



Rhinebeck Central School District Internal Controls Over Payroll Disbursements

Report of Examination

Period Covered:

July 1, 2004 - February 28, 2006

2006M-98



ALAN G. HEVESI

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State of New York Office of the State Comptroller

Division of Local Government Services and Economic Development

August 2006

Dear School District Officials:

One of the Office of the State Comptroller's top priorities is to identify areas where school districts can improve their operations and provide guidance and services that will assist school district officials in making those improvements. Further objectives are to develop and promote short-term and long-term strategies to enable and encourage school district officials to reduce costs, improve service delivery and to account for and protect their school districts' assets.

The reports issued by this Office are an important component in accomplishing these objectives. These reports are expected to be a resource and are designed to identify current and emerging fiscally related problems and provide recommendations for improvement. The following is our report on the Rhinebeck Central School District — Internal Controls Over Payroll Disbursements.

This audit was conducted pursuant to the State Comptroller's authority as set forth in Article V, Section 1 of the State Constitution and Article 3 of the General Municipal Law. The report contains opportunities for improvement for consideration by school district officials.

If we can be of assistance to you or if you have any questions concerning this report, please feel free to contact the local regional office for your county listed at the back of this report.

Respectfully submitted,

*Office of the State Comptroller
Division of Local Government Services
and Economic Development*

Introduction

Background

The Rhinebeck Central School District (District) is located in the Towns of Milan, Stanford, Red Hook, Hyde Park, Rhinebeck, and Clinton in Dutchess County. The District is governed by the Board of Education (Board) which comprises seven elected members. The Board is responsible for the general management and control of the District's financial and educational affairs. The Superintendent of Schools (Superintendent) is the chief executive officer of the District and is responsible, along with other administrative staff, for the day-to-day management of the District under the direction of the Board.

There are three schools in operation within the District, with approximately 1,240 students and 240 employees. The District's budgeted expenditures for the 2005-06 fiscal year are approximately \$21 million, funded primarily with State Aid, real property taxes and grants. The District's major expenditures are employee salaries and related fringe benefits.

The District processes its own payroll through the Business Office, primarily by one account clerk. For the year ending June 30, 2005, payroll disbursements totaled \$10.7 million and from July 1, 2005 through February 17, 2006, disbursements totaled \$5.8 million for salaries paid to appointed officials, instructional and non-instructional staff. The District utilizes the Info-Matic financial management system to process payroll.

Objective

The objective of our audit was to determine if the District has established adequate internal controls over payroll disbursements to protect against fraud, abuse and professional misconduct, and if the controls are operating effectively. Our audit addressed the following related question:

- Has the District established adequate segregation of duties over the payroll processing function to safeguard District assets?

Scope and Methodology

Our overall goal was to assess the adequacy of the internal controls put in place by officials to safeguard District assets. To accomplish this, we performed an initial assessment of the internal controls so that we could design our audit to focus on those areas most at risk.

Our initial assessment included evaluations of the following areas: cash receipts and disbursements, purchasing, payroll and personal services, and capital assets and consumable inventories. Based on that evaluation, we determined that controls appeared to be adequate and limited risk existed in most of the financial areas we reviewed. We did determine that risk existed in the payroll area and therefore, we examined internal controls over payroll disbursements for the period July 1, 2004 to February 28, 2006.

We conducted our audit in accordance with generally accepted government auditing standards (GAGAS). More information on such standards and the methodology used in performing this audit are included in Appendix B of this report.

**Comments of District
Officials and Corrective
Action**

The results of our audit and recommendations have been discussed with District officials and their comments, which appear in Appendix A, have been considered in preparing this report. District officials generally agreed with our recommendations and indicated they planned to initiate corrective action.

The Board has the responsibility to initiate corrective action. Pursuant to Section 35 of the General Municipal Law, the Board should prepare a plan of action that addresses the recommendations in this report and forward the plan to our office within 90 days. For guidance in preparing the plan of action, the Board may refer to applicable sections in the publication issued by the Office of the State Comptroller entitled *Local Government Management Guide*. We encourage the Board to make this plan available for public review in the District Clerk's office.

Internal Controls Over Payroll

A strong system of internal controls includes adequate segregation of duties through organizational restrictions and controls over the financial management system. Proper segregation of duties is a key internal control that reduces some of the risk of fraud and professional misconduct by dividing the applicable payroll functions between multiple employees so that no one employee performs all aspects of payroll, including the ability to add new employees to the computer system, updating salary information, and processing and distributing checks. A good financial management system limits employees' access to certain applications through assignments of user rights that restrict the features that are available to them, as well as create an audit trail of the activity performed by the individual user.

