INDEPENDENT ACCOUNTANT'S REPORT ON APPLYING AGREED-UPON PROCEDURES TO THE KENTUCKY RACING COMMISSION

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Due to file size limitations, the appendices are not included in this report. To view an appendix, just click on its' title in the Table of Contents and you will be directed to the appendix.

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List of abbreviations/acronyms used in this report

APA	Auditor of Public Accounts
Council	Equine Drug Research Council
EPPC	Environmental and Public Protection Cabinet
FAC	Finance and Administration Cabinet
FY03	Fiscal Year 2003
GOT	Governor's Office for Technology
KAR	Kentucky Administrative Regulations
KHRA	Kentucky Horse Racing Authority
KRC	Kentucky Racing Commission
KRCSystem	Kentucky Racing Commission Enterprise Licensing System
KRS	Kentucky Revised Statutes
OAG	Opinion of the Attorney General
PPRC	Public Protection and Regulation Cabinet
RCI	Association of Racing Commissioners International, Inc.
RFP	Request for Proposal
UKRF	University of Kentucky Research Foundation

CRIT LUALLEN
AUDITOR OF PUBLIC ACCOUNTS

June 22, 2004

Governor Ernie Fletcher
Commonwealth of Kentucky

LaJuana S. Wilcher, Secretary
Environmental and Public Protection Cabinet

RE: Agreed-upon procedures applied to Kentucky Racing Commission

Dear Governor Fletcher and Secretary Wilcher:

In Governor Fletcher's March 3, 2004 letter, this office was requested to perform an audit of certain activities of the Kentucky Horse Racing Authority and the former Kentucky Racing Commission (KRC). In subsequent meetings and discussions with Secretary Wilcher and her staff it was determined that the most appropriate form of engagement for this office to address the specific issues brought to our attention was to apply "agreed-upon procedures."

An agreed-upon procedures engagement involves performing specific procedures to a subject matter and issuing a report of findings and recommendations. In this type of engagement, the auditor does not perform a financial statement audit, the object of which is to express an opinion on whether the subject's financial statements are presented fairly in all material respects. Agreed-upon procedures engagements are governed by attestation standards established by the American Institute of Certified Public Accountants. The procedures performed were specified by the Environmental and Public Protection Cabinet (EPPC) and were not limited by the Auditor of Public Accounts (APA). The APA is willing to expand the scope of the procedures should the EPPC so request.

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AN EQUAL OPPORTUNITY EMPLOYER M / F / D

Transmitted herewith is our report, with findings and recommendations, resulting from the procedures agreed upon with EPPC. Included as appendices are reports previously issued by the APA, which address some of the same KRC issues discussed in the current report.

We thank the Cabinet Secretary, employees of EPPC, Kentucky Horse Racing Authority, and others that provided their cooperation and assistance during this engagement.

Very truly yours,

Crit Luallen
Auditor of Public Accounts

Independent Accountant's Report
On Applying Agreed-Upon Procedures

We have performed the procedures enumerated below, which were agreed to by the Environmental and Public Protection Cabinet (EPPC), solely to assist in evaluating the Kentucky Racing Commission's (KRC) past practices and certain activities of the Kentucky Horse Racing Authority (KHRA) and offer recommendations for the future. The former Public Protection and Regulation Cabinet (PPRC) was responsible for the KRC financial processes and corresponding controls. The successor cabinet, EPPC, is responsible for KHRA financial processes and corresponding controls. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. As required by these standards, the sufficiency of these procedures is solely the responsibility of those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

Agreed-Upon Procedures and Findings are summarized below:

1) Review work performed by EPPC regarding travel charges in calendar years 2003 and 2004. In particular, examine the specific potentially fraudulent travel reimbursements identified by EPPC.[1] Determine whether expenses submitted are allowable under Kentucky travel regulations and offer recommendations to resolve any audit findings. Recommend to KHRA policies and procedures to ensure future compliance with travel regulations.

   Finding:
   - Former Executive Director and Staff Assistant inconsistently applied travel regulations.

2) Evaluate the EPPC and KHRA time and attendance policies and procedures, including employee classification and the associated method of compensation (hourly vs. salary). Test compliance with applicable time and attendance policies, procedures, statutes, and regulations referenced above and offer recommendations as necessary.

   Finding:
   - Lack of written policies and procedures resulted in inconsistent use of earned leave, overtime, and use of "inclement weather" paid leave code.

[1] The potentially fraudulent travel reimbursements identified by EPPC and reviewed by the Auditor of Public Accounts occurred in calendar year 2003, except for one reimbursement made in January 2004.

3) Examine fiscal year 2003 (FY03) procurement contracts, or the lack thereof, for the following vendors:
    a. Dr. Sams
    b. Attorney Bruce Miller
    c. University of Kentucky contract with Equine Drug Research Council. As part of this issue, examine statutes to determine compliance.

   Determine whether these contracts complied with all appropriate procurement statutes, regulations, and policies. Determine that all parties complied with the terms of these FY03 contracts.

   Findings:
   - As noted in a prior report, KRC did not follow policies for procuring the services of Dr. Sams.
   - KRC followed policies for procuring FY03 attorney contract.
   - Payments to the University of Kentucky Research Foundation were statutorily allowed and in compliance with procurement policy.

4) Determine whether new policies and procedures enacted by EPPC for KHRA as of mid-January 2004 are properly designed to achieve the desired objective and are operational and consistently applied.

   - We concur that new policies and procedures implemented by EPPC and KHRA will strengthen internal controls and clarify procedural processes. Our office made additional recommendations to address issues identified in this report.

5) Determine whether dual employment of any existing KHRA employees is in compliance with existing statutory, regulatory, or policy requirements. Recommend policies and procedures to be followed by KHRA to ensure dual employment is properly administered.

   Finding:
   - While not expressly prohibited by law, an individual employed both as KRC Executive Director and Chief Steward creates conflicts of interests.

6) Determine whether track assessment rates implemented by KRC comply with 811 KAR 1:115 and offer recommendations as needed. Further, determine if the authority cited by KRC to increase these track assessment rates is accurate.

   Finding:
   - The law is ambiguous as to KRC's authority to assess track fees.

7) Determine the adequacy of the general and application controls governing the KHRA licensing system and offer recommendations as needed.

   Findings:
   - Racing system developed in 2001 has segregation of duties control weaknesses for system access.
   - Security Administration functions over the KRCsystem should be improved.
   - System design modifications are needed to improve data integrity and security.

8) Perform reconciliation for license receipts for the period of January 2003 to present. As part of this, develop internal control procedures to ensure receipts are handled properly.

   Findings:
   - KRC did not deposit license receipts in a timely manner.
   - KRC did not perform a timely reconciliation of license receipts to the licensing system and to bank deposits.

Findings and recommendations resulting from the performance of these procedures are detailed in the following pages of this report.

We were not engaged to, and did not conduct an examination, the objective of which would be the expression of an opinion on financial processes and corresponding controls. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported.

This report is intended solely for the information and use of the Environmental and Public Protection Cabinet and the Governor's Office and is not intended to be and should not be used by anyone other than those specified parties.

Respectfully submitted,

Crit Luallen
Auditor of Public Accounts

June 16, 2004

Findings and Recommendations

Agreed-Upon Procedure 1 addresses compliance of travel reimbursements with appropriate criteria.

Review work performed by Environmental and Public Protection Cabinet (EPPC) regarding travel charges in 2003 and 2004. In particular, examine the specific potentially fraudulent travel reimbursements identified by EPPC. Determine whether expenses submitted are allowable under Kentucky travel regulations and offer recommendations to resolve any audit findings. Recommend to Kentucky Horse Racing Authority (KHRA) policies and procedures to ensure future compliance with travel regulations.

Former Executive Director and Staff Assistant inconsistently applied travel regulations.

The former Kentucky Racing Commission (KRC) had employees such as detention barn associates, license administrators, veterinarians and stewards that travel to each of the eight Kentucky race tracks to perform their normal work duties. Travel vouchers for reimbursements were submitted to KRC on a regular basis.

