

**EXAMINATION OF CERTAIN FINANCIAL  
TRANSACTIONS, POLICIES, AND PROCEDURES  
OF THE KENTUCKY LEAGUE OF CITIES, INC.**



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The Auditor Of Public Accounts Ensures That Public Resources Are Protected, Accurately Valued, Properly Accounted For, And Effectively Employed To Raise The Quality Of Life Of Kentuckians.

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**List of abbreviations/acronyms used in this report**

<b>APA</b>	Auditor of Public Accounts
<b>CERS</b>	County Employees Retirement System
<b>CFO</b>	Chief Financial Officer
<b>Compensation Program</b>	Key Executive Compensation Enhancement Program
<b>HR Director</b>	KLC's Director of Human Resources
<b>IT</b>	Information Technology
<b>KDOI</b>	Kentucky Department of Insurance
<b>KLC</b>	Kentucky League of Cities, Inc.
<b>KLCIA</b>	KLC Insurance Agency
<b>KLCIS</b>	KLC Insurance Services
<b>KLCMFC</b>	KLC Municipal Finance Corporation
<b>KLCPFC</b>	KLC Premium Financing Company
<b>KLCURT</b>	KLC Unemployment Compensation Reimbursement Trust
<b>KLCWCT</b>	KLC's Worker's Compensation Trust
<b>KRS</b>	Kentucky Revised Statute
<b>NADA</b>	National Automobile Dealership Association
<b>NewCities</b>	NewCities Institute
<b>NLC</b>	National League of Cities
	National League of Cities Risk Information Sharing Consortium
<b>NLC-RISC</b>	
<b>PSS</b>	Partnership for Successful Schools
<b>TPA</b>	Third Party Administrator
<b>VOIP</b>	Voice Over Internet Protocol





CRIT LUALLEN  
AUDITOR OF PUBLIC ACCOUNTS

December 17, 2009

Hon. Michael Miller, President  
Board of Directors  
Kentucky League of Cities, Inc.  
333 Broadway Street  
Jackson, Kentucky 41339

RE: Examination of Certain Financial Transactions, Policies, and Procedures of the Kentucky League of Cities, Inc.

Dear Mayor Miller:

We have completed our examination of certain expenditures, policies, procedures, and management practices of the Kentucky League of Cities, Inc. (KLC). The report identifies 30 findings and offers over 140 recommendations to strengthen the management and oversight of KLC to ensure its financial resources are used for the maximum benefit of its member cities.

Examination procedures included interviews of the current and three former KLC Board Presidents, other board members, as well as KLC management and staff. In conjunction with a review of applicable KLC policies and procedures, a review of credit card expenses, employee reimbursements, and direct payments was conducted to determine whether expenditures were appropriate. The scope of our examination encompasses records and information for the period July 1, 2006 through June 30, 2009, unless otherwise specified. The objectives developed by the APA for this examination include:

- Examine all credit card expenses, employee and board member reimbursements, and other expenses paid directly by KLC and its various programs;
- Determine whether expenditures were excessive or unusual;
- Review KLC policies and procedures; and,
- Report findings and recommendations related to these and other matters identified during the examination.

It is not the intent of this examination to report on the operations of the insurance component of KLC, as the Department of Insurance has regulatory authority to audit self-insurance funds.



Hon. Michael Miller, President  
KLC Board of Directors  
December 17, 2009  
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The Auditor of Public Accounts requests a report from the KLC Board on the implementation of audit recommendations within (60) days of the completion of the final report. If you wish to discuss this report further, please contact Brian Lykins, Executive Director of the Office of Technology and Special Audits, or me.

Respectfully Submitted,

A handwritten signature in black ink, appearing to read "Crit Luallen". The signature is fluid and cursive, with a large initial "C" and "L".

Crit Luallen  
Auditor of Public Accounts



## **Examination of Certain Financial Transactions, Policies, and Procedures of the Kentucky League of Cities, Inc.**

### **Examination Objectives**

On July 1, 2009, the Auditor of Public Accounts (APA) informed the Kentucky League of Cities, Inc. (KLC) that an independent examination would be conducted on certain policies, financial transactions, and other activities of KLC and its affiliate funds, programs, and organizations. This examination was in response to reports and concerns presented to the APA regarding certain financial transactions of KLC. The objectives developed by the APA for this examination included:

- Examine all credit card expenses, employee and board member reimbursements, and other expenses paid directly by KLC and its various programs;
- Determine whether expenditures were excessive or unusual;
- Review KLC policies and procedures; and,
- Report findings and recommendations related to these and other matters identified during the examination.

It is not the intent of this examination to report on the operations of the insurance component of KLC, as the Kentucky Department of Insurance has regulatory authority to audit self insurance funds.

The scope of the examination encompasses records and information for the period July 1, 2006 through June 30, 2009, unless otherwise specified.

