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November 8, 2012

The Honorable Ervin Dahl
Mayor, City of Carlos
P.O. Box 276
Carlos, Minnesota 56319-0276

Dear Mayor Dahl:

The Office of the State Auditor (“OSA”) reviewed certain financial records for the City of Carlos (“City”). Based upon the OSA’s review, it appears the former City Treasurer received a total of **\$34,585.31** in unauthorized City checks during the time period of February 16, 2011, through June 13, 2012.

During its review, the OSA identified a number of weaknesses in the City’s internal control and management practices. The purpose of this letter is to provide the City with recommendations to better protect City funds in the future.

Background

The City had a City Clerk and a City Treasurer until early in September 2012, when the Treasurer’s employment with the City was terminated. The Clerk was primarily responsible for City Council meeting minutes, maintaining a list of addresses for City residents, and City mailings. The Treasurer was primarily responsible for handling the City’s financial matters, including utility billings. The Clerk and Treasurer were part-time City employees, paid once a month.¹ The Treasurer’s pay was split between the City’s General Fund and Utility Fund, resulting in two paychecks to the Treasurer each month.²

¹ Generally, the Clerk and Treasurer each worked three hours per week. In addition to their regular pay, the Clerk and Treasurer received, generally on an annual basis, compensation for special meetings they attended.

² The Clerk received one check per month from the General Fund. In addition to the General Fund and the Utility Fund, the City maintained the following accounts: Fire Department, First Responders, Water Head Protection Fund, Public Improvement Revolving Fund, and a 4M Fund.

At the monthly City Council meetings, the City Council was provided with a “Treasurer’s Report” that generally consisted of printouts from the City’s computerized accounting system (“CTAS”), including a “Disbursements Register” that should have listed all City checks issued during the prior month.³ The City Council meeting minutes generally noted whether the Treasurer’s Report, including the Disbursements Register, was approved by the City Council. In addition to maintaining the City’s financial records on CTAS, the Treasurer maintained a handwritten ledger recording disbursements from and deposits into the City’s accounts.

Summary of OSA’s Findings

Based upon the OSA’s review, it appears the Treasurer received a total of **\$34,585.31** in unauthorized City checks during the time period of February 16, 2011, through June 13, 2012. More specifically, the OSA found:

- \$32,983.17 in checks written to the Treasurer that were not paychecks, and were not included on the Disbursements Registers presented to the City Council for approval.⁴
- \$1,111.62 in duplicate paychecks written to the Treasurer.
- \$208.60 in inflated paychecks written to the Treasurer.
- A check written to the Treasurer for \$281.92 more than the authorized amount.

During its review, the OSA found that some City checks were signed prior to the monthly City Council meetings. In addition, the OSA found that most of the unauthorized checks identified by the OSA did not contain three signatures. The OSA also found that not all City checks were included on the Disbursements Registers provided to the City Council or on the handwritten ledger.

The OSA provided a more complete summary of its findings to the Douglas County Attorney and the Douglas County Sheriff’s Office.⁵

³ The City uses the Small City and Town Accounting System (CTAS), a program written and maintained by the OSA and available to small Minnesota cities and towns. Additional information about CTAS is available on the OSA’s website, www.auditor.state.mn.us. In addition to the Disbursements Registers, the City’s “Treasurer’s Report” generally included Cash Balance Statements and Receipts Registers.

⁴ \$14,782.34 was from the Utility Fund. \$18,200.83 was from the General Fund.

⁵ See Minn. Stat. § 6.50. This letter is public data. However, data supporting this letter are considered not public data at this time. See Minn. Stat. § 6.715.

Recommendations

The OSA recognizes that the limited number of City personnel prevents the segregation of accounting functions necessary to ensure adequate internal accounting controls. While this situation is not unusual in cities the size of Carlos, the City Council, Clerk, and Treasurer should constantly be aware of this condition and realize that the concentration of duties and responsibilities in a limited number of individuals is not desirable from an internal control point of view.

Generally, responsibilities among employees should be separated so no single employee is able to authorize a transaction, record the transaction in the City's accounts, and be responsible for the receipts resulting from the transaction. In situations where it is not possible to segregate duties to a desirable level, implementation of proper management oversight procedures becomes an integral part of internal control.

