

**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).¹ 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;²
- The STO financial statements had not been audited since 2004;³
- 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

¹ Collectively, its “clients.”

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

³ 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.⁴

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).

⁴ 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 2008.⁵
- 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.

⁵ 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;



- Met with Jack Marx, CPA, of Marx Accounting & Forensic Services, the independent CPA engaged to audit the STO financial statements for the 2005 calendar year;
- Interviewed the following STO personnel:
Maria Costanzo, Auditor;
John Kolcharno, Retired Chief Clerk;
Henry Biglin, Cashier; and
Charles Coxe, Chief Clerk;
- Developed an understanding of existing STO procedures for the receipt, deposit and recording of all taxes received from taxpayers;
- Developed an understanding of the processes for posting and detailing of resident and non-resident EIT receipts;
- Prepared a bulk proof / testing of cash receipts / postings to general ledger records and reconciliation to bank statement activity;
- Analyzed accounting system generated trial balances for years ended December 31, 2005, 2006, 2007 and 2008;
- Analyzed disbursement records and activity in general ledger accounts where disbursements of non-resident wage tax are recorded;
- Inspected and analyzed data extracted from the Paragon system; and
- Interacted with Paragon representatives throughout our investigation to develop an understanding of system processing and data table structures. This interaction included requests for relevant transaction data and accounting system reports.

FINDINGS

STO Operations

The STO serves as a single collection and distribution point for various taxes imposed by its "clients." These taxes include 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 receives payments for current taxes and distributes receipts to the taxing authorities. As such, the STO performs a largely ministerial function, providing receipt, deposit, disbursement and accounting services to various taxing authorities. The STO has no authority to levy taxes or to collect delinquent taxes (real estate) and as an entity has essentially no balance sheet (i.e. assets or liabilities).

The STO serves as a conduit, collecting taxes from various sources and remitting those collections to the appropriate authority. Conceptually, with the limited exception of funds received and held for its operating purposes, the STO should not maintain balances in bank accounts. Funds collected and processed by the STO are held in "trust" and belong to its clients or, in the case of non-resident earned income taxes, another taxing jurisdiction. This reality is reflected in the STO accounting process and titles assigned to individual accounts. Taxes collected by the STO are reflected as liabilities to a third party.

While the conceptual model may not envision the existence of bank account balances, reality dictates that the STO will always have a work-in-process (WIP) balance. This WIP balance represents collected taxes that have not yet been distributed to the appropriate taxing authority.

During calendar year 2004 the STO received more than \$118.5 million from all sources and paid out more than \$117.8 million. Taxes collected constituted \$117,725,891 of the total receipts. Remittances to its clients constituted \$116,537,362 of the total disbursements during the same period. The following table presents selected information extracted from STO's 2004 financial statement (**Attachment 1**).

	Real Estate Tax	Earned Income Tax	Occupational Privilege Tax	Business Privilege / Mercantile Tax	Total
Tax Collections	\$76,209,836	\$35,561,743	\$516,660	\$5,437,652	\$117,725,891
Tax Remittances	\$76,018,978	\$34,634,639	\$521,045	\$5,362,700	\$116,537,362

As discussed later in this report, the balance in the STO bank accounts at December 31, 2004 was approximately \$7.1 million. This balance increased to approximately \$12.3 million at December 31, 2008.

Data extracted from the STO computerized accounting system indicates tax collections have increased since 2004 from approximately \$118 million to approximately \$140 million in 2008.



STO operating expenses are funded by the County, School District and the City. Personnel costs (i.e. wages for staff) are paid directly by the clients. Other operating expenses of the office (e.g. outside services and other costs) are paid by the STO from funding provided by its clients. Historically, this funding has been received via a check paid to the STO by a client or by the allocation of amounts from collected taxes to the STO operating account.⁶

Attachment 2 shows the historic funding and costs incurred for the operation of the STO that were actually paid from the STO operating account. As noted, personnel costs (i.e. staff wages) are not paid from the STO operating account.⁷ Our analysis indicates that the STO's operating costs have, at times, exceeded its direct funding from its clients. We are advised that a material portion of the STO's annual operating expenses since 2004 are attributable to accounting / computer system conversion and continuing support provided by Paragon.

