OFFICE OF THE CONTROLLER

CITY OF PHILADELPHIA
PENNSYLVANIA

**REPORT ON
INTERNAL CONTROL
AND ON COMPLIANCE
AND OTHER MATTERS
FOR THE
SCHOOL DISTRICT OF
PHILADELPHIA**

FISCAL 2006

CITY OF PHILADELPHIA

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REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

To the Chair and Members of the
School Reform Commission of the
School District of Philadelphia

We have audited the financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the School District of Philadelphia, Pennsylvania, a component unit of the City of Philadelphia, Pennsylvania, as of and for the year ended June 30, 2006, which collectively comprise the School District of Philadelphia, Pennsylvania's basic financial statements and have issued our report thereon dated January 22, 2007. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the School District of Philadelphia, Pennsylvania's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the School District of Philadelphia, Pennsylvania's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. The following reportable conditions and management's response are discussed in greater detail in this report:

- Internal control procedures do not ensure the accuracy of capital asset balances.

- Internal control weaknesses allow operating expenditures to be charged to the capital fund.

- Control deficiencies over the administration and processing of payroll and fringe benefits increase the risk of possible overpayments.

- An internal control weakness over food services expenditures contributes to possible inaccurate recording and reporting.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the School District of Philadelphia, Pennsylvania's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards.*

However, we noted certain conditions that are not required to be reported under *Government Auditing Standards*, but nonetheless represent deficiencies in internal control over financial reporting that should be addressed by management. These conditions are listed in the table of contents and included in this reporting package.

This report is intended solely for the information and use of the management of the School District of Philadelphia, Pennsylvania and the School Reform Commission and is not intended to be and should not be used by anyone other than these specified parties.

January 22, 2007

ALBERT F. SCAPEROTTO, CPA
Deputy City Controller

ALAN BUTKOVITZ
City Controller

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CAPITAL ASSET ACCOUNTING DEFICIENCIES

Lack of Comprehensive Capital Asset Policies and Procedures

As noted in previous reports, the District has not established formal comprehensive capital asset policies and procedures. Such policies and related procedures would help to formalize managerial control and financial accountability practices by addressing issues such as accounting for capital assets and consistent application of a capitalization policy.

The need for formal comprehensive written policies on the capitalization of capital assets is discussed in the "Manual of Accounting and Financial Reporting for Pennsylvania Schools" issued by the Pennsylvania Department of Education. The manual indicates that policies should be formalized which address matters such as whether the threshold for capitalizing asset purchases is to be based on individual equipment or on systems/categories or groups of assets. Other topics to be considered are disposition and donation of capital assets. Further, the manual states that the policy concerning capitalization and expensing of capital asset purchases should be consistently applied each year.

As part of action taken to address comments made in previous audits, the District updated the capital asset procedures which were drafted several years ago. However, they have not been codified or consistently applied. In addition, the updated procedures omit critical control activities. For instance, there are no procedures that address equipment tagging requirements, dispositions and transfers, thresholds for capitalizing equipment systems, and capitalization of payroll costs.

The need for policies and procedures has resulted in a number of control weaknesses. For example, we again found cases where assets were not capitalized at the appropriate cost, capital projects fund expenditures that were not properly reconciled to the financial statements, artwork capital inventory records that were not properly maintained, and inadequate communication resulting in the Accounting Services Unit not being aware of capital asset acquisitions.

With the continuation of an ambitious, and consistently increasing, $3.1 billion multi-year capital improvement program, it is imperative that the District provide a structured policy to ensure proper accountability and reporting for capital assets. Therefore, we continue to recommend that the District initiate a concerted effort to establish a comprehensive capital asset policy with detailed procedures. [60104.01]

Inaccurate Capital Asset Recordkeeping

In our prior year report, we noted multiple instances where capital asset balances were not properly reflected in the financial statements. Our current review disclosed that accurate recording of capital assets continues to be a problem.

As the table below indicates, the District did not capitalize over $26.6 million in costs associated with four projects. In addition, the related depreciation charges were not properly captured. The under-reported assets were discovered by comparing detailed capital project records and project audit reports submitted to the state during fiscal 2006 as part of the cost-sharing reimbursement process with the FASGOV capital asset recordkeeping system, which is the source for amounts posted to the general ledger and reflected in the financial statements. The District posted our adjusting journal entry to correct the financial statements for these errors.

PROJECT	COSTS PER FINANCIAL STATEMENTS	ACTUAL PROJECT COSTS	COSTS NOT CAPITALIZED
New DeBurgos School	1,269,647	24,397,999	23,128,352
Little School House – Webster	2,662,083	5,170,780	2,508,697
Little School House – Spruance	4,727,601	5,226,706	499,105
Franklin Elementary - Addition	6,735,775	7,290,331	554,556
Total	$15,395,106	$42,085,816	$26,690,710

GASB Statement No. 34, requires reporting all capital assets with associated depreciation in the District-wide financial statements. Therefore, it is critical that the financial statements properly reflect the cost of all assets as reflected in the detailed records. In addition, generally accepted accounting principles require that any addition to capital assets be capitalized.

