



Montauk Union Free School District Internal Controls Over Selected Financial Operations

Report of Examination

Period Covered:

July 1, 2006 — August 31, 2007

2008M-13



Thomas P. DiNapoli

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State of New York Office of the State Comptroller

Division of Local Government and School Accountability

March 2008

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, in part, 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 Montauk Union Free School District, entitled *Internal Controls Over Selected Financial Operations*. This audit was conducted pursuant to Article V, Section 1 of the State Constitution, and the State Comptroller's authority as set forth in 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 Montauk Union Free 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 processed cash disbursements through the Business Office, primarily by the Treasurer. For the fiscal year ending June 30, 2007 cash disbursements totaled about \$12.4 million. Payroll totaled \$4.9 million. The District processed these transactions using a computerized financial system.

Scope and Objective

The objective of our audit was to determine if the District's internal controls over selected financial operations are appropriately designed and operating effectively for the period July 1, 2006 to August 31, 2007. Our audit addressed the following related questions:

- Are internal controls over the claims audit function appropriately designed and operating effectively?
- Are access controls over the computerized financial system appropriately designed to safeguard District assets?
- Has the District established adequate segregation of duties over the cash disbursement processing function to safeguard District assets?
- Has the District established adequate segregation of duties over payroll to safeguard District assets?

Audit Results

The District does not have an effective claims audit process. The claims auditor has significant accounting duties and is directly supervised by the Superintendent. She is therefore not independent, and her appointment as the claims auditor does not comply with SED regulations. As a result, the Board has only limited assurance that the claims auditor will be able to resist management attempts to override internal controls in the event questionable claims are found and there is an increased risk that fraud or abuse could occur.

Internal controls over the computerized financial system, cash disbursements and payroll processing were not appropriately designed. Specifically, the Treasurer had administrative access and her duties were not properly segregated. Due to these internal control weaknesses, we examined computer access rights, cash disbursements and payroll processing. Although our audit testing did not identify any material exceptions, there is an increased risk that errors or irregularities could occur and remain undetected and uncorrected.

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 findings and recommendations and plan to initiate corrective action.

Introduction

Background

The Montauk Union Free School District (District) is located in the Town of East Hampton, Suffolk 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 320 students and 70 employees. The District's budgeted expenditures for the 2006-07 fiscal year were approximately \$13.5 million, which were funded primarily with State aid, real property taxes, and grants.

The District processed cash disbursements through the Business Office, primarily by the Treasurer. For the fiscal year ending June 30, 2007, cash disbursements totaled about \$12.4 million. Payroll totaled \$4.9 million. The District processed these transactions using a computerized financial system.

Objective

The objective of our audit was to determine if the District's internal controls over selected financial operations are appropriately designed and operating effectively. Our audit addressed the following related questions:

- Are internal controls over the claims audit function appropriately designed and operating effectively?
- Are access controls over the computerized financial system appropriately designed to safeguard District assets?
- Has the District established adequate segregation of duties over the cash disbursement processing function to safeguard District assets?
- Has the District established adequate segregation of duties over payroll to safeguard District assets?

Scope and Methodology

We examined claims auditing and the segregation of duties for the computerized financial system, cash disbursements and payroll processing of the School District for the period July 1, 2006 to August 31, 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 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 findings and recommendations and plan 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*.

Claims Auditor

An important aspect of the District's internal controls over cash disbursements rests with the claims auditor. The claims auditor assumes the powers and duties of the Board for approving or denying claims against the District. This person must report directly to the Board, not be involved in any other business or accounting functions within the District, and conduct a thorough review of documentation to ensure that proposed payments are proper. State Education Department (SED) regulations¹ specifically prohibit clerical or professional personnel under the direct supervision of the Superintendent from serving as the claims auditor.

The claims auditor is also the District secretary and receiving clerk. She does not report directly to the Board, is under the direct supervision of the Superintendent and has duties that include significant accounting functions.

Due to these incompatibilities, we reviewed 19 personal reimbursements to key officials and a judgmental sample of 50 disbursements. Our audit testing did not identify any material errors or irregularities. However, the failure to appoint an independent claims auditor provides the Board with only limited assurance that the claims auditor will be able to resist management attempts to override internal controls in the event questionable claims are found, and increases the risk that fraud or abuse could occur.