Independent Audits

Historically, the STO has been subjected to annual financial statement audits by an independent accounting firm, as well as periodic audits by auditors from local and state government. The annual financial statement audits were conducted by the firm of McGrail, Merkel, Quinn & Associates (McGrail). McGrail completed its audit of STO's December 31, 2004 financial statements. Its report on this audit, dated September 13, 2005, presented the following information (Attachment 1):

- The STO maintained its accounting records on the cash basis of accounting. The STO financial statements did not recognize receivables, payables or certain other accounts that would be recognized under generally accepted accounting principles.
- The STO maintained separate "self-balancing" accounts for each type of tax collected (i.e. real estate, EIT, etc.).
- Cash balances in bank accounts totaled \$7,119,503 and \$6,196,467 at December 31, 2004 and December 31, 2003, respectively.

⁶ See discussion of 2005 accounting conversion. After 2004, the STO operating account was not a separate bank account.

⁷ The operating account is also used to capture interest on deposit balances. The presentation on Attachment 2 excludes interest from the operating statement.

As part of its audit, McGrail also performed certain tests to assess compliance with applicable laws and regulations. McGrail issued a separate report on STO's compliance and internal control over financial reporting. In this report McGrail recommended:

- The STO maintain a "complete, self-balancing general ledger";
- The STO maintain and record all invoices into "an accounts payable software accounting package";
- The STO implement certain security procedures to restrict access to taxpayer information; and
- The STO maintain its accounting records on the accrual basis of accounting.

The STO responded to McGrail's recommendation for changes / improvements to its accounting system by advising that the recommendations had "been implemented with the new accounting software system that was installed earlier this year."

In 2006, Jack Marx, CPA returned to the STO to commence the audit for 2005.⁸ He was assisted on the 2005 audit by another CPA whom he shares with the McGrail firm. Marx advised they did not complete the 2005 audit or issue a report. Marx explained that barriers to completion included:

- Unresolved questions about the sources and components of certain account balances arising from the aforementioned accounting system conversion;
- Deficiencies in the training of STO personnel and Paragon's involvement in the accounting process; and
- The inability of STO or Paragon personnel to resolve questions about the new accounting system and conversion process.

The auditors were continuing their efforts to complete the 2005 audit as recently as the Fall of 2007. They provided copies of working papers showing receipts and disbursements for 2005. These working papers also highlighted concerns about deficiencies / inaccuracies within the accounting records and specific accounts (**Attachment 3**).

⁸ After the 2004 audit, Jack Marx, CPA, the partner on the STO audit, left the McGrail firm. It was agreed that his new firm would retain the STO engagement.

McDowell (the former Tax Collector) was aware in 2006 that the accountants were unable to complete its audit of the 2005 STO financial statements. McDowell understood that the auditors were unable to resolve an issue with the 2005 opening balances that had been input during the accounting conversion. McDowell further understood that the accountants were continuing efforts to resolve these 2005 issues at the end of 2007.

Accounting System Conversion / Implementation

In early 2005, the STO acquired and implemented a new computerized accounting package called MunicPal. MunicPal integrated the general ledger accounting with accounts receivable and other system modules used to record tax billings, receipts and collection activity. MunicPal was purchased from an entity named ACI and is currently supported by Paragon Consulting Services, Inc. (Paragon).⁹ This system is often referred to as the “Paragon system.”

McDowell anticipated that the new accounting system would facilitate the correction of accounting system deficiencies identified by the independent auditors, simplify existing accounting procedures and allow for the accelerated processing and distribution of funds to the clients and other taxing jurisdictions.

Disruption of normal activity and changes in past practices are inherent aspects of a system conversion or change in processing. These system conversions require careful planning, close monitoring and, at times, immediate modifications / adjustments to address issues that arise during the conversion. By various accounts, the transition to this new system was not closely monitored. Experienced staff began having difficulty performing what had previously been routine accounting procedures.

Pre-2005 Procedures

Prior to 2005, the STO maintained certain tax collection records on a mainframe computer system that was designed and maintained by Lackawanna County. The STO supplemented these computerized records with various manual recordkeeping systems in which it recorded collection and disbursement activity. Day-to-day responsibility for this recordkeeping and related accounting function rested with the chief clerk. The chief clerk reports to the Tax Collector. The chief clerk relied on support from other STO personnel, many of whom, possessed years of experience with these systems under various tax collectors.

