



Observations of the Vermont State Auditor

June 21, 2006

CITY OF RUTLAND

Opportunities Exist to Improve Internal Controls Over Financial Reporting

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Vermont State Auditor
No. 06-03

Mission Statement

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**RANDOLPH D. BROCK
STATE AUDITOR**



**STATE OF VERMONT
OFFICE OF THE STATE AUDITOR**

June 21, 2006

The Honorable John P. Cassarino
Mayor
City of Rutland
City Hall
PO Box 969
Rutland, VT 05701

Dear Mayor Cassarino:

I am pleased to provide you with the results of our work, performed at your request, on the City of Rutland's (the City) financial operations. The findings, observations and recommendations are contained in the attached Appendix I.

Our work consisted of interviews with current and former employees of the City, inspection of documents, and observation of business processes. These findings and observations, all of which have been reviewed and agreed to by Treasurer Wilkinson, represent opportunities for the City to enhance internal control over financial reporting, improve the quality of its financial reporting, and improve the efficiency of the Treasurer's office operations.

I would like to thank you and Treasurer Wilkinson for the courtesies extended to my staff. Should the City require further assistance, please do not hesitate to call my office.

Sincerely,

A handwritten signature in black ink, appearing to read "Randolph D. Brock".

Randolph D. Brock
State Auditor

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Based on the results of the procedures applied to the City of Rutland, Vermont, we have identified opportunities for improvements in the internal controls and other operating efficiencies. Our findings and recommendations are summarized as follows:

Computerized Accounting System - Training

The City has invested significant resources in the purchase and maintenance of a computerized general ledger accounting system named “MUNIS”. While all of the modules associated with the system have not been purchased or installed, the package is a powerful tool in the financial management of the City. However, the City has failed to invest in adequate training of staff in the full functionality of the system. As a result, the Treasurer’s staff, and possibly other employees, does not have an adequate understanding of MUNIS. Staff appears to understand the mechanics for the recording of routine transactions and the printing of reports. The processing of nonroutine transactions or special reporting is generally not attempted.

The City should assess the skill level of the current staff and develop a plan to obtain adequate training within the next several months. This assessment should also consider whether staff possess appropriate accounting experience to process and record the City’s financial transactions. In addition to general MUNIS training, the training should include training and education specifically designed for each employee to eliminate the weaknesses in the skills needed for their specific job assignment. Cross training of employees is also necessary to ensure adequate coverage during peak processing times or during vacation periods.

Automated Accounting System – Grants and Special Funds

In addition to the lack of proficiency with the full functionality of the automated general ledger package, we also noted that the City does not use its MUNIS general ledger package to record all of the City’s financial activity. Grant funds and special funds are not recorded on MUNIS. The activity for these funds is posted manually to paper ledger cards, summarized manually after fiscal year end, and presented to the external auditor in connection with the audit of the financial statements. We found that many of the so called “funds” were never recorded or reflected in the City’s own general ledger accounting system.

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During our fieldwork in October 2005, the City had not recorded any grant fund or special fund activity for the fiscal year July 1, 2004 through June 30, 2005. In addition, there was no grant fund or special fund activity recorded for the new fiscal year which began July 1, 2005. When we inquired as to the status of entering the information for the grants and special funds, the assistant treasurer, who was responsible for recording the financial activity in these funds and the custodian of the cash, stated she did not know how to enter the activity into MUNIS. This again demonstrates the lack of attention to training in the use of the automated accounting system.

We recommend that the City record all its financial activity contemporaneously into the MUNIS system. This is especially relevant to the grant funds and special funds. The general ledger should also track these funds by resource provider (e.g., federal, state, local). Contemporaneous recording of the activity will enable the City to comply with the uniform administrative requirements, more effectively exercise controls over the funds, and reduce the time burden on staff related to manual bookkeeping. For example, the uniform administrative requirements specify that grantees expend and account for federal funds received according to the standards for their own funds. No distinction should be made in the internal controls over local, state or federal funds.

Consideration should also be given to assessing the accounting skills of the personnel in the Treasurer's office. To the extent accounting and financial reporting skills need improvement, a plan to provide training and development or supplementing with additional resources should be developed and implemented.

Grant Acceptance Policy – Grants and Special Funds

A significant portion of the City's operations are funded, in whole or in part, through grants. These grants, generally from the State of Vermont or the federal government, impose certain conditions on the City. These conditions specify the allowable uses of the funds, the reporting requirements, and often times special terms and conditions. In many cases, compliance with the terms and conditions requires the coordination of multiple departments. Some organizations have realized, albeit too late, that compliance with the terms of certain grants is so restrictive that there is little or no benefit derived from the funding.