In order to further enhance management controls over the capitalization and reporting of its assets, we recommend that procedures be established that call for obtaining and reviewing project audit reports to ensure that all related costs have been included in the FASGOV capital asset recordkeeping system with noted differences thoroughly investigated and properly disposed. [60105.01]

Capital Expenditures Not Effectively Reconciled

In previous reports, we noted that the District did not fulfill the objective of its capital expenditures reconciliation. Such a reconciliation, reviewed and approved for completeness and accuracy, should show the disposition of all capital projects fund expenditures. It should provide information regarding the amount of expenditures added to capital assets, a well as those that are not eligible for capitalization.

Although a capital fund expenditure reconciliation was prepared, it lacked completeness and was not utilized by the District in the capital asset recording process or in the financial statement preparation process. It did not present in sufficient detail the disposition of expenditures other than those that were added to the real property balance. For fiscal 2006, $180.7 million of the $233.3 million in capital fund expenditures resulted in additions to real property. However, there was no disposition presented for most of the remaining $52.5 million in expenditures made in the capital projects fund. In theory, all capital projects fund expenditures should eventually be added to fixed assets.

Failure to prepare a timely and accurate capital expenditure reconciliation increases the risk that capital assets could be misstated and that non-capital items could be improperly paid from the capital projects fund. Accordingly, we continue to recommend that the District prepare a timely and accurate reconciliation of capital expenditures and additions to capital assets. The reconciliation should be prepared at least annually, and should include a review of supporting documentation performed by supervisory personnel. [60100.01]

Inadequate Artwork Inventory Records and Procedures

According to inventory records, the District possesses 1,189 pieces of art (comprised of artwork and artifacts) at an approximate value of over $10 million. This inventory is held at 196 locations including various schools, the Education Center, and a private storage facility. During our current year review, we noted significant control weaknesses related to the record-keeping and custody functions related to art in the Districts' possession. These weaknesses are described in the table on page 4. Failure to establish proper policies and procedures, establish physical accountability, and maintain accurate inventory records could lead to the misstatement of the financial statements and misappropriation of assets.

We initially requested the District's art inventory listing on July 25, 2006. An inventory listing was finally received on December 15, 2006. However, upon review, we found a number of errors. After three attempts, the District provided what was believed to be their complete listing. It took over 4 months for the District to produce its 4th listing. After reviewing this last listing, we again found errors and notified the District. As part of our review, we also received a Catalogue of artwork compiled by an art consultant during fiscal 2004 that was based on physical observation. This Catalogue represents a comprehensive record of all District art along with the value associated with each item.

In order to gain additional insight into the extent of potential safeguarding deficiencies, we conducted our own physical observations of a sample of 403 works of art that, according to District records, were located at certain schools and the Education Center. The results of our testing disclosed 85 works of art that could not be located. According to the District's records, the value of these items is $838,450.

Location	Number of Artifacts Sampled	Number of Artifacts that Could not be Located	Percentage of Artifacts that Could not be Located	Value of Artwork that Could not be Located
Schools	375	75	20.0%	799,050
Education Center	28	10	35.7%	39,400
Total	403	85	21.1%	$838,450

Additionally, according to records provided by the private storage facility, 54 pieces of art that were originally held there were returned to schools. 40 of these pieces were among the 85 works of art we could not locate. In order to fulfill our audit responsibility, we requested to conduct a physical count at the storage facility. However, we were not permitted to do so without agreeing to a restrictive confidentiality agreement, the terms of which were not acceptable.

The following table categorizes the deficiencies noted during our review of recordkeeping and safeguarding controls over the District's artwork:

Deficiency	Condition
Policy and Procedure Deficiencies	The District does not have any policies or procedures for safeguarding artwork. Specifically, there are no established inventory or recordkeeping requirements, no documentation to substantiate transfers from one location to another along with related authorizations, and no policies on care, display, curriculum use, etc.
Location and Tracking Deficiencies	No documentation could be provided for a sample of 20 works of art whose locations changed from the previous year. The District explained they were unable to provide documentation because the locations of the art work were incorrect on the previous year's listing.
	The value of the art stored at a storage facility as reported on District records decreased $2.3 million, from $3.9 million in fiscal year 2005, to $1.6 million in fiscal year 2006. The District stated the decrease was caused by incorrect location codes assigned to art on the previous year's listing.
	Non-discrete location codes for art are utilized on the District inventory records. For instance, single codes are used to specify multiple locations, and multiple codes are used for single locations.
	29 pieces of art valued at $121,850 are reported to be held at locations that have been closed or sold. Specifically, 24 pieces of art valued at $80,850 are reported to be held at six schools that are closed, and 5 pieces of art valued at $41,000 appear to be fixtures located in the previous administration building that was sold during fiscal year 2005.
Duplicate Entries	26 items appear to be duplicated on the District's inventory records resulting in a potential overstatement of $292,900.
Ownership Questions	At least three items valued at $50,800 included on the District's inventory records are not owned by the District. Specifically, the "Beach Scene" by Lewis Smith, valued at $50,000, is owned by the Pennsylvania Academy of Fine Arts. Inventory records also include two student-owned pieces of art, one valued at $500, and another at $300.
Record Review Deficiencies	The District's inventory listing overstates art holdings by $2,117,324 compared to Catalogue values. The overstatement is a combination of 1) artwork valuation variances of $1,639,700 between the District's inventory and the Catalogue; 2) the inclusion by the District of 77 items, valued at $448,074, that are not shown in the Catalogue; and 3) 10 pieces of art, valued at $29,550, included in the Catalogue but not shown on the District's records.
	District art inventory records include a snow blower, art supplies and computer hardware.
	A detailed record of art that was once held at one school and transferred to the storage facility includes five works of art that are not accounted for on the District's listing.

In order to adequately safeguard and properly account for its art inventory, we recommend that the District develop and implement a formal comprehensive art policy. At a minimum, the policy should establish safeguarding procedures that include central office and school location recordkeeping requirements, requirements for documenting transfers, and procedures on the care and display of art. In addition, we recommend that the District prepare a comprehensive art inventory listing utilizing its current listing and the 2004 catalogue. Physical verification of all items should be performed to ensure the existence and location of all objects. Follow-up should be performed for any unlocated items and their disposition determined. Finally, our staff should be granted non-restrictive access to the storage facility so that the physical existence, condition, and security of artwork kept there can be determined. We were informed of the District's intention to initiate a project involving a physical inventory and updating of the capital asset records. [60106.01]

Communicating Capital Acquisitions

In our prior year report, we noted a weakness relating to the District's recording of capital projects transactions. Specifically, we found that when the Accounting Services Unit recorded the construction of its new Education Center, it did not have copies of the construction invoices on hand, nor did it have a complete understanding of the project's terms. As a result, these transactions were improperly recorded, necessitating audit adjustments to properly record cash, expenditures and prior period fund balance. We noted that the Accounting Services Unit is responsible for obtaining a sufficient understanding of transactions so that they can be properly recorded.

During the current audit, we noted a recurrence of this condition. The District's Food Services Division, as part of a multi-year contract whereby a vendor assumed operations for a significant number of District cafeterias, installed a point-of-sale system at selected locations. We learned that District accounting personnel were unaware of the contract and the need to book both a capital asset and a contingent liability in the Enterprise Fund. Further inquiries revealed that personnel in the Food Services Division did not inform Accounting Services Unit of its contractual agreement and related capital asset acquisition. Accounting Services eventually received a copy of the contract from Food Services, but later learned that the contract provided had already been superseded. The subsequent contract postponed the asset acquisition date until fiscal year 2007.

Although this weakness ultimately did not affect fiscal year 2006, we believe it is indicative of a breakdown in controls. The Food Services Division accounting personnel should have informed the Accounting Services Unit of the contract and the need to record the transaction. To mitigate the possibility of a similar problem in future periods, we recommend that the Accounting Services Unit issue a memorandum to all operating departments, as well as the Accounts Payable Unit, requesting that it be notified of all capital asset acquisitions so that these transactions may be properly recorded on a timely basis. [60105.06]

CAPITAL EXPENDITURES DEFICIENCIES

PILOT Bond Expenditures

As part of its Capital Improvement Program, the District created an initiative designed to accelerate classroom modernization while upgrading security, band and sports programs. The initiative was made possible through the issuance of $31 million in bonds (referred to as the PILOT bond) with a dedicated funding source from sports stadiums payments made to the District. The PILOT bond has a 15-year repayment schedule.

Of the $31 million in total bond proceeds, the District allocated $8 million for athletic improvements such as renovations to athletic fields, and equipment for the crew program. Of this amount, $650,000 was earmarked to provide students with safe, state-of-the-art sports equipment. In reviewing the purposes for which these funds were actually used, we found that over half the amount, $365,173, was actually used to purchase new uniforms (basketball, football, etc.), not equipment. In addition, a few cases were also found where equipment purchases included items unrelated to enhancing safety. Included in this category are items such as measuring tapes, orange field paint, and water bottles.