⁹ ACI was acquired by Paragon in 2004.

The STO maintained accounting records for each type of tax or functional area. For example, the STO maintained separate manual records for STO operations, county real estate, city and school real estate, wage tax and non-resident wage tax funds. The STO also maintained separate bank accounts for each of these taxes or functional areas.¹⁰ Balances in the underlying bank accounts described above could be compared directly to the records / general ledger accounts for each type of tax.

Post Conversion Procedures

With the transition to the Paragon system, the various deposit / bank accounts were closed and consolidated into one “master” account at Fidelity Deposit and Discount Bank (Fidelity). The underlying accounting records were organized into four funds, as follows:

- 01 Operating Fund
- 02 County Fund
- 03 School Fund
- 04 City Fund

The distinctions based on the types of tax under the old system gave way to four sets of general ledger accounts that identified more closely with the ownership of the tax collections. The consolidation of cash balances due to various taxing authorities into a single bank account that also included the STO’s operating funds made the need for accuracy and reconciliation of the accounts / funds within this system important.

With the implementation of the Paragon system and consolidation of banking activity, transactions between the various funds needed to be balanced on a continual basis. For example, a collection of \$1,000 recorded in the County Fund 02 involves the following entries to record the receipt:

Fund Name and #	Account Description	Debit	Credit
Operating Fund #01	Cash	\$1,000	
Operating Fund #01	Due to Fund #02		\$1,000
County Fund #02	Due From Fund #01	\$1,000	
County Fund #02	Tax Collections		\$1,000

In addition to reconciling the total cash balance (Fund 01) to the bank account at the end of each month, the due to / due from accounts in Fund 01 and Funds 02, 03 and 04 must also be reconciled. By contrast, under the old system a single entry was required to record the receipt and as noted above, cash balances for each type of tax could be reconciled directly with the corresponding bank statement.

¹⁰ Approximately 17 separate bank accounts were maintained.

Based upon our inquiries and analyses, we understand that the development of a chart of accounts and general ledger account structure for the Paragon accounting system was a collaborative effort on the part of STO personnel, Paragon personnel, the independent accounting firm and MLB, an outside consulting firm retained by the STO. Opening account balances to the Paragon system were based on from December 31, 2004 year-end account balances shown in the STO financial statements.

We have inspected journal entries that establish these opening account balances in the Paragon general ledger. Our inspection of these journal entries coupled with other analyses has identified inaccuracies / deficiencies in the establishment of these opening account balances.

For example, we determined that the balance in the non-resident EIT account at December 31, 2004 (approximately \$4 million), originally questioned by the Pennsylvania Treasury Department auditors, was not linked to post-2004 EIT collections and distributions. This failure gave the appearance that this \$4 million was an accumulation of prior year taxes against which there were no distributions. Our inspection revealed that the STO made distributions of 2004 EIT collections during 2005 and later periods, some of which should have been applied to reduce this opening \$4 million account balance.¹¹

The non-resident EIT issue discussed above is associated with a larger failure to establish opening balances in the “due to / due from” accounts for each of the four funds established in the accounting system conversion. To elaborate, account balances entered into Fund #01 required corresponding and offsetting entries in the other funds. Our analysis indicates that a “due to” was established in Fund #01 but no corresponding “due from” was established in Funds #02, #03 or #04 as required.

We also determined that certain reports generated from the accounting system were, at times, cumbersome and confusing. Notably, the system generated trial balance reports reflect cumulative data (i.e. all activity from the inception of the system). These reports require manual adjustments before becoming useful.

Increases in and Composition of Cash Balances

As stated, we were engaged to analyze and identify the source(s) of an apparent accumulation of funds in bank accounts maintained by the STO. According to an accounting system generated “trial balance” report, the balances in STO controlled accounts totaled \$12,874,377 at December 31, 2007. This balance represented opening account balances that had been entered into the Paragon system plus the net result of all

¹¹ Additional information relating to this analysis appears later in this report.

receipts and disbursements processed through the accounting system from December 2004 through December 31, 2007.

