



Arkport Central School District Internal Controls Over Selected Financial Operations

Report of Examination

Period Covered:

July 1, 2005 — June 7, 2007

2007M-252



Thomas P. DiNapoli

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State of New York Office of the State Comptroller

Division of Local Government and School Accountability

December 2007

Dear School District Officials:

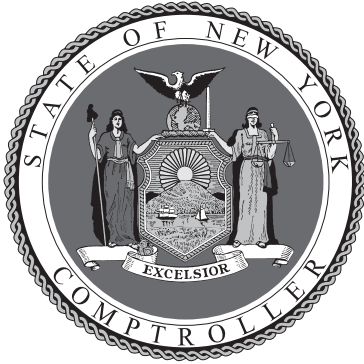
A top priority of the Office of the State Comptroller is to help school district officials manage their districts efficiently and effectively and, by so doing, provide accountability for tax dollars spent to support district operations. The Comptroller oversees the fiscal affairs of districts statewide, as well as districts' compliance with relevant statutes and observance of good business practices. This fiscal oversight is accomplished through our audits, which identify opportunities for improving district operations and Board of Education governance. Audits also can identify strategies to reduce district costs and to strengthen controls intended to safeguard district assets.

Following is a report of our audit of the Arkport Central School District, entitled Internal Controls Over Selected Financial Operations. 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.

This audit's results and recommendations are resources for district officials to use in effectively managing operations and in meeting the expectations of their constituents. If you have questions about this report, please feel free to contact the local regional office for your county, as listed at the end of this report.

Respectfully submitted,

*Office of the State Comptroller
Division of Local Government
and School Accountability*



State of New York Office of the State Comptroller

EXECUTIVE SUMMARY

The Arkport Central School District (District) is governed by the Board of Education (Board) which comprises five 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.

The District's annual payroll expenditures were about \$3.7 million. The payroll clerk processes payroll for an average of 100 employees every other week. The Treasurer reconciles the payroll account and the Superintendent certifies the payroll. The information technology (IT) department comprises a technology coordinator and one technician. The Western New York Regional Information Center (WNYRIC), that provided the District with its financial software application, administers the financial application.

Scope and Objective

The objective of our audit was to assess the District's internal controls over its payroll function and information technology for the period July 1, 2005 through June 7, 2007. Our audit addressed the following related questions:

- Are internal controls over the segregation of duties in payroll appropriately designed and operating effectively to adequately safeguard District assets?
- Are internal controls over the information technology systems appropriately designed to adequately safeguard District assets?

Audit Results

Payroll duties are not properly segregated and compensating controls are inadequate. The payroll clerk's responsibilities include adding, deleting and modifying employee information; adding and changing pay rates and salaries; entering hours worked; printing payroll checks containing the Treasurer's signature; and distributing paychecks. As a result, the payroll function is at a heightened risk for fraud, abuse, or professional misconduct, and for payroll errors and irregularities to occur and go undetected.

The Board has not effectively addressed the safeguarding of computer data. The Board has not adopted comprehensive policies and procedures to address the use of passwords for the financial software.

In addition, the current financial software used by the District does not provide basic tools such as exception reports and change reports. Further, the Board has not established formal policies and procedures to address disastrous events that may result in the loss of critical functions and/or data. The lack of comprehensive policies and procedures related to information technology puts the District's data, network and applications at risk for damage or loss.

Comments of District Officials

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.

Introduction

Background

The Arkport Central School District (District) is located in the Towns of Almond, Birdsall and Burns in Alleghany County and the Towns of Hornellsville, Fremont and Dansville in Steuben County. The District is governed by the Board of Education (Board) which comprises five 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 is one school in operation within the District, with approximately 600 students and 100 employees. The District's operating expenditures for the 2005-06 fiscal year were about \$7.4 million. These were funded primarily with State aid, real property taxes, and grants.

The District's annual payroll expenditures were about \$3.7 million. The payroll clerk processes payroll for an average of 100 employees every other week. The Treasurer reconciles the payroll account and the Superintendent certifies the payroll. The information technology (IT) department comprises a technology coordinator and one technician. The Western New York Regional Information Center (WNYRIC), that provided the District with its financial software application, administers the financial application.