Using bond proceeds to make purchases with such a short useful life as those described above will result in the District making debt service payments long after the items are no longer in use. For this reason, we recommend that the District implement procedures that will prohibit using capital funds for operating-type costs [60106.02]

Operating Payroll Charged to Capital Fund

As part of our current year testing, we selected a sample of employees whose salaries were paid through the capital projects fund. The position titles for many of these individuals did not appear to be capital in nature. For example, our sample selection included a limited number of individuals whose jobs were clerical in nature, whose job functions could have been either capital or operating, and, in some cases, were clearly not capital-related – such as teachers.

Before providing the detailed records we requested, the District performed its own review of payroll costs charged to the capital projects fund and identified approximately $1.8 million in costs related to employees whose duties were operating in nature. These costs were then transferred to the general fund. In our opinion, our request for records prompted the District's review and, without our inquiry, the District would have continued to improperly charge teachers' and other operating salaries to the capital fund.

In order to limit the possibility of operating costs being paid from the capital projects fund, we recommend the District establish procedures whereby the Capital Financial Management unit approves the addition of employees to the fund's payroll and the Accounting Services Unit conducts regularly scheduled reviews of the positions for which salaries have been charged. [60106.03]

PAYROLL AND FRINGE BENEFIT RELATED DEFICIENCIES

Payroll Procedures Not Documented

In our prior year report, we noted that the District has neither formal, written procedures for payroll entry in the ADVANTAGE System nor a current payroll/human resources policies and procedures manual. Our current year testing disclosed that this condition remains uncorrected. Proper internal controls dictate that payroll policies and procedures be formally reduced to writing to ensure that transactions are processed in a consistent and uniform manner, and in accordance with management's intent. For example, we found that not all employees sign daily attendance records ("TPER" forms) indicating their daily presence. We again recommend that management prepare and disseminate formal written procedures for payroll entry in the ADVANTAGE System, and a payroll/human resources policies and procedures manual. [60105.03]

Integrity of Payroll Passwords Compromised

Current year testing of the District's payroll system again disclosed that the payroll secretaries, rather than the principals, are approving attendance records at 11 of 88 (13%) school locations visited. Although this represents an improvement over the prior fiscal year, this condition continues to exist because principals, in a breach of confidentiality, delegate the approval authority and disclose the payroll closeout code to the payroll secretaries. By doing so, principals improperly delegate authority for attesting to the accuracy of the time and attendance entries and the authenticity of employees.

Delegating the authority for payroll approvals circumvents the system of internal controls, and seriously compromises the integrity of the payroll system by not ensuring an independent review of the payroll prior to its submission to the Payroll Unit. This practice could result in the falsification of payroll time and attendance with little chance of detection.

We again recommend that management re-issue closeout codes to any principals who have shared their codes with other District personnel, continue to instruct principals of the necessity to maintain the confidentiality of their closeout codes, and consider establishing other mitigating control procedures. [60104.06]

Insufficient Employee Compensation Processing Procedures – Unpaid Termination Compensation Balances

The District annually reports in its financial statements a liability for Termination Compensation. Included in this amount is the liability to former employees for accumulated leave. In several previous reports, we commented that the District's Vacation, Personal and Illness Leave (VPIL) report, which is the source of its annual Termination Compensation liability, included leave balances associated with a substantial number of former employees, some of whom have been separated from employment since 1999. We recommended that the termination pay for any former District employees who could not be located should be escheated to the State in accordance with Pennsylvania escheat laws governing unclaimed wages. Management believes that some of the former employees may have received their Termination Compensation payments, but remain on the list due to problems associated with the implementation of the District's ADVANTAGE System in 2000.

Although District management insists that it is actively pursuing the resolution of this issue, the progress made to date is minimal. The following table summarizes the termination compensation liability owed to separated employees as cited in our reports:

Fiscal Year Ended	Termination Compensation Owed to Employees Separated Prior To December 31, 2003
June 30, 2004	$3.2 million
June 30, 2005	$2.7 million
June 30, 2006	$2.5 million

At last year's exit conference, District management informed us that they had initiated a Termination Pay Working Group which is responsible for correcting the problem by positively identifying which former employees had received their Termination Compensation and implementing changes to the system to ensure that all District employees will, in the future, receive their Termination Compensation on a timely basis after separation. Management also acknowledged that Termination Compensation for former employees who could not be located would be escheated to the State.

During the current year audit, we were informed that the District's review has reduced the amount of the outstanding balance to approximately $2.5 million; however, no monies have yet been escheated to the state.

In our opinion, as evidenced by the total of over 700 former employees that have not received termination pay owed since December 2003, delays in processing these payments significantly affect the District's ability to later locate separated employees and provide them with the payments they are due. Furthermore, we were informed that the District's recently enacted policy of depositing employees' termination pay directly into their deferred compensation accounts (see comment on FICA taxes on page 10) has presented an additional problem related to this issue. Terminated employees must designate the investment account where they would like their termination pay deposited. If an employee fails to make this designation known, the District does not release the funds. As a result, the employee and related termination compensation balance are included on the VPIL listing indefinitely.