Our analysis of this account balance began with a comparison to the bank account balance. In doing so we learned that the reconciliation procedures in place at the STO are more accurately characterized as procedures to calculate an adjusted bank account balance. These procedures consisted of comparing the bank statement balances to manual ledgers maintained by the Administrative Assistant to the Tax Collector. The manual ledgers are a hybrid record that consists of deposits recorded from deposit slips and summary entries for checks based on reports from the computerized system. At the end of each month, a report is prepared from the Paragon system that lists outstanding checks. Deposits in transit could be determined from the manual ledger. The STO reconciliation process did not attempt to compare or reconcile the cash balances reported on the bank statements to corresponding account balances in the Paragon system.¹²

Our analysis of STO's bank account information indicates that the adjusted bank balance was \$11,854,056.15 at December 31, 2007. As noted, this adjusted bank balance did not agree with the bank account balance reported on STO's accounting system. A similar analysis as of December 31, 2008 also identified variances between the adjusted bank balances and balances reported on the STO accounting records. Our analysis indicates that the adjusted bank balance at December 31, 2008 is \$12,312,775.60. Our investigation identified errors, transit and unrecorded items such as interest, that, when considered, reduce these variances to \$14,651 as of December 31, 2008.

Comparison of this adjusted bank account balance at December 31, 2008 to the combined bank account balances at December 31, 2004 indicates that the balances in accounts maintained by the STO increased by approximately \$5.2 million in this four year period.

Increases in year-end balances in STO accounts were not unique to the 2005 through 2007 period. The following table presents information compiled from historic STO audited financial statements, McGrail working papers and bank account analyses performed as part of our engagement. As shown, year-end balances in accounts maintained by the STO increased from 1998 through 2007.

¹² This failure to reconcile bank account activity to corresponding entries in the general ledger was acknowledged by John Kolcharno, the former chief clerk.

Year	Cash Balance	Increase over Prior Year
1998	\$ 3,228,072	N/A
1999	\$ 3,056,211	\$ (171,861)
2000	\$ 4,378,043	\$1,321,832
2001	\$ 4,390,754	\$ 12,711
2002	\$ 4,822,754	\$ 432,000
2003	\$ 6,196,467	\$1,373,713
2004	\$ 7,119,503	\$ 923,036
2005	\$ 7,967,197	\$ 847,694
2006*	\$ 8,786,788	\$ 819,591
2007*	\$11,854,056	\$3,067,268
2008*	\$ 12,312,775	\$ 458,719

**2006, 2007 and 2008 balances are based on N&R analyses.*

The audited financial statements for 1999 through 2004 also reflect cash balances by type of tax. For example, as of December 31, 2004, cash balances were grouped and reported by type of tax as follows (see Attachment 1):

Type of Tax	Account Balances @ 12/31/03	Account Balances @ 12/31/04
Real estate	\$2,097,344	\$2,418,601
Earned Income	3,839,969	4,380,384
Occupational privilege	10,216	4,710
Business Privilege / Mercantile	4,899	153,759
Operating	244,039	162,049
Total	\$6,196,467	\$7,119,503

Attachment 4 shows cash balances in bank accounts maintained by the STO by type of tax for each year-end from December 31, 1998 through December 31, 2004. Attachment 4 was compiled from information presented in the audited financial statements for the respective year-ends. We made the following observations from our inspection and analysis of information presented on Attachment 4.

- Balances in accounts maintained by the STO increased from \$3.2 million at December 31, 1998 to \$7.1 million at December 31, 2004;

- Approximately \$3 million of this increase occurred in the accounts maintained for EIT which increased from \$1.4 million to \$4.4 million during this period. An additional \$700,000 increase occurred in the real estate accounts; and
- Increases in year-end account balances coincide with increases in tax collections.

The corresponding increases in taxes collected and year-end balances could be interpreted as increases in WIP¹³ that will be addressed in the subsequent calendar period. Closer scrutiny of STO's historic financial statements indicates some of these increases arise from delays in processing and distribution of tax collections.

