

Internal Audit Report

**EARMARKED BUDGET
APPROPRIATIONS AUDIT
MARCH 2022**

Office of the County Auditor





OFFICE OF THE COUNTY AUDITOR


Craig Glendenning, CPA
County Auditor

March 1, 2022

The Honorable Members of the County Council
The Honorable Calvin Ball, County Executive

Pursuant to Section 212 of the Howard County Charter and Council Resolution 22-1985, we have conducted an audit of the County's practice of earmarking budget appropriations. This report contains recommendations we believe will strengthen internal controls and improve accountability and compliance with applicable policies and procedures.

This report has been reviewed with the Chief Administrative Officer and we have included the Administration's response. We wish to express our gratitude to the Administration for the cooperation and assistance extended to us during the course of this engagement.



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EXECUTIVE SUMMARY

We conducted a performance audit of the County's use of budgetary earmarks. The objectives of our audit were to:

1. Determine if adequate controls have been implemented over the County's practice of earmarking budget appropriations.
2. Determine if earmarks are used in accordance with their approved purpose.
3. Determine if the practice of earmarking budget appropriations complies with the County Charter and Government Accounting Standards.

Conclusions

For the audit objectives, we found that:

1. Internal controls over the County's practice of earmarking budget appropriations were not adequate.
2. Earmarks were not always used in accordance with their approved purpose.
3. The Office of Law was unable to reach a conclusion, one way or the other, if earmarks are encumbrances within the meaning of Section 611 of the Howard County Charter. Based on discussions with the County's external auditors, earmarks are a budgetary tool and therefore Government Accounting Standards are not applicable.

BACKGROUND

Earmarks are a budgetary mechanism the County utilizes to reserve current year budget appropriations to be used in a future fiscal year for a specific purpose. The Department requesting approval of an earmark must complete and submit an internal memorandum and provide justification for the earmark. All earmark requests are approved by the Director of Finance, the Budget Administrator, and the Chief Administrative Officer.

Earmarks are classified into one of the following categories:

- New – First time an earmark request has been submitted.
- Carryforward – Earmarked funds have not been used or fully depleted, and a request is submitted to carry the funds forward into the next fiscal year for the same purpose.
- Re-Purpose – Earmarked funds for a specific purpose have not been used or fully depleted and a request is submitted to use the funds for a different purpose.

The County considers and records earmarks as encumbrances which are included in the Assigned category of Fund Balance in the County's Balance Sheet of General Funds. As of Fiscal Year 2021, encumbrances totaled \$21,778,477, of which \$15,070,097 (69%) represented earmarks.

FINDINGS AND RECOMMENDATIONS

Finding 1 – Earmarks Improperly Recorded as Encumbrances

As noted in the Background section above, the County considers and records earmarks as encumbrances. The term encumbrance is defined in the County's Fiscal Year 2021 Annual Comprehensive Financial Report as "commitments related to contracts executed, but not performed, and purchase orders not yet fulfilled."

During our test of earmarks, evidence of unperformed contracts for goods or services was not identified or contained in the County's financial accounting system (i.e., SAP) to support the earmark. For example, we noted earmarks for Executive travel overseas, meals while attending training for the Drone Program, and moving money from one general ledger account to another general ledger account to purchase gift cards. Supporting documentation (i.e., executed contracts and purchase orders) for these transactions were not unavailable. Furthermore, these transactions do not meet the County's definition of an encumbrance.

These types of earmarks should have lapsed into the County treasury in accordance with Section 611 of the County Charter which states "unless otherwise provided by public general law, all unexpended and unencumbered appropriations in the current expense budget remaining at the

end of the fiscal year shall lapse into the County treasury, except that appropriations to the risk management and grants funds shall be non-reverting.”

Recording earmarks as encumbrances when unperformed contracts for goods or services do not exist bypasses the annual budgetary process and approval authority of the County Council.

We recommend that earmarked funds be recorded as encumbrances only when they are commitments related to contracts executed, but not performed, and purchase orders not yet fulfilled. Further, if they do not meet these requirements, we recommend the funding be recorded as Unassigned Fund Balance in the County’s General Fund Balance Sheet.

Additionally, we recommend that such contracts be available in the County’s financial accounting system as supporting documentation for the earmarked funds.

Administration’s Response:

We do not agree. Earmarks are a management tool, as equally stated by the independent auditor, to encumber the budget when there is not enough time left in the fiscal year to issue a purchase order or contract for a project that was planned but was unable to be initiated/finalized, or other spending needs. Thank you for pointing out that the definition included in the ACFR is not inclusive of earmarks which are considered to be encumbrances. The sentence in the ACFR will be revised to say: "under encumbrance accounting, purchase orders, contracts and other commitments are recorded in order to reserve budget appropriations for that purpose."

