



Honeoye Central School District Internal Controls Over Segregation of Duties and the Computerized Financial System

Report of Examination

Period Covered:

July 1, 2005 — May 31, 2007

2008M-132



Thomas P. DiNapoli

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State of New York Office of the State Comptroller

Division of Local Government and School Accountability

November 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 is mandated to oversee 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 Honeoye Central School District, entitled Internal Controls Over Segregation of Duties and the Computerized Financial System. 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 Honeoye Central School District (District) is located in the Towns of Richmond, Canadice, Bristol, South Bristol, and West Bloomfield in Ontario County, and the Town of Livonia in Livingston 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.

Scope and Objective

The objective of our audit was to determine if controls over selected financial activities were appropriately designed and operating effectively for the period July 1, 2005 to May 31, 2007. Our audit addressed the following related questions:

- Did the Board segregate the duties of the Treasurer and payroll clerk, or implement adequate compensating controls?
- Are internal controls over the District's computerized business management system appropriately designed and operating effectively to protect District assets?

Audit Results

District officials did not develop policies and procedures to effectively address the duties and responsibilities of the Treasurer or the payroll clerk to ensure that the duties were properly segregated, nor did they establish sufficient compensating controls. Even though our tests did not disclose significant exceptions, without proper segregation of duties or adequate compensating controls by management, the District's taxpayers cannot be assured that the District's assets are protected against error or impropriety.

The District's internal controls over the computerized business management system (system) were inadequate to protect District assets and data. District officials did not restrict access authorizations to the only functions the individuals needed to perform their job duties. In addition, the system does not generate basic reports necessary to monitor financial activity. As a result, District's assets and data were exposed to the risk of loss or impropriety.

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 that they planned to initiate corrective action.

Introduction

Background

The Honeoye Central School District (District) is located in the Towns of Richmond, Canadice, Bristol, South Bristol, and West Bloomfield in Ontario County, and the Town of Livonia in Livingston 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.

The District had approximately 930 students and 200 employees during the 2006-07 fiscal year. The District's budgeted expenditures for the 2006-07 fiscal year were approximately \$15 million, funded primarily with State aid, real property taxes, and grants.

The Business Office is made up primarily of three employees: the District Treasurer/Business Manager (Treasurer); a payroll clerk who performs nearly all aspects of payroll; and an account clerk who performs aspects of the purchasing and accounts payable functions. The District uses a computerized business management system (system) to process its financial transactions.

Objective

The objective of our audit was to determine if controls over selected financial activities were appropriately designed and operating effectively. Our audit addressed the following related questions:

- Did the Board segregate the duties of the Treasurer and payroll clerk, or implement adequate compensating controls?
- Are internal controls over the District's computerized business management system appropriately designed and operating effectively to protect District assets?

Scope and Methodology

We examined internal controls over selected financial activities of the Honeoye Central School 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 that 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.

Segregation of Duties

A good system of internal controls should be designed to provide reasonable assurance that District assets are properly safeguarded; accounting transactions are authorized, recorded and reported properly; work performed is monitored and reviewed routinely; and operations are efficient and effective. Furthermore, an effective system of internal controls provides for the segregation of duties so that no single individual controls all phases of a transaction. When it is not practical to segregate duties because of limited staff resources, District officials should establish compensating controls. Such compensating controls would include the Board or other administrative staff periodically reviewing the work in question, rotation of duties and mandatory vacations.

District officials did not develop policies and procedures to effectively address the duties and responsibilities of the Treasurer or the payroll clerk to ensure that the duties were properly segregated, nor did they establish sufficient compensating controls.

- The Treasurer maintained, or was authorized to maintain the books of original entry (general journals and records of cash receipts and disbursements) and the general and subsidiary ledgers, and she prepared journal entries. Additionally, the Treasurer collected, recorded, and deposited cash, and she signed checks and prepared bank reconciliations. She also initiated bank wire transfer requests without independent verification. Therefore, she controlled all phases of cash custody and accounting. Although the Superintendent indicated that he reviewed, initialed and dated the bank reconciliations prepared by the Treasurer, such reviews did not include an examination of the cancelled checks, or verification of the deposits in transit and outstanding checks, at least on a sample basis. As a result, the Superintendent's review of the bank reconciliations did not constitute an adequate compensating control. Due to these weaknesses, we examined eight wire transfers totaling \$246,954 made from the general, special aid and trust and agency fund bank accounts in March 2006 and found the transfers proper. We also examined the Treasurer's bank reconciliation reports for the general fund for the test months of June 2006, November 2006, and May 2007 and the payroll fund for the month of May 2007 to verify that bank reconciliations were properly performed.
- The payroll clerk performs nearly all aspects of the payroll process. The payroll clerk is directly responsible for the