For example, the audited financial statements show that the STO received \$998,937 in real estate tax overpayments during 2001, 2002, 2003 and 2004. During this same period, the STO only refunded \$661,063, a difference of \$337,874. Further inspection and analysis indicates \$220,302 of this excess collection was received prior to 2004. If, for purposes of this discussion, we assume that one year is a reasonable period for the reimbursement of these overpaid taxes, then this simple analysis suggests that \$220,302 is not current period WIP and constitutes an accumulation from prior periods.¹⁴

A similar analysis of activity in the EIT accounts yields a similar result suggesting that \$2.4 million of the \$4.4 million in the EIT account at December 31, 2004 was not current period WIP and constituted a prior period accumulation.

Our inspection of the pre-2005 financial statement information merely illustrates that the bank account balance at any year-end is comprised of multiple components. Current period WIP is one component. The year-end bank account balance at December 31, 2004 also included EIT collected prior to 2004 that had not been distributed to the appropriate taxing authority or, in the case of real estate overpayments, not returned to the taxpayer.¹⁵

Non-Resident EIT

To this point, much of our discussion has focused on total EIT collections, distributions and account balances. For example, the \$4.4 million balance in the EIT account at December 31, 2004 was comprised of undistributed EIT collections from both Scranton residents and non-residents (i.e. persons working within Scranton but residing outside of

¹³ As noted above, while theory dictates that the STO would not maintain cash balances in bank accounts, reality dictates that, at any point in time, the STO will have some amount of cash in bank accounts attributable to WIP.

¹⁴ Our investigation determined that during 2007 the Tax Collector remitted approximately \$249k to Lackawanna County. This amount represented unreimbursed real estate tax overpayments.

¹⁵ While not discussed in detail above, the bank account balance at any point in time may include undistributed taxes of any type collected by the STO.



Scranton). As detailed elsewhere in this report, our investigation indicates that undistributed EIT collections from non-residents comprise a material component of the balances STO maintained bank accounts from a time prior to 2004 and continuing to the present period.

Our discussion of this non-resident EIT begins with an analysis of the EIT account balance at December 31, 2004. As noted, the STO financial statements presented information for amounts in the EIT accounts but did not separately identify an amount representing the non-resident portion of this balance.

Using the working papers prepared in connection with the 2004 financial statement audit as a starting point, we “rolled” the EIT account cash balance relating to the non-resident portion back to 1999 (**Attachment 5**). Based upon our analysis of these documents, the non-resident cash balance was \$1,569,432 at the end of 1999 and grew steadily to \$4,292,404 at the end of 2004.

Undistributed non-resident EIT continues to be a consideration when assessing the components of the balance in the STO maintained bank account at December 31, 2008. Additional analysis of the non-resident EIT issue is presented in the *Appendix* to this report.

STO Collection and Distribution Procedures

Any further discussion of balances in accounts, whether the multiple bank accounts that existed prior to 2005, or the electronic accounts established in the post-2004 computerized accounting system, requires an understanding of the process whereby STO receives, processes, distributes and records taxes remitted from taxpayers.

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 a similar manner.

Attachment 6 is a flowchart illustrating our understanding of the STO collection process as modified in 2005 to accommodate the new accounting system. The modifications necessitated by the system change did not materially alter the flow of funds and information within the STO.

Real Estate Tax Collections

At the beginning of each calendar year, the Tax Collector receives a “tax duplicate” from its clients. This tax duplicate provides the basis for real estate tax bills that are sent to property owners and accounts receivable amounts that are entered into the Paragon system for 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.).

EIT and Other Tax Collections

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. 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 results in receipts being cleared from suspense and recorded to the appropriate collection accounts.

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. Detailed collections are then transferred from the suspense account to the respective collection account (i.e. resident or non-resident) through this process. If an employer does not provide a breakdown of the funds remitted to the STO as resident / non-resident, the STO will currently allocate these collections to resident collections.¹⁶

The second step involves detailing the receipts that have been transferred to 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 an adjusting entry transferring the collections from one tax type (or collection period / year) to another. 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.

¹⁶ Prior to 2008, unidentified employer collections were divided between resident and nonresident EIT using a 60% / 40% allocation formula, respectively.

