



January 24, 2013

Audit Committee
Town of North Kingstown, Rhode Island
North Kingstown, Rhode Island

In planning and performing our audit of the financial statements of the Town of North Kingstown, Rhode Island (the Town) as of and for the year ended June 30, 2012, in accordance with auditing standards generally accepted in the United States of America, we considered the Town's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Town's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as discussed below, we identified deficiencies in internal control that we consider to be significant deficiencies.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following deficiencies in the Town's internal control to be significant deficiencies:

Cash:

Observations:

By its nature, cash is an asset more susceptible to the risk of theft or other misappropriation and misstatement. The Town's internal controls related to cash deposits and monthly bank reconciliations are key controls that serve to reduce the risk of misstatement due to fraud or error. During the performance of audit procedures, the following was noted:

- Cash collected at different locations within the Town is brought to the Town Hall for deposit to the bank and recording to the general ledger. Certain School Department deposits, totaling \$15,379, that the School Department asserts were brought to the Town Hall for deposit, did not get deposited to the bank or recorded to the general ledger. The Town's system of controls did not timely identify that the deposits were deposited to the bank. The School Department was successful in obtaining replacements for the portion of the deposits that were in check format, and the ultimate loss to the School Department was about \$500.
- There were instances when monthly bank reconciliations were not performed timely.
- There is no independent review or sign-off on the bank reconciliation from someone other than the individual performing the reconciliation. The necessity of a system of checks and balances such as this ensures that an organization is not dependent solely upon one individual's work or performance.

Recommendations:

The more standardized procedures are throughout an organization, the less likelihood there is for errors to occur. If an organization has many locations that receive cash (checks, cash or credit card payments), then the procedures for controlling the cash prior to deposit should be standardized to ensure that all cash collected is deposited timely and recorded accurately.

In order to strengthen the safeguards over cash, we recommend the following:

- Implementation of standardized procedures and forms for the acknowledgement of deposits brought to the Town Hall for processing, including a sign-off on the listing of receipts evidencing the transfer of cash from one department to another in order to provide a trail of accountability. In addition, the monthly bank reconciliation process, to be performed by someone independent of the deposit process, should include comparing the listing of deposits sent to the Town Hall that month, received directly from the respective departments, to the actual deposits to the bank as recorded on the monthly bank statement.
- Bank reconciliations should be performed as soon as possible upon receipt of the monthly bank statement.

Cash (Continued):

Recommendations (continued):

- Bank reconciliations should be reviewed within a short time after completion, and signed off to indicate review and approval, by an individual independent of the individual preparing the reconciliation.
- Each department manager should review the monthly revenue and expenditure reports for accuracy and completeness for both revenues and expenditures, as compared to independent expectations.

Response:

The collections division has already tightened up their internal policies and procedures regarding cash handling from decentralized locations and is now providing the individual with signed consent that the correct amount of cash was properly documented/received and was verified by staff.

The timeliness of reconciling the bank statements has been difficult due to staffing shortages during the end of fiscal year 2012 and beginning of fiscal year 2013. However, we have been able to fill the accounts receivable manager position, the family medical leave staff person has returned, and we were fortunate to hire a full-time employee rather than a part-time employee to complement the finance staff.

Town Finance Department and School Business Office Communication:

Observations:

The 1992 Integrated Framework on Internal Control issued by the Commission on Sponsoring Organizations (COSO), and adopted by the Government Accounting Office in 2004 as applicable to governments at all levels, lists the fundamental and essential objectives of any government's system of internal controls.

While most governments have implemented many of the recommended elements of the Control Environment and Control Activity components of the COSO report, an equally important component is Information and Communications. This component emphasizes both the **quality** of information generated within the government and the **effectiveness** of communications, whether written or oral, particularly as they relate to the government's ability to prepare accurate financial information on a timely basis. This requires an integrated accounting system and sufficient oral communications among those charged with the responsibility to maintain accounting records to ensure that the financial information being generated by the accounting system is accurate.