The OSA believes that, even with the limited size of the City's staff, there are steps the City should consider to improve internal control and better protect City funds. The following recommendations are based upon the OSA's review.⁶

1) Approval of Claims, Check Issuance, and Meeting Minutes

The City Council received a Disbursements Register, but did not receive a separate claims list for approval at each meeting. The OSA recommends that the City Council be presented with a claims list at each City Council meeting. The City's financial accounting system, CTAS, will print a claims list that has a place for the Mayor to sign after the claims are approved by the City Council at the meeting.

Some City checks were signed before the related claims were approved by the City Council. As a general rule, Minnesota law prohibits the disbursement of city funds until a claim has been approved by the city council.⁷ Pre-signing city checks defeats this statutorily-mandated safeguard. The OSA recommends that City checks be signed only after the related claims are approved by the City Council, except as authorized by Minnesota law.

⁶ The OSA did not perform a full financial audit of the City which could disclose other areas where additional controls are needed.

⁷ See Minn. Stat. § 412.271, subds. 1 and 3. The exceptions to this general rule include the payment of judgments, salaries and wages previously fixed by the city council, and rent or other fixed charges where the exact amount has previously been determined by a contract authorized by the city council. See Minn. Stat. § 412.271, subd. 1. Another exception is for claims that cannot be deferred until the next city council meeting without losing a discount or other privilege. In those cases, however, the law requires the claim to be formally acted upon at the next city council meeting. See Minn. Stat. § 412.271, subd. 4.

Most of the unauthorized checks identified by the OSA did not contain three signatures. Under Minnesota law, City checks should contain three signatures – the Mayor’s signature, the Clerk’s signature, and the Treasurer’s signature.⁸ The OSA recommends that all City checks contain three signatures. In addition to being required by Minnesota law, multiple signatures are part of the City’s internal controls. When more than one person signs a check, each person is verifying that the City Council has approved the corresponding claim for payment.

The City Council meeting minutes did not separately identify the approval of claims or the amount of claims approved. The OSA recommends that the meeting minutes identify the claims approved at the meeting. This can be accomplished by referencing the total amount of claims approved, and attaching the corresponding signed claims list to the meeting minutes. The meeting minutes should also identify how each member voted on the claims presented.⁹ A copy of the OSA’s Statement of Position on Meeting Minutes is enclosed for further guidance on this issue.¹⁰

2) Bank Reconciliations

The Treasurer was responsible for recording disbursements in the City’s financial accounts.¹¹ Therefore, someone other than the Treasurer, such as the Clerk or a City Council member, should have been responsible for reconciling the City’s bank statements. While the Clerk informed the OSA that she performed “reconciliations” on the handwritten ledger, the reconciliations performed were not adequate.

The OSA recommends that monthly bank reconciliations be performed by someone other than the Treasurer. The reconciliations should look for checks that were not approved by the City Council, checks written for an amount that is different from the amount approved by the City Council, gaps in check number sequences, checks recorded as void that were actually cashed, checks made out to someone other than for whom payment was approved, and any other irregularities.

To facilitate the monthly bank reconciliations, the OSA recommends that the City obtain from its financial institutions, along with the bank statements, copies of City checks that have cleared the City’s account.¹² The City should retain the check copies, as well as all voided checks.

⁸ See Minn. Stat. § 412.271, subd. 1. In the Mayor’s absence, the Acting (Assistant) Mayor was authorized to sign City checks. See Minn. Stat. § 412.121.

⁹ See Minn. Stat. § 13D.01, subd. 4.

¹⁰ The OSA’s Statements of Position are also available on the OSA’s website.

¹¹ The duties of a city treasurer are generally found in Minn. Stat. § 412.141. Duties of a city clerk are generally found in Minn. Stat. § 412.151, subd. 1. Chapter 8 of the League of Minnesota Cities’ (“LMC”) Handbook for Minnesota Cities discusses the duties of the clerk and the treasurer. It is available on the LMC’s website, www.lmc.org.

¹² The City had to obtain copies of City checks for the OSA’s review from the City’s financial institutions.