The EPPC internal auditor conducted a review of all KRC travel vouchers submitted and reimbursed between July 2002 and January 2004. EPPC then provided to our office 26 travel vouchers identified as potentially fraudulent.

The former Executive Director and a Staff Assistant within the KRC were designated to have signature authority for approving travel vouchers.

While reviewing the specified travel vouchers we found no evidence of a formal supervisory review or approval on two of the 26 travel vouchers submitted for further consideration. Although the documents were electronically approved through the MARS system, no signature appeared on these documents, indicating that the travel vouchers lacked a proper review for compliance with state regulations.

Travel vouchers did not include all required information.

In addition, for 21 of these travel vouchers, reimbursements were made to employees when the vouchers were incomplete as to hours, locations, or purpose. Capturing the hours and locations are critical in determining the reasonableness of the mileage and the eligibility of the employee for subsistence. To be reimbursed for subsistence, state regulation 200 KAR 2:006 Section 7 requires an employee to be in travel status during the

entire established mealtime hours. Further, Section 10 of that KAR states that the purpose of each trip shall be included on the travel document.

Meal allowances were not consistently applied.

EPPC identified, and we confirmed, inconsistent practices regarding payment of subsistence allowances to employees resulting in certain employees receiving meal reimbursements while others did not. This inconsistency was due, in part, to a lack of written policies concerning non-racing or "dark" days.

Lax oversight resulted in one employee being inappropriately reimbursed over $10,000.

From November 2002 through January 2004, one employee was inappropriately reimbursed $10,763.32 in travel related expenses that he incurred for traveling to and remaining at his workstation during the workweek. The employee's workstation is in Boone County; however, his home residence is in Ohio. The KRC reimbursed this employee's travel, meals, and lodging for being present at his workstation.

We interviewed the employee to determine whether his supervisor or others authorized him to submit reimbursement requests for travel between his home and his workstation. According to this employee, the topic of his travel had not been addressed until he received a memo in March 2004 from the new Interim Executive Director of the KHRA. Inappropriate reimbursements made to this employee occurred due to the failure of KRC's management to properly scrutinize travel reimbursements to ensure compliance with state travel regulations. According to the March 2004 memo, expenses of this type would no longer be reimbursed.

Further, two employees presented receipts for reimbursement for lodging from providers that were not in the business of renting accommodations. We contacted the providers to confirm lodging and receipt of payment from a KRC employee. We then contacted the Finance and Administration Cabinet (FAC) Controller to request his interpretation of travel regulations regarding lodging. The Controller stated that agency discretion in interpreting travel regulations is allowable. However, the best interest of the agency should be considered when authorizing travel. Further, in circumstances where an employee is staying with someone who is not in the business of renting accommodations, the employee should obtain prior approval from the agency.

We also inquired about lodging reimbursements of two individuals working at the Ellis Park meet in the summer of 2003. One was reimbursed $1,250 and the other $1,270 for staying a month at the same complex in separate two-bedroom apartments in Evansville. The apartment manager could not confirm whether one-bedroom apartments were available, but said summer was a busy time of year because of the race meeting and one-bedroom units could have been scarce. The monthly cost of these apartments equates to approximately $40 per night, which is not excessive when compared to local motel rates.

Upon inquiry, the manager explained that extended-stay units were negotiable so it was not uncommon for differing rates to be charged.

Other instances of incorrect travel reimbursements to employees were identified that resulted from the failure of the Public Protection and Regulation Cabinet (PPRC) and KRC management to properly communicate and implement travel regulations. Also, lax scrutiny of travel reimbursement requests contributed to these incorrect reimbursements. In some instances, employees were reimbursed for unallowable expenses while on other occasions allowable expenses were not reimbursed.

KHRA has directed employees to adhere to travel policies.

On February 27, 2004, the Interim Executive Director of the KHRA directed employees to adhere to the following travel policies and procedures:

- Prior Supervisor and Executive Director approval is needed for all travel. Additional approvals are required for all out-of-state travel.

- All information required on the travel voucher must be completed. This information includes: departure and arrival times, a purpose for each trip, and receipts must coincide with the date of travel status. Incomplete or unauthorized travel vouchers will not be processed.

- An overnight absence is required for an employee to be eligible for breakfast or lunch. The destination must be at least 40 miles from their workstation or home; whichever is closest. The employee must be in travel status during the entire mealtime period:

Breakfast 6:30a.m. – 9:00a.m.
Lunch 11:00a.m. – 2:00p.m.

An employee is eligible for dinner with no overnight travel if the destination is more than 40 miles from their workstation or home; whichever is closest. They must be in travel status during the entire mealtime period:

Dinner 5:00 p.m. – 9:00p.m.

- An employee may only claim mileage from the workstation or home, whichever is closest to the travel destination. Required vicinity mileage may also be reimbursed.

- The central office state vehicle must be used for conducting official state business (purchasing supplies, bank deposits, etc.) whenever the vehicle is available. The Authority will not approve reimbursement for personal vehicle mileage if the state vehicle was available. In order to track the availability of the car, a usage log will be located in the reception area. Personal business or errands may not be conducted with the state vehicle.

We concur that the policies and procedures noted above, which are consistent with state travel regulations, should result in the fair and equitable reimbursement of employee travel expenses.

Recommendations

We recommend:

- Written policies should be adopted and distributed by EPPC to all employees that address:

  (1) allowable expenses for non-racing or “dark” days while employees are in travel status;
  (2) prior authorization for unusual travel arrangements such as lodging with friends or others that are not in the business of renting accommodations; and,
  (3) the most economical travel arrangements that are in the best interest of the agency.

- KHRA determine an approach to rectify incorrect travel reimbursements made to employees.

Agreed-Upon Procedure 2 addresses time and attendance policies.

Evaluate the EPPC and KHRA time and attendance policies and procedures, including employee classification and the associated method of compensation (hourly vs. salary). Test compliance with applicable time and attendance policies, procedures, statutes, and regulations referenced above and offer recommendations as necessary.

Lack of written policies and procedures resulted in inconsistent use of earned leave, overtime, and use of "inclement weather" paid leave code.

A total of 26 employees and 11 commissioners were employed by KRC during FY03. We reviewed the timesheets for all KRC employees for February and September 2003. For these four pay periods, 74 and 70 timesheets were examined from February and September, respectively. The 11 commissioners' timesheets recorded "no activity" for each of the pay periods.

KRC lacked written policies and procedures governing leave and overtime, resulting in numerous deficiencies.

Time records reflect no prior approval for employee leave.

Time records examined provided no evidence of prior approval for annual, sick, or compensatory leave. According to the Kentucky Department of Personnel Employee Handbook (Personnel Handbook), employees must get approval in advance before taking annual and compensatory leave, and sick leave when feasible. The Personnel Handbook states: "you should complete your agency's appropriate leave form and give it to your supervisor early enough to obtain the supervisor's written consent before you take time off."

We identified no documented evidence of prior approval for overtime. Strong internal controls require that supervisors provide prior written approval for employees to work overtime.

The Personnel Handbook also addresses flex-time scheduling, "[a]n agency may offer some or all of its employees the opportunity to design their own work schedules. Usually, agencies operating under flex-time require that their employees work certain 'core' hours during each day to ensure that there is a steady flow of work during the peak hours when services are most needed."

The former KRC Executive Director distributed a memorandum to all KRC staff dated January 13, 2003, to clarify and control flex-time schedules worked by KRC staff. This memorandum required an employee's work schedule to be given to the Executive Director on Monday of each week.

"[B]ecause some staff members have not adhered to his or her submitted schedule" an August 29, 2003, memorandum sent by the Executive Director to KRC office staff further defined KRC's flex-time policy. This memorandum stated that "flextime will no longer be permitted without prior approval from your supervisor." It also required employees, allowing for exception, to follow one of two work schedules and to provide updates as needed. We were given documentation providing evidence that employees submitted weekly work schedules.