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We found that the Treasurer's files on grant funds and special funds did not include copies of grant agreements or the documentation of the terms and conditions for the use of restricted funds. Having a tracking system for grants would enable the Treasurer to be fully informed about the source of the funds and any restrictions. This should include a comprehensive grant acceptance policy. The policy should include appropriate review and approval from the Treasurer's office so that appropriate controls are in place to prepare the financial reports required by the grant agreement.

Federal Single Audit Compliance

Currently, the grants and special funds files are organized alphabetically by their familiar names, without regard to the source of the funds or other legal restrictions. Special funds may include gifts received under the terms of wills and estates, or through other means whereby funds are restricted as to use. Inquiries of the Treasurer and Assistant Treasurer indicated that neither was certain which grants were federal grants or state grants. Proper classification is particularly important for federal funds, because annual expenditures of more than \$500,000 in federal funds in a fiscal year require the City to prepare required supplementary information as part of its financial statements, and subject the City to additional audit requirements under the federal Single Audit Act. The inability to identify federal funds is apparently a recurring issue. For example, a March 16, 2005 letter from the City's external auditor, AM Peisch, to Treasurer William Shortle made it clear that in March, 2005 the auditors had only recently identified those funds expended during the fiscal year ended June 30, 2004 that were federal funds. Proper custody and knowledge of the contents of the legal agreements governing grants is a fundamental requirement for the proper management of the Treasurer's office.

We recommend that the Treasurer's office retain complete copies of agreements for all such grants and restricted funds. The Treasurer and Assistant Treasurer should examine the grant agreements, wills or other terms of gifts of restricted funds. The originals of the documents should be segregated and stored in a fireproof safe. The Treasurer should also ensure that a complete and accurate schedule of expenditures of federal awards is prepared in a timely manner. This will allow sufficient time to plan and perform the mandatory federal Single Audit by the statutory deadline.

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Segregation of Duties

Internal controls broadly refer to the policies and procedures put in place by management to ensure that transactions are initiated, processed, recorded and reported in accordance with management's intentions. Internal controls are also intended to reduce to a relatively low level the risk that errors or misstatements, including misstatements due to fraud, could occur and not be detected by employees in the normal course of their responsibilities. Management is ultimately responsible for internal controls.

We have interviewed a number of individuals in the Treasurer's office. Based on these interviews, the inspection of documents, and other procedures, we have identified several opportunities to strengthen internal controls. These include the physical safeguarding of cash, access to the books and records, recordkeeping, and segregation of duties. Many of these observations have already been discussed with Treasurer Wilkinson. Since we have not performed an audit of the financial statements, nor have we performed an exhaustive examination of the internal controls, we can not, and do not, express an opinion or any other type of assurance on internal control.

Of particular concern is the lack of segregation of duties for grants and special funds. The Assistant Treasurer has custody of the cash as an authorized signer, records the activity as recordkeeper of the special funds files, and reconciles the bank statements for these funds. The department receiving the award authorizes expenditures from these funds or transfers from these funds to reimburse for expenditures recorded in the general fund. The department files requests for reimbursement with the awarding agency, and then informs the Assistant Treasurer to expect a transfer via ACH or check. The departments file the periodic reports required by the grants. There is no indication that someone other than the Assistant Treasurer reviews the bank statements or approves the bank reconciliations. The activities performed by the Assistant Treasurer represent an inadequate segregation of duties over the grant and special funds.

As noted above, recording the grant activity in MUNIS will enhance the overall control environment. It will also allow the City to identify additional opportunities to segregate responsibilities over the funds and enhance internal controls.

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Grants and Special Funds – Cash Management

Over the past several years, the City has served as the fiscal agent for certain quasi-governmental entities. The City is also a party to some of these same entities. However, it is difficult to determine the nature of the financial assets held by the City on behalf of the third parties. For example, the bank accounts for grants to separate legal entities that are managed at the City Treasurer's office are named "City of Rutland, LEPC", and not named according to the entity that was awarded the funds and should have legal title to the funds.

Bank accounts for separate legal entities should be titled to those legal entities, and not the City of Rutland. The City Treasurer can still manage these funds, by being designated an authorized signatory to the account. These funds should be clearly identified as agency funds within the general ledger.

Treasurer's Office Duties

As is often the case with small organizations, roles and responsibilities often accumulate due to expediency and efficiency at the time the matter first arises. However, over time, the roles and responsibilities do not always keep pace with the evolving nature of the underlying business processes or best practices in fiscal control. This is true of the functions performed by the Treasurer's office. The Treasurer's office has accumulated many responsibilities that appear to violate appropriate segregation of duties. For example, the Treasurer's office prints, sorts and mails water, sewer and property tax bills. Typically, these are prepared by the department responsible for the billing. The Treasurer's office also receives payment for these bills, records receipts for the payment of accounts receivables, and posts those receipts to the general ledger.