### **Background**

KLC was formed in 1927 when 12 Kentucky cities assembled to address common legislative issues and to benefit from the economies of cooperative purchasing. KLC currently operates as a non-stock, non-profit corporation exempt from federal income tax under section 115 of the Internal Revenue Code. KLC has grown to include 382 member cities and has significantly expanded its services. Member cities receive core services from KLC and can purchase additional services through KLC's affiliated organizations. The services provided by KLC and its affiliates include insurance coverage, insurance loss control and employee benefits, policy development and research, training and education, and legislative advocacy as well as financial, legal, and information

technology services. The following describes these entities and the services each provides to the city members:

#### **KLC Insurance Services (KLCIS)**

KLCIS was established for the purpose of creating and operating various self-insurance and/or third-party insurance coverage to protect policyholders from public liability exposures. KLCIS provides a complete line of competitive insurance to municipalities and agencies. In providing this insurance, KLCIS administers the KLC Worker's Compensation Trust (KLCWCT) and the KLC Unemployment Compensation Reimbursement Trust (KLCURT).

#### **KLC Municipal Finance Corporation (KLCMFC)**

KLCMFC was formed for the purpose of issuing tax-exempt bonds to finance or refinance member city projects. The corporation was established as an agent of the City of Danville that issued tax-exempt bonds so that the proceeds could be pooled and loaned to member cities. The corporation is only authorized to pay reasonable compensation for services rendered.

#### **KLC Funding Trust**

KLC formed KLC Funding Trust through an interlocal cooperative agreement to oversee a combination of many separate bond pools but primarily it serves the same function as KLCMFC. These funds are made available to cities for financing municipal public projects all across Kentucky. These projects include the construction of parks, fire stations, city halls, water and sewer systems, and other infrastructure. This program offers Kentucky cities low, tax-free interest rates with reduced issuance fees compared to the loan rates that the cities would be able to obtain as individual entities.

#### **NewCities Institute**

NewCities Institute was established as a 501(c)(3) non-profit corporation with a separate board to research, study, educate, and innovate communities about civic engagement. The stated purposes of NewCities Institute include improving local governance through the distribution of information and better communication between all levels of government, supporting activities to improve educational opportunities, and bringing the public and private

sectors together in forums to enhance the quality of life in local communities.

KLC Insurance Agency, Inc. (KLCIA)

KLCIA was incorporated as a Kentucky for-profit agency to transact business as an insurance agency. KLCIA sells health, life, and bonding insurance to municipalities in the Commonwealth of Kentucky and markets the insurance services offered by KLCIS. KLCIS pays a commission to KLCIA for member accounts marketed or serviced by KLCIA.

KLC Premium Financing Company, Inc. (KLCPFC)

KLCPFC is another subsidiary of KLC that was incorporated as a Kentucky for-profit corporation, to finance insurance premiums for member cities that purchase property, liability, and workers compensation insurance through KLCIS. KLC is its sole stockholder.

**Financial Information**

In fiscal year 2008, 87 percent of KLC revenue came from the administrative fees and commissions paid by the insurance and financial programs administered by KLC staff. The remaining revenue sources of membership dues, interest, and conference revenue, account for only 13 percent of KLC's total revenue. From fiscal year 1998 to fiscal year 2008, KLC's revenues increased 155 percent from \$4.3 million to \$11 million. The significant increases in KLC revenue resulted from an increased amount of administrative fees paid by KLCIS and its related insurance trust programs, KLCWCT and KLCURT, and the commissions earned by the KLC insurance agency subsidiary KLCIA.

In fiscal year 2008, salaries, retirement, employee benefits, and payroll taxes accounted for 72 percent of KLC total expenditures. From fiscal year 1998 to fiscal year 2008, KLC's expenditures increased 202 percent from \$3.9 million to \$11.8 million. KLC's total assets increased 354 percent from fiscal year 1998 until fiscal year 2008, due primarily to the purchase of an office building and other investments.

**Findings and Recommendations**

**Finding 1: The KLC Executive Board did not provide effective leadership and governance over its financial resources to the ultimate benefit of its member cities.**

While the insurance and financing programs under the KLC umbrella increasingly brought in additional revenue to KLC, the Executive Board's lack of oversight allowed KLC's Executive Staff to spend additional funds, in many instances, for their primary benefit, rather than providing additional benefits to Kentucky's cities and communities. The financial growth of KLC could have allowed greater services to

its member cities or reduced its member's fees or the insurance premiums charged to those cities and governmental entities that purchased insurance through KLC.