We again recommend that management take effective action to promptly address this condition by:

- Establishing procedures for removing the liability for terminated employees from the VPIL listing when termination compensation payments are made; and,
- Escheating unclaimed termination pay to the State as required by Pennsylvania Abandoned and Unclaimed Property regulations.
- Informing terminated employees that unclaimed funds, including undirected deferred compensation deposits, will be escheated to the state. [60105.04]

FOOD SERVICES FUND DEFICIENCIES

For the year ended June 30, 2006, the District's food services fund suffered a loss of $5.7 million. This loss was absorbed by the accumulated fund surplus carried into the year of $11.3 million, leaving an accumulated balance of $5.6 million. Prior to fiscal 2006, this fund completed the last three fiscal years with the following operating results:

- Fiscal 2005 - $ .4 million surplus
- Fiscal 2004 - $ .8 million deficit
- Fiscal 2003 - $ .7 million surplus

Beginning in fiscal year 2006, a major portion of the District's food services operations was carried out through a contract with an outside vendor. This action was taken by the District in an attempt to establish better controls over cafeteria operations. Under the terms of the contract, the vendor is responsible for day-to-day operations such as ordering and paying for food and supplies, and collecting students' payments. All cash receipts are turned over to the District for deposit to the food services account. The District is to reimburse the vendor for purchases within thirty days of each invoice's receipt.

Contract Administration

Of the fiscal 2006 $5.7 million loss, $4 million is attributable to the portion of food services operations carried out under the vendor's contract. Although the contract calls for the vendor to reimburse the District for any losses resulting from operations, a number of provisions must be met for this to occur. For example, contract clauses call for a minimum number of meals to be served and a minimum average daily attendance. Loss amounts to be reimbursed by the vendor are reduced if these minimums are not met. This was the case for fiscal 2006. Because the minimum guaranteed meals and attendance were not met, there was no loss reimbursement by the vendor. The District contributed to the loss by requiring the vendor to provide meals on days when there were class trips and early dismissals, etc., and by charging District cafeteria employee wages over the maximum provided under the contract.

Expenditure Review

We found that the District performs no verification of invoices submitted by the vendor. Total cost of operations under this contract were $37.7 million for fiscal 2006. Although our sample testing found no irregularities, there is no assurance on the District's part regarding the authenticity of costs before making reimbursement. Payments could be made for items not received or incorrectly billed. Improper payments, if any, could contribute to food services fund operating losses.

The purpose of an enterprise fund in governmental entities is to have costs covered by revenues, i.e. to break even. The food services fund substantially met this objective in past years. However, if deficits continue to occur, the food services fund may very well have to look to the general fund to subsidize its operations, causing a further drain on resources. In order to prevent this, the School District should reevaluate how guaranteed minimum contract requirements such as the number of meals and attendance quotas are set in order to minimize food services fund losses. [60106.04] It should also establish procedures for reviewing the vendor's invoices before remitting payment. [60106.05]

IMPROPER REVENUE RECOGNITION

During fiscal 2006, the District accrued $7.6 million of general fund revenue related to the state subsidy for Debt Service Reimbursement. This revenue was actually received on October 26, 2006, or 118 days after the fiscal year end.

This revenue represents state reimbursement for a portion of bond interest and principal payments for new construction, land acquisition, and major building renovation. A multi-step approval process must take place before the state grants final approval and forwards reimbursements for the District's debt service costs.

According to GAAP, revenues are recorded on the modified accrual basis of accounting when they are both measurable and available. Revenues are considered available when they are collectible within the current fiscal period, or soon thereafter, to pay liabilities of the current fiscal period. GAAP does allow some flexibility to this rule for highly unusual circumstances if not including revenues available this period will distort normal reporting patterns. According to District policy, revenues are considered to be available for the general fund if they are collected within 60 days (or beyond the normal time because of highly unusual circumstances) of the current fiscal period end.

In accruing this revenue transaction, the District stated that they encountered highly unusual circumstances surrounding this transaction which promulgated them to extend the period of availability from 60 to 118 days. Specifically, District officials explained that Hurricane Katrina prompted an increase in construction activity and related reimbursement requests throughout the State. They also noted that the state office location was relocated during the year. However, our review of the cited unusual circumstances, including interviews with state officials, interviews with District personnel, and examination of the dates projects were submitted for approval, has led us to conclude that the District did not meet the requirements of highly unusual circumstances and therefore should not have accrued this revenue.