We were unable to substantiate the persistent allegation that one KRC employee consistently failed to meet the required 7.5-hour daily work schedule. Employees were permitted great latitude in establishing their flexible work schedules. This flexibility allowed for an employee to arrive at work early and work through the lunch hour. We verified, through records of the security company employed by KRC, the employee's habit of arriving an hour or more before the normal workday began at 8 a.m. A comparison of weekly work schedules to the employee's timesheets revealed no indication of abuse. We also interviewed the employee's supervisor, who said he was unaware of any failure by the employee to properly account for the required 7.5-hour workday. Further, we made inquiries but obtained no evidence to substantiate that the employee had personal commitments conflicting with the employee's KRC work schedule.

Employees inconsistently used a special leave time code.

Also, employees inconsistently used leave code 914 "Special Leave Governor's Request/Agency-Directed." As stated in a February 21, 2003 email from the Personnel Cabinet, adopted as KRC's policy, code 914 was for use when a "building was closed due to dangerous weather conditions and employees are sent home or cannot report to work." The policy was ambiguous and not clearly understood by KRC employees. We identified race dates that were canceled and compared those dates to employee timesheets. Some employees charged full days to the 914 code, some charged partial days, and some did not charge any time to that code.

Timesheets lack supervisory review contributing to numerous errors.

Other KRC timesheet issues include:

- 11 timesheets with errors in calculation;
- five timesheets with no employee signature;
- four timesheets with no supervisor signature;

- one timesheet with excess hours coded to overtime with pay, when the employee was required to receive compensatory time; and,
- one timesheet with 7.5 hours entered in the "other" column, without identifying a time code.

Supervisory review of timesheets was inadequate. A thorough supervisory review of employee timesheets would eliminate or minimize the errors and inconsistencies noted in the above paragraphs.

Regarding employee compensation, statutes and regulations are silent as to whether a permanent, full-time employee's compensation is established as a salary or an hourly wage. Appointing authorities have broad discretion in deciding which work hours best meet their particular needs. Given the latitude of appointing authorities, we find no reportable issues concerning KRC's distinction of compensating employees on an hourly versus salaried basis.

KHRA Interim Executive Director implemented new policies and procedures.

The KHRA Interim Executive Director has implemented the following policies and procedures effective March 1, 2004:

- "All KHRA employees must sign in when they report to a workstation and they must sign out when they leave the premises. It may not be practical for all employees to sign in/out at one location at racetracks, so KHRA's stewards may designate multiple sign in/out sheet locations. It is the steward's responsibility to inform all KHRA employees of the location of sign in/out sheets."

- "All KHRA employees must submit their leave or overtime requests prior to taking/earning the time. The requests and the approvals shall be submitted with the employee's time sheet every pay period. Exceptions to prior approval are expected to occur (for example, to request sick leave due to an illness), but exceptions should be extremely rare."

The consistent application of the policies and procedures recommended by the KHRA Interim Director should improve the reporting of employees' time and attendance.

Recommendations

In addition, we recommend that the KHRA develop and implement policies and procedures to provide adequate review of timesheets by supervisors to ensure that:

- Timesheets are complete and mathematically accurate, with all time coded to a specific work or leave code.

- Consistent use of inclement weather policy is used by employees.

Upon receipt of KHRA timesheets for entry, the EPPC payroll administrator should ensure that timesheets are complete and signed by appropriate personnel. Incomplete or unsigned timesheets should be returned to the KHRA payroll administrator for further review and correction.

KHRA should also document and adhere to a flex-time scheduling policy that will ensure compliance with the Personnel Handbook. This policy should include coverage of "core" office hours.

Agreed-Upon Procedure 3 addresses certain procurement contracts.

Examine FY03 procurement contracts, or the lack thereof, for the following vendors: a) Dr. Sams; b) Attorney Bruce Miller; c) University of Kentucky contract with Equine Drug Research Council (Council). As part of this issue, examine statutes to determine compliance. Determine whether these contracts complied with all appropriate procurement statutes, regulations, and policies. Determine that all parties complied with the terms of these FY03 contracts.

As noted in a prior report, KRC did not follow policies for procuring the services of Dr. Sams.

In FY03, KRC attempted to contract with Dr. Richard A. Sams, DVM, of Columbus, Ohio to perform equine drug research. The Auditor of Public Accounts (APA) released a special examination report on August 5, 2003, that addressed this and other issues. See Appendix B. At the request of the APA, FAC reviewed the proposed FY03 personal service contract and concluded the proposed contract was deficient.

Dr. Sams FY03 contract was not approved.

The FY03 Dr. Sams contract was never approved or implemented. FAC concluded that the KRC should develop a clear description of the service and work products required to determine whether state personnel, including state universities, could meet the requirements. If state personnel could not perform the required services, a request for proposals (RFP) should be developed and sufficiently advertised to ensure all potential respondents would have the opportunity to apply. A copy of FAC's report is included in Appendix B.

KRC did follow the APA's and FAC's recommendation in July 2003 and issued an RFP solicitation for "equine drug research." The description of work to be performed was more detailed in the solicitation as well. The solicitation was placed on the FAC website with Dr. Sams being the only respondent. However, this FY04 contract was not approved by FAC.

Dr. Sams performed drug equine research without an approved contract.

Despite the lack of an approved FY03 contract, KRC allowed Dr. Sams to perform equine drug research. We found evidence of work performed by Dr. Sams that included a detailed listing of hours worked addressing various issues. A letter written by the Council Chairman described Dr. Sams' job duties as the "[c]onsultant to the Equine Drug Research Council." KRC provided our auditors with a report written by Dr. Sams regarding drug testing and research. Further, we examined meeting minutes and memoranda of the Council indicating the Council's desire to appoint Dr. Sams and documenting the Chairman's approval for doing so.

In addition, KRC received a letter dated January 28, 2003, from Dr. Ed Ford, Governor Patton's Secretary of the Cabinet. His letter, in part, states "[b]ecause of the importance to the Commission in obtaining a comprehensive analysis of its sizeable investment in its drug and testing research and because the funds for this contract are provided for under the provisions of KRS 230.265 (3) and will therefore not adversely effect the current budget situation, you should proceed with the previously authorized contract." Notwithstanding Dr. Ford's letter, it was not appropriate for KRC to proceed with the proposed contract without first receiving FAC approval; nor was it appropriate for KRC to pay the contract fees from a restricted account.

Equine Drug Research Fund is restricted to work done in Kentucky.

Though Dr. Sams performed work for the Council, payment should not have been made from the Equine Drug Research Fund because Dr. Sams performed his work in Ohio. KRS 230.265(3) states that money from the Equine Drug Research Fund "shall be used in financing drug research and testing research **in Kentucky** …." [Emphasis added]

Equine Drug Research Fund should be reimbursed for the $30,000 payment made to Dr. Sams.

On October 3, 2003, a check was issued to Dr. Sams for $30,000 with KRC approval. The payment was for work performed by Dr. Sams in FY03. The APA sent a letter to the Chairman of the KRC on October 16, 2003, stating that the $30,000 payment to Dr. Sams from the Equine Drug Research

Fund violated the restricted use of that fund. The APA recommended that to comply with KRS 230.265(3), the fund should be reimbursed $30,000 from an appropriate unrestricted account. See Appendix C.

The APA received a response from KRC's attorney on October 22, 2003 stating, "[y]our recommendation is appreciated, but is declined. Kentucky is widely recognized in the racing industry as having the most lax equine drug policy in the nation. This is unsatisfactory and terribly concerning. The Racing Commission will continue with its policy of enhancing its equine drug policies from the assistance and advice of the nation's equine drug experts, wherever they may reside, in order to bring Kentucky's procedures and enforcement into line with the nation's efforts in this regard." See Appendix D.

While the APA does not intend to interfere with the management decisions regarding equine drug policies, we are obligated to report noncompliance with Kentucky's statutes and regulations. If KHRA determines that nationally recognized expertise outside of Kentucky is needed to perform equine drug testing, statutes must be changed to allow for a broader use of the Equine Drug Research Fund.