**Recommendations:** We recommend KLC reshape its mission to clearly reflect its purpose to efficiently and effectively serve member cities, to meet its member's reasonable expectations, and to provide the greatest benefit possible for the use of its public funds. We recommend KLC's Executive Board develop policies that provide specific guidance to staff members on the proper use of KLC financial resources for necessary and appropriate expenditures

**Finding 2: KLC Executive Board had not adopted a compensation administration policy with definitive guidelines.**

KLC Executive Staff salaries increased significantly between 2002 and 2009, with a 93 percent increase. The top ten employee salaries increased 25 percent between FY 2006 and FY 2009. KLC salary increases were based on the recommendations of an outside consultant whose recommendations were accepted and approved by the Budget and Audit Committee without an evaluation of performance or a comparison to local and regional salaries. KLC's Employee Handbook Policy for "salary adjustments" allowed KLC Executive Staff latitude and control over salary administration that resulted in substantial salary increases for Executive Staff and other KLC employees. Only the Executive Board members who were on the Budget and Audit Committee were informed of the Executive salary data recommended by the consultant. The other Executive Board members only saw the budget's one-line item for "Salaries."

**Recommendations:** We recommend the Executive Board evaluate current staff compensation amounts. We recommend the Executive Board review and approve a formal compensation policy that includes factors relating to the employees' performance. We also recommend the Executive Board select and approve the compensation consulting firm and ensure future compensation decisions are based on KLC's financial resources and regional economic conditions.

**Finding 3: Bonus and loans made to KLC staff cost over one-half million dollars with questionable benefit to KLC.**

KLC provided \$533,998 to six employees in the form of a bonus, contribution, and forgivable loans for the purpose of rewarding loyalty and incenting continued employment with KLC. Those funds were used primarily by the employee to purchase five years of service or "Airtime" in the CERS. Participants in this program who purchased "Airtime" received significant lifetime incremental pension benefits of up to \$514,571. It is not clear that the Executive Board gave adequate

consideration to the significant financial impact of such a program on KLC or the substantial personal benefit to the participating employees.

**Recommendations:** We recommend the KLC Executive Board review the entire compensation program to ensure all employee compensation and additional rewards are in the best interest of KLC and are approved by the Executive Board prior to being implemented. The Executive Board should evaluate compensation and retirement packages for all employees, require measurable individual performance goals, and implement a documented employee performance evaluation process.

**Finding 4: KLC Executive Staff represented that employee loans and a bonus were repaid because KLC Executive Staff did not receive salary increases suggested by a consultant.**

In October 2004, the incoming KLC President questioned the amount of compensation that Executive Staff received through salary, forgivable loans, and a bonus. In response, KLC Executive Staff decided to offset the consultant recommended salary increases by either the net bonus amount for the Executive Director/CEO and the annual loan amounts forgiven for the Deputy Executive Director and Chief Insurance Services Officer. Even with offsets to their recommended salary increases, KLC Executive Staff experienced salary increases of 21 percent, 15 percent, and 13 percent. Executive Board meeting minutes do not document the Executive Board's approval of the "repayment" method determined by the Executive Staff; nor do Executive Board meeting minutes document a discussion of this issue.

**Recommendations:** We recommend the Executive Board require, and KLC General Counsel provide, affirmation that all contracts and agreements are in compliance with documented actions taken by the Executive Board. We also recommend that any repayment methodology be established and approved by the Executive Board. Further, we recommend the Executive Board meeting minutes document board action and approval of any employee loan bonus, as well as the related terms and conditions.

**Finding 5: KLC Executive Staff extended, forgave, and granted loans without Executive Board authorization.**

The Compensation Program approved by the KLC Executive Board states that if the employee is terminated or leaves KLC voluntarily before the loan is fully repaid, "the balance due on the note becomes payable." However, the former General Counsel resigned his position October 31, 2005 and KLC Executive Staff forgave a loan balance of \$21,230 without his fulfilling the original loan requirements specified in the Compensation Program. The former

Director of Finance and Administration received a \$47,000 forgivable loan under the Compensation Program. After retiring on October 1, 2006, KLC Executive Staff and the former Director of Finance and Administration entered into an employment agreement that included an additional loan of \$17,300 to be added to the remaining forgivable loan balance of \$11,569. In FY 2008 and FY 2009, KLC Executive Staff contributed a total \$35,600 to the Director of Policy Development's Section 457 retirement account even though he was not eligible for a forgivable loan according to the approved Compensation Program. There was no documentation that the Executive Staff obtained approval from the Executive Board for the loan forgiveness subsequent to termination, the extension and forgiveness of a loan subsequent to retirement, nor the contribution to an employee's Section 457 retirement account.

**Recommendations:** The KLC Executive Director/CEO and other Executive Staff should comply with the Board approved Compensation Program and associated resolution. The initiation of any loans or other compensation enhancements and related terms should receive prior approval by the Executive Board and periodic reporting on all compensation enhancements should be provided to the Executive Board.

