

APPENDIX

**TO REPORT ON INVESTIGATION
OF
STO BANK ACCOUNT BALANCE**



APPENDIX TO REPORT ON INVESTIGATION OF STO BANK ACCOUNT BALANCE

The findings and observations presented in this Appendix elaborate on issues discussed within the body of our report issued in connection with our investigation of the STO bank account balance. These findings and observations are integral to the conclusions expressed in our report.

Accounting Controls / Office Hierarchy

The STO may be compared to a small to medium sized business. Currently, the STO handles in excess of \$137 million of receipts and disbursements annually on behalf of the County, City, SSD and non-resident tax authorities.¹ The STO issues tax bills to more than 96,000 property owners, records receipts and maintain accounts receivable. The office also receives payments from approximately 29,000 employers and / or merchants that are located in the City. The STO maintains records of employee withholding tax remitted by employers and processes EIT refunds based on tax returns filed by Scranton residents each year.

The responsibility for the operation of the STO and its accounting rests with the Tax Collector. Normal turnover in this elected position also means that employees often have more experience than the Tax Collector. Apart from changes in the administration of the office, the daily, weekly, monthly and annual tasks could be expected to change little and the continuity of operations relies to a large extent on the training and experience of the STO staff.

In addition to the system changes that took place during McDowell's tenure, key positions were vacated during this period by staff that had occupied them for many years. The loss of continuity in key positions may have contributed to some of the problems described here or elsewhere in this report. The following are also factors that contributed:

- Job descriptions and procedures are outdated or undocumented;
- Lines of authority within the STO are not well defined. The job descriptions for the Act 511 Administrator, Administrative Assistant to the Tax Collector and possibly the Chief Clerk position, appear to provide a layer of mid level management responsible for office operations;
- The Chief Clerk's position description identifies certain financial and / or reporting responsibilities in vague terms but does not provide for a role like that of a controller or chief financial officer;
- Certain responsibilities for financial oversight reside with the Chief Clerk and others with the Administrative Assistant to the Tax Collector;

¹ Amount is based on receipts and disbursements during 2005.



- Job qualifications / requirements for both the Chief Clerk position require only minimal accounting experience or training;
- There is no involvement in the oversight or reconciliation of earned income tax receipts and disbursements by the Act 511 Administrator;
- Individuals occupying staff positions are not cross trained and on-the-job training is limited; and
- Open positions may be filled without regard to qualifications.

The conversion to the Paragon accounting system took place in this setting. During our engagement, we interviewed both the current and former Chief Clerks. These interviews disclosed a lack of certain, basic control procedures. For example, bank accounts were reconciled only to manually prepared records of deposits and disbursements. The bank balances were not compared or reconciled to balances in the general ledger control accounts that captured transactions within the computerized system. Despite having an automated accounting system (Paragon), there is no evidence that the system was used to prepare financial reports other than trial balances that were used to prepare other reports “off-line”. For example, certain reporting and remittance functions are accomplished via subsidiary records / spreadsheets prepared by the Chief Clerk.

Interviews conducted with various staff members, including the current and former Chief Clerks, as well as the former independent auditors indicated that information was not shared freely between members of the STO staff, including individuals responsible for overseeing the accounting / financial operations. As a result, staff members had a limited understanding of office operations outside of their immediate area of responsibility. In some cases, there was a mistaken perception or assumption that certain procedures and controls were in place, or that others were performing tasks.

Limitations on communication between STO staff personnel were, in part, a function of security features designed into the 2005 accounting system. These security features were intended to enhance security over taxpayer information processed by the STO.

During the conduct of our investigation we received varying reports concerning the extent and nature of training, as well as parallel processing during the conversion period. STO staff personnel advised that there was no transition with parallel / dual processing, but rather an immediate conversion from what were known systems and procedures to the Paragon system during early 2005. These same staff personnel have advised there was only minimal consultation with staff or the outside accountants prior to and / or during this process. Former Tax Collector McDowell recalled STO management being involved in the process, as well as consultations with MLB Consultants and some involvement by the outside accountants. He also recalled a period of parallel processing at the end of 2004.



