STATE OF NORTH CAROLINA

DEPARTMENT OF CORRECTION

FISCAL CONTROL AUDIT

OFFICE OF THE STATE AUDITOR

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STATE AUDITOR

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AUDITOR'S TRANSMITTAL

September 30, 2011

The Honorable Beverly Eaves Perdue, Governor
The General Assembly of North Carolina
The Honorable Alvin W. Keller, Jr., Secretary, Department of Correction

This report presents the results of our fiscal control audit at the Department of Correction. 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.

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OBJECTIVES, SCOPE, METHODOLOGY, AND RESULTS

OBJECTIVES, SCOPE, AND METHODOLOGY

As authorized by Article 5A of Chapter 147 of the *North Carolina General Statutes*, we have conducted a fiscal control audit at the Department of Correction. 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 result, we were able to project our results to the population but not quantify the sampling risk.

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, 2010 through February 28, 2011, and included selected internal controls in the following organizational units:

Division of Departmental Purchasing & Services

This is the centralized unit for procurement, warehousing, transportation/communications, and leased property acquisition and management for the Department. It is responsible for negotiating contracts with prison units and selected state agencies on behalf of Correction Enterprises, a separate revenue producing division that provides goods and services for the Department. It is also responsible for purchases of autos, trucks, and buses for use at the prisons, administrative sections, and other departmental facilities.

Division of Administration - Controller's Office

This unit is responsible for the general accounting functions of the Department. It provides oversight for the recording and presentation of the Department's accounts receivable. The intergovernmental receivables section is responsible for tracking and monitoring receivables from local counties and municipalities related to Safekeeper and medical care services provided to non-state prisoners.

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

Autos, Trucks, & Buses - During the period audited, the Department reported expenditures of $1,258,185 for the Autos, Trucks, & Buses capital account. These expenditures are incurred and paid by the Department for vehicles purchased either on State-contract or through an open bid process. We examined controls designed to ensure that the Department properly paid and accounted for vehicle purchase expenditures. We also examined internal controls designed to ensure that the Department complied with appropriate state and departmental policies and procedures in obtaining these vehicles.

Contracted Services - During the period audited, the Department reported $25,698,767 in non-medically related contracted services such as administrative temporary services, laundry services, waste and recycle services, miscellaneous outside housing costs, and miscellaneous other services. We examined the nature of these services and controls over their acquisition to ensure proper accounting for the costs as well as compliance with state and departmental policies and procedures.

Supplies and Materials - During the period audited, the Department reported $8,214,925 in the supplies and materials account related to the purchase of gasoline and food/dietary supplies. The gasoline was for vehicles owned and operated by the Department and the food and dietary supplies were for the inmate population that were not produced by or stocked by Correction Enterprises.

Other Fixed Charges - During the period audited, the Department reported $2,096,254 in maintenance agreements for buildings, equipment, offices, and various computer equipment. We examined the nature of these services and controls over their acquisition to ensure proper accounting for the costs as well as compliance with state and departmental policies and procedures.

Grants and State Aid - During the period audited, the Department reported $5,543,939 in expenditures in the Criminal Justice Partnership Program (CJPP), which is designed to facilitate the reintegration of released inmates back into society. We examined the program's funding allocation and the controls over monitoring the program to ensure that the program complied with the stated goals and objectives.

Intergovernmental Receivables - During the period audited the Department reported $3,559,877 in intergovernmental receivables from local governments, the majority related to Safekeeper activities for the housing of inmates that the local governments either did not have room for or did not have the security/medical capability of housing. We examined controls over the recording, aging, and collection of these receivables; the calculation of the amounts due to the State; and the methodology used for determining the Department's allowance account. We examined the Department's compliance with state and departmental policies related to cash management and the collection of receivables, including the possibility of offsetting accounts payable against amounts owed to the Department.

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.

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AUDIT FINDINGS AND RESPONSES

1. INCORRECT CHARGES FOR SAFEKEEPER SERVICES

The Department did not comply with its own policies for determining the rate to charge counties when the State holds county prisoners due to safety and security concerns (known as Safekeeper program). Our analysis determined that the Department has undercharged counties by $465,000.

The Division of Prison's policy (.1609(b)) states that the rate to be charged for Safekeeper services is determined based on the per day reimbursement rate that the Department is to pay counties for the cost of housing prisoners awaiting transfer to the state prison system. This rate was originally established by *North Carolina Session Law 1997-443*. Accordingly, the Department is charging counties $18 per day for holding county inmates in state facilities. However, the reimbursement rate that the State pays counties was increased to $40 per day by *North Carolina Session Law 2009-451*, and the Department failed to update the rate it charges. Therefore, the Department has been undercharging counties by $22 per day for Safekeeper services since the new rate became effective on July 1, 2009.

Recommendation: The Department should strengthen internal control to ensure that it charges counties at rates that comply with state law and departmental policy.

Department Response: The Department agrees with this audit finding. The Department has since adjusted the reimbursement rate to $40 per day for safekeeper services. The County Sheriffs and County Managers were notified of this rate change in a letter dated September 27, 2011, and the Department will begin to bill the counties $40 per day effective October 1, 2011.

2. CHARGES FOR HOLDING INMATES NOT BASED ON ACTUAL COSTS

The rate that the Department charges counties when the State holds county prisoners due to safety and security concerns (known as Safekeeper program) and the rate the Department pays counties for the cost of housing prisoners awaiting transfer to the state prison system (known as Jail Backlog) is established in statute and is not based on the actual costs of housing prisoners. As a result, there may be an unrecognized transfer of costs between the two levels of government.