Town Finance Department and School Business Office Communication (Continued):

Observations (continued):

Much of the financial information of the School Department requires collaborative effort by both the Town Finance Department personnel and School Business Office personnel. However, we observed a lack of timely communication and collaboration among the Town's Finance Department personnel and the School Business Office personnel. Collaboration and cooperation between departments is a key control procedure, based on the significance of the nature and amounts of the transactions to be recorded.

Specific observations include:

- The School Payroll Fund (payroll clearing account) is an agency fund utilized by the Town as a clearing account to record and process payroll transactions, including salaries and benefits. Each time payroll is processed, cash is transferred into the payroll clearing account in an amount sufficient to cover payroll and benefits. By its nature, the balance in the payroll clearing account should approximate zero after all transactions are settled.

At June 30, 2012, there is a \$228,000 unidentified liability, with an offsetting amount in cash, remaining in the payroll clearing account, which appears to date back to the fiscal year ended June 30, 2009.

Because there is no agreement between Town Finance Department personnel and School Business Office personnel as to what the cash and liability represent and how the balances should be resolved, the cash balance remains in the bank account unavailable to the Town.

- The Town Finance Department is the central location for recording general ledger entries affecting the Town-wide nonmajor funds. During the course of the audit, it was noted that several general journal entries proposed by the School Business Office and provided to the Town Finance Department for recording in the general ledger were not recorded for months.

Recommendations:

The Town Finance Department and School Business Office personnel should work to establish a system of communication that allows for the timely recording and resolution of accounting and reporting matters arising in the normal course of business, including the recording of journal entries and other standard transactions.

Specifically, the Town Finance Department and School Business Office personnel should collaborate in researching and resolving the \$228,000 balance in the payroll clearing account.

Town Finance Department and School Business Office Communication (Continued):

Response:

Again, staffing shortages contribute to the timely recording of journal entries. However, a conscious effort will be made to stay up-to-date on recording journal entries. It is acknowledged by both groups that communications could be better between the School and the Town. Management of both groups are committed to working on these issues in the future.

The liability of \$228,000 remaining in the School Payroll Fund can and will be transferred to the School Department upon resolution and pursuant to an appropriate reconciliation. Research will be done to identify the nature of the liability.

Financial Reporting and Close Process:

Observations:

Accounting principles generally accepted in the United States of America (GAAP) mandate that management of the Town is responsible for the Town's financial statements and external financial reporting. Independent auditors are required to assess whether the Town has properly designed controls placed in operation to prepare financial statements in accordance with GAAP. Based on that assessment, the number and dollar volume of entries that were required to adjust the Town's financial statements to conform to those accounting principles constitutes a significant deficiency in internal control.

In particular, it was noted that:

- The internal year-end closing process does not include adjusting the funds to the required financial reporting basis in accordance with GAAP. Funds are maintained during the year, and were provided to us on a budgetary basis utilizing the modified accrual basis of accounting, which required a significant dollar volume of audit entries.
- Proprietary funds, by their nature, are accounted for under the full accrual GAAP basis of accounting, different from governmental funds. The Town does not maintain its proprietary funds on the full accrual basis, but rather on the budgetary basis utilizing the modified accrual basis of accounting, including the use of encumbrances and the expensing of items that qualify for balance sheet treatment under the full accrual basis (capital assets, principal payments on long-term debt). As a result, a significant dollar volume of audit entries was required.
- Many of the internal year-end closing procedures occurred concurrent with the audit fieldwork. During the course of audit fieldwork, management provided more than thirty journal entries for recording, which significantly affected the balances being audited and caused auditor rework.

Financial Reporting and Close Process (Continued):

Recommendations:

In order to prepare a timely and accurate financial reporting package in accordance with GAAP, we recommend that the Town:

- Conclude the year-end closing process and record all necessary journal entries prior to the start of audit fieldwork, in a timeframe that allows sufficient time for audit completion and timely delivery of the audited financial statements to the State prior to the December 31 reporting deadline.
- Incorporate recording of closing entries so that all funds are presented in accordance with the appropriate basis of accounting and GAAP.

Response:

Typically, the final close happens in September, 60 days after the fiscal year-end, to allow for the proper posting of accruals. The 2012 fiscal year was not closed until October due to staffing shortages and for allowing certain process to be completed prior to the final close.