following duties: adding, deleting and changing employee information, including pay rates; preparing, processing, printing and distributing all bi-weekly payroll paychecks; releasing direct deposit funds to the bank; and keeping payroll records. Although both the Superintendent and payroll clerk stated that the Superintendent certified payrolls prior to the direct deposit release date,¹ we were unable to verify this information because the Superintendent did not date his certification. In addition, the Superintendent stated that his certification process consisted of scanning the payroll register for any large pay raises or changes in tax deductions that may stand out to him during this review. The certification process did not include a review of personnel files to determine that employees listed were actually employed by the District, or a verification of employee pay amounts. Thus, the certification process used did not constitute an adequate compensating control for the lack of segregation of duties because it did not reduce the risk that errors or irregularities could occur without detection and correction in a timely manner. Because of the aforementioned weaknesses, we conducted a payroll payout audit on the October 12, 2007 payroll. We found that all payees were legitimate District employees.

Even though our tests did not disclose significant exceptions, without proper segregation of duties or adequate compensating controls by management, the District's taxpayers cannot be assured that the District's assets are protected against error or impropriety.

Recommendations

1. District officials should establish written policies and procedures that adequately segregate financial related duties of the Treasurer and the payroll clerk or provide for effective compensating controls over these duties.
2. Management should consider performing more thorough payroll certifications, including verifying employee pay amounts paid against personnel contracts and reviewing names to ensure that all persons are actual current employees.

¹ The date (Wednesday) by which the District must notify their bank of the amounts to be transferred to individual employee bank accounts so the funds reach the employees' accounts on payday (Friday).

Computerized Financial System

The use of information technology affects the fundamental manner in which the District initiates processes, and records and reports transactions. The extent to which the District uses computer processing in significant accounting applications, as well as the complexity of that processing, determines the specific risks that information technology poses to the District's internal control. The District's widespread use of information technology presents a number of internal control risks that must be addressed. These risks include unauthorized access to data, unauthorized changes to data in master files, and potential loss of data. Effective controls over users' access to computer operations restrict authorizations to only those functions needed for individuals to perform their job duties, and ensure that such access prevents them from being involved in multiple aspects of a financial transaction. Also, it is essential that the computerized financial system generate reports that help monitor financial activity. Audit logs, exception reports, and change reports maintain a record of activity by system or application process, as well as changes to the financial system. Audit logs should provide information such as the identity of each person who has accessed the system; the time and date of the access; what activity occurred; and the time and date of logoff. Exception reports should provide detailed exceptions to ordinary transactions, and change reports should provide changes made to the financial application (for example, vendor or payroll changes, or the addition or deletion of general and subsidiary ledger accounts). Management or management's designee should review these reports to monitor user activity and changes to the data, to provide a mechanism for individual accountability, reconstructing events and problem monitoring.

The District's internal controls over the computerized business management system (system) were inadequate to protect District assets and data. District officials did not restrict access authorizations to only the functions the individuals needed to perform their job duties. In addition, the system does not generate basic reports necessary to monitor financial activity. As a result, the District's assets and data were exposed to the risk of loss or impropriety.

User Access Rights

The District was unable to properly assign user rights within the system used during the audit period. The three users of the system — the Treasurer, the accounts payable clerk, and the payroll clerk — had full access to all of the modules of the system that were installed on their computers. The system comprises four modules. Each module can be installed on a user's computer separately; however, once installed, the

user has full access to that module. Without the ability to limit access rights within a module, users with access to the general financial module had the ability to process nearly any financial transaction including but not limited to transferring funds, and creating, deleting and editing journal entries or vendor information. Users with access to the payroll module had the ability, among other things, to change employee pay data, add new employees, and process payrolls. The system did not allow management to assign restricted user access rights. Prior to the end of our audit fieldwork, the District was in the process of upgrading the system to a version that can properly restrict all user privileges.

Monitoring Reports

The District's system will not generate the desired reports needed to properly monitor financial activity. Specifically, the system software will not generate change reports showing vendor or payroll changes, or the addition or deletion of general and subsidiary ledger accounts. Also, while the system has the ability to generate a payroll exception report for each payroll, showing a comparison between current and prior payroll gross pay amounts for each individual, it does not generate other exception reports showing detailed exceptions to ordinary transactions. The software also does not have the ability to generate reports showing user IDs of those who entered transactions into the system. Accordingly, both the Treasurer and payroll clerk had full access to the payroll module allowing them to individually prepare payrolls and change employee information (e.g., add and delete employees or change pay rates) without identification as to who was responsible for the changes. There were no reports generated that would allow an independent review of the payroll functions on a periodic basis.

