



STATE OF NORTH CAROLINA

ADMINISTRATIVE OFFICE OF THE COURTS FISCAL CONTROL AUDIT

OFFICE OF THE STATE AUDITOR

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FISCAL CONTROL AUDIT



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AUDITOR'S TRANSMITTAL

September 3, 2009

The Honorable Beverly E. Perdue, Governor
The General Assembly of North Carolina
Honorable John W. Smith, Director
North Carolina Administrative Office of the Courts.

This report presents the results of our fiscal control audit at the Administrative Office of the Courts. Our work was performed by authority of Article 5A of Chapter 147 of the *North Carolina General Statutes* and was conducted in accordance with the performance audit standards contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. The objective of a fiscal control audit is to identify improvements needed in internal control over selected fiscal matters, such as financial accounting and reporting; compliance with finance-related laws, regulations, and provisions of contracts or grant agreements; and/or management of financial resources.

The results of our audit disclosed deficiencies in internal control and/or instances of noncompliance or other matters that are considered reportable under *Government Auditing Standards*. These items are described in the Audit Findings and Responses section of this report.

North Carolina General Statutes require the State Auditor to make audit reports available to the public. Copies of audit reports issued by the Office of the State Auditor may be obtained through one of the options listed in the back of this report.

A handwritten signature in cursive script that reads "Beth A. Wood".

Beth A. Wood, CPA
State Auditor

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OBJECTIVES, SCOPE, METHODOLOGY, AND RESULTS

As authorized by Article 5A of Chapter 147 of the *North Carolina General Statutes*, we have conducted a fiscal control audit at the Administrative Office of the Courts. There were no special circumstances that caused us to conduct the audit, but rather it was performed as part of our effort to periodically examine and report on the financial practices of state agencies and institutions.

The objective of a fiscal control audit is to identify improvements needed in internal control over selected fiscal matters, such as financial accounting and reporting; compliance with finance-related laws, regulations, and provisions of contracts or grant agreements; and/or management of financial resources. Our audit does not provide a basis for rendering an opinion on internal control, and consequently, we have not issued such an opinion.

Management is responsible for establishing and maintaining effective internal control. Internal control is a process designed to provide reasonable assurance that relevant objectives are achieved. Because of inherent limitations in internal control, errors or fraud may nevertheless occur and not be detected. Also, projections of any evaluation of internal control to future periods are subject to the risk that conditions may change or compliance with policies and procedures may deteriorate.

To accomplish our audit objectives, we gained an understanding of internal control over matters described below and evaluated the design of the internal control. We then performed further audit procedures consisting of tests of control effectiveness and/or substantive procedures that may reveal significant deficiencies in internal control. Specifically, we performed procedures such as interviewing personnel, observing operations, reviewing policies, analyzing accounting records, and examining documentation supporting recorded transactions and balances. Whenever sampling was used, we applied a nonstatistical approach but chose sample sizes comparable to those that would have been determined statistically.

As a basis for evaluating internal control, we applied the internal control guidance contained in *Internal Control Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). As discussed in the framework, internal control consists of five interrelated components, which are (1) control environment, (2) risk assessment, (3) control activities, (4) information and communication, and (5) monitoring.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Our audit scope covered the period July 1, 2008 through December 31, 2008 and included selected internal controls in the following organizational units:

OBJECTIVES, SCOPE, METHODOLOGY, AND RESULTS (CONTINUED)

Financial Services Division

This division is responsible for the budgeting and general accounting functions for organizations within the judicial branch of government.

Human Resources Division

This division is responsible for establishing and implementing human resource policies and procedures for organizations within the judicial branch of government. Since judicial organizations are not subject to oversight by the Office of State Personnel, the Division also recommends pay plans and evaluates job classifications for the organizations, except for salaries set by the General Assembly.

During our audit, we considered internal control related to the following accounts and control objectives.

Personal Services – The Administrative Office of the Courts recorded approximately \$173 million in personal services during our audit period. These expenditures are primarily salaries for permanent and temporary judicial employees. We reviewed the personal service controls and processes for newly hired and for separated personnel. We examined internal controls designed to ensure the proper entry of newly hired personnel into the statewide payroll system and to ensure the proper removal of separated personnel from the statewide payroll system. In addition we examined evidence to support compliance with laws and regulations concerning how non-exempt personnel, who are eligible for overtime, account for their work time, overtime and leave in the statewide payroll system.

Accrued Vacation Leave – As of June 30, 2008, the Administrative Office of the Courts reported approximately \$19.86 million in accrued vacation leave. We examined evidence to support the reasonableness of the compensated absence accrued liability reported on the June 30, 2008 financial statements. Judicial employees are not subject to the State Personnel Act or Office of State Personnel policies.