An adjusting entry to reverse the accrual was proposed. However, the District disagreed with our determination and did not book the adjustment. As a result, fiscal 2006 general fund revenues were overstated by $7.6 million. In the future, we recommend that the District accrue only those revenues that will be available to pay current year expenditures. [60106.06]

FICA TAX WITHHOLDING FOR TERMINATION PAYMENTS

Effective June 1, 2005, the District redefined termination payments (i.e. accrued vacation, sick, personal days, etc.) made to retiring employees and deposited to their 403(b) deferred compensation accounts as employer contributions. Employer contributions deposited directly into a qualified 403(b) plan are not subject to FICA, state and local taxation. The District and its retirees benefited from this arrangement as no FICA, state or local taxes were being withheld for these large payouts.

It is our position that termination payments represent compensation and not employer contributions. Our position is based on the fact that the contracts between the District and its collective bargaining units define termination pay as compensation earned and accrued by employees during their employment. Accordingly, we believe termination payments are compensation and should be subject to FICA as well as state and local taxes. As additional support, we have sought legal advice for our interpretation of Internal Revenue Service (IRS) regulations. In the opinion of our outside legal consultant, the District is not in compliance with current tax law and is liable for payment of the respective taxes.

The District, based on advice of its legal counsel, believes that the tax treatment accorded termination payments is proper and its position would be upheld if challenged by any taxing authority. However, in the event of a successful challenge, the District estimates the tax liability would be $2.7 million at June 30, 2006. We have determined that this potential tax liability has not reached the point where it would be material to the District's financial statements. However, there will be a time when the accumulated liability will become material and will affect our audit opinion.

In order to address and resolve this issue before the amount of the potential tax liability becomes material, we recommend that the District follow the recommendation included in the advice it received from its own legal consultant and request a formal Private Letter Ruling (PLR) from the IRS, citing the facts of its specific case. It should not rely on other PLRs with facts dissimilar to those of the District. [60106.07]

NO FORMAL DEBT MANAGEMENT POLICY

During fiscal years 2004 and 2006, and again in November 2006, the District employed complex, derivative debt instruments which are subject to various risks. However, as noted in our previous reports, the District has not formalized a written debt management policy that would help ensure the comprehensive management of its ever-increasing debt.

Formal debt management policies provide written guidelines and restrictions that affect the amount and type of debt issued, the issuance process, and the management of the debt portfolio. Also, a debt management policy improves the quality of decisions, provides justification for the structure of debt issuance, identifies policy goals, and demonstrates a commitment to long-term financial planning, including a multi-year capital plan. Finally, adherence to a sound debt management policy signals to rating agencies and the capital markets that an entity is well managed and should meet its obligations in a timely manner.

As we previously reported, the Government Finance Officers Association (GFOA)[1] recommends that a comprehensive debt management policy specify the certain considerations regarding the use of derivative debt instruments. Further, in September 2004, Standard and Poor's (S&P)[2] published its Debt Derivative Profile (DDP). The DDP outlines a rating process for municipal issuers of derivative products. According to the DDP, S&P will base each issuer's rating profile on four equally weighted components, one of which is "management policies and procedures related to derivatives."

In its response to the fiscal 2005 audit report, the School District stated that it intends to formalize its debt practices and policies and has contracted an outside financial advisor to prepare a formal policy for presentation and adoption by the School Reform Commission. To date, the District has not established or adopted a formal debt management policy.

In light of the District's significant amount of net bonded debt, its continued use of complex, derivative instruments, and the industry's acknowledgement of the importance of management policies and procedures, we believe it is essential that the District adopt a comprehensive debt

[1] An independent organization dedicated to the sound management of government financial resources.
[2] One of the world's prominent providers of credit ratings.

management policy. A formal debt management policy that demonstrates the importance of financial planning should be a cornerstone to the District's commitment to major school renovations and new construction. In recent years, the District has seen its outstanding debt as well as tax revenue received from the City of Philadelphia increase significantly, with a greater percentage of those revenues being devoted to debt service.[3] A formal debt management policy would provide stability to the budgetary process by establishing a framework for the use of debt and giving consideration to the effect of debt service costs on the District's resources. The formal policy should include the District's already established rate management plan and the considerations regarding the use of debt instruments discussed above. Accordingly, we continue to recommend that District management adopt a formal debt policy, review it annually, and make necessary revisions. [60102.06]

WRITE-OFF OF EMPLOYEE RECEIVABLES

During fiscal 2006, the District wrote-off approximately $1.2 million in employee accounts receivable as uncollectible. The receivables represented the balance of salary and termination compensation overpayments during the period from 1996 to 2002. The overpayments are the result of incorrect paychecks issued during implementation of the ADVANTAGE System and erroneous termination payments.

Because there is no policy requiring that such actions be submitted to the SRC for review, these receivables were written-off without the approval of the District's oversight commission.

