

**Report on Investigation of  
Balances Accumulated in  
Bank Accounts Controlled by the  
Scranton Single Tax Office**

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## **BACKGROUND**

The Scranton Single Tax Office (STO) was established to serve as a single collection and distribution point for various taxes imposed by the City of Scranton, Pennsylvania (the City); the Scranton School District (the SSD); and Lackawanna County, Pennsylvania (the County).<sup>1</sup> The STO collects real estate taxes for all of its “clients” and so-called Act 511 taxes including earned income tax (EIT), occupational privilege taxes (OPT), and business privilege / mercantile taxes for the City and the SSD. Once taxes are collected, the STO processes and accounts for the collections and, based upon its accounting, distributes these taxes to its clients. The STO serves as a convenience for its “clients” and local taxpayers, allowing residents of Scranton to pay city, local or county taxes at one location.

The STO is supervised by the Tax Collector, an elected official. The Tax Collector oversees a 27 person staff and is charged with responsibility for the collection, processing, distribution and accounting functions discussed above. The operating costs of the STO office, including payroll for employees of the STO are shared by the County, the City and the SSD. Historically, the STO reported its operating results for each calendar year to its “clients” in an annual financial statement. This financial statement was audited by McGrail, Merkel, Quinn & Associates.

Marilyn Vitali-Flynn (Vitali-Flynn) currently serves as Tax Collector. Vitali-Flynn was appointed in February 2008 to complete the unexpired term of Kenneth McDowell who resigned in January 2008 to accept the position as Lackawanna County Controller.

After accepting the position of Tax Collector, Vitali-Flynn obtained information that caused her concern. More specifically, Vitali-Flynn learned:

- The STO had not prepared or issued a financial statement since 2005 when it released its 2004 statement;<sup>2</sup>
- The STO financial statements had not been audited since 2004;<sup>3</sup>
- In early 2005 the STO implemented a new computerized accounting system. This system is alternatively referred to as the MuniPal system or the Paragon system;
- The independent CPA firm had commenced 2005 audit procedures in early 2006 but had not been able to complete their audit due to deficiencies in the STO accounting procedures and apparent inaccuracies in the STO accounting records; and

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<sup>1</sup> Collectively, its “clients.”

<sup>2</sup> The McGrail Merkel Quinn & Associates report on the December 31, 2004 financial statements is dated September 13, 2005.

<sup>3</sup> Lackawanna County personnel performed a limited “audit” of real estate collections and distributions in 2007.



- The STO accounting records reflected a bank account balance in excess of \$12,000,000. This account balance exceeded expectations and the sources and nature of these accumulated funds could not be easily determined from the STO accounting records.

Published reports in media outlets of this accumulation of cash in accounts controlled by the STO led to an investigation by the FBI, scrutiny of the STO office in the local press and demands by local government officials for an “audit.”

### **SCOPE OF ENGAGEMENT AND INITIAL INQUIRIES**

In July 2008, Nihill & Riedley, PC was engaged by the Tax Collector with the approval of its “clients” to investigate the concerns outlined above. This investigation included inquiries of current and former STO personnel and analyses of relevant accounting / financial records. These procedures are detailed later in this report.

At the outset of our investigation, we were provided with a General Ledger Trial Balance report dated as of December 31, 2007. This “trial balance” report had been generated from the “Paragon” computerized accounting system. The “trial balance” report is a summary report that shows balances in individual accounts as of the report date. The most notable entries on this report were the aggregate balances in bank accounts which were reported to total \$12,874,377.

We were also made aware of an ongoing “unclaimed property audit” that had been initiated by the Pennsylvania Department of the Treasury. STO personnel and representatives advised that the Treasury Department auditors had raised concerns about the adequacy of STO’s internal accounting controls and the resulting impact of these perceived deficiencies on the accuracy of system generated accounting reports. STO personnel further understood that the Treasury auditors had focused some attention on a \$4 million balance in an account that was intended to reflect EIT collected from persons working within Scranton but residing in other locales (i.e. non-resident EIT). The Treasury auditors had noted that the balance in this non-resident EIT account had remained unchanged since early 2005, raising concerns that this amount was due to outside taxing authorities. The Treasury auditors also questioned other items such as uncashed checks and real estate tax overpayments.

Using the information outlined above, we proceeded to develop a limited understanding of STO accounting procedures and made requests for selected reports from the STO accounting system. We also requested and were granted an opportunity to meet with the Treasury auditors assigned to the “unclaimed property audit” to develop a more complete understanding of observations they had made in the course of their audit.