Recommendations

We again recommend that the restricted Equine Drug Research Fund be reimbursed $30,000 from an appropriate unrestricted account for the payment made to Dr. Sams for testing he performed in Ohio.

We also recommend KHRA, with appropriate scrutiny from EPPC, ensure all FAC procurement policies are followed, including those requiring contract approval.

KRC followed policies for procuring FY03 attorney contract.

The KRC submitted an RFP solicitation for an FY03 "professional services-legal" contract on FAC's website. KRC received only one response and that individual was awarded the contract. KRC followed contract procurement policies. The attorney subsequently submitted detailed invoices as required. The KRC executive secretary completed a "Contract Management Review" of the legal services contract and identified no compliance exceptions.

Considering there was only one respondent to the RFP, we compared his hourly rate to the Legislative Research Commission's Government Contract Review Committee rate schedule and found the rate charged to be appropriate.

Payments to the University of Kentucky Research Foundation were statutorily allowed and in compliance with procurement policy.

The Council is a panel created by KRS 230.265 to advise the KRC on the conduct of equine drug research and testing. On December 22, 1999, the KRC entered into an agreement with the University of Kentucky Research Foundation (UKRF) to provide equine drug research through August 30, 2000. This agreement was amended by the KRC and UKRF through August 30, 2001. There is correspondence and other written memoranda evidencing that the agreement was considered by the parties to have been amended several times thereafter by the Council or the KRC to allow work to continue between August 30, 2001 and December 31, 2003, and to modify the fee structure.

An agreement entered into between a state agency and a state university is not defined as a Memorandum of Agreement in accordance with KRS 45A.690(1)(d)(4), and as such, is exempt from review by the Legislative Research Commission's Government Contract Review Committee. We could find no statutes, regulations, or policies that require an agency to submit its agreements with state universities to FAC, which is charged by statute with overseeing procurement for executive branch agencies; however, the longstanding practice of the FAC is for all state agencies to report their agreements with universities to FAC for informational purposes and monitoring. KRC did not follow this practice. Further, we found no law to require this agreement, or any amendments thereto, to be in writing. While the authority of the Council to act on amendments rather than the KRC is questionable, the KRC and UKRF continued to operate and make payments in a manner consistent with the original agreement.

The EPPC Finance Branch, Office of Legal Services, as of February 2004, is reviewing all proposed contracts. We commend this action and believe this practice should be continued.

Recommendation

EPPC should continue to monitor KHRA to ensure KHRA contracting complies with statutes, regulations, and best practices.

Agreed-Upon Procedure 4 addresses new policies and procedures enacted by EPPC for KHRA.

Determine whether new policies and procedures enacted by EPPC for KHRA as of mid-January 2004 are properly designed to achieve the desired objective and are operational and consistently applied.

We concur that new policies and procedures implemented by EPPC and KHRA will strengthen internal controls and clarify procedural processes. Our office made additional recommendations to address issues identified in this report.

Agreed-Upon Procedure 5 addresses dual employment.

Determine whether dual employment of any existing KHRA employees is in compliance with existing statutory, regulatory, or policy requirements. Recommend policies and procedures to be followed by KHRA to ensure dual employment is properly administered.

While not expressly prohibited by law, an individual employed both as KRC Executive Director and Chief Steward creates conflicts of interests.

We did not find that an existing employee of the KHRA currently has dual employment; however we will address the situation of a 20-year employee who had two concurrent positions with the KRC for 11 years prior to that employee's retirement. There being no statutory, regulatory, or personnel policy definition of "dual employment," for the purpose of this report, "dual employment" is considered as the situation in which a state employee holds a full-time state position, and at the same time holds another position with the Commonwealth, receiving separate compensation for each position.

In April 1993, the above-described employee of KRC began dual employment with the state when he was appointed by the Governor to the position of Executive Director of the KRC, a permanent, full-time, ungraded position, without status, at an initial monthly salary of $5,000. KRS 230.230(1) requires the Governor to appoint the KRC's Executive Director. This individual continued to hold this position, with no apparent break in service, until his retirement on March 1, 2004, at which time his monthly salary in this position was $9,403.22.

Since April 1993, the Executive Director has also been employed as the Chief State Steward.

Also in April 1993, the same employee was appointed by the KRC Chairman as Chief State Steward, an interim, part-time, graded position, without status, at an hourly wage of $25.72. KRS 230.240(1) permits "the chairman and the executive director of the commission" to appoint stewards. He continued to hold this position, as it was regularly established, abolished, and re-established numerous times on a seasonal basis, until June 1999, at which time his hourly wage was $33.926. At this time, he was appointed to a newly established, full-time,

ungraded position of Chief State Steward, without status, at a monthly salary of $3,058.78, which was shortly thereafter corrected to $3,166.98. The employee held this position at the same salary until his retirement on March 1, 2004.

The only reference in either Kentucky statutes or administrative regulations that addresses the "dual employment" situation is found in 101 KAR 2:095, Sec. 4(1), which states that "[a]n employee holding a full-time position with the Commonwealth shall not hold another state position except upon recommendation of the appointing authority and the written approval of the secretary [of the Personnel Cabinet]."

It appears from the records we have examined in this employee's personnel file, each time the Chief State Steward's interim position was re-established, the Chairman of the KRC recommended the appointment to the Steward's position, and each appointment was approved by the Secretary of the Personnel Cabinet.

During the Executive Director's employment with the KRC, the KRC was attached, for administrative purposes, to the PPRC, now the EPPC. According to statements made by the Executive Director to APA examiners, before June 1999, during the time he held both the Executive Director and the Chief State Steward positions, he kept two separate timesheets, and avoided working the same hours at both positions. During these years, he worked as a steward primarily during the Keeneland and Churchill Downs race meetings and was only paid as Chief State Steward for the hours actually worked as a steward.

In June 1999, the Chief State Steward position was changed from part-time to full-time. The salary of this new position was annualized at a rate equal to the average of the most recent three years' pay for his work in the seasonal steward's position. The new Chief State Steward position had no additional leave or health benefits attached, and no raises or increments were subsequently added during his tenure in the position. The Executive Director stated that the Deputy Secretary of the PPRC told him that he did not have to keep separate timesheets any longer, and could work the same hours at both positions.

Separate timekeeping for dual employment ceased in 1999.

Therefore, beginning in June 1999, the Executive Director filed only one timesheet showing the hours worked (for the Executive Director position), and attached to this timesheet a second timesheet that he left blank (for the Chief State Steward position).

Beginning in 1999, both positions held by the employee became salaried.

Thus, from June 1999 to his retirement in March 2004, this employee was receiving two salaries for two full-time positions, both at the KRC, without accounting separately for the time he spent working at each position. However, his timesheets for calendar years 2000 through 2003 reflect an annual average of 676 hours worked in excess of normal and compensatory hours claimed for his Executive Director's position. These hours are attributable to his dual position as Chief State Steward, primarily worked during the race meetings at Keeneland and Churchill Downs. This is contrasted with the wage information used to compute the full-time Chief State Steward's salary in 1999. According to these calculations, during the three base years of 1996 – 1998 when he was keeping separate timesheets, the Executive Director also worked an average of 1130 hours in the Chief Steward's position.

We were unable to find any statute, regulation, appellate court case, or personnel policy which directly addresses the issue of whether it is legal or proper for an employee holding two permanent, full-time positions with the Commonwealth to be paid a separate monthly salary for each of the two positions while working at both concurrently. The only reference we did find was a 1991 Opinion of the Attorney General, OAG 91-145, which offers limited guidance, as it was a non-binding response to a specific question. The Opinion states:

> if an employee works full-time for a department within a particular cabinet, he may obtain dual employment, on his own time, with another department within the same cabinet upon recommendation of the appointing authority and approval of the Commissioner of Personnel.

No law specifically prohibits an employee from concurrently working in two positions at the same time.