Within two years after the system conversion, the Chief Clerk and administrative assistant with the most knowledge of STO accounting procedures, retired from their positions. The current Chief Clerk advised that upon taking the job his general instructions from the Tax Collector were to “pay the bills, run trials and make distributions.” Prior to our interview, he had never seen a copy of his job description and by his own admission does not have any training as an accountant.

The current Chief Clerk manages the performance of the three designated tasks using instructions (“go-by’s”) provided to him, by mimicking or replicating work performed by the prior Chief Clerk, or with assistance from Paragon consultants.² Although he routinely runs trial balances, he was unable to produce a trial balance for a prior year-end in response to our initial request for one and contacted Paragon for assistance. Monthly closing procedures were not performed or followed for some period of time after conversion. Other evidence suggests that year-end closings were also not completed in every year.

The STO requires a professional accounting presence responsible for accounting, reporting and supervision of staff that assists with these functions. It seems likely that the presence of a trained accountant with sufficient authority to manage STO staff handling accounting and recordkeeping functions would have identified and corrected current deficiencies early in the conversion process. Standard control procedures such as reconciliation of accounts to third party or subsidiary records are needed.

During the conduct of this engagement we have informally communicated findings and recommendations to the current Tax Collector. Some procedural adjustments have been taking place in response to our findings. Others have been discussed for future implementation. Several members of the current staff serve as go-to resources for other staff and have shown a willingness to be involved in these procedural changes; however their training and overall knowledge of accounting procedures is limited.

As noted above, certain procedures have been updated and some system training has been provided by Paragon to STO staff at considerable expense. Certain procedures that were apparently abandoned previously have resumed and Paragon has been pressed to address system processing issues as they are identified.

² The current Chief Clerk did receive training and / or instruction in these functions from the former Chief Clerk.

Comparative Trial Balances

We requested and received accounting system generated trial balance reports for calendar years-ending 2005, 2006 and 2007 as part of our initial analysis and assessment of fluctuations in account balances. Selected information from our analysis of these trial balance reports is presented below.

In performing this analysis we identified apparent inaccuracies and deficiencies in the accounting reports generated from the Paragon system. This analysis highlighted deficiencies in STO accounting controls and procedures. Paragon representatives have also outlined problems with this process, including differences between the AR module (delinquency list) and the general ledger. Paragon attributes these differences to a failure by the STO to verify or balance the accounts, accepting and recording collections from prior years and making adjustments to prior periods.

Attachment 9 is a summary comparing the trial balances for each of the four funds described above at December 31, 2005, 2006, 2007 and 2008. The source documents used to prepare Attachment 9 are also enclosed (**Attachment 10**). We have seen trial balances prepared on various dates that reflect different balances for the same effective date (i.e. year-end date). Changes in account balances reflected on the trial balances are likely the result of processing work / adjustments to prior periods after the accounting period is otherwise closed.

When viewing the trial balances, it is important to understand that the balances shown on them are often cumulative in nature. For example, the \$193,112,683.57 shown on the 2008 trial balance as real estate distributions (AC# 02-00-29910) is the cumulative total for distributions during 2005, 2006, 2007 and 2008, not the amount distributed during 2008. Ordinarily, period activity is closed out to an account that represents net activity such as fund balance. The cumulative nature of the balances that are carried in the Paragon system is cumbersome and requires a comparison of the trial balances provided to us for successive periods to determine activity in a specific year.³

Our analysis of the comparative trial balances highlighted certain anomalies in the accounts. For example, the various due to / due from accounts within the funds are not in balance. This is illustrated for each fund in the table below:

³ Other reporting options may be available in the system but are not known by STO users.