The District previously implemented collection efforts in order to recover these amounts and collected a portion of the outstanding amount. We were informed that the District determined the remaining balance was uncollectible. At the recommendation of the Accounting Director and with the concurrence of the Chief Financial Officer and the Comptroller, the $1.2 million balance was therefore written-off. However, there is nothing formal to document this decision and any analysis that may have been performed in reaching the decision.

In reviewing this write-off, we selected 48 employees and found 6 are still active, with total salaries of $308,374 and a receivable balance of $38,606. While this is not a material amount, it nevertheless represents an amount that can be recovered from employees' pay.

In order to collect the debt owed, we recommend that the District:

- Reverse the write-off entry for current employees.
- Recover amounts owed by payroll deduction.
- Explore the possibility of recovering amounts due from retired employees by having deductions made from State retirement payments.

[3] Outstanding debt has increased in the last six years from $900 million at the end of fiscal 2000 to $2.4 billion at June 30, 2006. Historically, bond covenants have set forth tax revenues received from the City of Philadelphia as the funding source for debt service expenditures. For fiscal years 1994 through 2000, tax revenue allocated to debt service averaged 11.3%. From fiscal years 2001 through 2006, the average was 14.4%. For fiscal 2006, the City of Philadelphia provided over $700 million in tax revenue to the District.

- Improve the review process so that receivables due from active employees are not written off in the future.
- Establish a policy requiring SRC approval for such actions and submit any future write-offs to the SRC for its approval. [60106.07]

STUDENT ACTIVITY AND PETTY CASH FUNDS CONTROL DEFICIENCIES

Student Activity Funds

In previous reports, we noted that controls over Student Activity Funds were weakened because certain reporting requirements stipulated in the "Principal's Financial Training Manual" and designed to help ensure accountability were not followed.

As a result of corrective action taken by the District, our current year testing disclosed slight improvement; however, non-compliance with these requirements still exists. Specifically, our testing of 20 sampled schools disclosed that:

- Six did not submit the required bank statements with their EH-204 Form.
- Five did not prepare the bank reconciliation section on the EH-204 Form.
- One did not submit documentation for the appropriate reporting period.

In addition, we found one case where Student Activities Fund monies were used for general school operations.

To enhance internal controls and ensure accurate reporting of the Student Activity Funds on the financial statements, we continue to recommend that the District enforce its established policies and procedures related to controls over Student Activity Funds. [60103.04]

Petty Cash Funds

In prior year reports, we noted that the Petty Cash Imprest Fund requirements, as stipulated in the "Principal's Financial Training Manual", were not consistently followed. Non-compliance with established control procedures detracts from the District's ability to safeguard and account for these funds.

As part of the District's corrective action plan, random compliance checks by Regional Business Specialists were implemented and stricter enforcement policies were established. Nevertheless, our current year testing disclosed no improvement over previously reported conditions involving the operation of the petty cash accounts. Briefly, our tests of petty cash funds at 14 schools disclosed the following weaknesses:

- Although not material, cash shortages and overages were found at ten schools. These cash overages and shortages ranged from $1,081 to ($1,304), respectively.
- Insufficient segregation of duties, whereby the fund custodian maintains the checkbook and also reconciles the petty cash fund, was noted at 10 schools.
- Monthly bank reconciliations were not prepared at three schools.

- Petty cash funds were reconciled to an unauthorized amount at two schools. Therefore, shortages were actually larger than what was reported on the fund reconciliation.

In addition to the above weaknesses, we also noted the absence of running checkbook balances, a lack of documentation showing supervisory review and approval of the monthly bank reconciliation, "plugged" and incorrectly prepared imprest fund reconciliations, long outstanding reimbursement requests, and missing support documentation for expenditures.

In order to enhance internal controls and minimize the risk of undetected errors or misappropriation of petty cash funds, we again recommend that the District enforce established policies and procedures relating to the management and reconciliation of all petty cash imprest funds. [60103.05]

PAYMENTS TO TAX DELINQUENT VENDORS

During expenditure testing, we discovered several vendors receiving payments from the District who have owed delinquent taxes to the City of Philadelphia (City). Although most of the delinquent balances we found do not represent material amounts, the potential exists for the District to make payments to vendors who owe the City substantial amounts of back taxes. In fact, one case was noted where a District vendor owes over $400,000 in delinquent real estate taxes. Real estate tax collections were split between the District and the City at a rate of 58 and 42 percent, respectively, during fiscal 2006.