Distribution Procedures

For the past four years, the procedure for the distribution of real estate taxes and resident EIT to the County, SD and City has been based on the aggregate collection activity recorded on the STO's general ledger accounting system. The current chief clerk transfers information from a trial balance report to an EXCEL spreadsheet, which he uses to compute the amount of each distribution to the County, SD and City (Attachment 7).

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 periodic disbursements of the taxes collected and posted as of the respective general ledger date. Any errors in recording receipts, disbursements or adjustments could result in an over or under payment in a given period.

Procedures for distribution of the non-resident collections differ from procedures used to distribute all other taxes. The nonresident distributions are based on town codes¹⁷ that are part of the employee / taxpayer records in the system. The general ledger / trial balance reflects disbursements that are based on both estimates and payments or "transfers" generated by the Paragon system. These transfers accumulate amounts from detail records for employees to establish an amount payable to the appropriate taxing authority. 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.

Estimated distributions of non-resident EIT collections are typically made in periodic installments. This estimated process is supplemented by a reconciliation process that occurs after the collections are detailed. STO personnel generate a "transfer" report that lists all collections detailed to a "town code." The amount on the report is compared to the estimated payments and any additional payment is made at that time.

The "town code" system outlined above includes an "888" code. This "888" town code is used to identify non-resident EIT collections for individuals residing in municipalities that do not levy an EIT. We were advised that STO personnel responsible for detailing the non-resident EIT collections assign a "town code" to non-resident EIT collections as part of the detailing process.

¹⁷ A more detailed discussion of town codes is presented in the *Appendix* to this report.

Distribution procedures for “888” collections differed from procedures for other non-resident EIT collections. There was no formal reconciliation process for identifying and remitting “888” collections to the City of Scranton. We have been advised that prior to 2005, the STO would periodically distribute “888” collections to the City of Scranton on an estimated basis. All “888” distributions to the City of Scranton ceased in 2005. The aforementioned EXCEL spreadsheet used by the chief clerk does not include provisions for the distribution of “888” collections.

As stated, our investigation disclosed variances between procedures for the detailing and distribution of EIT collections to the City of Scranton and procedures for non-resident EIT. The distribution process described above occurs after the first level of detailing has occurred such that resident EIT distributions to Scranton are not based on detailed employee records such as W-2 reporting by the employer. This included EIT collections that were allocated on the 60% / 40%, or, in 2008, on the 100% resident basis. Non-resident distributions are based upon the level 2 detailing process.

Non-Resident EIT Collections and Distributions After December 31, 2004

STO accounting records indicate that total non-resident EIT collections exceeded distributions by \$2,642,692 from January 2005 to December 31, 2008 (**Attachment 8**). Arguably, this increase is in addition to the \$4,292,404 balance that existed at December 31, 2004.

As noted, our investigation revealed that while the balance in the accounts representing the liability for pre-2005 non-resident collections has not changed, the actual liability for these pre-2005 obligations has decreased. A portion of the December 31, 2004 balance represented WIP (i.e. 2004) non-resident EIT collections that were distributed in 2005. The failure to properly “map” general ledger accounts at the time of the accounting system conversion created this misimpression.

Non-Resident Disbursements

Because the EIT distributions are aggregated on the STO’s books, we analyzed detailed disbursement records for the period from January 1, 2005 to December 31, 2007 to identify non-resident disbursements by tax year.

Based upon our inquiries and analyses, identified obligations to other taxing jurisdictions for 2004 and prior year non-resident EIT collected by Scranton have been and continue to be disbursed in accordance with STO procedures. To the extent that the cash accumulation in the non-resident tax accounts at the end of 2004 was the result of 2004 collections, the known obligations for prior years’ tax appear have apparently been



eliminated while the due to / from accounts capturing the 2005 – 2007 activity have been reduced by the same amount.

Composition of Bank Account Balance at December 31, 2008

The inaccuracies in reports generated from the accounting system (noted by us and others) preclude strict reliance on these reports when attempting to break down any year-end bank account balance into its component parts. Despite these deficiencies, the system generated reports, combined with an understanding of STO procedures, provide a means for assessing the components of the balance in the bank at December 31, 2008. Essentially, by determining the portion of the bank account balance that necessarily constitutes current year WIP, we can estimate the portion representing prior period accumulations. The system generated reports can then be used to assess the components / sources of these prior period accumulations.