3) Compensation of Employees and Elected Officials

The City Council meeting minutes reviewed by the OSA did not state the approved hourly rate or monthly amount to be paid to the Clerk and Treasurer.¹³ Nor did the City have a written contract with the Clerk or Treasurer. Similarly, the City Council meeting minutes reviewed by the OSA did not identify any compensation to be paid to elected officials.

The OSA recommends that the City maintain documentation regarding the compensation for City employees and officials. If the City does not have written employment contracts for the Clerk and Treasurer, then their compensation, including their hourly or monthly rate of pay and any benefits they may receive such as insurance, per diem amounts, or paid leave, should be recorded in detail in the City Council meeting minutes on an annual basis. Similarly, any compensation that will be paid to City elected officials should be approved by the City Council at the beginning of each year and recorded in the City Council meeting minutes.

If the Clerk and Treasurer are paid on an hourly or daily basis, Minnesota law requires the City to implement certain internal control procedures, including the completion of signed declarations attesting to the hours/days worked.¹⁴ The OSA's Statement of Position on Employee Timekeeping Procedures for Employees Paid on an Hourly or Daily Basis is enclosed for further guidance on this issue.

4) Maintain Accurate and Complete Financial Records

During its review, the OSA found that numerous General Fund, Utilities Fund, and 4M Fund receipts and disbursements were not recorded in CTAS. As a result, the Treasurer's Reports printed from CTAS and provided to the City Council each month were not accurate. The City's accounting system could not be relied upon for complete and accurate information.

The OSA recommends that the City record all transactions in CTAS for 2011 and 2012. The OSA recommends that, in the future, CTAS entries be made on a timely basis to provide the City with complete and accurate financial information. For additional guidance in this area, the OSA provides CTAS training and maintains CTAS educational materials on its website.¹⁵

¹³ The OSA received and reviewed monthly City Council meeting minutes for January and February 2011, and for April 2011 through July 2012. The OSA did not receive minutes for the March 3, 2011, City Council meeting.

¹⁴ See Minn. Stat. § 412.271, subd. 2(b).

¹⁵ A CTAS user manual, reference guide, on-line trainings, and numerous other CTAS-related materials are available on the OSA's website at: <http://www.auditor.state.mn.us/default.aspx?page=ctas>.

5) Transfers Among City Accounts

The OSA identified various transfers of monies among City accounts. Based upon the OSA's review of City Council's meeting minutes, most of the transfers were not separately discussed or approved by the City Council.¹⁶ For example, the OSA identified transfers and disbursements from the City's 4M Fund, an investment account. More specifically, during the time period of January 1, 2011, through April 1, 2012, the balance in the 4M Fund went from \$136,803.47 to \$159.69. The Fund was used for fire truck payments, a transfer to the Utility Fund, and a bond payment.¹⁷ Although the transfers and disbursements were contained on the Disbursements Registers, the City Council meeting minutes did not record any separate discussion or approval of the transfers and disbursements. In addition, the Treasurer's Reports for January and February 2012 did not accurately reflect the balance in the 4M Fund. As a result, it is unclear whether the City Council was fully aware of these transfers and disbursements.

The OSA recommends that any transfer among City funds/accounts be discussed by the City Council, approved during City Council meetings, and recorded in the City Council meeting minutes. These discussions will help the City Council understand the City's financial position and clarify the purpose for the transfer. The City Council meeting minutes should identify the amount to be transferred, the funds/accounts involved in the transfer, the reason/purpose for the transfer, and the City Council's approval of the transfer.

In some instances, for example, a transfer may actually be a loan from one fund to another, in order to alleviate a temporary cash shortage.¹⁸ Such transfers are referred to as interfund loans and need to be recorded accordingly in the City's books. In addition, the City Council needs to consider repayment provisions for interfund loans. The OSA's Statement of Position on Temporary Interfund Loans is enclosed for further guidance on this issue.

¹⁶ Some transfers were reported on the Receipts and Disbursements Registers. These transfers appear to have been approved by the City Council as part of the Treasurer's Report.