The Town has always provided the auditors with trial balances based on the budgetary basis. Town staff will work with the auditors to properly record and prepare financial statements in accordance with GAAP to eliminate the large volume of audit entries. Again, the lateness of these entries was in direct correlation with staffing shortages.

Independent Review of Significant Estimates:

Observations:

The concept of internal control includes, among other things, the necessity of a system of checks and balances so that an organization such as the Town is not dependent solely upon the accuracy of any one individual's work or performance and it reduces the likelihood that errors (intentional or unintentional) will remain undetected.

Management's estimates, in particular, are particularly susceptible to material misstatement or manipulation (intentional or unintentional), as they may materially change based on assumptions utilized to generate the estimates.

It was noted that there is no independent review of the calculation of the estimated pollution remediation liability related to the landfill clean-up, totaling \$1,660,000 at June 30, 2012.

Independent Review of Significant Estimates (Continued):

Recommendation:

All significant estimates should be reviewed and signed off by an individual independent of the person who generated the estimate. If applicable, the calculation of the estimate should identify significant assumptions utilized.

Response:

The Town has been working with a consultant, ATC Lincoln Environmental, on the steps required to move the landfill closure project along. All estimates provided in the Capital Improvement Project document are preliminary but well investigated/calculated. A Site Investigation Report for one of the landfills has been completed and a closure recommendation remediation has been submitted to RI Dept. of Environmental Management. The Town will work with ATC to further identify the assumptions used to develop our estimates.

We identified the following control deficiency that we determined does not constitute a significant deficiency or material weakness:

Fund Classification and Use:

Observations:

The third principle of governmental accounting and financial reporting for state and local governments states that:

Governmental units should establish and maintain those funds required by law and sound financial administration. Only the minimum number of funds consistent with legal and operating requirements should be established, however, since unnecessary funds result in inflexibility, undue complexity, and inefficient financial administration. In addition:

- Governmental Accounting Standards Board Statement No. 54 *Fund Balance Reporting and Governmental Fund Type Definitions* (GASB 54), eliminated the use of special revenue funds, except in certain specific instances, such as to account for and report the proceeds of specific revenue sources like federal grants. The Town maintains many special revenue funds which may not qualify as separate special revenue funds for financial reporting purposes.

Fund Classification and Use (Continued):

- Enterprise funds are used to account for activities for which a fee is charged to external users for goods or services, such as the fees for water usage charged and recorded as revenue in the water fund. The Town has historically reported a separate enterprise fund, Water Capital Reserve Fund, in the Town's basic financial statements. However, the Water Capital Reserve Fund does not qualify as a separate enterprise fund as its main source of revenue is a transfer from the Water Fund, and not user fees.
- The Police Pension Fund is not a legal trust and may not qualify to be presented and reported as a fiduciary fund for financial reporting purposes.

Recommendations:

Management should begin the process of reviewing the Town's funds to determine that the reporting in the basic financial statements is in accordance with governmental accounting and reporting standards. In particular:

- Internal use of various separate "special revenue" funds for ease of internal and financial record-keeping and recording is permissible, with consolidating those that do not qualify as a special revenue fund under GAAP into the General or School Unrestricted Fund for financial reporting purposes, as applicable.
- Consider consolidation of the Water Capital Reserve Fund into the Water Fund for financial reporting purposes.
- Research the nature and origin of the balances within the Police Pension Fund, in order to support the fund type classification and determine if the cash balance in the Police Pension Fund is actually restricted as to its use.

Response:

The Town will consider the recommendations provided by the auditor; however, some of the funds recommended during the audit process to be consolidated are reported separately because (1) they are considered major funds within the category and (2) separately reporting these funds provides the taxpayers with transparency and certainty that their tax dollars and/or user fees are being properly handled and accounted for.

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The Town's written responses to the deficiencies identified in our audit have not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

This communication is intended solely for the information and use of management of the Town and members of the Audit Committee and Town Council and is not intended to be and should not be used by anyone other than these specified parties.

LGC & D LLP