Legal Services: Expert Witness Fees - The Administrative Office of the Courts recorded approximately \$590,000 for expert witness services legal fees for non-capital trials during our audit period. We reviewed the Expert Witness contract program and examined internal controls designed to ensure that the process of obtaining expert witnesses was consistent with policies and procedures. We examined evidence to support compliance with the finance-related laws and regulations over these expenditures.

Purchasing and Procurement Policy - The Administrative Office of the Courts recorded over \$9.2 million in procurement expenditures related to capital outlay, materials and supplies, and fixed charges during our audit period. We reviewed the procurement procedures and policies, and examined the internal controls designed to ensure that these items were procured according to procedures. We also examined evidence to support compliance with finance-related laws and regulations over these expenditures. These laws and regulations set the thresholds for which additional approvals are required and establish the conditions under which different purchasing procedures may be used.

OBJECTIVES, SCOPE, METHODOLOGY, AND RESULTS (CONCLUDED)

Travel - The Administrative Office of the Courts recorded over \$3 million in travel expenditures during our audit period. We examined internal controls designed to ensure that travel advances and subsequent travel costs were properly authorized, reimbursed and accounted for and that the advances were processed in accordance with State travel policies. We also examined evidence to support compliance with finance-related laws and regulations over these expenditures.

RESULTS

The results of our audit disclosed deficiencies in internal control and/or instances of noncompliance or other matters that are considered reportable under generally accepted government auditing standards. These items are described in the Audit Findings and Responses section of this report.

AUDIT FINDINGS AND RESPONSES

1. PAYROLL OVERPAYMENTS

We identified several employees who were erroneously paid for overtime and one employee who received an inappropriate longevity payment. These overpayments totaled over \$3,100.

The excess overtime payments occurred as the result of time entry errors and untimely supervisory approvals of time entered. According to the Administrative Office of the Courts' (AOC) internal policy, overtime cannot be paid until 60 days after the overtime is worked, providing no vacation leave is taken during the 60-day period. However, we determined the following:

- Four employees were paid a total of \$298 for overtime even though they took time off within 60 days. However, since the vacation time was not approved timely, the payroll system did not account for the leave taken and paid the employee for overtime. AOC was not aware of these overpayments at the time of our audit.
- One employee accidentally entered two days' work time on one day, which the payroll system recognized as overtime. These additional hours were approved, and the employee was inappropriately paid \$219 as overtime. AOC was not aware of this overpayment at the time of our audit.
- Eight separated employees were overpaid a total of \$2,222. Four of these were overpaid \$344 because they did not properly record holiday time. Another four employees worked partial months but were paid full month's salary of \$1,878 due to late supervisory approvals. AOC was aware of these overpayments and has either recovered or is seeking recovery of these overpayments.

The payroll system has been set up to pay employees whether time has been entered and approved or not. AOC's policy and procedures required that nonexempt personnel's time be entered and approved weekly. We examined a sample of 60 employees eligible for overtime pay and noted that 22 employees either did not properly enter their time or the leave balances were not approved timely. Late approvals ranged from one week late to 4 months late.

We also found that a longevity payment of approximately \$400 was erroneously made to a person who had been retired for two years, reinstated, worked only one day, and then separated. AOC policy requires that a reinstated person complete 12 months of additional service before receiving longevity pay. The payroll section did not recognize this error, and AOC had not initiated recovery at the time of our audit.

Recommendation: The AOC should implement monitoring controls to ensure its payroll and timekeeping policies are followed. Furthermore, the agency should seek to recover overpayments made in error.

AUDIT FINDINGS AND RESPONSES (CONTINUED)

Agency Response: We concur with the findings. To address these issues, we have changed our payout policy for overtime comp time from 60 to 365 days for employees subject to the overtime provisions of the Fair Labor Standards Act (FLSA). In addition, NCAOC Human Resources has begun to employ additional reports in BEACON which have enhanced our audit and reconciliation of time/leave entry issues. As overpayments are identified, we have a process in place to review and recover monies.

2. INADEQUATE SEGREGATION OF DUTIES OVER PAYROLL

The AOC did not adequately segregate duties over payroll. Job functions should be segregated so that the duties of one employee automatically provide a cross-check on the work of others to prevent or detect errors or fraud.

Each salary administrator initiated, authorized, and recorded new hires and separated personnel's payroll data in the payroll system. This included the ability to enter and possibly change some sensitive data in the payroll process without the involvement of another employee.

Recommendation: The AOC should segregate the payroll duties so that no one person can initiate, authorize and record payroll data. If complete segregation of duties is not feasible, the agency should implement compensating monitoring controls.

