



Schroon Lake Central School District Internal Controls Over Financial Operations

Report of Examination

Period Covered:

July 1, 2006 — February 29, 2008

2008M-190



Thomas P. DiNapoli

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State of New York Office of the State Comptroller

Division of Local Government and School Accountability

December 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 Schroon Lake Central School District, entitled Internal Controls Over 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*

Introduction

Background

The Schroon Lake Central School District (District) is located in the Towns of Schroon Lake and North Hudson in Essex County, and the Town of Chester in Warren 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 280 students and 55 employees. The District's budgeted expenditures for the 2006-07 fiscal year were approximately \$5.2 million, which were funded primarily with State aid, real property taxes, and grants. Payroll costs for the 2006-07 fiscal year were approximately \$2.4 million.

Objective

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

- Have adequate internal controls been established over the financial operations of the Business Office to ensure that District assets are properly safeguarded?

Scope and Methodology

We examined the District's control environment and its internal controls over financial operations of the Business Office for the period July 1, 2006, to February 29, 2008.

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, a written corrective action plan (CAP) that addresses the findings and recommendations in this report must be prepared and forwarded to our office within 90 days. To the extent practicable, implementation of the CAP must begin by the end of the next fiscal year. For more information on preparing and filing your CAP, please refer to our brochure, *Responding to an OSC Audit Report*, which you received with the draft audit report. The Board should make the CAP available for public review in the District Clerk's office.

Financial Operations

District officials are responsible for designing internal controls that help safeguard the District's resources. Such controls include policies and procedures requiring that cash disbursements are properly authorized and documented and that describe employee responsibilities in preparing and disbursing payroll and performing bank reconciliations. Proper internal controls also normally include the segregation of various duties so that one person does not control a transaction from beginning to end, such as authorizing a purchase to issuing a check for payment of the same purchase. In small business offices, establishing an optimum separation of duties can be difficult because of the small number of office staff members. When it is not practical to segregate duties because of limited staff resources, District officials can establish other compensating controls that include reviewing the work performed by staff and requiring mandatory vacations for staff members who perform incompatible duties.

The Board had not effectively addressed the Business Office operations to ensure that incompatible duties are adequately segregated or established sufficient compensating controls to address the lack of segregation of duties. The District did not have comprehensive written policies and procedures in place to provide adequate guidance and internal controls over cash disbursements, payroll processing, and bank reconciliations. This lack of guidance has contributed to the lack of segregation of duties and compensating controls over those financial operations.

Policies and Procedures

The Board is responsible for adopting policies, and District officials are responsible for establishing procedures to implement those policies, that ensure that the District's cash assets are adequately safeguarded. Effective policies and procedures over cash disbursements ensure that cash is disbursed only upon proper authorization, when supported by appropriate documentation, for valid business purposes, and is properly recorded. In addition, effective internal controls consist of written policies and procedures that describe employee responsibilities in preparing and disbursing payroll and in performing bank reconciliations.

The District did not have policies and procedures to provide guidance to District employees when handling cash disbursements, processing payroll, or performing bank reconciliations. As a result, the Treasurer performed virtually all duties with regard to these key functions, which created a situation where the Treasurer was performing incompatible duties. In addition, District officials did not review her work. Because

the Treasurer can initiate transactions, make accounting entries, and perform bank reconciliations, there is a risk that inappropriate transactions could be initiated and hidden. Also, because the Treasurer performs all of the payroll processing duties, she could enter a non-existent employee into the payroll, certify the payroll payments to this non-existent employee, and then cash the related payroll checks.

Although our testing revealed no discrepancies,¹ when incompatible duties are performed by one individual with little or no oversight, this significantly increases the risk that incorrect or inappropriate payments could occur and go undetected and uncorrected.

Cash Disbursements

In general, the objectives of internal controls over cash disbursements are to ensure that cash is disbursed only for valid business purposes upon proper authorization and when supported by the appropriate documentation, and that cash transactions are properly recorded. Also, 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. Proper division of responsibility ensures that the work of one employee is independently checked in the course of another employee's regular duties. Although optimal segregation of duties may not always be possible, at a minimum, the duties and abilities of recordkeeping, reconciling bank accounts, and making disbursements must be separated.