**Finding 6: KLC Executive Staff altered a Compensation Program loan agreement without board approval and did not comply with the terms of the resulting employment agreement.**

The former Director of Finance and Administration retired on October 1, 2006, and was rehired by KLC on November 1, 2006 as a Senior Accounting Analyst. The former Director of Finance and Administration's existing unforgiven loan amount of \$11,569 was combined with a new loan amount of \$17,300 for a new loan of \$28,869. Per the employment agreement, repayment of the new loan was required over a 30-month term. However, according to KLC Executive Staff, that was "not the intent" and the loan was forgiven. Approval from the Executive Board to alter or amend the original loan was not documented.

**Recommendations:** We recommend the KLC General Counsel review all contracts for completeness and accuracy. We further recommend KLC Executive Staff ensure that approval of the Executive Board is obtained when the terms of an agreement alters or supersedes the terms of the board approved Compensation Program. We recommend the Executive Board review all employment agreements and ensure the employees comply with the approved terms and conditions of the agreements.

**Finding 7: Discrepancies between the board-approved Compensation Program and the corresponding Promissory Notes and Loan Agreements impacted the accuracy of income reported.**

The Compensation Program indicates that KLC should supplement the salaries of participating employees to offset any tax or interest costs associated with the forgivable loan and that the employee should pay interest to KLC through payroll deductions. However, the Promissory Note only states that interest is payable through payroll deductions without any mention of salary supplements. The Loan Agreement does not contain any language related to payroll deductions or salary supplements. These discrepancies are significant because neither the salary supplements nor payroll deductions were actually executed by KLC. Instead, the amount of the annual loan principle and any added taxes or interest were reported on the employee's W-2 form as "Other" non-cash income. In years 2005 through 2007, forgiven interest was not included on the W-2 tax forms for the Deputy Executive director, Chief Insurance Services Officer, and the former General Counsel.

**Recommendations:** We recommend that KLC's Executive Board ensure that the terms of any policy or program adopted by the board are complied with by KLC staff. We also recommend KLC staff ensure that all terms and conditions of contractual agreements are enforced and the related financial transactions are accounted for properly. We also recommend the KLC Executive Board direct the CFO to determine the additional amount of compensation that should have been reported on the loan participants W-2. These amounts should be reported to the Executive Board so that a decision as to amending the participants W-2 can be made.

**Finding 8: KLC's Executive Board had not adopted a policy governing the purchase of vehicles.**

Between April 2007 and December 2008, KLC Executive Staff authorized and purchased vehicles totaling \$314,738 for KLC employees' use with no discussion or approval by the Executive Board. Clear guidelines were not established to identify who was eligible to use the vehicles and for what purposes. The vehicles were for both personal and business usage yet in certain instances the mileage related to personal mileage could not be determined.

**Recommendations:** The Executive Board should oversee a comprehensive analysis of KLC ground transportation needs to determine the most efficient and cost effective methods of addressing the organization's needs. If the board determines vehicles should be retained, then a policy that addresses the acquisition,

utilization, and maintenance of KLC-owned vehicles should be implemented.

**Finding 9: KLC sold a vehicle at less than fair market value to an Executive Staff member.**

KLC's lack of a replacement policy for its fleet vehicles allowed the Deputy Executive Director to purchase his assigned vehicle for less than market value. Even without a policy or Executive Board approval, vehicles were replaced approximately every three years. When KLC Executive Staff decided to replace a 2005 Volvo XC90 SUV assigned to the Deputy Executive Director, a dealership offered a \$9,000 trade-in on the purchase of a new vehicle. Instead of requiring the employee to pay fair market value, KLC allowed the Deputy Executive Director to purchase the vehicle for the trade-in offer of \$9,000. During the year prior to this purchase, this vehicle had received new tires, brakes, and maintenance services costing KLC \$1,903.

**Recommendations:** We recommend the KLC Executive Board establish and require compliance with a policy that details the process to be followed when KLC replaces or disposes vehicles. This policy should require that vehicle purchases and replacements should be reported to the Executive Board. All supporting documentation related to the valuation, sale, and transfer of vehicles should be maintained by the CFO.

**Finding 10: KLC had no credit card policy to control over one million dollars that was charged on cards issued to employees.**

Twenty-six credit cards were issued to KLC staff members without the KLC Executive Board establishing a policy for the use of the cards or the review and approval of credit card expenditures. In addition, the Board was not involved in the review or approval of KLC's executive staff's \$523,261 credit card expenditures that accounted for 50 percent of the \$1,046,702 of total credit card expenditures. Numerous expenditures made via credit card had no supporting documentation and/or lacked any business purpose.