Objective

The objective of our audit was to assess the District's internal controls over its payroll function and information technology. Our audit addressed the following related questions:

- Are internal controls over the segregation of duties in payroll appropriately designed and operating effectively to adequately safeguard District assets?
- Are internal controls over the information technology systems appropriately designed to adequately safeguard District assets?

Scope and Methodology

We examined internal controls over payroll and the information technology systems of the District for the period July 1, 2005 to June 7, 2007.

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 is 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, Section 2116-a (3)(c) of the Education Law and Section 170.12 of the Regulations of the Commissioner of Education, the Board must approve a corrective action plan that addresses the findings in this report, forward the plan to our office within 90 days, forward a copy of the plan to the Commissioner of Education, and make the plan available for public review in the District Clerk's office. For guidance in preparing the plan of action, the Board should refer to applicable sections in the publication issued by the Office of the State Comptroller entitled *Local Government Management Guide*.

Payroll Segregation of Duties

An effective system of internal control requires the separation of duties so that no single individual controls most, or all, phases of a transaction. An individual should not be allowed to perform the three key payroll duties of authorization (i.e., entering employees and making changes in hourly and annual salary rates in the software), recordkeeping, and asset custody (i.e., signing or distributing checks). If it is not feasible to segregate duties, District officials should consider mitigating the control weakness by having someone independent of the process review completed payrolls. At a minimum, the review should include random checks to verify that payrolls are based on actual hours worked and authorized leave time, and that hourly rates or annual salaries were approved by the Board, and a comparison between payroll checks and payroll journals to determine whether the payrolls are reasonable.

We found that payroll duties are not properly segregated and that compensating controls are inadequate. Although the Treasurer performs monthly bank reconciliations and the Superintendent certifies the payroll, the payroll clerk's responsibilities include adding, deleting and modifying employee information; adding and changing pay rates and salaries; entering hours worked; printing payroll checks containing the Treasurer's signature; and distributing paychecks. Although the Treasurer's signature should be affixed to District checks by the Treasurer, or under the Treasurer's direct supervision, the Treasurer does not directly oversee this process for payroll.

District managers have not instituted policies and procedures over the payroll function. These policies and procedures should create effective compensating controls, such as supervisory review, to compensate for the lack of segregation of duties. The payroll function is at a heightened risk for fraud, abuse, or professional misconduct, and for payroll errors and irregularities to occur and go undetected.

Due to these control weaknesses noted above, we performed various procedures including verifying that two payrolls totaling approximately \$326,500 in employees' gross pay were properly approved. We also verified that the amounts and benefits paid to 17 employees on one of these payrolls were proper. We also distributed paychecks (or paystubs to employees with direct deposit) for the July 27, 2007 payroll. All paychecks and paystubs were delivered to the respective employees who provided identification in the form of a driver's license and signed receipt.

Because of this testing, we noted that personnel files for seven employees lacked supporting documentation for all payroll deductions taken from their gross pay. These payroll deductions included bank direct deposits, deductions for life insurance premiums, and deductions for tax sheltered accounts.

Recommendations

1. District managers should develop written payroll procedures establishing proper segregation of duties and/or adequate mitigating controls. These procedures should:
 - a. Require written authorizations to be received by the payroll clerk prior to adding, deleting or modifying employee information in the financial software.
 - b. Require the Treasurer to print or directly oversee the printing of checks containing her signature.
 - c. To the extent possible, assign duties related to payroll processing in a manner that provides adequate segregation of duties. Where segregation of duties is limited, procedures should call for the work of one individual to be reviewed by another in the course of their regular duties.
2. District officials should ensure that personnel files contain all required forms for all District employees.

