



North Merrick Union Free School District

Internal Controls Over Selected Financial Operations

Report of Examination

Period Covered:

July 1, 2005 — May 31, 2007

2008M-63



Thomas P. DiNapoli

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State of New York Office of the State Comptroller

Division of Local Government and School Accountability

October 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 North Merrick 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 North Merrick Union Free School District (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 Elementary Schools in operation within the District with approximately 1,300 students and 270 full-time employees for the fiscal year 2006-07. The District's budgeted expenditures for the fiscal year 2006-07 were \$22 million, funded primarily with real property taxes, State aid and grants.

Scope and Objective

The objective of our audit was to examine the District's internal controls over selected financial operations for the period of July 1, 2005 through May 31, 2007. Our audit addressed the following related questions:

- Did District officials establish and appropriately maintain the employee benefit accrued liability reserve (EBALR) fund?
- Does the Board receive sufficient and timely financial data to adequately monitor the District budget?
- Does the Treasurer maintain adequate control over her signature disk?
- Did District officials establish and monitor internal control policies and procedures over the procurement of professional services?
- Did District officials effectively develop policies and procedures for information technology to ensure that electronic data is appropriately safeguarded?

Audit Results

We identified certain weaknesses in the District's financial operations. District officials established an employee benefit accrued liability reserve (EBALR) in April 2003 using \$2.25 million of excess fund balance. There was no analysis performed to determine if this was a reasonable amount and as a result, it is over funded by as much as \$1.7 million. Since the fund was established, District officials have only used \$100,000 from the reserve as of May 2007.

Additionally, the Board did not receive timely information for monitoring the District's fiscal operations. Commissioner of Education's Regulations require District officials to present a quarterly budget status report to the Board for each fund, or monthly, if a budget transfer has been made since the last report. This lack of financial information limits the Board's ability to monitor the budget and make decisions concerning budget status and budget transfers. We also found a lack of control over the Treasurer's signature disk, which could result in the misuse of District funds.

We reviewed contracts and procurement procedures for 11 professional service providers who were paid a total of approximately \$1,133,035 during the audit period. The District did not solicit competition for any of these services. While the District is not legally required to use RFPs for procuring professional services, using RFPs is an effective way of ensuring the District receives the desired services for the best price.

Finally, the Board has not adopted comprehensive information technology (IT) policies and procedures, access to the computer system is not controlled, audit logs are not maintained and servers are not secure. As a result, the District's IT system and electronic data are subject to increased risk of loss or misuse.

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 North Merrick Union Free School District (District) is located in the Town of Hempstead, Nassau 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. During our audit period the Board performed the claims audit function.

There are three elementary schools in operation within the District, with approximately 1,300 students and 270 full-time employees. The District's budgeted expenditures for the fiscal year 2006-07 were \$22 million, which were funded primarily with real property taxes, State aid, and grants.

Objective

The objective of our audit was to examine the District's internal controls over certain financial operations. Our audit addressed the following related questions:

- Did District officials establish and appropriately maintain the employee benefit accrued liability reserve fund?
- Does the Board receive sufficient and timely financial data to adequately monitor the District budget?
- Does the Treasurer maintain adequate control over her signature disk?
- Did District officials establish and monitor internal control policies and procedures over the procurement of professional services?
- Did District officials effectively develop policies and procedures for information technology to ensure that electronic data is appropriately safeguarded?

Scope and Methodology

We examined internal controls over certain financial operations of the District for the period July 1, 2005 to May 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 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*.

Financial Operations

District officials are responsible for establishing adequate internal controls to properly safeguard and account for District assets and to ensure compliance with Education Law. A good system of internal controls should be designed to provide reasonable assurance that District assets are properly safeguarded, accounting transactions are recorded and reported properly, pertinent regulations and laws are complied with, and work performed is monitored and reviewed routinely.

We identified weaknesses in the District's financial operations including the establishment and maintenance of the employee benefit accrued liability reserve (EBALR), which is over funded by as much as \$1.7 million. Additionally, District officials did not receive timely information for monitoring the District's fiscal operations. This lack of financial information limits the Board's ability to monitor the budget and make decisions concerning budget status and budget transfers. Finally, we found a lack of control over the Treasurer's signature disk, which could result in the misuse of District funds.