**Recommendations:** We recommend KLC Executive Board strengthen its credit card policies by establishing procedures that:

- Provide examples of unallowable expenses;
- Specify when prior approval of certain expenditures is required;
- Limit the types of purchases made by credit card;
- Require supervisory approval;
- Address employees' responsibilities for reimbursing unsupported expenses;
- Require the Executive Director/CEO to review and approve credit card expenses of Executive Staff members;

- Require the KLC President or other designee of the Executive Board to review and approve credit card expenses made by the Executive Director/CEO; and
- Limit the number of staff assigned credit cards.

**Finding 11: KLC’s travel and entertainment expense policies were insufficient to prevent excessive spending.**

During the examination period, travel and entertainment expenses for all employees totaled over \$1.3 million. The lack of controls to monitor credit card and reimbursement expenditures created an environment in which excessive and unsupported purchases were allowed. The policy for these expenditures that were in effect during our review period did not provide specific guidance or review procedures that would limit excessive and unreasonable travel and entertainment expenses.

**Recommendations:** The KLC Executive Board must strengthen its “Travel and Meeting Expense Reimbursement Policy” established in August 2009, to require the Executive Director/CEO to provide financial oversight of staff travel and entertainment expenses, require periodic reports of travel-related expenses to the Executive Board, provide specific parameters for allowable meal and entertainment expenses, prohibit the payment of spousal travel; and include parameters to limit the number of employees attending each conference/training event.

**Finding 12: KLC’s budget and financial information does not provide a breakdown of the projected or actual expenses associated with its affiliated organizations.**

The actual costs incurred by KLC to operate each of its affiliated organizations were not presented to the KLC Executive Board or the affiliate boards. While KLC charges an administrative fee from each affiliate organizations, this fee was not based entirely on actual costs. Each organization’s administrative agreement had a different method for determining the administration fee paid to KLC. A cost allocation was performed by the CFO in coordination with KLC Executive Staff, but this method was not based on a written, approved policy nor was it presented in the budgets to the applicable boards or in audited financial statements. Accordingly, members of KLC’s Executive Board, as well as members of its other affiliated boards, were not informed of actual costs incurred to operate their respective organizations.

**Recommendations:** We recommend that KLC’s Executive Board and affiliate boards, to enhance transparency, approve a cost allocation method to be used in determining the actual cost of operating the affiliated organizations. When budgets are approved, a

detailed breakdown of the projected expenses of each affiliate should be provided to the KLC Executive Board and the affiliate boards to ensure an adequate understanding of actual operating expenses. In addition, the KLC Executive Board should reimburse NewCities based on actual costs incurred for providing staff and services instead of making an in-kind contribution for these costs.

**Finding 13: Policies for ethical behavior were weak or nonexistent for board members, officers, and staff.**

Receipt of public funds to operate KLC requires that KLC board members, officers, and staff be accountable to the public for their actions and comply with standards of ethical conduct. The KLC Employee Handbook included minimal requirements for the conduct of employees, but did not address many other areas of conduct, nor did it extend such standards to board members. The new work conduct policies adopted August 19, 2009, allow improper exceptions, do not provide enough direction or specificity, and do not address many of the areas of conduct required for employees and board members to be accountable and ethical in their decision-making for KLC.

**Recommendations:** We recommend KLC strengthen its work conduct policies for “Conflicts of Interest” and “Gifts” and further develop and implement a comprehensive code of ethics including other standards of conduct. We further recommend that KLC adopt a code of ethics for its Board of Directors, Executive Board, and for the trustees of its various affiliated boards, that include guidance regarding the acceptance of gifts and gratuities, provides for specific direction regarding conflicts of interest and solicitation, and includes a comprehensive code of ethics with additional standards of conduct. Finally, we recommend once the new comprehensive code of ethics is implemented, KLC should provide initial training on the code, as well as an annual review, for all staff and board members.

**Finding 14: Numerous conflicts of interest existed that contributed to the appearance of, if not actual, improprieties by certain KLC board members and staff.**

Several instances of specific conflict of interest situations were identified that may have contributed to unfair business practices and poor quality services. It is impossible to determine if the vendors KLC used provided the best services to KLC members when the staff allowed friendships or other relationships to potentially provide favoritism and influence independent decision-making. KLC board members and employees should be independent and impartial in the actions they undertake and decisions they are called on to render, ascertaining that such actions and

decisions are based on the best interests of KLC members and policyholders.

**Recommendations:** We recommend the KLC Executive Board, within its comprehensive code of ethics, provide standards of conduct for conflicts of interest that prohibit employees and all affiliated board members from involvement in discussions or decisions of certain issues that cause a conflict between their personal interests and their duties for KLC. Employees or board members who abstain from involvement in discussions or decisions, should not be present during such discussions and the abstention should be documented.