	2005	2006	2007	2008
Fund 01 (Due to)	\$(2,199,692)	\$(3,367,191)	\$(5,986,652)	\$(5,569,882)
Fund 02, 03, 04 (Due From Fund 01)	\$ (357,611)	\$ 1,169,738	\$ 3,899,029	\$ 3,481,245
Out of Balance	\$(2,557,303)	\$(2,197,453)	\$(2,087,623)	\$(2,088,637)
Beginning Entries	\$ 2,197,453	\$ 2,197,453	\$ 2,197,453	\$ 2,197,453
Remaining Imbalances	\$ (359,850)	\$ 0	\$ 109,830	\$ 108,816

*The EIT / OPT Suspense Accounts in Fund 01 are not included.

As noted in the body of our report, our analysis indicates that the out-of-balance condition identified above arises from a failure to record corresponding receivables from "Fund 01" on the general ledgers of Funds 02 through 04 at the time of the 2005 system conversion. A simple balancing of these accounts on a monthly basis would have disclosed this problem immediately after the conversion took place.

Another observation from the trial balances is that while the Paragon system / trial balances captures collections for each type of tax by tax year, distributions have been aggregated. Coupled with the cumulative balances, this lack of consistency in the data and / or details captured by the accounting system makes an analysis of the disbursements at other than a gross level impossible, particularly in the case of the EIT.

STO Collection and Distribution Procedures

Taxpayers can make payments in person, by mail addressed to the STO or through a lockbox arrangement with Fidelity Bank. While there are obvious differences in the handling and deposit of cash, all of these receipts are processed in essentially the same manner.

Real estate tax bills are sent at the beginning of each year for the county, SD and City taxes and an account receivable is set up for the amounts due from each property owner. As collections are received, they are applied to taxpayer accounts reducing the outstanding accounts receivable. Receipts are applied against an identified amount due and any credits, discounts or penalties due are processed within the system and recorded to the appropriate accounts on the STO general ledger (i.e. collections, credits, discounts, etc.).

By contrast, receipts for business privilege, mercantile, OPT and EIT cannot be applied against a predetermined bill or amount due. The first step in the receipt process for these taxes involves the recording of cash receipts / deposits to an employer's account. These receipts are posted to a suspense account on the STO's general ledger through an entry generated by the Paragon system (i.e. an AR / CR entry). The suspense account is a temporary holding area for these receipts, which must be detailed from forms or other documentation provided by the merchant or employer. Due to the amount of detail that



must be verified and input, this process of detailing is performed by staff in the STO's back office. This detailing process, or "split form", results in receipts being cleared from suspense and recorded to the appropriate collection accounts via system generated entries (i.e. an AR / JE entry).

The detailing process for EIT involves two steps. The first step is splitting or segregating tax receipts into resident and non-resident categories based on the periodic returns filed by the employer moving the collection from suspense to the respective collection account. In the event that the employer does not provide a breakdown of the funds received as resident / non-resident, a decision concerning the allocation of funds must be made to process the "split form." Prior to 2008, a 60/40 allocation was used (resident / nonresident). For most of 2008, any amounts that cannot be identified from employer reports or prior entries were recorded as resident tax collections (100%).

The second step involves detailing the receipts in an employer account into employee records that reflect earnings and tax withholding for each individual taxpayer. To the extent that the tax has been correctly allocated to the resident / non-resident categories in step one, there are no changes to collection accounts on the general ledger. Should a receipt, detailed at the employer level be incorrectly recorded as resident / non-resident or in the wrong tax year, the detail process results in a system generated general ledger entry transferring the collections from one tax type, or year, to another (AR / JE). The second step also provides for the allocation of non-resident receipts to outside tax authorities using town codes that are part of the employee record.

For the past four years, the procedure for the distribution of taxes to the county, SD and City and has been based on the aggregate activity recorded on the STO's general ledger (see **Attachment 7** to our report). The cumulative activity in each tax collection account is captured from the trial balance at the end of each month. Collections are then compared to cumulative distributions for the same type tax, and the difference is disbursed during the subsequent month. If everything is recorded correctly, this process should result in monthly disbursements of the tax collected during the prior month. However; to the extent errors in recording receipts, disbursements or adjustments are not corrected or not adjusted on a timely basis, an over or under payment would result.