Recommendation

1. The Board should immediately comply with SED regulations by appointing a claims auditor that reports directly to the Board and does not have incompatible duties.

¹ - 8 NYCRR, Section 170.12

Segregation of Duties

The Board is responsible for establishing a system of internal controls to ensure that duties are segregated so that no single individual controls all phases of a transaction, or that compensating controls are established to provide reasonable assurance that District assets are properly safeguarded, and that accounting transactions are properly authorized, recorded and reported.

The Board and District officials did not adequately segregate the duties in the Business Office or establish compensating controls. The risk lies primarily with the duties of the District Treasurer. As a result, there is an increased risk that errors or irregularities could occur and remain undetected and uncorrected.

Computerized Financial System

A computerized financial system must have access controls to ensure that system users have access to only those levels they need based upon their job descriptions and responsibilities, and to prevent users from being involved in multiple aspects of financial transactions. Administrative access allows a user to add new users, change access rights, and control and use all aspects of the software. Therefore, a good system of internal controls must ensure that employees with administrative access do not have incompatible duties related to business operations and financial transactions to reduce the risk that the District's financial information or resources could be misused.

The Treasurer had administrative access to the computerized financial system and significant involvement in the day-to-day Business Office operations and financial transactions, including accounts payable and payroll. Due to this internal control weakness, we examined all payments to the Treasurer, Superintendent, District secretary, claims auditor and District Clerk; including payrolls, direct payments and personal reimbursements to ensure that the amounts were properly approved and authorized. We also judgmentally selected 10 additional employees for payroll testing. Although we did not note any exceptions or irregularities, the granting of administrative access to an employee that has significant involvement in business operations and financial transactions increases the risk that financial information or resources could be misused.

Subsequent to the completion of fieldwork, the system access rights of the Treasurer were changed and a system administrator, with administrative access, was appointed who was external to the Business Office. In addition, the Superintendent began to monitor the

system access rights to ensure that the assigned rights were consistent with job duties.

Cash Disbursements

An effective system of internal controls over cash disbursements requires the proper distribution of duties so that the same individual does not perform incompatible functions. A proper division of responsibility must provide that the work of one employee be independently checked in the course of another employee's regular duties. Although it may not always be possible to achieve an optimal segregation of duties, at a minimum, the duties of recordkeeping, reconciling bank accounts and making disbursements must be separated, or compensating controls must be put in place, to reduce the risk that errors or irregularities could occur.

We found the Treasurer is responsible for recording disbursements, signing checks, reconciling bank accounts, making wire transfers and preparing journal entries. Although the performance of all these duties by one person represents a significant internal control weakness, compensating controls (such as having a Board or other administrative staff member periodically review the work in question) are not in place.

Due to this lack of segregation of duties, we examined all personal reimbursements to the Treasurer, bank reconciliations, wire and automated clearinghouse transfers, warrant approvals and a sample of disbursements for the period July 2006 to August 2007 to ensure that all disbursements were properly approved, authorized, appropriate and recorded. Although our testing did not identify any material exceptions, the failure to properly segregate cash disbursement duties or establish compensating controls increases the risk that errors or irregularities could occur and remain undetected and uncorrected.

Payroll Processing

Strong internal controls over payroll must be established to reduce the risk that employees could be paid wages and salaries, and provided benefits, to which they are not entitled. Specifically, one person must not have the ability to authorize, execute and record transactions, and reconcile bank statements.

We found the Treasurer can perform all aspects of the payroll process without any other employee's involvement or oversight. Specifically, the Treasurer is directly responsible for adding, deleting and changing employee information including salary amounts, preparing and processing payrolls, maintaining payroll records and reconciling payroll bank statements. Therefore, she has the ability to add fictitious employees or to make unauthorized changes to personnel and payroll records without detection.

Due to this internal control weakness, we judgmentally selected 11 employees who received more than their stated salaries, balloon payments, additional checks, payments to all key officials and payments to those individuals with access to the computerized financial system payroll application for testing. We also judgmentally selected six employees to verify the salary paid was consistent with their Board-approved contracts, all employees for two pay periods to determine that Federal withholdings were present and reasonable, and eight employees who received more than the normal 26 payments for the year to determine if payments were proper. Although our testing did not identify any material exceptions, the failure to properly segregate the duties for payroll processing increases the risk that employees could be paid wages and salaries, and provided benefits, to which they are not entitled.