Agency Response: We are working to revise our procedures to ensure adequate internal controls. In addition, we have in place the following audits:

- All actions are being (1) provided in a report to the payroll department. The payroll department is then able to view the paystub (2) and verify the action was processed correctly.
- A monthly report is run on all employees which shows pay changes from the previous month. This report is audited to detect irregularities and mistakes resulting in incorrect pay as well as confirming approved variations.
- A weekly vacancy report is generated and is monitored for changes.
- Information is provided to District Attorney and Public Defender offices on a monthly basis which show position, employee, and salary. These offices view them to confirm employees, actions, and salary changes.
- The Clerk's office schedule report is produced yearly providing each clerk with employee name, from salary, to salary, from step, to step, and amount of increase.
- The benefits group produces BEACON reports of new hires, separations, leave of absences, etc. They verify that new hires sign up for benefits.

AUDIT FINDINGS AND RESPONSES (CONTINUED)

- Over 85% of leave of absence and leave of absence reinstatement actions are thoroughly audited each month by an employee who did not participate in the processing of the action.
- Dataflex is our information management system. The notes associated with personnel actions are provided to the Human Resources Information System Specialist who updates the Dataflex system. Any detected errors are communicated and corrected.

3. PROCEDURES NOT FOLLOWED FOR SEPARATED EMPLOYEES

The AOC did not consistently follow its internal control procedures over employee separations. As a result, there was an increased risk of erroneous final payments to employees and failure to safeguard assets and data. Our test of 60 separated employees revealed the following:

- Four separated employees had no evidence that their final payments were verified by the payroll section, though our test of these final payments revealed no errors in payment amounts. However, as discussed in finding 1, other overpayments at separation did occur.
- Twelve employee files had no separation forms required by the AOC's policy. There was no evidence in the file that computer access was revoked or all equipment and keys were returned for these employees. Further testing indicated computer access was not terminated for two of the employees. However, neither of these employees attempted to gain access after separation. After bringing this to AOC's attention, the access was revoked.

AOC's separation policies and procedures require adequate documentation that includes completed separation forms and communication with the payroll section to ensure proper separation.

Recommendation: The AOC should adhere to its separation policies and procedures and also enhance its controls over employee separations to prevent overpayments.

Agency Response: We modified our procedures for separations to address these concerns. We have added steps where we exchange reports with our security office (agency wide systems access / password administration) to cross-reference all separations to ensure all access has been revoked.

4. INCONSISTENCIES WITH COMPENSATED ABSENCES REPORT

The AOC reported compensated absences liability amounts to the Office of the State Controller that were apparently misstated. Although not significant to the State as a whole, this would result in an error in North Carolina's *Comprehensive Annual Financial Report*.

AUDIT FINDINGS AND RESPONSES (CONCLUDED)

The differences in the reported ending liability at June 30, 2007 and the reported beginning balance for the year ended June 30, 2008 was \$15,768. Looking back at the prior year, we found that the difference between the ending liability at June 30, 2006 and the beginning balance for year ended June 30, 2007 was \$1,494,513. This resulted in a cumulative two-year difference of \$1,510,281, which could be either over or understated in the financial statements. The amounts were determined from the compensated absence accrued liability reports obtained from the Office of the State Controller, but the variances were not investigated by the AOC.

Part of this difference could be attributed to bonus leave. The bonus leave shown on the report as having been used in 2007 was \$48,737 for 22,306 hours, which equates to an obviously incorrect salary rate of \$2 per hour. The bonus leave shown on the report as having been used in 2008 was valued at a negative \$245,467 for 346 hours. Therefore, the ending balance of bonus leave increased in 2008 even though there was no bonus leave earned in 2008.

Recommendation: AOC should review the documentation used to support journal entries for accuracy and reasonableness and investigate any unusual amounts before preparing the entry.

Agency Response: We concur with the recommendation that NCAOC should review documentation and investigate unusual amounts. However, related to beginning and ending balances, our understanding from staff of the Office of State Controller (OSC) is that the balances presented on the Compensated Absences Report reflect those employees that are active as of June 30 of a given fiscal year.

Employees that retire or separate during the fiscal year are not included in the report for that fiscal year. Thus the beginning balances shown in a current report may not agree with the ending balances shown in a previous year's report. Based on our understanding of how the amounts are accumulated in the Compensated Absences Report, the amounts shown in the Total Liability column for the current fiscal year should be accurate as it reflects balances for all current active employees. The liability recorded by the NCAOC in the *Comprehensive Annual Financial Report* (CAFR) agrees with the Total Liability column in the report.

ORDERING INFORMATION

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