Employee Benefit Accrued Liability Reserve

There are two types of fund balance, reserved and unreserved. Reserved fund balance represents moneys that the District has set aside and may only use for specific purposes and, therefore, is not available for the District to use for other purposes. Unreserved fund balance is the amount that is uncommitted and is available for funding District operations. The portion of the unreserved fund balance that is used to help finance the next year's budget is known as appropriated fund balance. The portion of the unreserved fund balance that the District retains and that can be used for cash flow purposes and unanticipated expenditures is known as the unappropriated fund balance.

Reserve funds are created under various laws and are used to finance the cost of a variety of objects or purposes. The legal statutes under which the reserves are established (or sometimes mandated) determine how the reserves may be funded, expended and discontinued. An EBALR fund may be created under General Municipal Law. Moneys from this reserve may be used to make cash payments to employees upon separation of service for unused sick leave, holiday leave, vacation time, time allowances granted in lieu of overtime compensation and any other forms of payment for accrued leave time due. Interest earned on money in the EBALR becomes part of the reserve fund. Should the District determine that the EBALR is no longer needed, the moneys in the fund may be transferred to certain reserve funds authorized by law, but only to the extent that the moneys in the fund exceed a sum

sufficient to pay all liabilities incurred or accrued against the fund, as certified by the fiscal and legal officers of the local government or district.

The District established an EBALR in April 2003 using \$2.25 million of excess fund balance. District officials did not perform any analysis to determine if this was a reasonable amount and only \$100,000 has been used since the fund was established through May 2007. This amount was used for appropriate reserve purposes. While the 2005-06 audited financial statements show a long term liability of \$1.2 million for compensated absences, the EBALR totaled \$2.86 million, more than twice the amount of the reported liability. If the additional \$1.7 in this reserve is not needed, the money may be transferred to another reserve and used to benefit the District.

The District is not required to establish a separate bank account for this reserve; however, it must be accounted for separately from other moneys of the District and interest must accrue to the fund. The District has invested the money with general fund moneys. While it is permissible for the District to invest moneys in this fund together with general fund moneys, the separate identity of the sources of the moneys invested must be maintained and a pro rata share of the interest earned credited to the reserve fund. However, we found that the District had not allocated any of its interest earnings to the EBALR. Had the District properly accounted for the interest earned by the EBALR, we estimate that, approximately \$83,000 of the interest earned should have been prorated and allocated to the reserve fund during the 2005-06 fiscal year. After discussing this issue with District officials, they appropriately allocated \$92,000 of the interest earned during the 2006-07 fiscal year to the reserve fund.

In addition, the District did not establish this fund solely for the intended statutory purposes. The resolution establishing the fund indicates that the EBALR is also intended for payment of the future costs of retiree health insurance or other negotiated benefits. The EBALR may be established and used only to pay for accrued but unused time earned upon separation of service. Retiree health insurance and other negotiated benefits are not permitted purposes of this fund. Moreover, currently there is no reserve fund authorized by law for the purpose of paying retiree health care costs.

Budget Status Reports

It is the Board's responsibility to monitor the District's expenditures and keep them within the amount of the total annual appropriations to guard against incurring expenditures in excess of budget appropriations. The Commissioner of Education's Regulations require District officials to present a quarterly budget status report to the Board for each fund. Reports are required monthly if a budget transfer has been made since

the last report. These reports should, at a minimum, include each fund's budgeted revenues and expenditures, original appropriations, transfers and adjustments, revised appropriations, expenditures to date, outstanding encumbrances, and unencumbered balances.

We reviewed the Board minutes and documentation and found that the Board does not receive complete budget status reports. District officials informed us that the report the Board received only contains information on the budget lines attributable to the Board, not the entire budget.

District officials did not comply with Commissioner of Education's Regulations that require District officials to present a budget status report to the Board on a periodic basis. This lack of financial information limits the Board's ability to monitor the budget and make decisions concerning budget status and budget transfers.

Treasurer's Signature Disk

Education Law establishes the Treasurer as the custodian of all District moneys. As the District official responsible for signing checks, the Treasurer plays a critical role in the cash disbursement process. The Treasurer uses an electronic signature disk to affix her signature to District checks. It is therefore essential that the Treasurer's signature disk be under the Treasurer's direct supervision at all times. The Treasurer must ensure that his/her signature is not used to make payments that have not been approved.