¹⁷ The OSA reviewed the Disbursements Registers and bank statements. Although requested by the OSA, the City did not provide the OSA with copies of the checks written on the 4M Fund. Based upon the OSA's review, it appears two fire truck disbursements from the 4M Fund totaled \$49,463.76; a transfer totaling \$51,408 was made to the 4M Fund from the Utility and General Funds; a transfer of \$75,000 was made to the Utility Fund from the 4M Fund; and a bond payment of \$63,605 was made. The account also received dividends/interest payments.

¹⁸ This was the case with a \$30,000 transfer from the Water Head Fund to the General Fund discussed in the October 6, 2011, City Council meeting minutes.

6) Public Purpose Expenditures

During its review, the OSA noted City expenditures that do not appear to comply with Minnesota's public purpose doctrine. The expenditures included donations to Girl Scout and Cub Scout troops, donations to baseball teams, a get-well fruit basket, flowers for a funeral, and clothing items such as coats. The expenditures were included on the Disbursements Registers, and therefore appear to have been approved by the City Council.

In order to expend city funds under Minnesota's public purpose doctrine, a city must have specific or implied authority to make the expenditure. In addition, the expenditure must be for a public purpose. The Minnesota Attorney General's Office has issued opinions stating that cities have no authority to donate city funds to organizations such as the Boy Scouts.¹⁹ In addition, the OSA knows of no authority for a city to purchase flowers or a fruit basket for city staff or city officials who are ill or have lost family members.²⁰

Some of the questionable purchases were made using City credit cards. Purchases made with a credit card must be consistent with other state laws, as well as the public purpose doctrine.

If the clothing purchases were for employment purposes, the City will need to determine whether the purchases or any clothing allowance provided to an employee was taxable income for the employee.²¹ The OSA questions whether any clothing purchases that were not employment related would comply with Minnesota's public purpose doctrine.

The OSA recommends that, in the future, the City comply with Minnesota's public purpose doctrine when making expenditures of City funds. In addition, the OSA recommends that any employee clothing allowances be clearly documented for each employee, just as other types of employee compensation and benefits should be documented. The OSA recommends that the City determine whether any clothing purchases or clothing allowances were taxable income for City employees. Finally, the OSA recommends that the City adopt a credit card policy that prohibits the use of a City credit card for personal purchases, requires supporting documentation for all purchases

¹⁹ See, e.g., Op. Att'y Gen. 59-A-3 (Sept. 28, 1933) (Boy Scouts).

²⁰ In these situations, public employees or officials generally contribute their own money for gifts. Additional information on public purpose expenditures may be found in the League of Minnesota Cities' ("LMC") "Public Purpose Expenditures" publication, available on the LMC's website, www.lmc.org, and in the OSA's Statement of Position "Public Expenditures: Donations and Dues." A copy of the Statement of Position is enclosed.

²¹ The LMC has additional information on this topic on its website. See, e.g., "IRS Audits of City Payroll: Payroll Pandemonium" on LMC's website.

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made with the credit card, and establishes a review process for all purchases made with the credit card.²²

Conclusion

The Office of the State Auditor reviewed certain financial records for the City of Carlos. Based upon the OSA's review, it appears the former City Treasurer received a total of **\$34,585.31** in unauthorized City checks during the time period of February 16, 2011, through June 13, 2012. This letter provides the City with recommendations to address a number of weaknesses in the City's internal control and managements practices that the OSA identified during its review.

If you have any questions, or if we can provide the City with additional assistance, please feel free to contact me at 651-297-5853 or Nancy.Bode@osa.state.mn.us, or Kathy Docter at 651-282-2388 or Kathy.Docter@osa.state.mn.us.

Sincerely,

/s/ Nancy J. Bode

Nancy J. Bode
Assistant Legal Counsel

Enclosures

cc: The Honorable Sharon Illetschko, City Council Member
The Honorable Dave Schackel, City Council Member
The Honorable Jeffrey Schiffman, City Council Member
The Honorable Teresa Zweig, City Council Member
Ms. Marcia Okerlund, City Clerk
Mr. Thomas P. Klecker, City Attorney
The Honorable Chad M. Larson, Douglas County Attorney
The Honorable Troy Wolbersen, Douglas County Sheriff
Investigator Ron Boyden, Douglas County Sheriff's Office

²² The OSA's Statement of Position on "Credit Card Use and Policies" has additional information on this topic. A copy of the Statement of Position is enclosed.