Due to the weaknesses mentioned we traced 110 duplicate receipts totaling approximately \$5.8 million to the cash receipts journals of all funds for the months of March through May 2007, and we traced recorded receipts in the cash receipts journals of all funds to the bank deposits for the same test months. Our review did not disclose significant discrepancies. We also tested certain bank reconciliations to ensure they were prepared monthly and agreed with accounting records. We also reviewed a sample of 26 selected disbursements of all funds totaling \$116,883 to the corresponding 24 warrants and supporting documentation to ensure they were supported and represented proper charges against the District.

Although our tests did not disclose improprieties or other exceptions, the lack of limitation of access privileges to the individual employees' job needs combined with the lack of segregation of duties and the system's inability to generate exception reports for independent review can result in errors or irregularities occurring and not being detected and corrected in a timely manner.

Recommendations

3. District officials should use built-in controls within the accounting software to promote the segregation of duties. If the accounting software does not have the built-in controls, or generate reports necessary for oversight, District officials should work with their financial software provider to update the financial management system to establish such controls that will produce exception and change reports. If the system cannot be modified, District officials should consider purchasing replacement software that has such controls or implement other compensating controls.
4. District officials should properly assign user access rights within the system. Users should only have access to the system as required for their respective jobs.
5. Management should determine which monitoring reports can be generated by the system. If the desired reports are unavailable, Management should work with the system vendor to obtain these reports.

APPENDIX A

RESPONSE FROM DISTRICT OFFICIALS

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



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Web Page: Honeoye.org

David C. Bills, Superintendent

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

Attn: [REDACTED]

Dear [REDACTED]

Please accept this letter as the official response to the Audit Examination of the Honeoye Central School District performed by the New York State Comptrollers Office for the period of July 1, 2005 through May 31, 2007.

The District found the audit process to be both a positive experience and a helpful one. The auditors offered informal suggestions during the course of their investigation that enabled the District to begin implementing some corrections in advance of the recommendations. We are proud to acknowledge that there was no "misuse" of school funds found as a result of that investigation. The Board of Education and Administration have reviewed this draft and are in agreement with your findings.

Although the segregation of duties continues to be a struggle for small school districts, we believe that we have added some additional levels of control to the duties of Payroll Clerk and Treasurer to assure compliance with regulation. Some of the duties of each of these positions can be shifted to a third person in the Business Office to offer a better segregation of duties. Also, as you already know, the District upgraded the financial system while the audit was under way. The move had been planned and budgeted for in the previous year. The upgrade moved us from a [REDACTED] system to a [REDACTED] version of [REDACTED]. The new system allows us to assign passwords to individuals and to control user access to the various functions.

The School District would like to extend our appreciation to [REDACTED] and [REDACTED] for their comprehensive review of our financial operations and their professionalism on conducting this important audit.

Sincerely,



David C. Bills
Superintendent
Honeoye Central 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, payroll and personal services, and information technology.

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

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

Our audit procedures included:

- Reviewing key control activities of the Business Office including the manner in which goods and services are purchased, bank accounts are reconciled, duties are assigned, and checks are signed
- Reviewing District financial records, bank statements, and cancelled checks to verify that transactions occurring during the month of March 2006 were appropriate for the general, school lunch, special aid, cafeteria fund, and trust and agency fund checking accounts. We also examined the Treasurer's bank reconciliation reports for the general fund for the test months of June 2006, November 2006, and May 2007 and the payroll fund for the month of May 2007 to verify that bank reconciliations were properly performed.
- Conducting a payroll payout test on the October 12, 2007 payroll
- Tracing 76 claims (totaling \$326,620) to a sample of five corresponding warrants and supporting documentation of all funds for unusual payments for the test months of December 2005 and September 2005
- Examining 295 bank charges (from the test month of March 2006) made against the general, school lunch, special aid, and trust and agency funds to determine if they were supported by cancelled checks, audited claims, payrolls, contracts or other appropriate documentation

- Tracing a sample of 26 selected claims of all funds totaling \$116,883 to the corresponding 24 warrants and supporting documentation such as purchase orders, purchase requisitions, invoices, and claim forms of all funds to determine if the claims were proper
- Examining eight bank wire transfers made from the general, special aid and trust and agency fund bank accounts in March 2006 (totaling \$246,954) to determine if the transfers were proper
- Tracing 110 duplicate receipts (totaling \$5,804,276) to the cash receipts journals of all funds for the months of March through May 2007, and tracing recorded receipts in the cash receipts journals of all funds to bank deposits for the same test months
- Examining duplicate receipts with cash receipts journals of all funds for the months of March 2007 through May 2007 and comparing the recorded receipts with the bank deposits.

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.

APPENDIX C

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