Information Technology

One of the Board's managerial responsibilities is to design and implement a system of internal controls incorporating policies and procedures to provide reasonable assurance that all assets – including computer data – entrusted to their care are safeguarded against waste, loss, and misuse, and are used in accordance with all laws, regulations, policies and sound business practices. District management relies on computer data for making financial decisions and for reporting to State and Federal agencies and to the general public. If the computers on which this data is stored fail, the results could range from an inconvenience to a catastrophic event. Even small disruptions in electronic data systems can require extensive employee and consultant hours to evaluate and repair. Access to computer data systems should be adequately guarded by strong passwords, and monitored to reduce risks of misuse and/or alteration of data resulting in potential financial loss to the District. Finally, a formal disaster plan is necessary to provide guidance on the prevention of loss of computer data in the event of a disaster.

The District uses a software package for processing its financial transactions. The District's computerized financial system includes accounts payable, payroll, personnel, employee attendance and general ledger modules. The financial software is installed on two computers in the Business Office. The Board has not effectively addressed the safeguarding of computer data by establishing policies and procedures to do so. Computer data is an extremely valuable asset that should be protected. In addition to its inherent value, sensitive computerized personal data can represent a potential liability if lost or compromised. Our audit disclosed several control weaknesses with respect to the computerized financial system regarding passwords, software reports and disaster recovery.

Passwords

To access a network, computer or application, users are required to enter their user names and authentication. Users can be authenticated by a computer system using passwords. Passwords are one of the most basic controls that can be used to mitigate the risk of unauthorized users obtaining access to the District's computer systems. It is essential that password systems be adequately established and safeguarded. Complex passwords, containing a combination of uppercase and lowercase letters, punctuation and at least eight characters, are necessary to prevent unauthorized users from accessing the system. In order to protect confidentiality, users should change their passwords periodically.

We found that the Board has not adopted comprehensive policies and procedures to address password use. The Network Administrator generates passwords from a random password generator for all users. This password allows them access to the District's system. Additionally, District faculty and staff use the same password until the Network Administrator changes them again. According to the Network Administrator, the last time he changed the passwords was approximately two years ago. Passwords should be changed on a more regular basis, for example every 30 to 60 days.

Because password policies are not adequately established, especially regarding the periodic changing of passwords, there is an increased risk that an unauthorized user may be able to gain access to the District's data and damage the network and/or applications or obtain confidential information.

Financial Software Reports

A good financial software package provides adequate tools to allow the District to set up a strong system of internal controls. Exception reports and change reports are two of the basic tools available in most financial software packages. Board policies should require that the financial software provides these tools and that District employees use them. Exception reports are detailed lists of transactions that are exceptions to ordinary transactions. Change reports show changes that are made to certain data records such as vendor information or personnel information.

The Board has not adopted policies and procedures regarding the use of financial software. These policies should express the Board's objectives for what the financial software will accomplish, and the procedures should outline the steps to be followed to achieve these objectives. In addition, the current financial software used by the District does not provide basic tools such as exception reports and change reports. According to the Treasurer, the software was purchased prior to her employment with the District, and District officials have continued to use the same software because they were unaware of any deficiencies.

The internal controls over the financial software package and data held within it are weakened by the lack of policies and procedures. These weaknesses are compounded by the lack of tools that could be offered by the financial software package to strengthen internal controls.

Disaster Recovery

An effective internal control system for information technology requires the adoption of a formal disaster recovery plan to prevent loss of the computer equipment and data, and procedures for the

recovery of data in the event of a loss. A disaster recovery plan (DRP) – sometimes referred to as a business continuity plan (BCP) or business process contingency plan (BPCP) – describes how an organization is to deal with potential disasters. A plan consists of the precautions taken to minimize the effects of a disaster and to enable the organization to either maintain or quickly resume mission-critical functions. Typically, disaster recovery planning involves an analysis of business processes and continuity needs; it may also include a significant focus on disaster prevention.

The Board has not established formal policies and procedures to address disastrous events that may result in the loss of critical functions and/or data. Therefore the District does not have a formal disaster recovery plan, and in the event of a catastrophic event, District personnel will have no written guidelines or plan to follow. This could result in the District losing critical equipment and/or data with no ability to recover functionality.