We recommend that the Treasurer evaluate the current workload of the office and determine how each task aligns with the mission of the office. This may require that certain tasks be reassigned to other departments within the City government structure. Once the roles and responsibilities are determined, the Treasurer should ensure that proper job titles and accurate position descriptions exist for all employees. This will serve to clarify the role each person plays in the overall control environment. Once the roles and responsibilities are assigned, the Treasurer should establish a business calendar for the office that schedules the month to month responsibilities and

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takes into account the flow of activity for the office. Specifically, the calendar should take into consideration the following:

- property tax deadlines
- payroll processing
- accounts payable processing
- set specific monthly financial reporting requirements and deadlines
- set specific quarterly financial reporting requirements
- quarterly tax reporting requirements
- annual financial reporting requirements and deadlines
- preparation for the annual audit and Single Audit

Mapping out the business calendar will allow the office to plan how it will deal with peak periods and continue to meet financial reporting deadlines.

General Accounting - Cash Management

The City Treasurer's office has custody of cash, responsibility for recording financial transactions, and also reconciles the bank statements. Having both custody of cash and responsibility for recording transactions is a lack of separation of duties that raises the City's control risk. This lack of segregation of duties is not uncommon in small entities, but steps should be taken to improve the controls over cash.

We recommend the following:

- 1) Implement a lockbox for cash receipts. A lockbox is an effective way to expedite the processing of cash and improve cash flow while at the same time allow for effective controls over cash.
- 2) Separate responsibility for cash receipts, accounts receivable, and cash disbursements from responsibility for reconciling the bank statement. Separate duties for maintaining the accounts receivable subsidiary ledger and the general ledger.
- 3) Make all deposits intact daily. The employee making the deposit should not be the cashier or work in accounts receivable. Separate the duties of preparing the deposit slip from making the deposit.

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4) As staffing levels permit, someone not involved in making the bank deposit should open the daily mail, count the cash and check amounts received, and prepare a list of daily cash receipts. The list should be compared to both the amount deposited and the customer account postings by a person independent of either cash receipts or accounts receivable.

5) A manager or other appropriate person should make independent comparison of deposits on bank statements to general ledger postings and validated deposit slips. Someone outside the routine accounting function should periodically review the detailed bank reconciliation documentation and any adjusting entries made to the books.

Computer Access Controls

As noted above, the City installed an automated general ledger system in 2003. However, the City does not appear to have implemented appropriate policies, procedures or controls with respect to the MUNIS system to safeguard the City's assets and the accuracy of the financial system. According to staff interviews, a former Treasurer did not have an individual user identification and password for several months. Rather the Treasurer used the user identifications and passwords of two former employees. In addition, the former Treasurer would often use various office computer terminals some of which had on-line banking access.

We also noted that access controls within MUNIS are not as strong as they should be. For example, employees with MUNIS access can also access the Payroll module and make changes. The only "control" over unauthorized access is the lack of knowledge as to how to effect the changes. This is not an appropriate level of control over one of the more critical accounting functions. Similar concerns with respect to accounts payable were also identified.

We recommend that the City implement policies, procedures and controls over access to information technology applications. These controls should, at a minimum, require each user to have their own specific user identification and password, prohibit individuals from logging in under the identification of another employee, and prohibit the sharing of passwords. User identification and passwords for former employee should be deactivated immediately upon termination of employment. The MUNIS software should record and document the identify of individuals who initiate transactions, and all entries and changes should be associated with a specific individual and be logged

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through the use of an audit trail, so that individuals can be held accountable for unauthorized actions.

General Accounting

Miscellaneous cash receipts are typically credited to expense accounts when posted to the general ledger. Accounting principles generally accepted in the United States of America require that revenue and expense be recorded at the gross amounts in the City's financial records and in the financial statements.

We recommend that all general bills and miscellaneous receipts be recorded as revenue when earned. This will allow recording in MUNIS when received allowing for better control. Recording these transactions as revenue will also allow better tracking of the amount of accounts receivable related to general bills so that the City can better manage the general bills receivables and improve cash flow.

Grant Accounting

Recent financial statement audit reports have noted that grants to the Police Department are initially recorded by the City as a reduction of general fund expense. In a telephone conversation with Chief of Police Bossi, it was noted that police department expenditures under the grants, such as payroll expense for time on grant projects, are posted to a zero-balance general ledger account. He uses this account to track grant related general fund expenditures. When grant funds are received, they are credited to the same account.