We also note that in connection with resident EIT, this process results in a distribution based on the first level of detail described above. In other words, receipts of EIT withholding have not been detailed at the employee level and as such, may be subject to change if it is later determined that the employee is a non-resident. While not normally thought of as such, the payment of current EIT collections on this basis is similar to estimated payments.

The procedure for distribution of the non-resident collections is driven by the town codes that are part of the employee / taxpayer records in the system. The general ledger / trial



balance reflect disbursements that are based on both estimates and payments or “transfers” generated by the Paragon system. This transfer uses amounts from detail records for employees to establish an account payable for payment to the tax authority based on the town code. Where estimated payments have been made, the amount payable is reduced to reflect the net amount due. The transfer process relies on the receipt and accuracy of information captured in the system from employer returns and employee W-2’s.

Liability for Non-Resident Wage Tax at the End of 2004

In addition to separate liabilities representing amounts due to the other funds arising from collections throughout 2005, 2006 and 2007, the trial balances for Fund 01 include a liability captioned “Due for NonRes Collections.” This \$4,084,411 liability represents cash that was on the books as non-resident collections at the end of 2004. Another account captioned “Capital Improvement Fund” reflects a liability of \$207,993. The work papers for the 2004 audit indicate that these two accounts comprise the non-resident cash balance of \$4,292,404 at the end of 2004 described in our report. At the time of conversion (February 2005), these amounts (\$4,084,411 and \$207,993) were recorded in the operating fund as a liabilities and the balances have not changed since the account was established.⁴

The number assigned to the account “Due for NonRes Collections” (01-00-20805) suggests that a fifth fund, representing non-resident collections may have been contemplated at some point. However; beginning in February 2005, receipts and disbursements for non-resident wage tax were recorded in accounts that are part of the “city trust fund” in the Paragon system (Fund 04). Neither a Fund 05 nor a corresponding “due from” account in Fund 04 was ever established in the Paragon accounting system until the beginning of 2009.

If the “Due for NonRes Collections” and “Capital Improvement Fund” liabilities are treated as due to Fund 04, the imbalance between the funds described above is significantly greater. As noted, our analysis indicates that the out-of-balance condition identified above arises from a failure to record corresponding receivables from “Fund 01” on the general ledgers of Funds 02 through 04 at the time of the 2005 system conversion.

⁴ Entries were recorded in the “Due for NonRes Collections” account during 2005, including a credit / amount due for January 2005 and distributions in August 2005, but were reversed later. John Kolcharno described these entries to us during an interview.

Non-Resident Collections After December 31, 2004

Income tax collections, including non-resident wage taxes, are recorded in accounts that reflect the tax year. Distributions are not likewise identified by tax year. **Attachment 8** shows that non-resident collections exceed disbursements by \$2,642,692 during years 2005 - 2008. The activity captured in the collection and disbursement accounts reported on the trial balances that are summarized in Attachment 8 has been accumulating since February 2005. The excess collections over disbursements reflected in these accounts (\$2,642,692), appears to be new amounts due for non-resident collections since January 2005. This is in addition to the \$4,292,404 balance that existed at December 31, 2004.

Although the book balance of the accounts representing the liability for prior years non-resident collections have not changed, the collection accounts represented on the trial balances and shown in the table above reflect receipts for tax years prior to 2005. The collections that occurred after the conversion to the Paragon system impacted the due from Fund 01 in Fund 04 and due to Fund 04 account in fund 01, but the liability (i.e. due to Fund 04) for prior years' non-resident tax remained unchanged.

Non-Resident Disbursements

Because the disbursements are aggregated on the STO's books, it is necessary to analyze detailed disbursement records in an effort to identify non-resident disbursements by tax year.