Recommendations

3. The Board should adopt a policy and establish procedures requiring that passwords be changed at regular intervals.
4. District officials should work with their financial software provider to update the financial management system. If the system can be modified to produce exception and change reports, someone independent of the Business Office should review the monitoring reports generated. If the system cannot be modified to produce appropriate exception/change reports, then compensating controls should be instituted by District management.
5. The Board should adopt a formal disaster recovery plan.

APPENDIX A

RESPONSE FROM DISTRICT OFFICIALS

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

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SUPERINTENDENT

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K-12 BUILDING PRINCIPAL

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December 3, 2007

Office of the State Comptroller
The Powers Building
16 West Main Street
Suite 522
Rochester, NY 14614

Dear Ladies and Gentlemen:

This is a **Response to the Preliminary Draft Findings** of the audit of the Arkport Central School District. It is also a **Corrective Action Plan** in regard to the report.

RESPONSE TO FINDINGS

The Arkport Central School District Board of Education is pleased with both the process and the outcome of the Comptroller's Audit. The examiner(s) were professional at all times, while the entry and exit conferences were handled with aplomb. Several suggestions were made for improvement that were either immediately implemented or will be in a very short time frame. In summary, the Arkport Board of Education agrees with the report.

CORRECTIVE ACTION PLAN

District managers should develop written payroll procedures.

1a)- Effective immediately, The Arkport Central School District will require that all modifications of employee payroll information be in writing with copies of said documents retained in the employees' personnel folder that is maintained in the office of the district clerk.

1b&c)- Effective immediately, the check printer will be kept locked in a room that is only accessible to the treasurer, the business manager and the payroll clerk. During non-work hours this room is further protected by a 24/7 security alarm system. Only the treasurer will authorize and supervise the printing of checks, and in his or her absence the payroll clerk will be authorized to print

checks only under the supervision of the business manager. The treasurer and payroll clerk will be the only employees to be issued passwords to access the check printing system. In addition, the superintendent will spot check cancelled checks.

District officials should ensure that personnel files contain required forms.

2)- During the spring of 2008 and at least annually thereafter, a 100% audit of the payroll regarding all deductions will be performed by the business manager and the treasurer.

The Board should adopt a policy regarding passwords

3)- In the spring of 2008 the Board will consider a policy requiring that all District passwords be changed at regular intervals .

The District should update their financial package

4)- During the current 2007-2008 school year the Board has been transitioning into a new Financial Software Package that is scheduled to be fully implemented by July 1, 2008. [REDACTED] will generate exception and charge reports that will be reviewed on a monthly basis by the Board.

The Board should adopt a formal Disaster Recovery Plan

5)- Currently, all servers are backed up by a [REDACTED], a manual back-up and/or a back-up located off-site. A formal Disaster Recovery Plan will be prepared for presentation to the Board by April of 2008.

On behalf of the Arkport Central School Board of Education I thank you for your positive suggestions to improve the efficiency of our operation. We thoroughly enjoyed working within the process and look forward to improving our operations through the implementation of your suggestions.

Sincerely,



William S. Locke
Superintendent of Schools

WSL/pll

CC: Dr. Richard Mills, Commissioner of Education
BOE
Mrs. Meghann Khork, Arkport District Clerk

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: financial oversight, cash receipts and disbursements, purchasing, and payroll and personal services.

During the initial assessment, we interviewed appropriate District officials, performed limited tests of transactions and reviewed pertinent documents, such as the 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. We then decided upon the reported objectives and scope by selecting for audit those areas most at risk. We selected the payroll function and information technology for further audit testing.

We performed the following tests:

- Examined personnel files and distributed paychecks to employees listed on the payroll.
- Traced benefits to supporting documentation for appropriate signatures and dates.
- Examined completed payrolls for signatures of appropriate department heads.
- Tested payroll calculations, footings and extensions.
- Traced pay rates from payrolls to approved schedules, contracts, and other documentation.
- Reviewed Board minutes and District policies and procedures.
- Interviewed and observed District employees and officials.

We conducted this performance audit in accordance with generally accepted government auditing standards (GAGAS). Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

APPENDIX C

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