We determined that duties related to disbursements were not adequately segregated and that the Treasurer performed all aspects of the cash disbursement process, including creating purchase orders; recording disbursements; processing, printing and signing checks; printing all warrants; recording journal entries; and reconciling the bank statements. These duties are incompatible when performed by one individual. In addition, District officials did not institute compensating controls to alleviate the risks posed by the Treasurer's incompatible duties, such as reviewing her work.

As a result of these control weaknesses, we selected and traced 20 issued checks back to their corresponding cash disbursement reports (approved warrants) and traced another 20 cash disbursement source documents to the amounts listed on issued checks. We did not find any discrepancies. We also examined 95 voided checks from August 1, 2006, through December 31, 2007, to verify that personnel issue District checks in sequence and properly control voided checks and found no exceptions.

¹ Refer to the Cash Disbursements, Payroll Processing, and Bank Reconciliations sections for further information.

Although we did not find any exceptions, because the Treasurer can initiate transactions, make accounting entries, and perform bank reconciliations, there is a risk that inappropriate transactions could be initiated and hidden.

Payroll Processing

Written payroll policies and procedures, combined with job descriptions affixing responsibilities for specific payroll activities, help to ensure that employees understand their role in the payroll process and that no individual has uncontrolled access to the entire payroll processing cycle. An effective system of internal controls over payroll provides proper segregation of duties so that one individual does not 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, it is important that District officials consider mitigating the control weakness by having someone independent of the process review completed payrolls.

We determined that the Treasurer was directly responsible for the following payroll duties: creating employee records, inputting all payroll changes, collecting timesheets, entering the hours worked or salaries paid, printing payroll checks, and maintaining checks until disbursed to District employees. The Treasurer performs all of these duties with minimal oversight. The only independent review procedure implemented by the District is the Superintendent's certification of the final payrolls.

Due to the lack of segregation of duties and compensating internal controls over the processing of payroll, we tested payroll payments made to 20 employees to determine if they were paid the correct amounts and that the corresponding entries to the payroll accounting records were correct. We found no discrepancies.

Although our testing did not disclose any exceptions, concentrating key payroll duties with one individual weakens internal controls and significantly increases the risk that errors and/or irregularities could occur and remain undetected. The lack of proper oversight over the payroll process, as evidenced by the absence of compensating controls, further increases the potential for fraud and abuse.

Bank Reconciliations

The reconciliation of bank account balances to general ledger cash is an essential control activity. When done effectively, this process provides for the timely identification and documentation of differences between District and bank records. Without accurate and complete bank reconciliations, performed and reviewed by an individual independent of the cash custody function, District officials cannot

have a reasonable level of assurance that the accounting records are correct or that monies are accounted for properly. Although optimal segregation of duties may not always be possible, at a minimum, the duties and abilities of recordkeeping, reconciling bank accounts, and making disbursements must be separated.

Bank reconciliations were not performed by an individual who was independent of the cash custody and recordkeeping functions. Specifically, the Treasurer performed bank reconciliations and was responsible for collecting cash; making daily deposits; recording receipts within the financial management software; transferring funds from District accounts; signing checks; and preparing, approving, and reviewing journal entries. In addition, the Treasurer received bank statements and copies of cancelled checks and reconciled the bank accounts with only minimal oversight. Although District officials told us that the Superintendent occasionally reviews bank reconciliations, because his review occurs on an infrequent basis, this oversight procedure alone is insufficient to adequately reduce the District's exposure to the possibility of fraud, abuse, and professional misconduct.

To verify the adequacy of the bank reconciliations, we randomly selected and reviewed two reconciliations: July 2007 and December 2007. We determined that both reconciliations were done in a timely manner and agreed with the general ledger, and the cash transfer activity appeared to be appropriate and recorded accurately.

During our fieldwork, the District implemented some compensating controls that included hiring a claims auditor to review and approve all cash disbursements prior to the release of the payment.² The Superintendent also continues to occasionally check bank reconciliations and review cash disbursements issued by the Treasurer. With the review of the claims auditor and the Superintendent, we feel that the two combined will provide a better control environment and more acceptable oversight over the District's cash disbursements, payroll process, and bank reconciliations.