The adjusted cash balance in accounts controlled by the STO at December 31, 2008 was \$12,312,775. Our analysis indicates that approximately \$7,341,179 should be considered current period WIP. The balance, \$4,971,596, represents an accumulation of funds from pre-2008 periods.

The current period WIP includes:

Amount	Description
\$3,791,008	This represents taxes collected during December 2008 less distributions of these current period collections.
\$2,966,364	This represents our estimate of 2008 non-resident EIT collections that have not been detailed or distributed. Unlike real estate and other tax receipts, the normal cycle for receiving, processing and distributing non-resident EIT may exceed one year.
\$377,780	This represents interest earned during 2008 on balances in the STO maintained bank accounts.
\$206,027	This amount represents unreimbursed real estate tax overpayments received by the STO. Some portion of this balance was received before 2008.
\$7,341,179	TOTAL ESTIMATED CURRENT PERIOD WIP

Reconciliation of Accumulated Funds to STO Accounting Records

A precise reconciliation of the accumulated funds to the STO accounting records is not attainable without a concerted effort to revisit and analyze the entire universe of transactions and entries processed through the system since January 2005. This universe includes more than \$500 million of receipts and disbursements. We have not undertaken

this analysis nor do we consider such a detailed historic analysis warranted from a cost / benefit perspective. While the precise reconciliation is beyond our engagement, our analysis has identified factors that may contribute to an understanding of the composition of this accumulation and variances from the STO accounting records. The estimated \$4,971,596 of accumulated funds is, by its nature, a “net” amount. Theoretically, this would be the sum / net of all transactions processed through the “Due to” and “Due from” accounts.

Our analysis indicates this \$4,971,596 includes:

- \$790,000 of interest earnings in 2007 that were not distributed to the clients;
- \$2,446,701 of “net” undistributed non-resident EIT collections¹⁸ of which approximately \$2,430,598 of these non-resident EIT collections have been detailed and allocated by STO personnel to the “888” and “233” town codes. We understand that these town codes represent EIT collected from taxpayers employed within Scranton but residing in locales with no EIT; and
- \$654,033 representing real estate tax overpayments.

Another component of the \$4.9 million would be any undistributed collections from pre 2005 periods that were included in the \$7.1 million cash balance that existed at December 31, 2004. Our analysis indicates that as much as \$2.4 million of the current balance may arise from pre-2004 non-resident EIT collections.

Not surprisingly, the sum of the prior year interest, the \$2.4 million of undistributed non-resident EIT, real estate tax overpayments and pre-2005 non-resident EIT exceeds \$4.9 million. Some of this variance is attributable to identified unrecorded receivables arising from duplicate payments of tax refunds. We are also aware of a practice whereby the STO remitted funds to a taxing jurisdiction without receiving funds from an employer. STO operating expenses in excess of allowances would also constitute a portion of the variance. Finally, the excess distributions to the City of Scranton may account for a portion of the variance. The amount of any excess distribution cannot be assessed until current and prior year EIT collections have been detailed.

Our investigation and analysis of STO accounting records also suggests that apparent discrepancies between entries in STO accounting records and corresponding cash balances cannot be resolved until STO personnel are able to detail all EIT collections. As discussed, EIT collections are initially allocated to an employer account. This amount is then “split” between resident and non-resident collections. STO accounting records

¹⁸ This is comprised of undistributed non-resident EIT collections made during 2005, 2006 and 2007. STO personnel are researching entries to these codes at this writing.

indicate the clients received distributions of \$2.8 million from 2005 through 2007 of EIT collections that had not been detailed. These distributions were not characterized as estimated payments.

Funds Available for Distribution to Clients

As discussed above, our analyses have determined that as of December 31, 2008 the bank accounts maintained by the STO contained approximately \$7,341,179 that represents current WIP and \$4,971,596 representing an accumulation of undistributed interest earnings and undistributed tax collections pre-dating 2008 and extending back to late 1990's.

Given the mission of the STO, these accumulated funds should be distributed to the appropriate taxing authority. This seemingly straightforward task is hampered by several factors including the extended period during which these funds were accumulated and apparent inaccuracies in some STO accounting records.