Auditor’s Comments to Administration’s Response:

We do not agree with the Administration’s response and continue to reaffirm our recommendations as stated for the following reasons:

1. As we noted, the County’s external auditors stated that Government Accounting Standards are not applicable because the County is using earmarks as a budgetary tool. Furthermore, the external auditors did not specifically state that “Earmarks are a management tool to encumber the budget when there is not enough time left in the fiscal year to issue a purchase order or contract for a project that was planned but was unable to be initiated/finalized, or other spending needs” as noted in the Administration’s response.
2. During our test work we identified multiple occurrences of earmarks that do not provide for, and did not result in, a purchase order. For instance, the purpose of one of the earmarks tested was for funding Police personnel meal expenses while attending training. A purchase order or contract is not used for this kind of expense. Although

the Police Department appropriately utilized County Procurement Cards for their meals, the expenses should have been charged against the current year appropriation for meals and not an earmark.

3. We believe the County's planned definition change of encumbrances which states "under encumbrance accounting, purchase orders, contracts and other commitments are recorded in order to reserve budget appropriations for that purpose" causes confusion for the reader. Specifically, 'other commitments' is used in general terms whereas Committed Funds defined in the ACFR includes fund balance amounts for which constraints have been imposed by the government itself, using the highest level of decision-making authority via County ordinances.

Committed Funds in the General Fund are for items such as the Rainy Day Fund and not encumbrances. Therefore, in the General Fund, only encumbrances with purchase orders not yet fulfilled and contracts executed, but not performed, should be in the assigned fund balance. Conversely, earmarks without purchase orders and contracts should lapse to the treasury and be in the unassigned fund balance as recommended.

Finding 2 – Earmark Not Liquidated

During our test of earmarks, we noted that one earmark was approved and created for \$4 million to reserve funds designated to be transferred to a capital project in the Capital Improvement Program budget (CIP) until the property sales and resulting proceeds intended to fund the transfer had been finalized and verified.

Since inception of the earmark in Fiscal Year 2016, two properties were sold in November 2016 totaling \$1,330,377. The proceeds were charged to the earmark and transferred to a separate capital project. The earmark has an open balance of \$2,669,623 which has been carried forward every fiscal year since inception. In the most recent requests to carryforward the earmark, the County indicated that it planned to start the marketing and disposition process on two remaining properties.

One of the remaining properties, the Flyer building, was marketed for sale, and proposals were received and evaluated; however, a buyer was never approved. In its September 8, 2021, letter to the proposal respondents, the County informed them of its decision not to proceed with the disposition of the property. Currently, the two remaining properties have not been sold and are not actively on the market for sale.

In addition, the capital project related to the earmark has since been defunded and closed, and the two remaining properties are not being considered for sale. Therefore, the justification for the earmark is no longer valid.

We recommend that the earmark be liquidated and any revenue resulting from future property sales should lapse into the unassigned fund balance.

Administration's Response:

We agree with the recommendation and will cancel the earmark.

Finding 3 – Earmarked Funds Not Used for Approved Purpose or Initial Approved Purpose

Our test of 10 earmarks disclosed that funds for three earmarks were not always used for their approved purpose. Specifically, we noted the following:

- Funds approved for additional training needs in the areas of performance management and capital budgeting were used for expenses such as membership fees, office supplies, and health care training.
- Funds approved for a salary survey were used for expenses such as airfare, hotel stays, conference registration fees, facilitation training, and an organizational development study.
- Funds approved for a consultant to conduct a user fee study were used for a cost plan for the Fiscal Year 2021 budget.

Using earmarked funds for expenses that do not align with their approved purpose undermines the entire approval process for earmarks.

Our test also disclosed that three separate earmarks were not completely used for their initial approved purpose and were re-purposed for a different reason. Specifically, we noted the following:

- Funds initially approved for Phase 2 of the Development Regulations Review and Code Re-write Effort were re-purposed and approved for an update to the General Plan.
- Funds initially approved for regional planning for the development of Downtown Columbia and an update to the General Plan were re-purposed and approved to support a match requirement for grant funds.
- Funds initially approved for courses in the Getting Ahead Program were re-purposed and approved to purchase gift cards.

Re-purposing earmarks and not allowing the funds to lapse to the County treasury bypasses the annual budgetary process and approval authority of the County Council.

We recommend that earmarked funds be used for their approved purpose. We further recommend that the practice of re-purposing earmarks be discontinued.

Administration's Response:

We agree that earmarked funds should be used for their approved purpose. To that end, Finance will perform quarterly reviews of earmark expenses as discussed in our response to Finding 4. We further agree with the recommendation to discontinue the practice of re-purposing earmarks.

Finding 4 – Independent Monitoring Not Performed

Our review of the earmark process disclosed that there is no independent monitoring of expenses charged to earmarked funds. Specifically, the Department requesting approval of an earmark is also responsible for monitoring that expenses charged to the earmark are proper.

Independent monitoring controls provide for early detection of errors or deficiencies and timely corrective action. Implementing these controls increases the likelihood that the issues noted in Finding 3 will be detected.

We recommend that independent monitoring of earmark expenses be performed.