As discussed above, after 1999 when the Chief State Steward position was made a full-time position, the Executive Director did not work as Chief State Steward "on his own time" sufficient hours to comprise a second full-time "dual employment" position, but worked that position, for the most part, concurrently with his primary job as Executive Director.

101 KAR 2:095, Sec. 2(1) states:

> Attendance; Hours of Work. (1) The number of hours a full-time employee shall be required to work shall be thirty-seven and one-half (37½) hours per week **unless specified otherwise by the appointing authority** or the statutes. [Emphasis added]

Considering this regulation in the context of "dual employment," it would seem to require that an employee who holds two, full-time positions with the state work 37.5 hours per week in each job, unless "specified otherwise" by his appointing authority. In this employee's case, the Deputy Secretary of the PPRC "specified otherwise" by telling the employee he was not required to keep two separate timesheets.

Although we could find no law specifically prohibiting this arrangement of working at two positions at the same time, "there is always a possibility of a common law conflict where the duties of both positions cannot be performed with care and ability." OAG 78-14.

Long-standing precedent in Kentucky's case law on incompatible offices holds that when two offices are executed by the same person, the incompatibility to execute both does not consist in the physical impossibility to discharge the duties of both positions, but rather in a conflict of interests, as where the person in one position has the power to supervise, discipline, or remove the person in the other position. Hermann v. Lampe, Ky., 194 S.W. 122, 126 (1917).

Dual employment as KRC Executive Director and Chief State Steward appears to create conflicts of interests.

In this case, we found no evidence that this individual was unable to perform both his employments with care and ability. According to KRS 230.240(1), however, since stewards, including, apparently, the Chief State Steward, may be employed, disciplined, even dismissed by the KRC's Executive Director or Chairman, this appears to create a conflict of interests. One of his employment positions was subordinate to the other, with the Executive Director having the authority to supervise, even remove, the Chief State Steward. KRS 11A.020(1) also provides that no public servant shall knowingly use his position to influence any matter involving a substantial conflict between his personal or private interest and his duties in the public interest or create privileges or advantages for himself.

A further conflict of interests is revealed when a comparison is made of the duties of the Executive Director and the Chief State Steward. The statutes and regulations defining the duties of these two positions suggest that procedural due process is tainted by service of the same individual in both capacities. The Executive Director is charged with the duty of maintaining the records of the KRC, and other duties as the KRC and the statutes may prescribe. Among the duties of the stewards is a recommendation of disciplinary action against licensees of the KRC who violate the rules of the KRC. Since impartiality of the decision maker is a fundamental tenet of procedural due process, there is an inherent conflict in the same individual serving as the investigative and charging officer (as Chief State Steward) and acting as advisor (as Executive Director) to the administrative body (the KRC) to which the investigative officer's decision is appealed. It is important to note however that a separate administrative process is also afforded in certain appeals pursuant to KRS Chapter 13B that would mitigate the potentiality for conflict.

In this case, the individual who served in both positions stated that when decisions of stewards were appealed to the KRC, he would sometimes testify in his role as Chief State Steward, but that he would not be present during the rest of the appeal hearing, and did not advise, counsel, or consult with the KRC commissioners concerning matters on appeal. Nonetheless, the potential for the disparate interests of the steward (as charging officer) and executive director (as advisor to the commissioners) to conflict still exists.

We learned during this engagement that this precise conflict of interests issue was raised and explored by the Personnel Cabinet legal counsel just prior to the time the Chief State Steward's position became a full-time position. The Personnel Cabinet's Secretary, the Personnel Cabinet's General Counsel and the Director of the Division of Classification and Compensation discussed the possibility of conflicts as well as compensation concerns. After research, debate, and review within the Personnel Cabinet, and discussion between the Personnel Cabinet Secretary and Governor's Office, it was agreed that the long-standing dual employment situation was not illegal and would be allowed to continue.

A possible conflict of interests exists for salaries of the KRC Executive Director, stewards and other racing related employees to be paid from monies generated by the industry being regulated.

KRS 230.240 very clearly states that the salary of the KRC's Executive Director and the compensation of stewards, supervisors of mutuels, veterinarians, inspectors, accountants, security officers and others employed by the KRC, are to be paid by the "various associations," or horse race tracks licensed by the KRC to conduct horse races. Thus, the salaries and compensation of the racing related employees, including but not limited to stewards and the KRC Executive Director, were required by statute to be paid from monies collected from the same entities the KRC is charged by law to license and regulate. This creates a possible conflict of interests, to have the entities being regulated, the horse race tracks, supplying the money to pay the salaries of the employees of the regulator.

Recommendations

Considering the conflicts of interests discussed above, we recommend that the same individual not be employed as Chief State Steward and the Executive Director of the KHRA in the future. Furthermore, in any instance of dual employment, we recommend the best practice would be for an employee's hours to be worked and reported separately. Additionally, we recommend that the EPPC consider seeking an opinion from the Executive Branch Ethics Commission regarding possible violations of KRS 11A.020 involving the employee's dual employment.

We further recommend that the EPPC seek legislative support to amend KRS Chapter 11A provisions requiring oversight of an employee's secondary employment outside state government to include the same considerations for secondary employment inside state government.

The EPPC should monitor actions of the KHRA to ensure compliance with statutes and regulations.

Finally, we recommend that the EPPC seek clarification from the Executive Branch Ethics Commission whether KRS 230.240 is consistent with the Executive Branch Code of Ethics as set out in KRS Chapter 11A.

Agreed-Upon Procedure 6 addresses track assessment rates.

Determine whether track assessment rates implemented by KRC comply with 811 KAR 1:115 and offer recommendations as needed. Further, determine if the authority cited by KRC to increase these track assessment rates is accurate.

The law is ambiguous as to KRC's authority to assess track fees.

The KHRA and its predecessor, the KRC (hereinafter referred to collectively as KRC unless the context requires otherwise), provides each horse race track the following KRC personnel on race days: state steward(s), commission secretary, license administrator, veterinarians, detention barn associates, and other KRC employees deemed essential for any horse race meeting. In order to recoup the administrative costs of these personnel and related expenses, the KRC charges tracks fees, or assessments, for each race day services are provided by KRC personnel to the tracks.

KRC not in compliance with KRS 230.240(3).

KRS 230.240(3) requires the tracks licensed by the KRC to pay the compensation of these KRC personnel who work at the tracks on race days, and further requires the KRC to pay the salary of the KRC's Executive Director, such salary to "be prorated among and paid by the various associations [tracks] licensed under this chapter in the manner as the commission shall, by administrative regulation, provide." We found no administrative regulation addressing how the tracks are to prorate and pay the Executive Director's salary.

KRC charges race tracks it licenses daily assessment fees.

KRS 230.240(4) states that each track licensed by the KRC to conduct horse races "shall be deemed to have agreed to pay expenses and compensation as provided in this section and as may be actually and reasonably incurred."

According to documents provided to us by the KRC, it is currently levying daily "assessment" fees of $3,500 per race day on thoroughbred race tracks, and $1,750 per race day on harness race tracks, which fees cover the compensation of the KRC's personnel working at the tracks on race days, and other expenses of the KRC.

The issue is whether these daily "assessment" fees comply with 811 KAR 1:115 or other applicable law.

KRC is to prescribe by administrative regulation the conditions under which horse racing is conducted in Kentucky.

KRS 230.215(2) vests the KRC with "forceful control of horse racing in the Commonwealth with plenary power to promulgate administrative regulations prescribing conditions under which all legitimate horse racing . . . is conducted in the Commonwealth . . . [and] to regulate and maintain horse racing at horse race meetings in the Commonwealth of the highest quality . . .."

According to this statute, the KRC is to prescribe the conditions under which horse racing is conducted in Kentucky by promulgating administrative regulations; and, in fact, in accordance with the statute, the KRC has promulgated 46 such regulations that regulate horse racing in Kentucky.