We found the Treasurer does not maintain adequate control over her signature disk, which is located in a file cabinet in the Business Office. The District uses two signature disks; one for payroll that contains the Treasurer's signature only, and the other for accounts payable contains the signatures of the Board President, the Treasurer and the District Clerk. The passwords for the electronic signature disks were located on the envelope containing the disks. Therefore, an account clerk that has access to the financial software has the ability to print checks without the Treasurer's or the other signatories' supervision. We examined 20 claims totaling \$95,645 and tested them for inconsistencies in amounts or payees. We found no inconsistencies among the claim vouchers, warrants, and cancelled checks. However, the failure to establish sufficient internal controls to safeguard the signature disks could result in the misuse of District funds.

Recommendations

1. District officials should analyze the balance in the EBALR fund and transfer funds in excess of the amount certified as necessary to satisfy all liabilities incurred or accrued against the fund to other authorized District reserves.
2. District officials should credit the pro rata share of interest earned on invested funds to the EBALR.

3. The District should use the money in the EBALR only for its intended statutory purpose.
4. The Board should require the Treasurer to present budget status reports, at least quarterly, that include each fund's budgeted revenues and expenditures, original appropriations, transfers and adjustments, revised appropriations, expenditure to date, outstanding encumbrances, and unencumbered balances.
5. The Treasurer should maintain control of the signature disk at all times and directly oversee the printing of checks. The signature disk password should be protected and not disclosed or shared with other employees.

Professional Services

Competitive bidding is not required for the procurement of professional services that involve specialized skill, training and expertise; use of professional judgment or discretion; and/or a high degree of creativity. General Municipal Law requires the District to adopt policies and procedures governing the procurement of goods and services when competitive bidding is not required. An effective and comprehensive purchasing policy would require the District to request written proposals from professional service providers whenever such services are needed. A request for proposal (RFP) process is meant to ensure that the District receives the desired service for the best price.

In addition, a written agreement for professional services provides the District, along with the individual or firm furnishing services to the District, with a clearly defined and mutually agreed-upon basis for determining entitlement to payments. These written contracts provide a mechanism to help ensure the fees paid to professional service providers are in accordance with Board intent. In order to ensure that payments to professionals are made in accordance with contract provisions, it is essential that claims submitted by the professionals are compared to their contracts with the District.

The District's purchasing policy which was last revised in 1997, did not require that RFPs be used to solicit professional services. District officials could not provide us with any documentation that some of the agreements existed and/or that the Board approved the agreements that did exist. The District did not require the professional service providers to submit verification of services provided, such as time sheets signed by the teachers or the parents of the students; thus District officials could not confirm that claims for services provided were in accordance with the contracts, where such agreements existed.

We identified 23 professional service providers who were paid approximately \$1.25 million during the audit period. We reviewed contracts and procurement procedures for 11 professional service providers who were paid a total of \$1,133,035 during the audit period. We found that the District did not solicit competition for any of these services. The Board did not approve or enter into written agreements with three vendors that provided staff development services and were paid a total of \$60,975 during 2005-06. Additionally, there was no Board approval for a contract with an insurance agency that was paid \$357,676. We reviewed payments to these 11 professional service providers and had additional concerns about the claims:

- A law firm was paid about \$266,000 during our audit period. The Board resolution for legal services approved an annual retainer of \$20,500 for school counsel and \$20,000 for labor counsel during 2005-06, and \$22,500 for each service during 2006-07. The resolutions did not include the additional hourly rate to be charged for services over 100 hours, which was stated in an engagement letter. We found the District made monthly payments of the retainer without requiring the law firm to submit detailed invoices. Therefore, District officials did not know when the firm exhausted the 100 hours included in the retainer.

The law firm did not submit itemized invoices for their services in a timely manner. In August 2005, the firm submitted two invoices for the period July 1, 2003 to June 30, 2005 totaling \$89,736 for fees in excess of the retainer. In April 2006, the firm submitted three invoices for the period from July 1, 2005 to March 31, 2006 totaling \$30,725 for fees in excess of the retainer. Due to the lateness of the invoices, it would be extremely difficult, if not impossible, for District officials to verify the accuracy of the hourly invoices for services that, in some instances, had been provided two years earlier. It would also be quite difficult for the Board to audit the charges when they did not authorize the hourly fees for additional services rendered over the 100 hours included in the retainer.