**Finding 15: Ineffective policies for the acceptance of gifts resulted in personal benefits and the appearance of, if not actual, inappropriate relationships with vendors.**

KLC's standards of conduct for solicitation and acceptance of gifts and gratuities by board members and staff were not effective in preventing numerous conflicts of interest. Executive Staff members received personal benefits that resulted in the appearance of, if not actual, inappropriate relationships with vendors. Without a strong policy regarding solicitation and acceptance of gifts, conflicts for employees and board members/trustees may allow subjective decisions to be made that are not in the best interests of KLC members or policyholders.

**Recommendations:** We recommend KLC strengthen its gifts policy within its code of ethics by adopting a standard of conduct for the solicitation and acceptance of gifts and gratuities that would prohibit conflicts of interest for employees, as well as for Executive Staff and other board members and trustees. The effect of the policy should be that vendor decisions by employees, board members and trustees of KLC, and its affiliated programs, be made impartially and objectively in the best interest of KLC. Employees responsible for the selection and oversight of vendors should have limitations on the value of the gifts they may accept from vendors. Finally, the policy should address whether KLC, as an association of government entities, should solicit or accept gifts on behalf of KLC directly from its vendors.

**Finding 16: KLC did not require its board members, trustees and Executive Staff to file statements of financial disclosure revealing potential conflicts of interest.**

During the period of examination, KLC had no requirement for its board members or Executive Staff to file a statement of financial interests disclosure. Financial disclosure statements provide a means to determine whether officials responsible for the use of public funds possess any conflicts of interest or

potential conflicts between their private interests and their employment duties. Lack of such disclosure tends to reduce public confidence in the integrity of those officers and employees responsible for spending monies obtained ultimately from taxpayers.

**Recommendations:** We recommend the KLC Executive Board implement a financial disclosure policy within its code of ethics that requires the board members and Executive Staff to annually file a financial interests disclosure statement by a specified date with the appropriate committee of the Executive Board. The policy should require an affirmative statement by the filer that he or she has no interest that would cause a conflict with his or her official duties. Sanctions for noncompliance with the filing requirement should also be detailed in the policy.

**Finding 17: KLC had no whistleblower policies or procedures established to report ethical and other policy violations, or to investigate such potential violations, or to impose sanctions for violations.**

During the period of examination, KLC had no whistleblower policy or procedure for employees or others to:

- report potential ethical and other policy misconduct (other than for sexual or nonsexual harassment) or concerns;
- follow-up and investigate any reported activity;
- determine whether an actual violation of policy or abuse existed; and,
- establish criteria for sanctions or disciplinary procedures.

Without a method for employees or other citizens to report potential violations of policy without fear of repercussion, abusive actions by employees and board members may exist that are never corrected.

**Recommendations:** We recommend that the Executive Board further strengthen its whistleblower reporting policy for suspected violations of any in-house policies by creating and documenting an independent process for receiving, analyzing, investigating and resolving such alleged violations. The process should include multiple avenues by which concerns may be expressed, such as a toll-free hotline, an e-mail address, and a postal address. The complaint procedures should ensure that the complaint does not have to be filed directly with an employee or board member about whom the complaint is lodged, nor should any employee or board member against whom a complaint is filed have any involvement in the resolution of the matter.

**Finding 18: A procurement policy for the purchasing of goods and services was not established by KLC Executive Staff or the Executive Board.**

KLC paid \$63.7 million dollars to outside vendors, but did not have a sufficient procurement policy to ensure that the selection of these vendors and the services provided maximized benefits to KLC membership. KLC and its affiliated organizations did not have formal competitive bidding process for vendor selection. In the absence of an adequate procurement policy, KLC Executive Staff had the discretion of vendor selection, contract terms, and whether to disclose procurement details to respective boards.

**Recommendations:** The Executive Board should enact policies that establish the circumstances under which bids or competitive quotes must be secured in order to make a purchase. The policy should establish the criteria requiring board approval of contracts, including that all long term contracts must be presented to the appropriate board for full review and approval before a commitment is made to a vendor. Procurement policies should address purchasing approvals and purchasing methods required for the different types of services and products purchased to ensure proper monitoring and oversight of payments.

**Finding 19: KLC board members and trustees received no formal orientation on their legal and fiduciary responsibilities.**

No documentation was found indicating that KLC board members or the trustees of its affiliated insurance and financial organizations received formal orientation training on the purpose of the respective boards, their responsibilities as KLC representatives, as well as, their legal and fiduciary roles. Interviews of the current Executive Board president, as well as three former presidents and other board members, confirm no formal, detailed orientation was held during the period of review.

**Recommendations:** We recommend KLC provide an annual orientation training for new and returning board members/trustees to ensure their understanding of the KLC organization structure and policies, their responsibilities as board members, as well as their legal and fiduciary roles. The orientation should address ethical requirements of board members and staff and any significant policy changes adopted by KLC during the previous year.