Apparently, however, the only administrative regulation relating to fees to be paid to the KRC by race tracks on race days is 811 KAR 1:115. This regulation became effective in 1975 and has not been revoked or modified since that time, even though the statute authorizing its promulgation, KRS 230.630, was repealed in 1992. This regulation relates to the licensing of tracks conducting harness races; it does not cover thoroughbred race tracks. Section 3 states:

> [a]ll associations and tracks having gross wagering of less than an average of $75,000 per day based on their prior year's average daily handle shall pay a daily licensing fee of $125 to the Kentucky Harness Racing Commission for each day of racing. All tracks and associations having gross wagering of $75,000 and above per day, based on their prior year's average daily handle shall pay a daily licensing fee of $175 for each day of racing. In the event the commission allows two (2) racing programs on one (1) day, a separate daily fee for each racing program shall be paid (example: if an afternoon and evening program are scheduled the fee shall be $250 and $350 respectively for that day).

The regulation relating to the licensing of thoroughbred race tracks is 810 KAR 1:025, but no sections of this regulation, or any other regulation, establish "daily licensing fees" or provide for the payment by thoroughbred race tracks of fees or assessments of any kind to the KRC.

We could find no statute establishing the specific authority of the KRC to charge race tracks assessment fees, or that lists the amounts to be charged. KRS 230.300 does deal extensively with licensing race tracks, but contains no provisions relating to fees or assessments to be paid by the tracks.

Budget bills or memoranda contain no language regarding assessment fees.

Furthermore, we examined the executive budget bills and budget memoranda for 2000 and 2002 and found no mention of track assessment fees. The KRC, at its March 1, 2001 meeting, voted to increase the license fees it charges participants in horse racing, such as horse owners, trainers, jockeys, agents, track employees, and others (see KRS 230.310). However, the minutes of the meeting reflect no action taken with respect to fees or assessments to be paid by the tracks themselves.

811 KAR 1:115 is out of date and of questionable validity.

Because the statute that authorized the promulgation of 811 KAR 1:115 has been repealed, this regulation is outdated and of questionable validity. Furthermore, it deals with harness tracks (standard bred) only.

In summary, our findings are as follows:

- The daily "assessment" fees of $3,500 per race day charged by the KRC to thoroughbred race tracks, and $1,750 per race day charged to harness race tracks, are not in compliance with 811 KAR 1:115.

- 811 KAR 1:115 is outdated and of questionable validity. It does not authorize the KRC to assess all race tracks licensed by the KRC to conduct race meetings, as it pertains to harness race tracks only.

- It is unclear whether the KRC exceeded its lawful authority by charging daily "assessment" fees to the tracks without first promulgating an administrative regulation prescribing such fees. One statute, KRS 230.260(3), could be construed to allow the KRC to charge race tracks these assessments without first promulgating a regulation. This statute states that the KRC "shall have full authority to **prescribe** necessary and reasonable administrative regulations and **conditions** under which horse racing at a horse race meeting shall be conducted in this state . . .." This statute, together with the language of KRS 230.240(4), wherein the tracks are "deemed to have agreed to pay the compensation and expenses" of the KRC's employees at the tracks on race days, create an ambiguity in the law as to whether the KRC exceeded its authority by charging the assessment fees without first promulgating a regulation. [Emphasis added]

- The KRC did not promulgate an administrative regulation setting out the manner in which the tracks are to prorate and pay for the salary of the KRC's Executive Director, as required by KRS 230.240(3).

Recommendations

We recommend:

- The KHRA should either abolish 811 KAR 1:115 relating to licensing harness race tracks and charging "daily licensing fees," and promulgate a new regulation; or modify the existing regulation by updating it to conform with the current law and organizational structure of the KHRA.

- By administrative regulation, the KHRA should define and clarify its authority to charge licensed race tracks daily assessment fees to cover the compensation and expenses related to KHRA personnel working at race tracks on race days, and should establish and identify the amount of such assessments in the regulation.

- As required by KRS 230.240(3), the KHRA should promulgate an administrative regulation that specifically provides the manner in which the compensation of the KHRA's Executive Director shall be prorated among and paid by the various tracks licensed by the KHRA, after obtaining clarification from the Executive Branch Ethics Commission that such payments are consistent with the Executive Branch Code of Ethics.

- EPPC should review actions taken by KHRA to ensure regulations pertaining to track assessment fees are adequately defined, clarified, and consistently applied.

Agreed-Upon Procedure 7 addresses adequacy of licensing system controls.

Determine the adequacy of the general and application controls governing the KHRA licensing system and offer recommendations as needed.

Racing system developed in 2001 has segregation of duties control weaknesses for system access.

The Kentucky Racing Commission Enterprise Licensing System (KRCsystem) was developed by the Governor's Office for Technology (GOT) in 2001. This system is used to issue licenses as required by 230.310 and monitor the associated license fees. The KRCsystem is a database accessed via workstations at the race tracks and at the central office.

The database is accessed through a Kentucky Information Highway Internet connection that is managed by GOT. This system was designed to replace its predecessor that consisted of simple spreadsheets maintained on various laptop computers. The KRCsystem includes interfaces providing files from McKinney Systems that contain daily horse racing information, and rulings from the Association of Racing Commissioners International, Inc. (RCI). The RCI system is a primary repository of rulings concerning individuals in the horse racing industry.

The KRCsystem provides a mechanism for track stewards and patrol judges to enter and track new rulings as well. New rulings issued are submitted to the RCI system via email notifications from the KRCsystem. The KRCsystem generates various license activity and cash receipts reports. The system is maintained by GOT and is designed to limit access to specified computers.

Employee duties and system access were inadequately controlled.

We tested the application level access security established for the KRCsystem to ensure proper segregation of duties was provided for system security and data integrity from January 1, 2003 through March 31, 2004. The KRCsystem was designed to provide adequate system access security assuming specific user duties are assigned to the appropriate personnel. However, our testing revealed that duty assignments and access to the KRCsystem were inadequately controlled.

One employee that performed license inspector duties by issuing licenses and collecting fees also was granted access to KRCsystem maintenance and security administration. This access would allow the employee to establish other users within the system at any level, change passwords of other users, access their accounts to perform system functions, or to alter the user's access to the system. This employee was provided unwarranted system access allowing the employee to alter reports, system codes, change bank accounts or perform many other system maintenance type duties. The employee that was provided excessive system access was also responsible for cash collection duties.

System security administration was not segregated from financial activities.

Proper segregation of duties would require the system security function to be segregated from cash collection and deposit duties. Though this individual left employment of the KRC in January 2004, the employees access remained until the initiation of our agreed-upon procedures in April. The current security administrator does not have license fee cash collection duties.

Track stewards were provided "add," "change," and "delete" access to the global search screen that allows stewards to search for any licensee. The system design allows these users the same security authority for associated subscreens, such as "Application Maintenance" and "License Fees Due." Though no inappropriate activity by these users was discovered, this level of access provided them the system capability to add licenses identifying the licenses as paid and to edit licenses or to delete unpaid or voided licenses. System access should be limited to the minimum access necessary for users to perform their assigned duties.

GOT employees had system access.

Finally, the employees within GOT had full access to the KRCsystem. This access is used by GOT to assist in the maintenance of the system and to troubleshoot problems. Though we identified no inappropriate activity for the user ID assigned to GOT personnel, update and delete access to production systems and data should not be provided to programmers, system analysts, or consultants unless under pre-approved, limited, controlled circumstances.

Recommendations

We recommend the KHRA ensure:

- Proper segregation of duties is applied to those that can access the KRCsystem.
- Any employee involved with accepting and controlling receipts should not perform security administration functions and responsibilities.
- Access to the system should be limited to the minimum access necessary for the user to perform their assigned duties.
- The security administrator should consider that sub-screens inherit access provided to parent screens.

- Only read access to the global search screen should be provided unless the security administrator intends the user to have the assigned access to all screens.

- Current access for stewards should be revised so that those users are limited to "add" and "delete" capabilities to the rulings screen. Stewards' "change" access should be reviewed to determine exactly which screens require that level of access.