- The agreement with a special education resource room provider specified that billing would be at an annualized rate, payable in 10 equal installments. This provider was paid \$15,182 during the audit period for services provided to two students outside school premises. We compared invoices for services provided to one student during 2005-06, totaling \$7,992, to the student's attendance records submitted by the vendor. The annual rate for this student was based on the receipt of services for 5 days per week for 40 weeks. During this period, the child did not receive service for the entire 40-week period, and the services required by the child changed during the year. We determined that had the District paid for the services at an hourly rate, rather than at equal installments, the District could have saved \$1,618. Additionally, District officials did not have any internal control procedures in place to verify that the services billed by the vendor were actually provided, such as attendance records or documentation provided by the student's parent or guardian.
- A physical and occupational therapy provider was paid \$22,911 during the audit period. District officials could

not explain how they verified the accuracy of the invoiced amounts, as a determination of the charges could not be made when compared to the rates per the contract. A District official had to contact the service provider for an explanation of how the rates were calculated. Additionally, District officials did not have any internal control procedures in place to verify that the services billed by the vendor were actually provided, such as attendance records or documentation provided by the student's parent, guardian or teacher.

Because District officials awarded contracts to professional service providers without soliciting competitive proposals, they have no assurance that they received the best price for the services rendered. In addition, the failure to obtain adequate documentation to determine services were provided in accordance with contracts raises concerns about the effectiveness of the District's claims audit process for professional services.

Recommendations

6. District officials should award contracts to professional service providers only after soliciting competitive proposals.
7. The District should obtain written agreements with all professional service providers.
8. The claims auditor should verify that all claims submitted by professional service providers are in accordance with Board-approved written agreements and resolutions.
9. District officials should implement procedures to verify that services billed by professional service providers are according to contracts or agreements.

Information Technology

Computer data is a valuable District resource. The District relies on computer data for making financial decisions and for reporting to State and federal agencies. If the computers on which this data is stored fail, the results could range from inconvenient to catastrophic. Even small disruptions in electronic data systems can require extensive effort to evaluate and repair. Access to computer systems should be controlled and monitored to reduce the risk of misuse and/or alteration of data resulting in potential financial loss to the District.

District officials have not adopted a comprehensive information technology (IT) policy and written procedures that adequately address all major areas of IT operations. As a result, the District's IT system and electronic data are subject to increased risk of loss or misuse.

Access to the Computer System—Access controls are meant to provide reasonable assurance that computer resources are protected from unauthorized use and modifications including internal and external threats. Access controls include establishing adequate passwords, limiting administrator accounts, and restricting users to only the applications that are necessary for their day-to-day operations.

The District utilizes a financial accounting software package to process and maintain its financial transactions. This software package has the ability to restrict individuals' access to transactions within the scope of their job responsibilities. However, the Treasurer was granted full access to the accounting module as well as to the payroll module in the software package. In addition, there were no policies or procedures for District employees detailing the authorization and documentation requirements for user account additions, deletions or changes. The lack of formal policies and procedures creates an environment where employees may be granted access to computer resources that are incompatible with their position. These control weaknesses render the system vulnerable to unauthorized access. Because all District accounting records and reports are computer generated, the risk of improper usage of the financial software is substantial. Failure to establish policies and procedures for the District's computer data systems can result in unauthorized access to sensitive information, manipulation of District records and the loss or destruction of data.

Audit Log — The District's financial accounting software has the ability to produce a log indicating when, where and who enters the computer system. It can also generate a log of all changes made to the information included in the vendor master files.

Although the accounting software has the ability to track system activity, District officials did not implement procedures to periodically produce and review relevant reports such as logs, audit trails, exception and change reports. Additionally, the IT support person indicated that he did not generate any logs to determine when and who has accessed the system remotely. Because virtually all District accounting records and reports are computer generated, and no audit log is produced, an unauthorized user could change computer data (i.e., add and delete employees, change pay rates, add and delete vendors, change vendor information, and print checks) and the unauthorized activity could go undetected and uncorrected.