Administration's Response:

We agree. Finance will perform quarterly reviews of earmark expenses. To maintain our independence and avoid any potential conflicts of interest, Finance Department specific earmarks will be reviewed and monitored by the Budget Office.

Finding 5 – Supporting Documentation Not Adequate

Our test of earmarks disclosed that documentation to support approved earmark requests and the related expenses was not adequate. Specifically, 6 of the 10 earmarks we examined did not contain documentation to support the justification for the earmark as required. Instructions on the internal memorandum request for earmarks state that supporting documentation must be attached. The earmark requests were still approved despite the lack of supporting documentation.

In addition, 3 of the 10 earmarks did not contain adequate documentation in the County's financial accounting system (i.e., SAP) to support the related expense. For example, for one earmark, documentation provided for the expense did not always show that payment was made, the reason for the expense, or support for the expense amount. In this regard, we could not

always determine whether the expense was valid and in accordance with the earmark's approved purpose.

Supporting documentation provides evidentiary matter to validate transactions and approvals, minimizes the risk of fraud, and provides an audit trail.

We recommend that earmark requests be thoroughly reviewed and contain the required supporting documentation prior to approval. We further recommend that adequate documentation be maintained to support the earmark expense.

Administration's Response:

We agree with the recommendations. Finance will strive to ensure all earmark requests contain the required supporting documentation prior to approval. Further, Finance will also strive to ensure adequate supporting documentation of the earmark expense is in SAP. However, it should be noted that in some cases, reclass journal entries are done to move the expense from the operating budget to the earmark, so you need to reference the original payment document to see the reason and support for the expense.

Finding 6 – Standard Operating Procedures Do Not Exist or Not Adequate

Our review of the earmark process disclosed that the Budget Department did not have documented standard operating procedures (SOPs) over its review and approval of earmark requests. Our review also disclosed that while the Finance Department established a written SOP over the year-end earmark process, it was not always followed (see Finding 8) and did not reflect current practices. Specifically, the procedure did not incorporate the SNAP workflow process and the tasks associated with using the automated platform. We further noted that the procedure was not signed and approved.

Standard operating procedures assist organizations with their governance responsibilities and provide a mechanism for implementing routine operations in an efficient and effective manner. They further provide for uniformity of performance and quality of output while reducing miscommunication and noncompliance.

We recommend that the Administration develop a comprehensive written standard operating procedure (SOP) for earmarks. This could be accomplished by the Finance Department updating their SOP and incorporating the details of the tasks performed by the Budget Office to review and approve earmark requests. The SOP should contain approvals from both the Finance Director and Budget Administrator.

Administration's Response:

We agree with the recommendation. Finance has already updated its SOP to reflect current practices and will further update it to reflect the tasks performed by the Budget Office. Both the Finance Director and Budget Administrator will approve the SOP.

Finding 7 – Earmarks Not Properly Coded

Our test disclosed that funds and related expenses for 2 of 10 earmarks were not properly coded. Specifically, we noted the following:

- An earmark approved for a salary survey was coded to regular employee salaries instead of contractual services.
- An earmark approved for Executive travel overseas was coded to other expenses instead of out-of-state travel.

The Finance Department's Standard Operating Procedure entitled Year-End Earmark Process states that "the Bureau of Accounting validates the account assignment and reviews the justification before submitting it to the Director of Finance for approval." Proper coding of funds and expenses minimizes the risk of fraud and provides for the capture and reporting of accurate and complete financial information.

We recommend that earmarked funds and the related expenses be properly coded.

Administration's Response:

We agree with the recommendation. Finance will ensure that a review is conducted of account coding before earmarks are approved.

AUDIT SCOPE, OBJECTIVES AND METHODOLOGY

We conducted a performance audit of earmarked budget appropriations, including monitoring of related expenses and financial transactions.

We conducted our audit in accordance with generally accepted government auditing standards prescribed by the Comptroller General of the United States. Those standards require us to 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 we obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The objectives of our audit were to:

1. Determine that adequate controls have been implemented over the County's practice of earmarking budget appropriations.
2. Determine that earmarks are used in accordance with their approved purpose.
3. Determine that the practice of earmarking budget appropriations complies with the County Charter and Government Accounting Standards.

To accomplish our objectives, we met with Administration staff responsible for reviewing and approving earmark requests, creating earmarks in the County's financial system, and providing user access to the system. We reviewed earmark requests and documentation related to earmark expenses. We performed tests designed to determine whether earmarked funds and the related expenses were proper. Generally, transactions were selected for testing based on auditor judgment, which primarily considers risk. To maintain our independence and avoid any potential conflicts of interest, we did not test earmarks from the County's Legislative Branch.

Unless otherwise specifically indicated, neither statistical nor non-statistical audit sampling was used to select the transactions tested. Therefore, the results of the tests cannot be used to project those results to the entire population from which the test items were selected.

Management is responsible for establishing and maintaining effective internal control. 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. We conducted our field work from June 2021 to November 2021. The Administration's responses to our findings and recommendations are included in this report.

AUDIT TEAM

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