Our initial inquires and analyses determined:

- Prior to 2005, the STO relied heavily on manual accounting records to record collections and distributions of taxes, including EIT. The STO also maintained individual bank accounts for each type of tax (approximately 17 accounts in total).
- In 2005, the STO changed its accounting procedures and implemented a computerized accounting system. At this time, the STO consolidated all existing bank accounts into a single master account.
- STO personnel charged with responsibility for supervising and maintaining the computerized accounting system were incapable of generating reports from the computerized accounting system that detailed the transactions summarized in the aforementioned December 31, 2007 “trial balance” or even generate a duplicate December 31, 2007 trial balance from the system. Our initial requests for information and reports were being re-directed to the software vendor (Paragon) for action.
- The Pennsylvania Treasury Department auditors advised that they too had encountered difficulties in obtaining reports and transaction data from the computerized accounting system. Ultimately, the Treasury auditors had been placed in direct contact with Paragon. Paragon personnel extracted transaction data from the accounting system and forwarded to the Treasury auditors in an electronic format. The Treasury auditors shared this electronic data with us.
- The Treasury auditors confirmed that their inquiries and analyses had identified approximately \$4 million of the \$12 million residing in STO maintained bank accounts as non-resident EIT collections from the pre-2005 period. This observation was based upon findings that the general ledger account balance for collected but undistributed non-resident EIT had not changed since it was established as part of the 2005 implementation of the computerized accounting system.
- The STO “adjusted” bank account balance at December 31, 2007 did not agree with the balance shown on the “trial balance” report. The “adjusted” bank account balance was less than the balance reflected in the December 31, 2007 “trial balance” report. Our initial inquiries also indicated that STO



personnel had never attempted to reconcile the bank account activity to the cash balance reflected in the computerized accounting system.<sup>4</sup>

Confronted with this information, our investigation required:

- An understanding of STO operations for periods pre-dating the accounting system conversion through the present;
- An understanding of financial recordkeeping practices prior to the 2005 accounting system conversion;
- An understanding of the accounting system conversion that occurred in early 2005, including the sources / basis of opening account balances; and
- An understanding of current STO procedures for the collection, processing, recording and distribution of taxes.

The body of this report presents information we deem directly relevant to our analysis of increases in the balance in a bank account currently maintained by the STO and the nature and sources of funds held within that account. Other information relating to STO accounting procedures and detailed account analyses pertinent to our identification of sources of funds held in the STO account is presented in an *Appendix* to this report. The information presented in this *Appendix* is integral to the findings, observations and conclusions presented in the body of the report.

We are aware that this investigation has, at times, been referred to as an “audit.” The term “audit” has a specific definition within the accounting profession. As used in this report, quotation marks are used to differentiate procedures performed as part of this engagement from procedures performed in the context of a financial statement audit.

The procedures and analyses performed in connection with this engagement do not constitute an audit, review or attestation engagement as described in authoritative literature promulgated by the American Institute of Certified Public Accountants (AICPA).

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<sup>4</sup> At this writing, we have determined that no effort had been made to reconcile balances shown in the bank account with cash account balances since the implementation of the computerized accounting system in early 2005. The STO’s so-called reconciliation process was more accurately a calculation of an “adjusted” bank account balance at a month-end date. We will use this “adjusted” term throughout the report.



Furthermore, procedures performed during the course of this engagement were neither designed nor intended to detect fraud or other intentional misconduct motivated by individual interests for financial gain. Accordingly, we make no representations or assertions regarding the existence or absence of any fraudulent conduct.

As noted above, the STO acquired and implemented a new computerized accounting system in 2005. Our inquiries and analyses identified inaccuracies and deficiencies in system generated reports. Auditors from the Pennsylvania Treasury Department also questioned the accuracy of reports and other information generated by this system. Moreover, the STO financial statement auditors voiced similar concerns. While cognizant of these inaccuracies and deficiencies, we have, at times, used observations made from system generated reports in reaching conclusions expressed herein. We do not attest to or otherwise provide any assurance as to the accuracy of these system generated reports.