**Finding 20: The KLC board structure may impede oversight and accountability.**

The 2009-2010 KLC Board of Directors consists of 59 members that according to KLC By-Laws have no decision-making authority, but act in an advisory capacity. Board level decision-making authority is vested in an eighteen member Executive Board. Because these eighteen members are city mayors or city

managers, any void of governance may have been filled by KLC's Executive Staff. Although KLC succeeded in providing beneficial services to its members, our examination has identified various instances of Executive Staff benefiting from the void in board oversight and accountability.

**Recommendations:** We recommend that KLC's By-Laws be amended to provide for an alternative to decision-making solely by the Executive Board. We recommend that KLC consider renaming its Board of Directors to reflect their advisory role to avoid confusion that this board is not the governing body of KLC.

**Finding 21: KLC allowed credit card expenses and reimbursement requests to be paid with no or inadequate supporting documentation.**

Even though KLC had a credit card and reimbursement policy during our period of review, \$266,374 in purchases had either an unclear business purpose, inadequate documentation or were excessive and \$87,783 in purchases had no supporting documentation. Compliance with this policy was not enforced and KLC placed itself in a position for staff to abuse credit cards and employee reimbursements. Executive Staff made 64 percent of the unsupported credit card expenditures, and 59 percent of the unclear business purpose, inadequate documentation, or excessive credit card expenditures.

**Recommendations:** The Travel and Entertainment Expenses policy should be strengthened to explicitly state that expenses not supported by detailed, itemized receipts that verify a business purpose and are provided within a reasonable specified period will not be paid by KLC. All payments should be reviewed for appropriateness, reasonableness, and necessity, and to ascertain that adequate supporting documentation exists.

**Finding 22: KLC spent over \$430,000 on out-of-state travel with questionable benefit to KLC membership.**

During the period of examination, KLC spent \$431,354 for out-of-state travel costs associated with 162 trips. KLC staff and board members traveled out-of-state for a variety of conferences, meetings, training sessions, and conventions. While attendance at the various seminars, conferences and national gatherings can provide educational and networking opportunities, there is inadequate evidence that this level of out-of-state travel was justified by the benefits derived by Kentucky cities.

**Recommendations:** The Executive Board should establish a detailed policy to guide employee and board travel and address the scope of KLC's presence and representation. This policy should include consideration of the relevance of a national presence,

the amount of resources KLC should allocate to out-of-state activities, and the expected benefits of out-of state travel to the KLC membership. The Executive Board should receive reports of the cost and reasons for out-of-state trips, but spousal travel costs should be paid by KLC.

**Finding 23: KLC spent over \$56,000 on meals at local restaurants.**

An examination of KLC credit card statements and employee reimbursements documented expenses in excess of \$56,000 incurred for the purchase of local meals for KLC staff. It was acceptable practice to routinely expense lunches where only KLC employees were in attendance and to classify the expense as a “working lunch.” The frequency of those lunches was excessive and did not have a supportable purpose and benefit. The expense related to local meals also includes over \$28,000 spent at Azur, which is a restaurant co-owned by the spouse of the Executive Director/CEO.

**Recommendations:** The Executive Board should implement a policy to clearly define when it is appropriate for meals, including local meals, to be purchased on behalf of employees, board members, vendors, and guests. Employees not on travel status should pay for their own meals and subsequently be reimbursed after completing an established review and approval process. We further recommend the Executive Board establish policies as to the purchase of goods and services from vendors in which KLC employees, directors, and officers or their families have a financial interest.

**Finding 24: KLC spent approximately \$50,000 to purchase tickets for various events.**

Tickets were purchased for a variety of events, including university football and basketball games, horse racing events, and a concert. There were no records maintained listing those individuals who used tickets for university football and basketball games costing over \$17,000. The ticket purchases were not documented as being attributable to a specific marketing plan or having an identifiable business purpose. Without supporting documentation, it is questionable as to who actually benefited from the ticket purchases.

**Recommendations:** KLC should not allow the purchase of tickets solely for the entertainment of board members, staff, spouses, or guests. The expenditure of funds for sporting events and other entertainment venues should have a documented benefit detailing the expected benefit to KLC membership.

**Finding 25: KLC had no policy governing expenditures for alcohol.**

KLC purchased alcoholic beverages for KLC sponsored hospitality rooms during events such as their annual conference and other similar conferences. KLC also purchased or reimbursed employees for purchases of alcoholic beverages by the drink at restaurants and bars. During the examination period, specific purchases for alcohol totaled \$12,349, but this did not include purchases of alcohol accompanying individual meals. A complete analysis of alcohol purchases could not be performed because of \$354,158 in credit card and business expense reimbursement transactions either had no supporting documentation or lacked detailed receipts.