Recommendations

2. The Superintendent should continue to monitor the system access rights of District staff to ensure that the assigned rights are consistent with job duties.
3. The Board and District officials should segregate the duties of the Treasurer or implement sufficient compensating controls over her duties. At a minimum, the Treasurer should not be involved in the duties of recordkeeping, reconciling bank accounts and making disbursements.
4. The Board and District officials should ensure that no one person can perform all aspects of the payroll process. At a minimum, the person who enters new hire information and updates salaries should not have other payroll responsibilities.

APPENDIX A

RESPONSE FROM DISTRICT OFFICIALS

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

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"The Lighthouse School District"

J. PHILIP PERNA, SUPERINTENDENT
BRIGID COLLINS, ASSISTANT PRINCIPAL
PATRICIA A. LOEWE, DIRECTOR OF
PUPIL PERSONNEL SERVICES
P. GRACE LIGHTCAP, DISTRICT CLERK
MAURA A. MIRRAS, DISTRICT TREASURER

March 12, 2008

[REDACTED]
Binghamton Regional Office
Office of the State Comptroller
State Office Building, Room 1702
44 Hawley Street
Binghamton, New York 13901-4417

Ladies & Gentlemen:

The Montauk Board of Education is in receipt of the preliminary draft findings and recommendations of the examination of the Internal Controls Over Selected Financial Operations Audit which was completed in the fall of 2007 in our school district.

The report states that the Montauk UFSD does not have an effective claims audit process because the claims auditor has significant accounting duties and is directly supervised by the Superintendent. We have directed the Superintendent to reassign the duties of the claims auditor to an employee that is qualified and does not report directly to the Superintendent. The employee currently serving in that capacity will now perform the duties of a receiving clerk. The claims auditor will be asked to attend meetings and report to the Board of Education monthly.

The Treasurer no longer has administrative access to the computerized financial system. That has been reassigned to the Computer Resource Teacher who has no duties related to the business operations and the financial transactions of the district.

In order to insure an effective system of internal controls in the business office, the Montauk UFSD will hire a part-time assistant to the Treasurer who will be responsible for record keeping, reconciling bank accounts, and making disbursements, thereby checking the work of the Treasurer and will establish compensating controls reducing the risk that errors and irregularities could occur or remain undetected, and uncorrected.

The Montauk UFSD will have the district clerk be responsible for adding new hire information and will update salaries at the direction of the Superintendent and based on contractual agreements. The new Assistant to the Treasurer will also review payroll information to certify that no unauthorized changes have been made.

Thank you.

Sincerely,

A handwritten signature in cursive script that reads "Diane M. Hausman". The signature is written in black ink and is positioned above the printed name and title.

Diane Hausman, President
Montauk Board of Education

BOARD OF EDUCATION
DIANE M. HAUSMAN, PRESIDENT

ISE WATSON, VICE PRES.

LISA WARD

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 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 objective and scope by selecting for audit those areas most at risk. We selected claims auditing and the segregation of duties for the computerized financial system, cash disbursements and payroll processing for further audit testing.

- We interviewed employees in the Business Office concerning claims auditing procedures and the segregation of duties for cash disbursements and payroll processing.
- We interviewed employees in the Business Office and IT Department concerning access rights to the computerized financial system. We also reviewed user rights and permissions documentation, and judgmentally selected users to determine if their user rights were appropriate.
- To identify any associated effects of the deficiencies found, we judgmentally selected various claims for review for multiple procedures (authorization, reasonableness, compliance and data reliability). We focused on adherence to policies, procedures, laws and regulations pertinent to claims processing. We also reviewed payments to various employees, bank reconciliations, wire and automated clearinghouse transfers, warrant approvals and a sample of disbursements. This testing included an examination of the following:
 - Bank statements
 - Transaction history reports
 - Purchase orders

- Claims packets
- Cancelled checks
- Cash control accounts
- Board minutes
- Employee personnel files
- Collective bargaining agreements and individual employment contracts
- Leave accrual records
- Computerized payroll registers and employee earnings records
- Salary notification letters.

We conducted our 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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