#### **EXECUTIVE SUMMARY**

- The STO serves as a conduit for real estate taxes, earned income taxes and other taxes collected on behalf of Lackawanna County (the County), the City of Scranton (the City) and the Scranton School District (SSD). Other than a small amount of operating cash, the STO has no funds of its own. By its purpose and design, the STO is not intended to serve as a long-term repository for taxes collected on behalf of its clients.
- Year-end cash balances (i.e. adjusted bank account balances) in the accounts controlled by the STO increased steadily from \$3,056,211 at the end of 1999 to \$11,854,056 at the end of 2007 and \$12,312,775 at the end of 2008.<sup>5</sup>
- The adjusted bank account balance at any time includes a component of current work-in-process (WIP). Our investigation disclosed that a material portion of the increasing adjusted bank balances were attributable to increases in the volume of collections (i.e. amounts) processed by the STO. A smaller, but still material, portion of the December 31, 2007 and December 31, 2008 adjusted bank account balances represented the accumulation of funds that commenced prior to 1998.
- This accumulation of funds arose from a failure to properly account for and remit various types of tax collections on a timely basis. Our investigation determined that these accumulated funds included overpayments of real estate taxes and non-resident EIT receipts beginning no later than 1998 and continuing through the present.

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<sup>5</sup> After a decline during 1999, cash balances increased in every year from 2000 through 2008.

- STO accounting records show a balance of non-resident receipts in excess of disbursements in the amount of \$4,292,404 at December 31, 2004. As presented, this is a liability that represents non-resident EIT collections that were not disbursed during the periods prior to 2005 (i.e. 2004 and prior). STO accounting records indicate this balance remained constant during the period from 2005 – 2008 suggesting no distributions were made from these amounts after 2004. Our analyses determined that this presentation was inaccurate and that distributions were made from these amounts during 2005 and later periods.
- Our ability to precisely determine the source(s) of this accumulation was hampered by changes in accounting processes and procedures in 2005. The STO underwent an accounting system conversion in early 2005, as well as other procedural changes.
- Our investigation disclosed errors / inaccuracies during the implementation of the new STO accounting system in 2005. The implementation of the new accounting system and its subsequent operation have been impaired by inadequate supervision and a lack of personnel training.
- The independent auditor for the STO initiated but did not complete its audit of the STO's 2005 financial statements. The STO has not issued an audited financial statement since September 2005 when the 2004 report was issued.
- In 2007 the Lackawanna County Office of the Controller performed an "audit" of 2004, 2005 and 2006 real estate collections and distributions. As a result of this "audit", the STO remitted \$249,419 to the County. This payment represented overpayments of real estate taxes collected by the STO during 2002, 2003 and 2004.
- Our investigation disclosed that STO personnel did not routinely reconcile cash transaction entries in the STO accounting records with amounts shown on statements provided by banks. This failure contributed to variances between these records. For example, the cash account balances recorded on the STO accounting records were overstated by approximately \$1,020,321 at December 31, 2007 when compared to the adjusted bank account balance.
- The STO trial balance reports indicate non-resident EIT collections during 2005, 2006 and 2007 exceeded distributions contributing to an additional accumulation of funds. This trend was reversed during 2008 when distributions exceeded collections.



- Based on the data in the Paragon system, approximately \$2.4 million of non-resident EIT collections during 2005 – 2007 have been coded to town code “888” or other town codes for areas with no EIT tax. This amount has not been disbursed.
- While portions of the increases in the year-end cash balances from 1999 through 2008 are attributable to increases in collections and associated work-in-process balances, a material portion of these increases are attributable to a failure by prior tax collectors and / or STO staff to:
  - monitor cash balances and reconcile cash accounts;
  - to prepare or maintain subsidiary records, reports and / or analyses that reflect collections and distributions of non-resident tax; and
  - reconcile subsidiary records / system data to general ledger accounts.
- While the specific sources of collections in excess of disbursements that accumulated prior to 2005 are unknown at this writing, our investigation indicates undistributed non-resident EIT collections constitute the largest single source of this accumulation. Furthermore, these pre-2005 accumulations result from the same or similar procedural failures that occurred during the period 2005 – 2007.

### **PROCEDURES PERFORMED**

In connection with our engagement, we have performed procedures including but not limited to the following:

- Met with Vitali-Flynn and John McGovern, Esquire, solicitor to the Tax Collector;
- Met with auditors from Commonwealth of Pennsylvania, Treasury Department;
- Met with Kenneth McDowell (McDowell), the Tax Collector from 2002 until January 2008;
- Met with the representatives of McGrail, Merkel, Quinn & Associates, the independent CPA firm engaged to audit the STO financial statements for calendar years prior to 2005;
- Inspected STO financial reports and audit working papers provided by McGrail, Merkel, Quinn & Associates;