- GOT access to the KRCsystem should be disabled and procedures developed whereby the security administrator provides access on an "as needed only" basis for troubleshooting or system maintenance. Once GOT completes the requested tasks, their access should again be disabled.

Security Administration functions over the KRCsystem should be improved.

Until the end of January 2004, two employees acted as system security administrators for the KRCsystem. One of these employees that was responsible for security administration also collected license fees using another ID that was established for routine daily activities. The user ID and password to perform security administration are shared by the two employees responsible for security. Sharing user accounts prevents the specific identification of an employee performing actions. This reduces the effectiveness of audit trails used to determine the source of any inappropriate system activity.

Security procedures or manual were not developed.

No formal security procedures or security manual existed for the period examined. Further, the current security administrator stated that no documentation for security procedures was available other than on-line help files. These help files provided rudimentary procedures for adding and controlling users. Also, no training was provided to the security administrators concerning security administration of the KRCsystem.

The current security administrator was unfamiliar with the system and was unable to develop a report to identify specific system user access rights. Also, the current security administrator could not successfully perform other basic tasks within the system including disabling terminated employee user access.

Terminated employees retained system access.

System access remained active for certain terminated employees. This included access for the person identified earlier who performed dual functions collecting license fees and security administration. This employee's system access remained in effect after termination in January 2004 through early April 2004. Similarly, the backup administrator's access remained in effect after he left employment with KRC in March. GOT has offered to provide assistance as requested concerning proper training for KRCsystem security administration and functionality.

We discovered a logon warning banner was not developed for the KRCsystem. Logon warning banners are needed to ensure legal rights for prosecuting misuse of the system.

We also found that KRCsystem users do not sign confidentiality agreements or acceptable usage agreements. Internet usage forms were signed. Acceptable usage agreements encompass more responsibilities than Internet usage forms.

Recommendations

We recommend the following:

- KHRA should ensure that individual user IDs are established for each employee performing security administration duties for the KRCsystem.

- A backup security administrator should have a unique user account used only for security administration functions as necessary.

- Security administrator duties should be segregated from other conflicting responsibilities.

- Personnel responsible for security administration should request training assistance from GOT. Training should include proper control of access rights and the ability to generate a security report of system users access.

- KHRA should adopt a formal security policy that includes acceptable system use, security administrators' responsibilities, and penalties associated with policy noncompliance.

- Documented procedures should be developed to grant or modify users' access. This should include the development of templates for user access that will assist in ensuring proper segregation of duties.

- A warning banner should be developed for the KRCsystem to ensure anyone attempting to gain access to the system knows that its information is for official use only and that attempts to illegally logon to the system could lead to criminal penalties.

- An acceptable usage agreement should be developed and signed by employees that includes Internet and computer usage as well as user confidentiality responsibilities.

System design modifications are needed to improve data integrity and security.

Though the current system is a vast improvement over its predecessor and many good security controls were implemented, certain modifications are needed to improve controls over the system processes and data.

$6,200 in license fees were waived due to backdating of licenses.

Changes to license issuance and expiration dates should only be allowed during the last two weeks of December in any year. This permits a license for the following year to be purchased early. However, we discovered these dates can actually be modified anytime when issuing owner licenses. This allows license inspectors to backdate the issue date of owner licenses in order to forego required fees when previously issued temporary licenses have expired. Per system documentation, if a temporary license has expired, owners are required to pay a $100 fee to receive a new owner license. From January 1, 2003 through April 6, 2004, we identified 62 instances of backdating an owner license, resulting in waived fees of $6,200. Waiving fees could also be accomplished by setting the expiration dates to allow the temporary owner license to be active for more than 30 days. Temporary licenses should only be active for a 30-day period. Extending the temporary license expiration date occurred four times during the period resulting in waived fees.

Currently the system allows a payment classification of "other." This payment classification is not necessary as "cash," "check," and "charge" are sufficient to record all license receipts. Further, if the "other" payment classification

is selected, the payment does not appear on the Daily License and Activity Report for that license inspector. This requires the inspector to account for an out-of-balance amount for license fee deposits.

Financial reports generated by the system could be edited without restriction.

Critical output reports such as the "License Moneys to be Deposited Report" are by system default created in Adobe Acrobat in a format that cannot be easily altered. However, the user is provided the option to export the reports into various formats. This option may have been provided to improve system functionality for users. However, the user can export the reports into MS WORD, which allows for unrestricted edit of the reports. Therefore, a license inspector could create a false deposit report to be used for bank reconciliations. Such a situation could go unnoticed unless management compared supporting bank deposit documentation to a KRCsystem generated report.

The KRCsystem is designed to allow unpaid licenses to be deleted. Though this is acceptable, the system provides no warning to the user prior to deletion.

No audit tracking or change history feature exists for modifications to records other than providing the last user ID that modified a record. This does not provide an adequate audit trail of before and after images when changes are made to specific critical fields or objects.

The system is password protected but does not require complex password structures such as alphanumeric combinations or the use of special characters. Further, the passwords are not forced to expire after a determined period of time.

Recommendations

We recommend:

- KRCsystem should not allow license issue and expiration dates to be modified except during the last two weeks of December of any year. If KHRA desires to retain the capability to alter these defaults, then management should develop formal procedures to ensure consistent application and to prevent abuse.

- The "other" payment classification should be eliminated from the system.

- A system warning should be implemented to notify the user prior to deleting an unpaid license.

- The system should be modified to prevent exporting reports to an easily modifiable format such as MS WORD. At a minimum, this capability should be removed from the "License Moneys to be Deposited Report."

- Audit tracking should be developed to document significant database activity such as adding new users or the deletion of licenses.

- The system should be modified to improve password strength by requiring more complex passwords that expire after a 30-day period.

Agreed-Upon Procedure 8 addresses reconciliation for license receipts.

Perform reconciliation for license receipts for the period of January 2003 to present. As part of this, develop internal control procedures to ensure receipts are handled properly.

KRC did not deposit license receipts in a timely manner.

Licenses are issued and license fees collected at eight race tracks in Kentucky and at the central office located at the Kentucky Horse Park. KRC had five license administrators who issued licenses at the tracks on race days. These administrators must meet certain requirements found in 810 KAR 1:024. KRC allowed license administrators to issue licenses, collect money for those licenses, and make deposits of the funds collected.

In August 1998, the APA issued a report to the KRC that addressed the issue of license receipts. That report recommended that:

- Local bank accounts be established as temporary depositories for track locations outside the central office vicinity.

- Deposits of all receipts be made daily from each location.

The response provided to the APA from KRC stated: "[b]eginning in December of 1997 the deposit of license receipts has been accelerated and is done routinely within a day or two of receipt of monies at the Commission office. The Commission will follow up by establishing bank accounts for the deposit of license receipts at banks adjacent to the race tracks around the state. The deposit of license receipts will conform to the recommendations made in your report, with appropriate reporting to the Commission office daily." See Appendix A.

KRC failed to implement a corrective action plan in response to a 1998 APA finding regarding the lack of timely deposits.

Unfortunately, KRC failed to follow their proposed corrective action issued in response to our findings six years ago. Conditions of poor internal controls over license receipts persist. Local bank accounts were not established as temporary depositories. While deposits became timelier, an inadequate lag between receipt and deposit of money continued. Untimely deposits not only result in lost interest revenue, but dramatically increase the risk of loss through fraud, theft, or accident.

The KRC had one temporary deposit account in Georgetown, Kentucky. We obtained bank statements and deposit slips for the period of January 2003 to March 2004. KRC personnel consistently failed to make deposits on the day funds were received. Our analysis shows that 31 percent of the total number of bank deposits were not made until six or more days following collection. KRS 41.070 (1) states "[a]ll receipts of any character of any budget unit, all revenue collected for the state, and all public money and dues to the state shall be deposited in state depositories in the most prompt and cost-efficient manner available."

KRC had no means to secure funds overnight or temporary deposit accounts.