We recommend that all grant receipts be recorded as revenue when earned, and not as reductions of expense. The revenue and expense should be recorded at the gross amounts as they are earned. The current method of recording these grants results in additional year end adjustments and has the effect of delaying the audit. We further recommend that all grant funds be recorded in MUNIS.

Physical Safeguarding of Assets

As would be expected, the City collects a significant amount of revenue in the form of cash and checks. These are both highly liquid assets and are

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easily susceptible to theft or defalcation. In addition, the City's own blank check stock and individual checking account checkbooks are also susceptible to theft. We noted that checkbooks and bags of coins were sitting out in the open in the "vault," a room within the Treasurer's suite of offices. The "vault" can be readily accessible to someone walking in off the street when the door to the Assistant Treasurer's office is unlocked. In addition, the bags of coins, while not material in terms of dollars, are nonetheless fungible assets of the City and should be in an interest bearing account.

We recommend that the City perform an assessment of its physical security and safekeeping of financial assets. Procedures should be in place to deposit cash on hand in a timely manner. In addition, policies, procedures and controls should be in place to control access to and recordkeeping of the numerous checkbooks maintained by the Treasurer's office. Consideration should be given to reducing the overall number of cash accounts in favor of a centralized cash management system.

General Accounting - Reconciliations

Recent management letters issued in connection with the audit of the City's financial statements included comments that for the past three years the auditor found numerous discrepancies between the balances posted in the general ledger and the related subsidiary ledger or other supporting documentation. Specifically, the auditors consistently found discrepancies between interfund transfers and interfund receivables and payables.

Periodic reconciliation of the general ledger to supporting and subsidiary records is a key element of internal control. As part of its regular monthly closing schedule, the Treasurer's office should prepare complete and accurate reconciliations of all appropriate general ledger accounts with the underlying subsidiary records. Reconciliations should be reviewed and approved within a reasonable time following month end.

Audit Preparation

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America is the responsibility of management. At the City of Rutland, the City Treasurer is the primary point of contact for the preparation of the underlying information necessary to prepare complete and accurate financial statements. Based on

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our analysis of the underlying accounting records, a significant amount of work is required to be completed before audit fieldwork can begin.

We recommend that the Treasurer prepare a detailed schedule and plan for the preparation of information necessary to close out the fiscal year ended June 30, 2005. The plan should include the specific tasks to be completed, the person responsible for completing the task, and the date by which the task is to be completed. A list of the recommended tasks has been included as an Appendix to this letter.

Governmental auditing standards regarding independence preclude the auditor that will be auditing the financial statements from preparing the necessary schedules or performing the reconciliations for the City. Should the Treasurer deem it appropriate, an external bookkeeper or independent public accountant should be retained to assist in the preparation of the supporting documentation.

Timeliness of Financial Reporting

The audits of the City's financial statements have not been completed in a timely manner. Over the past several years, the reports have generally been issued more than 10 months after year end. In fact, as of the date of this letter, the audit report for the year ended June 30, 2004 has still not been issued.

There is general agreement that financial information is rather stale and of little informative value when issued so long after the reporting period. The City should work with its auditors to condense the time between the end of the fiscal year and the completion of the audit. This will require a significant effort on the part of the City Treasurer's Office to prepare the books and records for audit. This goal should be achievable as the City implements a routine monthly closing process and expands the use of MUNIS.

Use of Funds

The City maintains a large number of individual funds. These funds are either internally or externally restricted as to the purposes for which monies can be used. For several of the larger funds, we prepared a rollforward of the activity in the fund from July 1, 2004 through December 31, 2005. We noted a number of transactions that lacked supporting documentation to substantiate

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the nature of the expenditure, the approval of that expenditure, or both. The more significant matters noted include the following:

Grand List Fund – Three out of 6 expenditures charged to this fund were not supported by an invoice or other documentation.

Home Depot Fund – Four out of 6 expenditures charged to this fund were not supported by an invoice or other documentation. In addition, two other invoices lacked approval.

Local Emergency Planning Commission Fund – Twenty five out of 56 expenditures charged to this fund lacked proper approval. In addition, three of those 25 expenditures were not supported by an invoice or other documentation.

Maples Fund – Neither of the two expenditures charged to this fund were properly approved.

Routes 4 & 7 Fund – One of 30 expenditures charged to this fund lacked approval.

Fire Equipment Fund – This fund is comprised of both a checking and savings account. Twelve of the 63 expenditures paid out of the checking account lacked proper approval. Twenty three of the 29 expenditures charged to the savings account lacked approval. In addition, 22 of those 23 expenditures were not supported by an invoice or other documentation.