Server Room Security — Maintaining adequate security over District assets helps to ensure that computer resources are protected from loss and used effectively for their intended purpose. District officials can establish security over IT systems and equipment by controlling access to servers and components and by physically securing network components in a locked room.

The District's network servers and components were located in three locations. At only one of these locations was the server kept in a controlled environment; at the other two locations the servers were maintained in rooms without adequate security or ventilation. The main servers in the Business Office were located in a community area along with a copier. The doors to the area were always left open and faculty and staff were free to enter and leave as desired. Furthermore, the cabinets in which the servers were housed were left unlocked.

These security weaknesses could lead to loss of costly equipment, important financial data, and serious interruption to District operations, such as not being able to process checks to pay vendors or employees.

Recommendations

10. District officials should develop and adopt comprehensive IT policies and procedures to address all major areas of IT operations.
11. District officials should establish policies and procedures relating to computer usage including the restriction of access to programs based on job description.
12. District officials should periodically review access rights, audit trails and other relevant reports to ensure that employees are performing work consistent with their job duties.
13. Access to servers should be monitored and restricted to authorized employees.

APPENDIX A

RESPONSE FROM DISTRICT OFFICIALS

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



David S. Feller
Superintendent of Schools

June 18, 2008

Mr. [REDACTED]
Hauppauge Regional Office
250 Veterans Memorial Highway
Room 3A10
Hauppauge, New York 11788

Dear Mr. [REDACTED]

As per your request, we are responding to your preliminary draft findings. The audit examined July 1, 2005 through May 21, 2007.

Audit Results

The District did establish an Employee Benefit Accrued Liability Reserve. This year the Board of Education employed by RFP, [REDACTED] This firm completed the information needed to identify the amount necessary to fund the Employee Benefit Accrued Liability Reserve. This amount was updated and the Board approved the amount for the 2008-2009 school budget. The Board presented two propositions for vote with the Budget vote. One proposition authorized transfer of funds from the Employee Benefit Accrued Liability with an amount not to exceed \$1,100,000. The second proposition established a Capital Improvement and Construction Reserve Fund in an amount not to exceed \$1,100,000. Both propositions were approved by the voters. Interest is accounted for separately as income by you.

The Board of Education now receives each financial report, the appropriation Expenditure and Revenue Funds as well as all bills approved by the newly appointed Claims Auditor for this year. The Board can now make informed decisions with the budget concerning budget status and budget transfers.

The district has presented RFP's Claims Audit, Legal, Accounting, Speech, O.T., P.T. and other services this year.

Presently the Board is reviewing up to seven new policies for next year including all items mentioned in your report but specifically for IT policy.

Treasurer's Signature Disk

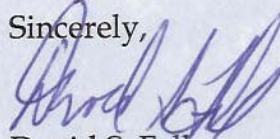
The Board of Education has hired a new Treasurer who does not work in any other Board position. She is serving in this position presently and has for the majority of the year. She has been informed that her signature disk should be under the Treasurer's direct supervision at all times.

The Claims Auditors review reports each month for the Board of Education.

Access to and an audit log are available for use in the district now. People who are using the system are checked and those who have left are deleted.

We appreciated the time spent with the District and managed to implement a number of subjects addressed at the beginning of the year. We will deliver a comprehensive and detailed report to you upon receipt of the final report.

Sincerely,



David S. Feller
Superintendent of Schools

DSF:ned

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 selected internal controls over purchasing and certain financial operations for further audit testing.

In our examination we:

- Examined audited financial statements
- Tested selected transactions to determine if the District's procurement practices conformed to the Board's purchasing policy and/or the provisions under General Municipal Law
- Tested payments to professional services providers during the period July 1, 2005 to May 31, 2007 to determine that payments were in accordance with contracts
- Examined purchase agreements and contracts for evidence of authorized signatures and Board approval
- Verified that purchases were made, goods were received, and claims were processed as authorized
- Interviewed Board members and District Officials and examined Board minutes and documentation
- Examined internal controls over the Treasurer's signature disk
- Interviewed District personnel and evaluated internal controls and safeguards over Information Technology.

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 objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

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