KRC did not adequately secure cash receipts. Collections at the track sites were not deposited to local bank accounts or kept in an office safe. Often, license administrators stored cash receipts in sealed plastic bags for transport to Georgetown for deposit to the KRC's account.

According to a KRC license administrator, KRC did not provide licensing administrators with a "change fund" at the beginning of each day. Therefore, this administrator stated that she had to "frequently dig around in my purse looking for change" and often writes "IOUs" and "makes loans" to the state.

On April 14, 2004, the interim KHRA Executive Director entered into an arrangement with Keeneland and Churchill Downs allowing the KHRA's licensing administrators to store cash and checks in track vaults at the end of business hours. Also, on a regular basis, Keeneland and Churchill Downs are to issue checks to KHRA in the amount of stored deposits.

Recommendations

To strengthen internal controls over license receipts we recommend the following:

- Duties should be segregated to prevent employees who receive cash from the performing bank deposit function. Likewise, a separate individual should be responsible for the monthly bank reconciliation, which will be discussed further below.

- As previously recommended, local bank accounts should be established as temporary depositories for track locations outside the central office vicinity, discontinuing the need to store license receipts within track vaults.

- Deposits of all receipts should be made daily from each location. The local accounts can be swept electronically daily to transfer funds to the state depository account.

- KHRA should provide the license administrators with "change funds" and begin each day with an audited balance.

KRC did not perform a timely reconciliation of license receipts to the licensing system and to bank deposits.

We reconciled license deposits, from January 2003 to March 2004, to individual daily activity sheets and to the licensing database system. We were able to resolve variances that were due to voided licenses and timing differences attributable to vendor prepayments and invoiced payments. The KRC did not reconcile daily activity reports to monthly bank statements. Considering the lack of segregation of duties of the license administrators, a monthly bank reconciliation is imperative to improve internal control over licensing receipts.

Further, license administrators were not adequately trained in using system reports to balance receipts with daily activity, nor were they familiar with proper accounting for vendor invoice payments. Since license administrators did not know how to process a single payment for vendors purchasing multiple licenses, some payments were held for several weeks.

In numerous instances the license administrators had not signed the daily activity report. This signature indicates the report was checked by an administrator for accuracy and completeness.

Recommendations

We recommend the KHRA ensure license administrators are adequately trained to process receipts through the licensing system and to produce corresponding system reports. Such understanding will help prevent inconsistencies and errors.

To facilitate timely deposits, license administrators should be trained to account for a single payment received from a vendor for multiple licenses.

As previously recommended, a monthly bank reconciliation should be performed by an individual not involved in the handling of license receipts.

We further recommend daily activity reports be reviewed to ensure all daily activity reports are accurate, complete, and signed by the license administrator.

Summary of Recommendations

Our findings consistently report that KRC's business practices were not effectively managed due to the lack of understanding and compliance with statutes, regulations, and financial controls. While EPPC has already implemented certain controls and procedures, we recommend additional steps be taken. We strongly recommend that the KHRA Executive Director report to the EPPC for administrative purposes. EPPC officials should ensure KHRA adopt strong financial controls and comply with appropriate statutes and regulations when conducting the activities of the KHRA.

As we have reported, KHRA should implement and adhere to financial controls in areas that include:

Financial controls must continue to be improved.

- Employee time and attendance reporting;
- Consistent application of travel reimbursement regulations;
- Compliance with contract procurement statutes and regulation;
- Improving the licensing system design and administrative functions to strengthen data integrity and security;
- The security and timely deposit of license fees and other receipts; and,
- The timely reconciliation of license receipts to licensing system data and to bank deposits.

In addition, the EPPC and KHRA should seek legislation and promulgate regulations to clarify the following issues:

Legal clarification is needed to address several issues.

- The establishment and modification of track assessment fees.
- The manner of prorating KHRA's Executive Director's salary among the various tracks.
- Modify the provisions of KRS Chapter 11A to include the same considerations for secondary employment inside state government as outside state government.

Further, we recommend EPPC not employ an individual to simultaneously hold the positions of KHRA Executive Director and Chief State Steward, and seek clarification from the Executive Branch Ethics Commission regarding:

Request Executive Branch Ethics Commission opinions regarding dual employment and conflicting duties.

- Possible violations of KRS Chapter 11A involving dual employment; and,
- Possible conflicts between KRS 230.240 and the Executive Branch Code of Ethics.

KHRA management should be adequately trained to ensure operations comply with applicable statutes and regulations. Board members should also be given appropriate orientation related to state policies and procedures. Further, as an ex-officio member of the KHRA Board, the EPPC Secretary or designee should attend and participate in Board meetings.

RESPONSE FROM THE HONORABLE GOVERNOR ERNIE FLETCHER

COMMONWEALTH OF KENTUCKY
OFFICE OF THE GOVERNOR

ERNIE FLETCHER
GOVERNOR

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June 17, 2004

The Honorable Crit Luallen
Auditor of Public Accounts
105 Sea Hero Road, Suite 2
Frankfort, KY 40601

Dear Ms. Luallen:

On March 3, 2004 I requested an audit of certain activities of the former Kentucky Racing Commission. The request was based on concerns identified by the Environmental and Public Protection Cabinet (EPPC) following its review of personnel, procurement and payment actions of the Commission, which the Cabinet documented and discussed in subsequent meetings with you and your staff. Thank you for your timely and detailed response.

Our administration is committed to eliminating waste, fraud and abuse in state agencies. Your audit has revealed many of the former Commission's activities that violated statutes, regulations and normal financial controls. It also indicates that this administration has already taken many of the steps necessary to develop and implement long overdue managerial and financial controls.

On January 6, 2004 I abolished the Kentucky Racing Commission and created the Kentucky Horse Racing Authority by Executive Order 2004-030. The new Authority is charged both with the regulatory oversight of the horse racing industry in Kentucky, and with promoting the industry within and outside of the borders of the state. The Authority has left the gate strong and has begun to look carefully at some of the financial issues identified in the report.

As you note in your report, the EPPC has already implemented many new administrative controls concerning personnel, travel and reimbursement practices. This administration implemented new travel policies and procedures and new policies on time and attendance on February 27, 2004 and March 1, 2004, respectively. The Cabinet will

continue to provide oversight and monitoring of financial and personnel documents to help ensure that all will be processed in accordance with applicable regulations.

The Cabinet already has taken steps to ensure that no one on the Authority staff would be paid for holding two state jobs and drawing two state paychecks for working the same hours. Regardless of whether you believe that paying someone two salaries at the same time violates state law, I believe it violates the public trust, and it is not how we will run this administration. This is yet another example of the waste and abuse of taxpayers' dollars that we are striving to eliminate.

When this practice came to Secretary LaJuana Wilcher's attention in January of this year, she immediately took action that remedied the situation. Moreover, we agree with your opinion and the 1999 opinion of the General Counsel for the Personnel Cabinet that it was a conflict of interest for a person to hold the positions of executive director and chief state steward concurrently. Steps have been taken to prevent this in the future.

Concerning personnel, an acting executive director has implemented our new policies. In addition, a financial officer recently has been appointed, and I expect to appoint a new executive director within the next few weeks.

The new director will be charged with following up on the additional recommendations that were made:

* Ensure the best methods of compensation (salary vs. hourly) are utilized for each classification.
* Issue written policies and procedures for scheduled "dark days" and inclement weather days at the tracks.
* Revise administrative regulations on fee assessment for clarity.
* Revise or place additional controls over the licensing system to ensure accuracy, including the timely deposit of funds and system security.
* Determine if an allotment increase is required to re-pay the $30,000 erroneously paid from the Equine Drug Research Fund.
* Develop training programs to ensure that staff are properly trained.

Concerning your additional recommendations, the Secretary will continue to attend and participate in Authority meetings as an *ex officio* member. We will evaluate additional recommendations concerning the need to refer certain issues to the Executive Branch Ethics Commission and the need for additional legislation.

Thank you for your review. We appreciate your views, and look forward to continuing to strengthen the operations of the Kentucky Horse Racing Authority.

Sincerely,

Ernie Fletcher