Recommendations

1. District officials should develop policies and procedures that describe employee responsibilities for the cash disbursement process, payroll process, and for performing bank reconciliations.

² The District also hired the claims auditor to assume the powers and duties of the Board with regard to the audit of claims against the District. Until the District hired the claims auditor, the Board audited claims against the District.

2. District officials should evaluate the financial operations of the Business Office and the Treasurer's duties and responsibilities, specifically in the areas of cash disbursements and payroll, and where practicable, properly segregate duties.
3. District officials should ensure that the Superintendent, or someone who is not directly involved in the cash or payroll process, regularly reviews bank account reconciliations.

APPENDIX A

RESPONSE FROM DISTRICT OFFICIALS

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

SCHROON LAKE CENTRAL SCHOOL DISTRICT

Schroon Lake, New York 12870

Phone (518) 532-7164

John Armstrong, President
Board of Education

Ellen Garland, Vice President

Tina Armstrong
Linda Löwe
Bruce Murdock



Michael Bonnewell
Superintendent

Danielle Y. Fosella
District Treasurer

Lisa DeZalia
District Clerk

November 25, 2008

Mr. Karl Smoczynski, Chief Examiner
Glens Falls Regional Office of the State Comptroller
One Broad Street Plaza
Glens Falls, N.Y. 12801-4396

Dear Mr. Smoczynski:

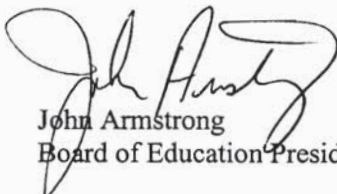
The Schroon Lake Central School Board accepts and supports the findings of the Report of Examination of Internal Controls Over Financial Operations of the District. The District Treasurer and Superintendent of Schools, the District's External Auditor, and the Board of Education had identified these issues and were working to resolve them.

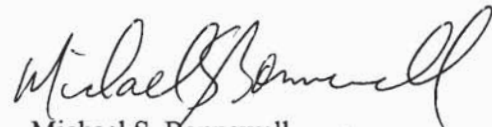
The Board of Education has been involved for several years in the lengthy task of reviewing and revising the Board of Education Policy Manual with the goal of providing current policy level direction to all school employees for the efficient operation of the district. The report reinforces the importance of this task.

The District was also in the midst of a Business Office Functional Analysis conducted by the New York State School Boards Association to assist officials to identify and correct or compensate for incompatible duties and responsibilities to the degree possible in a small school. The Board of Education had proposed a position to assume several business office functions as well as the duties of a Dean of Students in May 2008. The defeat of the budget proposal resulted in the elimination of that position—and the need to reassess the division of duties.

As with any small school district it is difficult to segregate duties with few positions. Schroon Lake Central operates with a small office staff to conserve the district's limited resources. An internal claims auditor verifies claims before payments are made. An accounting firm conducts the mandated annual external audit to verify, at the close of each fiscal year, that the district financial systems are functioning properly.

The Board and administration remain committed to safeguarding the assets of the Schroon Lake Central School District and will continue to seek the most efficient and effective operation possible. The Board of Education, Superintendent of Schools, and the District Treasurer are grateful for the opportunity to learn from this evaluation and to realize the improvements of the Corrective Action Plan.


John Armstrong
Board of Education President


Michael S. Bonnewell
Superintendent of Schools

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. 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 on the reported objective and scope by selecting for audit those areas most at risk. We selected the operations of the Business Office for further review.

To conduct the audit, we reviewed the District's existing policies and procedures and interviewed District officials and staff. Based on the lack of segregation of duties, our audit steps included testing cash disbursements, payroll processing, and bank reconciliations. To determine the effectiveness of internal controls for the period July 1, 2006, through February 29, 2008, we examined the following District records:

- The current check stock
- Claims
- Warrants
- Voided checks
- Payroll records
- Bank reconciliations.

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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APPENDIX D

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