141.010. This treatment also violates IRC §3111 by not paying employer's taxes, and IRC §3402 and KRS 141.310 by not withholding income taxes on these reimbursements. Employees' income reported on Form W-2 has also been understated. During the period from July 1, 1998, through June 14, 2000, \$20,177.49 in health insurance premium reimbursements were paid to six City employees. The City ceased paying such reimbursements as of June 14, 2000.

Cash management was non-existent during the City's 1999 fiscal year

Examination of the City's bank statements and check registers revealed that the timing of nearly all inter-fund transfers during fiscal year 1999 correlated with a financial crisis. 12 transfers totaling \$132,000 were initiated to cover actual overdrafts. Seven transfers totaling \$211,000 were initiated to prevent overdrafts from occurring. Three transfers totaling \$14,548.77 were also noted in which the General Fund payroll expenses were paid with Utility Fund resources.

According to City officials, two new trucks were ordered in December 1998 and purchased by the Utility Fund for \$45,651 in cash in January 1999. No documentation of any consideration of financing options was discovered in our examination. Given the readily apparent cash crisis at the time, this transaction is compelling evidence of the fiscal mismanagement suffered by the City.

Recommendations

We recommend that the City take the following actions:

- Ensure that all restricted funds are deposited in the appropriate accounts to facilitate reserve management, and that restricted funds are used only for the purpose for which they are restricted.
- Ensure that City Council conflicts of interests, either in fact or appearance, are eliminated.
- Replace the necessary reserve funds as soon as possible to bring the City back into compliance. Obtain waivers as needed until compliance can be achieved.

- Once compliance is achieved, ensure that debt covenants are continually met, and implement a procedure to monitor compliance throughout the year.
- Reimburse the Road Aid account for the \$10,595.83 withdrawn in violation of KRS 177.369(2).
- Ensure that any future reimbursements that qualify as compensation are included in gross wages. Coordinate with federal and state taxing agencies to remedy the unreported income.
- Pass an ordinance limiting inter-fund loans to emergencies only and requiring prior City Council approval.
- Ensure that financing options are considered and that payment methods and funding sources for significant capital expenditures are approved by the City Council prior to entering into a transaction.

CITY OF OLIVE HILL RESPONSE

CITY OF OLIVE HILL

P.O. BOX 1660
225 ROGER PATTON DRIVE
OLIVE HILL, KY 41164
PHONE (606) 286-5532
FAX (606) 286-8538

The City of Olive Hill agrees in substance with the findings and recommendations of the auditors. The current administration is presently in compliance with all applicable law regarding the fiscal management of the City and is attempting to manage the City's limited resources for the maximum benefit of its citizens.

Although the utility rate increase borne by the citizens of Olive Hill may have in part been fueled by inappropriate financial management, utility rates must, as all commodities do, rise in correlation with the cost of energy, goods and services. Therefore, given the substantial period of time that has passed since any significant adjustments of utility rates, the present increases, although appearing dramatic, are not without basis or justification.

Sincerely,


Jack Colley
Mayor