During 2005, the STO tried to change procedures for processing EIT receipts and distributions. McDowell wanted employers to submit detailed information concerning employee wages and locality on a quarterly basis and using the Paragon system disburse actual receipts as they were collected. In theory, this would permit the STO to process the detail and be in a position to pay actual amounts due to the non-resident tax authorities on a real-time basis. Historically, detail was provided at year-end and any payments made to non-resident tax authorities by the STO during the tax year were based on estimates. Payments to non-resident collectors are based on amounts reported as opposed to tax remitted by employers and in some cases estimates also exceeded the amount of tax reported for the year.

The employers submitting payments and quarterly reports during the tax year reportedly did not comply and it was not always possible to make payments that represented actual taxes due to the non-resident authorities. Confronted with continued requests from non-resident collectors for funds, McDowell continued the practice of sending estimated payments.



The general ledger / trial balance reflect disbursements that are based on both estimates and payments or “transfers” generated by the Paragon system. The transfers are the result of a system process that accumulates non-resident employee data under a town code that identifies the employee’s local tax authority or collector. Amounts from detail records for employees are used to establish an account payable for payment to the tax authority. Where estimated payments have been made, the amount payable is reduced to the lesser of the net amount due or zero through an edit process. The edit is a manual process that is necessary because the system does not provide a means to reduce the transfer by previous, estimated payments to the non-resident employee’s local collector. The net transfers recorded through this process plus any prior estimated payments should equal the amount of tax due.

Using copies of disbursement records supporting the system “transfers” and edit lists that can be matched to “transfer” entries that were established as vouchers in accounts payable and recorded in the general ledger, we analyzed disbursements by tax year.

We did not analyze all of the records supporting estimated payments, nor have we tested the adjustments or edits to vouchers that are based on the estimated payments. Based on these disbursement records, known obligations for non-resident tax collected by Scranton and due to outlying tax authorities have been, and continue to be, disbursed in connection with tax years 2004 and prior. To the extent that the cash accumulation in the non-resident tax accounts at the end of 2004 was the result of 2004 collections, although not accounted for properly or completely, known obligations for prior years’ tax appear to have been eliminated while the due to / from accounts capturing the 2005 – 2007 activity have been reduced by the same amount. Had the amount recorded as non-resident collections at the end of 2004 been included in the due to / due from accounting, the balance would have changed.

Analysis of Town Codes and Underlying Taxpayer Accounts

Comparison of the information available from the general ledger and other sources supports a conclusion concerning the accumulation of non-resident EIT receipts, but does not answer the question how the accumulation occurred or what claims may exist. We understand that non-resident funds collected from employees that reside in areas that do not have a local EIT are by definition City funds. The disbursement account does not appear to include any transfers or estimated payments to the City indicating that some portion of this amount is due to the City.

In an effort to identify claims, we have analyzed detail records in the Paragon system, representing individual tax payers. The process for capturing this detail includes identifying the individual first as a resident or non-resident. For non-residents, the individual’s home address used to identify his local taxing authority with the proper town code. For localities with no EIT, a town code of “888” is typically used although there are



some localities with town codes that also do not have a tax. All of the areas with no local EIT are generically referred to as "888." System data reflects \$2,446,700.77 of non-resident receipts during the past four years that identify with various town codes that have not been distributed. Most of these undistributed receipts identify with town codes "888" or "233", which is the code for Scranton. The remainder represents amounts due to or due from various tax authorities and others amounts that identify with erroneous codes that should be researched and corrected.

Related Issue - EIT / OPT Suspense

This account represents EIT and OPT amounts received from employers and deposited, but not yet detailed or allocated within the subsidiary records. The balance at December 31, 2008 should represent a temporary obligation to a fund or funds that were not identified and were part of work-in-process at the time the year was closed. The balance in the suspense account for EIT / OPT at December 31, 2008 was actually a debit (positive or asset balance) of \$120,093. A system generated report indicates that there are actually \$512,470 of receipts that remain in suspense within the system.