Capital Improvement Fund – Nine out of 10 expenditures charged to this fund lacked approval. In addition, 1 of those 9 expenditures was not supported by an invoice.

Zamias Impact Fund – One out of 11 expenditures charged to this fund was not supported by an invoice.

Stoolfire Fund – Four of the 6 expenditures charged to this fund lacked an invoice or other supporting documentation. As a result, we were not able to determine if the expenditure was allowable.

At the same time there appears to be a misconception as to the use of the funds and fund accounting. In general, the City maintains a separate bank / checking account for each fund. Each of the checkbooks is stored in open view in the vault room; they are not otherwise secured or restricted. In addition, the majority of these funds are not recorded in the City's automated accounting system. Rather, manual sheets or "ledger cards" are kept on file.

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As such the activity in the funds is typically not reconciled to the bank statements until year end.

We recommend that the City implement policies, procedures and controls over the expenditure of funds. Sufficient competent evidentiary support should be provided to substantiate the use of grant or restricted funds. All expenditures should be properly authorized and approved by management. The supporting documentation should be retained for a period of at least three years.

We also recommend that the City consider establishing a comprehensive cash management program. The maintenance of literally dozens of separate bank accounts is inefficient and requires considerable manual intervention.

Travel Reimbursement Policies

Under regulations issued by the Internal Revenue Service (IRS), organizations are required to implement policies, procedures and controls over travel reimbursement plans. There are generally two types of plans – accountable and nonaccountable. Under an accountable plan, there must be a business connection to the expenditure. This means that the expense must be a deductible business expense incurred in connection with services performed as an employee. If not reimbursed by the employer, the expense would be deductible by the employee on his/her 1040 income tax return. There must be “adequate” accounting by the recipient within a reasonable period of time. This means that your employees must verify the date, time, place, amount and the business purpose of the expenses. Receipts are required unless the reimbursement is made under a per diem plan. Excess reimbursements or advances must be returned within a reasonable period of time. Reasonable depends upon facts and circumstances. Under a nonaccountable plan, employees are not required to or do not substantiate timely those expenses to you with receipts or other documentation. You advance an amount to your employee for business expenses and your employee is not required to and does not return timely any amount he or she does not use for business expenses. It is our understanding that the City has an accountable plan.

Management of the City was not able to provide us with a travel and expense reimbursement policy. In connection with our work at the City, we reviewed travel and expense reimbursement payments to several employees. We found that the quality and quantity of documentation was not sufficient to meet the requirements of an accountable plan. We found the following:

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- Department heads are allowed to approve their own travel reimbursement without evidence of additional supervisory review or approval;
- The majority of reimbursements tested lacked supporting documentation other than the request for reimbursement;
- One travel reimbursement included a charge for alcohol;
- One reimbursement included a \$10 tip on a \$6.50 meal;
- A reimbursement in the amount of \$178.95 did not include a reimbursement request form or other evidence of approval;
- Reimbursements for meals were generally not supported by receipts indicating the date, time, location or business purpose;
- Payments of monthly automobile allowances were not supported by documentation

We recommend that the City implement policies, procedures and controls over travel and expense reimbursement. The policies and procedures should address, at a minimum, the requirements specified in IRS regulations. The City should also ensure appropriate controls are in place to review and approve all travel and expense reimbursement requests. Approvals should be required of all requests and employees should not approve their own reimbursements.

Quality of Financial Reporting

Consistent with the requirements imposed on all local governments, the City is required to comply with a number of accounting principles. These principles, known as Generally Accepted Accounting Principles or “GAAP”, specify the manner in which certain transactions shall be recorded and displayed in the City’s financial statements.

For the past several years, the City has received from its auditors an adverse opinion on the financial statements due to the City’s lack of compliance with GAAP. There have been two departures noted. The first deals with the fundamental display of the statements. Beginning with the year ended June 30, 2003, the City was required to adopt the provisions of Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments*. The City chose not to adopt the provisions of this statement. The second qualification relates to the accounting for property tax revenue. In accordance with GAAP, the City shall generally record revenue for that portion of tax revenue actually received within 60 days following year end.

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If the tax revenue is not received it shall be recorded as “deferred revenue”. Again, the City chose to not adopt this accounting requirement.

In order to present fully GAAP-compliant financial statements, the City would be required to adopt both of these mandatory accounting presentations. While the conversion to GASB 34 requires considerable planning and effort, the accounting for taxes is relatively straightforward to rectify. In fact, in order to prepare the adverse opinion, the auditor has provided much of the necessary information related to property taxes.