Despite these limitations and subject to the outcome of verification procedures currently underway at the STO, consideration can be given to distributing \$4,317,563. This amount represents the total excess funds of \$4,971,596 less \$654,033 of unreimbursed real estate tax overpayments.

Alternatively, the STO could consider a distribution of \$3,236,701 comprised of the following:

Amount to Distribute	Description
\$790,000	Pre-2008 interest earnings to distribute to clients. Historically, this has been a proportionate distribution. ¹⁹
\$2,446,701	Pre-2008 non-resident EIT detailed to the "888" town code. STO personnel are reviewing reports that identify EIT receipts detailed to this town code.
\$3,236,701	ALTERNATE DISTRIBUTION OF ACCUMULATED FUNDS

This alternate distribution methodology provides for a reserve or holdback of approximately \$1,000,000 to allow for claims that may arise from other entities. For example, at this writing, the Pennsylvania Treasurer has not finalized its "unclaimed property audit" of the STO. A possible claim by the Treasurer against the STO for "unclaimed property" consisting of un-cashed checks, real estate tax overpayments and

¹⁹ Our analyses indicate that the portion of the cash balance arising from non-resident EIT collections prior to 2005 has not been included in the calculation of interest distributions.

undistributed nonresident EIT cannot be dismissed at this time. We understand that the total of these claims could exceed \$1,000,000.

Current period WIP will be distributed in accordance with established procedures.

CONCLUSION

Based upon the inquiries and analyses discussed throughout this report and related *Appendix*, we have reached the following conclusions.

From the late 1990's to the present, the STO has collected more taxes than it has distributed to its clients or other taxing jurisdictions. Our investigation revealed that 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 \$12,312,775 at the end of 2008.

Our investigation disclosed that a material portion of the increasing adjusted bank balances were attributable to increases in the dollar amount of collections processed by the STO (i.e. increasing work-in-process). 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 smaller but still 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.

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.

Our ability to precisely determine the source(s) of this accumulation was hampered by changes in accounting processes and procedures in 2005 at which time the STO installed a new accounting system and implemented new procedures. 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. These errors and inaccuracies also hampered STO's independent auditor in the performance of an audit of the STO's 2005 financial statements.



RECOMMENDATIONS

Some of the above findings were communicated informally to the Tax Collector throughout the course of our engagement and through meetings with the Tax Collector, the solicitor and her technical advisor. These discussions also included some recommendations for improvement in internal controls and other recordkeeping procedures. The Tax Collector and her staff have been making procedural changes designed to address certain of the findings summarized above and within the body of this report.

Some of these observations and recommendations follow:

- Weak internal controls, lack of accounting or other oversight, and staff roles that limited access to information contributed to the growth of these cash balances and errors in the accounting for transactions. Consideration should be given to hiring a controller to oversee accounting operations and reporting. The current budget may not be sufficient to accomplish this goal.
- During the conversion process, these operating funds were consolidated, along with tax revenues into a single master account. This has the effect of a subsidy in the event funding is insufficient to cover expenses. In the context of trust funds (tax collections), this also amounts to a commingling of operating and trust funds, which is typically a discouraged practice for fiduciaries.
- STO personnel should aggressively pursue employers for information needed to detail EIT receipts.
- The current distribution process for EIT should be revisited to implement the aggressive pursuit of employer data. Furthermore, the 60% / 40% allocation process should be reassessed for accuracy.
- Processing controls should be implemented including:
 - Post all transaction batches on a daily basis so that batches tie to daily work;
 - Produce and save reports summarizing daily work for future research;
 - Compare and match deposits to general ledger postings to master account on a daily basis;
 - Post all work for accounting month before month-end close. After closing, any work posted to prior month should happen only with supervisory approval;



- Prepare monthly reconciliation of bank account to system record for master account;
- Reconcile remaining AR for real estate accounts to general ledger control account on a monthly basis; and
- Analyze and / or reconcile suspense account activity on a monthly basis and research any amounts outstanding for more than 30 days. Ideally, suspense account would be cleared before month-end minimizing need for analysis.

RJZ/ep