After analyzing activity in the suspense account, we requested assistance from Paragon. Based on several system inquiries, the Paragon consultant determined that there were entries that did not post correctly through the batch process that generates the AR / JE entries. That such entries could be omitted and or duplicated appears to indicate a problem within the system and underscores the need for periodic reconciliation.

Real Estate Duplicate Payments / Overpayments

At the time of the conversion, the STO recorded a beginning balance of \$474,406 in overpaid taxes from duplicate payments. This balance can be traced to the 2004 financial statement and according to the accountant's work papers, this amount relates to tax years 2000 – 2004. During the period from 2005 to the present, some refunds have been paid, but for the most part real estate overpayments continued to accumulate. The current balance in the overpayment accounts on the general ledger totals \$600,063. This balance reflects a reduction of \$249,419 in overpayments that were remitted to the counting in October 2007 for tax years 2002, 2003 and 2004 as a result of an audit by the county.

A report from the Paragon system indicates there are \$860,860 of overpayments in the system that have not been remitted to taxpayers. This suggests that overpayments identified by the audit and remitted to the county have not been recorded in the system. All of the overpayments represent a liability of the tax office to either taxpayers or the tax authorities that may receive claims in the future.



Distribution of Interest Earned on Deposit Balances

At the beginning of our engagement, we were advised that interest on the cash balances had been distributed for year 2005 and 2006, but interest earnings for years 2007 and 2008 had not been distributed and remained part of the cash accumulation. In connection with our analysis of cash receipt and posting activity, we also determined that interest earned was not always recorded, or recorded accurately. Our analyses indicate that \$1,257,426.43 of interest has accumulated in the accounts controlled by the STO. A portion of this interest has effectively been applied to eliminate the operating deficit incurred by the STO.

The methodology for distributing the interest earnings from 2005 and 2006 appears to be based on month end balances in the due to accounts, which omits the portion of the cash balance that relates to non-resident collections prior to January 2005 (see discussion of Liability for Non-Resident Wage Tax at the End of 2004 above). If the balance in "Due for NonRes Collections" (01-00-20805) was included in the City Fund 04, a significantly different allocation of the interest results. We recalculated the distribution of interest, including the portion for years 2007, 2008 and prior year amounts that have not been distributed as follows:

Interest	County Fund	School Fund	City Fund	Non-Resident Balance	Totals
Total Interest	\$390,385	\$328,297	\$899,667	\$695,276	\$2,313,625
Distributions	\$282,865	\$230,783	\$542,550	\$0.00	\$1,056,199
Undistributed	\$107,520	\$ 97,513	\$357,117	\$695,276	\$1,257,426
By Payee	\$107,520	\$ 97,513	\$1,052,393		\$1,257,426

These amounts do not include any reduction for amounts that have been applied to eliminate the operating deficits.

Real Estate Tax Accounting Entries / Closing Process

At the beginning of each year, the STO records an entry in each fund for real estate tax revenues billed / outstanding with a corresponding amount of accounts receivable.

Debit - Accounts Receivable	xxx,xxx	
Credit - Real Estate OS Billed		xxx,xxx

These beginning balances are reduced as collections are received throughout the year.



At the end of each year, the STO submits a delinquency list to its clients and stops accepting payments against the open accounts receivable for that tax year. The accounts receivable and collection accounts must be closed in order to accommodate the new billings for the coming year. While the accounts identified above are closed or zeroed out, any remaining balance or residual amount in the account is moved to a “prior year” account within the system rather than simply eliminating the balances.

These residual balances from prior years’ accounts receivable, OS Billed, credits and penalties reside in accounts on the books and accumulate from year to year. As noted above, these cumulative balances make the trial balance cumbersome and confusing at times. The real estate accounts in particular should be reconciled and closed out. To the extent that any net activity or difference remains, these amounts should be investigated. If necessary to close and balance, any remaining amounts should be recorded net in the accounts for prior year activity. The accounts reflecting cumulative prior year activity should be researched and closed in the same manner.