If it is not feasible for the District to adequately segregate duties over the payroll process, certain mitigating controls can be implemented to limit the risk. Mitigating controls are additional procedures or review that limit risk associated with certain circumstances. These controls should include having someone independent of the preparation process perform a review of the completed payrolls. The review should, at a minimum, include random reviews to: verify that employees actually exist; verify that payrolls are based on actual hours or days worked or authorized leave time; verify that the Board of Education authorized the hourly rates or annual salaries used; compare net payroll checks to payroll journals; and assess the payroll for reasonableness. Another mitigating control that can be used to verify payroll is a periodic payroll payout. A payroll payout requires employees to pick up their checks in person and to produce identification to verify their identity. This internal control procedure helps confirm the accuracy of payroll records by ensuring individuals receiving pay checks are legitimate employees.

Other procedures that can be implemented are through the utilization of exception reports. Exception reports are computer generated reports that are a function of the financial management system, which detail specific activities, such as new employee additions, salary increases, or other predefined criteria. These reports could be reviewed to make sure that the additions or changes made were authorized.

A computerized financial management system should provide a means of determining, on a constant basis, who is accessing the system and what transactions are being processed. Audit logs (commonly known as audit trails) maintain a record of activity by system or application

process. The audit log should provide information such as: (1) the identity of each person who has accessed the system, (2) the time and date of the access, (3) what activity occurred, and (4) the time and date of logoff. Ideally, this audit log or audit trail would be reviewed by management or management's designee, in order to monitor the activity of users who access the financial management software. This tool provides a mechanism for individual accountability, reconstructing events and problem monitoring.

Our audit found a lack of segregation of duties over the key aspects of the District's payroll function. The payroll clerk has the ability to create new employees, update employee information, input salary detail, set up direct deposits, print checks, have custody of the checks before distributing them, and create the annual salary notification letters. Though the letters are signed by the employee receiving them, they are not reviewed by anyone independent of the payroll process. More specifically, the current software application cannot limit privileges or access to the key components of payroll. The District is currently in the process of updating the software to a new Windows version, which district officials informed us will facilitate better controls over the payroll function. The District does not utilize exception reports, though the computer system has the capabilities to produce them.

The District has some limited mitigating controls in place, which include having the payroll certified by the Superintendent or Business Administrator before it is disbursed, the Business Official periodically compares actual salaries to budgeted amounts, and a yearly payroll audit is conducted. District Officials informed us this is an overall cursory procedure. Though these controls decrease risk, the District has an opportunity to further mitigate control weaknesses to address the specific risk associated with the lack of segregation of duties over all the functions of payroll.

Based on the lack of segregation of duties over payroll, we tested approximately 60 individuals, on the payroll, to verify they were indeed employees of the district. In addition, we tested the accuracy of 20 employees' and the key officials' salaries as well as a sample of time cards and mandatory deductions. Our testing did not reveal any material exceptions.

The lack of segregation of duties without mitigating controls in place puts the District at risk of fraud, abuse, and professional misconduct through unauthorized payroll disbursements.

Recommendations

1. The District should have an employee outside of the payroll disbursement process add new employees to the system and update all salary information. Once the accounting software is updated, access for these functions should be restricted to the employee in charge of the function.
2. The annual employee salary notification letters should be reviewed by someone independent of the payroll process.
3. A list of all board approved employees created by someone independent of the payroll process should be made available to the person certifying payroll so that periodic disbursements can be compared to ensure that all employees receiving payments are actual and authorized.
4. If duties cannot be segregated, someone independent of the payroll preparation process should review final payrolls to verify that they are based on actual hours or days worked, or authorized leave time; verify that the hourly rates or annual salaries used were authorized; compare net payroll checks to the payroll journals; and review the payrolls for reasonableness.
5. The District should consider requiring a review of payroll exception reports prior to the certification of the payroll. These reports are produced through the accounting software.

APPENDIX A
RESPONSE FROM DISTRICT OFFICIALS

The District officials' response to this audit can be found on the following pages.



POST OFFICE BOX 351
RHINEBECK, NEW YORK 12572
Telephone: 845-871-5500

August 10, 2006

██████████
Office of the State Comptroller
State Office Building, Room 1702
44 Hawley Street
Binghamton, New York 13901

Dear ██████████:

This letter is in response to the Report of Examination that was reviewed and discussed at the exit conference held on August 2, 2006 in the District Administrative Office with members of your staff. I would be remiss if I did not commend those individuals on the highly professional manner in which they conducted their audit, especially regarding their interactions with our district staff during the audit process.

The recommendations for our response to the lack of segregation of payroll duties that was addressed in the draft audit report are being addressed as follows:

1. The District should have an employee outside of the payroll disbursement process add new employees to the system and update all salary information. Response: When our accounting software is updated in late September 2006, access to these functions will be restricted to the employee in charge of the function. In October, the District will be hiring a new secretary to the Business Official as the result of a retirement. This employee will add new employees to the accounting/personnel system and update salary information, thus segregating these duties from those of the Payroll Clerk. Our accounting programs from Info-Matic, Inc. will provide additional security and audit trail capabilities. The programs of Info-Pay and Info-Staff will provide password protection for specific program functions, including the creation of employees, editing of employee information, processing payroll, printing checks, creating and editing user-defined codes, and the printing of reports. The programs will also log employee pay rate changes and provide report capability.