The Department's per diem rate is directed by legislation, most recently at $40 per day by *North Carolina Session Law 2009-451*. Ideally, the rate would reimburse both the State and the counties for their actual costs of holding the others' prisoners. The Department calculates an average daily cost per inmate for prison supervision on an annual basis. For the 2010 fiscal year, that rate, net of health services costs, was $57.67. Health services costs adds an additional $16.67 to the average daily cost per inmate. These two rates combined are significantly greater than the current reimbursement rate allowed per legislation, indicating that the State is not adequately recovering its costs for the services provided.

Recommendation: The Department should ensure that the General Assembly is provided the average daily cost per inmate for prison supervision so that the information may be considered when the applicable reimbursement rates are set.

Department Response: The Department already provides the General Assembly with the average daily cost per inmate for prison supervision on an annual basis. The reimbursement rate for safekeeper services is set by the General Assembly.

3. DEFICIENCIES IN COLLECTION OF CHARGES FOR HOLDING INMATES

We identified deficiencies in the Department's collection of accounts receivable related to charges to counties for holding county prisoners due to safety and security concerns (known as Safekeeper program). Specifically, the Department has not diligently sought collection as required by state policy or offset amounts due from counties against amounts owed to counties.

Noncompliance with the State Cash Management Policy

The Department did not follow state requirements for the collection of accounts receivable. *North Carolina General Statute 147-86.11(e)(4)* requires that unpaid billings due to a state agency be turned over to the Attorney General for collection no more than 90 days after the due date of billing. We noted that $2.36 million, representing 67% of the Safekeeper receivables, are more than 90 days overdue and have not been turned over to the Attorney General as required.

Discussions with Department officials revealed that counties routinely indicate that they are unable to pay the amounts due or dispute the billed charges. Disputed charges require the Department to perform additional procedures to provide evidence to the counties of their obligations. The guidelines for waiving a county's costs due to its inability to pay are specified in *North Carolina General Statute 162-39(c)* and requires certification by the county commissioners to the Governor that the county is unable to pay the bill submitted by the Department. We noted that the Department does not have formal documentation of its Safekeeper collection procedures. In addition, it does not appear that the Department is holding the counties to the requirements established by state law.

Offset of Safekeeper Accounts Receivable Against Jail Backlog Accounts Payable

As discussed previously, the State sometimes holds county inmates for safety and security reasons (Safekeeper program) and counties sometimes hold state inmates (Jail Backlog). The two parties charge each other a per day rate for the services but amounts owed are not always paid immediately.

North Carolina General Statute 147-86.22 provides guidance to state agencies related to the collection of accounts receivable. In the discussion of collection techniques, the law says that collection can be made through "a reduction of another payment, other than payroll, due from the State to a person to reduce or eliminate an account receivable that the person owes the State." While it is not clear that this provision applies to entities other than "persons" that owe an amount, it would be in the Department's best interest to be able to reduce its accounts receivable balances by offsetting them against payments owed to counties.

We performed an analysis of jail backlog costs by county and compared the amounts reimbursed by the Department to counties to the amount due to the Department from the counties for Safekeeper services. We noted that the Department could reduce its Safekeeper accounts receivable balance by $1.5 million if it was allowed to offset the receivable and payable amounts.

Recommendation: The Department should diligently seek to collect amounts it is owed by counties and comply with requirements to turn accounts over to the Attorney General for collection after 90 days. Further, the Department should seek to offset amounts that it is owed by counties against amounts it owes to counties if possible.

Department Response: Since the audit, the Department has developed procedures to ensure safekeeper bills over 90 days old and for which there is no repayment agreement are submitted to the Attorney General's Office in accordance with *North Carolina General Statute 147-86-11(e)(4)*.

The Department will formally document procedures currently in place including monthly invoicing, past due notices, etc., to be followed in collection efforts with safekeeper billings. In addition, current procedures will be expanded and documented to include additional collection efforts, including, but not limited to repayment agreements.

The Department will seek advice from legal counsel and the Office of the State Controller and the Office of State Budget and Management on the legality of offsetting safekeeper billings against payables the Department owes to these same counties.

4. INACCURATE ESTIMATE OF ALLOWANCE FOR DOUBTFUL ACCOUNTS

The Department has not determined a reasonable estimate of its uncollectible accounts receivable from charges under the Safekeeper program. Therefore, management and users of the Department's accounting information do not have available a realistic estimate of how much will be collected.

Generally, entities should estimate uncollectible accounts receivable amounts based on actual historical experience in collecting the amounts. This is typically done by identifying how long accounts have been outstanding and determining the percentage of each age group that historically has not been collected. The longer accounts receivable balances have been outstanding, the higher the probability that they will not be collected.

Our review of the Safekeeper accounts receivable balance at June 30, 2010 identified a balance of $3.5 million due to the Department. The corresponding allowance for uncollectible accounts had a balance of $121,000. The estimated uncollectible amount was based on the following percentages: 0.25% for amounts due within 90 days, 0.50% for amounts due within 91-120 days, and 5% for amounts greater than 120 days past due. However, the Department did not provide any historical data to support these percentages.

We noted that $2 million, or 58%, of the balance had been due to the Department for over one year. This suggests that a substantially higher amount of the balance may uncollectible than was estimated.

Recommendation: The Department should accumulate actual historical collection data to support its estimated allowance for uncollectible accounts receivable.

Department Response: The Department will accumulate historical data to support its estimate for uncollectible accounts receivable.

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