**Recommendations:** The Executive Board should ensure that effective processes and procedures are in place for executing and monitoring the newly adopted Alcohol Reimbursement Policy, including actions that will be taken in the event of non-compliance. Given the potential liability that could be incurred by KLC in the event of an alcohol related accident or incident, we recommend the Executive Board review the KLC policy regarding alcoholic beverages.

**Finding 26: KLC Executive Staff did not inform the Executive Board of a harassment investigation that raised broader concerns involving an Executive Staff member.**

KLC’s Executive staff did not inform the Executive Board of a harassment investigation involving an Executive Staff member. KLC hired an independent law firm to perform an investigation of a complaint filed by a KLC employee, but the implementation of the law firm’s recommendations were at the discretion of Executive Staff. In addition, broader concerns were raised regarding ethical and legal issues unrelated to the nonsexual harassment charges. The harassment policy, at a minimum, should include informing the Executive Board of harassment issues involving KLC Executive Staff.

**Recommendations:** The KLC Executive Board should have a policy to ensure they are informed of harassment complaints when preliminary internal investigations indicate that there is sufficient merit to the allegation. In addition, the Executive Board should be involved in the decision to hire an outside consultant and notified immediately when the complaint involves a member of KLC Executive Staff.

**Finding 27: The insurance programs of KLC were not organizationally independent of the primary KLC member association activities.**

Because the insurance programs of KLC were not organizationally independent of KLC member association activities, the Kentucky Department of Insurance (KDOI) requested on July 2, 2009, that KLC

implement a distinct and discernable separation between the activities of KLC and KLC's insurance programs. This separation was requested to assist in determining whether the purchase of insurance policies from KLC was in compliance with insurance regulations regarding illegal inducements. KLC's corrective action plan begins to address the concerns of KDOI, but further separation may be needed because the insurance program boards consist of several of the same members that serve as officers of the KLC Executive Board. Considering that the Chief Insurance Services Officer organizationally reports to KLC's Executive Director/CEO as well as the Deputy Executive Director, there is an appearance that KLC's Executive Director/CEO is also directing the insurance program activities, as well as membership services.

**Recommendations:** We recommend KDOI review the information presented in this report for its use in KDOI's oversight of KLCIS. We further recommend the KLC Executive Board determine whether further segregation between KLC and KLCIS is warranted.

**Finding 28: KLC subsidized NewCities through in-kind contributions and cash totaling \$7,239,378 over an eight-year period with few quantifiable results.**

NewCities Institute, a separate non-profit corporation formed to "research, study, educate, and innovate communities about civic engagement," contracts with municipalities, educational, and other non-profit groups to facilitate meetings and provide guidance to help recognize opportunities for projects that may improve the local standard of living. In eight years of operations, NewCities has incurred a cumulative net operating loss of \$603,507. This loss occurred even though it received \$6,789,378 of in-kind support from KLC and received an additional net cash contribution of \$450,000.

**Recommendations:** The KLC Executive Board must reassess its future commitment to the mission of NewCities to determine if continued support is the best use of KLC resources. The Executive Board must determine whether a \$7.2 million outlay to NewCities over the last eight years represents a responsible and acceptable use of member-provided resources. If the commitment with NewCities is continued, the following recommendations should be implemented:

- Limit engagement activities to in-state municipalities
- Improve financial reporting
- Consider additional board membership from the KLC membership
- Review the in-kind contributed services for accuracy and appropriateness

**Finding 29: Income related to personal use of vehicles was not accurately reported in executives' W-2 wages.**

KLC provided Executive Staff with organization-owned vehicles that were used for personal as well as business purposes. Executive Staff members were expected to submit mileage logs at year-end to document each employee's personal use of the automobile in order to calculate the amount of personal income to be added on the employee's W-2. In some cases mileage logs were not submitted and in other instances the personal use amount was miscalculated.

**Recommendations:** We recommend that KLC staff, in consultation with the IRS, amend any previously issued W-2s to appropriately reflect the non-cash fringe income that should have been reported for each of the employees who were provided the personal use of a vehicle. We also recommend that KLC staff assigned vehicle submit timely mileage records. KLC staff responsible for calculating the personal income should be properly trained and understand the methodology of the calculation. These calculations should be reviewed and approved by supervisory or other designated staff.

**Finding 30: Weak internal controls identified at KLC did not provide a sufficient review process prior to making a payment.**

KLC did not establish a formal process to ensure a thorough and consistent review and approval was performed prior to making a payment. Without proper guidance, the accounting staff was placed in the position of paying expenses without supporting documentation, which could lead to inappropriate expenditures.

**Recommendations:** The KLC Executive Board should ensure a procedures manual is developed to address the security of the accounting system, proper lines of authority for review/approval of expenditures, the types of allowable expenses, required supporting documentation, and requirements regarding expenditure payments. This manual should also include required procedures for reviewing payments and checks.