2. The annual employee salary notification letters should be reviewed by someone independent of the payroll process. Response: Signed salary notification letters will be reviewed by the Business Official when received from the employees. In addition, the listing of employees who are sent letters will be checked and signed off by the Business Official.

3. A list of all Board approved employees created by someone independent of the payroll process should be available to the person certifying payroll so that periodic disbursements can be compared to ensure that all employees receiving payments are actual and authorized. Response: A list of all Board appointments will be compiled by the Business Official, with the assistance of his/her secretary and the District Clerk.

4. If duties cannot be segregated, someone independent of the payroll preparation process should review final payrolls to verify that they are based on actual hours or days worked, or authorized leave time; verify that the hourly rates or annual salaries used were authorized; compare net payroll checks to the payroll journals; and review the payrolls for reasonableness. Response: The segregation of duties already has been addressed in district responses to items 1, 2 & 3 above. The review of final payrolls and the comparison of net payroll checks to the payroll journals, etc. will be a function of the internal auditor.

5. The District should consider requiring a review of payroll exception reports prior to the certification of the payroll. These reports are produced through the accounting software. Response: The payroll exception reports already are being reviewed and signed by the Business Official and/or the Superintendent of Schools prior to the checks being processed.

During our exit conference on August 2, 2006, the District provided the audit team with documentation related to the above recommendations that already have been set in place. We are confident that the audit that was performed, and the results and recommendations we have received, will enhance the effectiveness of our District's financial operations. We appreciate the opportunity to work with your staff and are eager to fully implement the suggestions as outlined above.

Sincerely,



Joseph L. Phelan

Superintendent of Schools

pc: Board of Education members
Shirley Cannelli, School Business Official

APPENDIX B

AUDIT METHODOLOGY AND STANDARDS

Our overall goal was to assess the adequacy of the internal controls put in place by officials to safeguard District assets. To accomplish this, we performed an initial assessment of the internal controls so that we could design our audit to focus on those areas most at risk. Our initial assessment included evaluations of the following areas: information technology, cash receipts and disbursements, purchasing, payroll and personal services, and capital assets and consumable inventories.

During the initial assessment, we interviewed appropriate District officials, performed limited tests of transactions and reviewed pertinent documents such as District policies and procedures manuals, Board minutes and financial records and reports. In addition, we obtained information directly from the computerized financial databases and then analyzed it electronically using computer-assisted techniques. This approach provided us with additional information about the District's financial transactions as recorded in its databases. Further, we reviewed the District's internal controls and procedures over the computerized financial databases to help ensure that the information produced by such systems was reliable.

After reviewing the information gathered during our initial assessment, we determined where weaknesses existed, and evaluated those weaknesses for the risk of potential fraud, theft and/or professional misconduct. Based on that evaluation, we determined that controls appeared to be adequate and limited risk existed in most of the financial areas we reviewed. We then decided upon the reported objectives and scope by selecting for audit those areas most at risk. We selected payroll disbursements for further audit testing.

The district was most at risk with disbursements through payroll. Our audit included documenting our understanding of internal controls over payroll disbursements and determining if they are appropriately designed and operating effectively to adequately safeguard district assets.

We examined the following records to identify any associated effect of deficiencies found due to the lack of segregation of duties:

- Payroll journals
- Personnel files
- Bank statements
- Substitute teacher claim forms
- Extra work claim forms

Audit steps included: traced annual payroll totals of key officials to their contracts and all personnel having access to the payroll software applications to supporting documentation; traced all employees that were on the payroll the period before the pay check audit, but were not on the tested period payroll, to supporting documentation to authorize their employment; traced all employees that received

pay checks through the mail to supporting documentation to ensure that employees were actual and properly authorized; traced a sample of employees receiving direct deposit to documentation to ensure that employees were actual and authorized; tested a sample of employees being paid under high risk account codes such as substitute teachers to ensure that each employee was actual and had been authorized; tested a sample of employees that exceeded their stated salaries by more than \$3,000 to ensure that their payments were accurate and authorized; judgmentally tested unusual payments; traced a sample of payroll disbursements to applicable time records/sheets that support the hours worked to ensure that all disbursements were accurate and supported; traced selected canceled checks and records of direct deposits to bank statements; tested the accuracy of payroll computations of net pay, Social Security and Medicare withholdings on a test basis; and traced total State and Federal withholdings and the District's portion of Social Security/Medicare to the subsequent remittance to the State and Federal governments and the related forms on file at the District.

We conducted our audit in accordance with generally accepted government auditing standards (GAGAS). Such standards require that we plan and conduct our audit to adequately assess those District operations within our audit scope. Further, those standards require that we understand the District's management controls and those laws, rules and regulations that are relevant to the District's operations included in our scope. An audit includes examining, on a test basis, evidence supporting transactions recorded in accounting and operating records and applying such other auditing procedures, as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for the findings, conclusions and recommendations contained in this report.

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