Because the District depends on the City for a significant portion of its annual budget, it has a vested interest in ensuring that its vendors comply with the City's tax regulations. In our opinion, legislation currently exists that would permit the District to enter into an agreement with the City and withhold payments until vendors satisfy any outstanding tax balances. We therefore recommend that the District and the City take steps to establish a tax delinquent program in order to help strengthen enforcement of tax regulations. [60106.08]

AUDIT SERVICES UNIT SHOULD REPORT TO THE SRC

In our previous report, we noted that the primary function of the District's Audit Services Unit is to ensure compliance with applicable laws and regulations, policies, and procedures, and that, functionally, the Unit reports to the Chief Financial Officer. In order for the Unit to provide assurance regarding the effectiveness of internal controls free from potential management interference, we recommended that consideration be given to establishing an audit committee under the direction of the SRC with Audit Services reporting to the committee. As an alternative, we noted that consideration could be given to having the Unit report to the Chief Executive Officer while having direct access and providing regular project status reports to the SRC.

Since our last report, the SRC has appointed its own internal auditor to help provide financial oversight. A Financial Accountability Unit (FAU), comprised of the SRC's internal auditor, the Chief Financial Officer, and others has also been established by the SRC to monitor budgetary matters. With the creation of the SRC's internal auditor position and the FAU, we recommend that consideration be given to having the Audit Services Unit either report to one of these newly created entities or at least provide project status reports to them. [60105.09]

SEVERANCE PAYABLE ADJUSTMENT

Our current year testing of the School Districts' Severance Payable liability for retiring employees revealed that $8.5 million in severances were charged to the wrong fiscal year before being corrected by District personnel.

The District accrues a portion of each ten-month employee's salary and distributes the accrued portion to the employee on a bi-weekly basis over the summer months. When a ten-month employee retires or resigns, typically at the end of the school year, the District pays the accrued amount to the employee as a lump-sum during the summer months. An adjusting entry is then prepared to properly record the payment as an expenditure of the prior year. During fiscal 2007, the District's ADVANTAGE System improperly recorded severance payments attributable to fiscal 2006 as though the employees had not terminated. As a result of this software flaw, the payments were recorded as fiscal 2007 expenditures. District personnel employed an alternative method using data supplied by its Information Technology (IT) unit to determine the correct amount of the year-end Severance Payable adjustment, and charged the expenditures to fiscal 2006.

We believe that correcting the software problem that caused the initial error is preferable to relying on alternative procedures to ensure that the Severance Payable liability is correctly calculated in future fiscal years. We therefore recommend that District management continue to monitor the progress of its IT unit in correcting the problem. If the software flaw cannot be corrected by the District's IT unit, we recommend the District seek the assistance and support of its software vendor to fix the problem. [60106.09]

We were informed at the exit conference that the software flaws that resulted in the initial mis-recording of these payments have been corrected.

NON-COMPLIANCE WITH PARKING TAX REGULATIONS

In our prior year report, we noted the District was not in compliance with Philadelphia Code §19-1200 (the Code) which establishes rules and regulations pertaining to the city's Parking Tax. Although the District charges its employees $120 per month to park at its 72-space parking lot at the Education Center, it does not charge, collect and remit Parking Tax to the city. We recommended the District obtain the necessary licenses and certification to operate its parking lot, determine the extent of its liability to the city for taxes it failed to collect and remit, and comply with all applicable sections of the Code. At the exit conference, District officials informed us that they were seeking the advice and counsel of outside legal consultants to verify the applicability of the Parking Tax to the District.

We were informed at the exit conference that District management acknowledges its liability for the Parking Tax. The District also informed us that they remitted all back taxes owed for calendar years 2006 and 2007, totaling approximately $13,000. In addition, District officials expressed their intent to pay future Parking Tax liabilities on an on-going basis as required by the Code. We will monitor the District's resolution of this matter in next year's audit. [60105.08]

CONTROLS OVER STUDENT DENTAL CARE EXPENDITURES

The internal controls over dental benefits paid through the District's Public Health Fund (Fund) are inadequate. Our review determined that the District is paying for student dental care without verifying that the billed services were actually rendered, or that the provider had not been previously paid by a private insurance carrier. In addition, we were informed that the District does not have formal contracts with the dental service providers.

A private donation by an individual benefactor provides Fund resources that are used to pay for needy, eligible students' dental/orthodontic treatment, eye exams, eyeglasses, and hearing exams. The Fund is administered by employees in the District's Office of Specialized Services and, at June 30, 2006 had a fund balance of approximately $328,000.

To strengthen existing controls, we recommend that District management require additional documentation from service providers before approving payment requests. This additional documentation should include, but not necessarily be limited to, a listing of dates of service for each student and verification from a parent or guardian that the services billed were actually provided. A determination that there is no third-party insurance coverage available should also be made by District officials prior to approving treatment. Finally, in order to define each party's responsibilities, we recommend the District enter into formal contracts with each of the providers. [60106.10]

As part of our current year audit, we followed up on conditions brought to management's attention in the prior year report. We will continue to pursue these conditions and report on them until management takes corrective action or until changes occur, making our recommendations obsolete. We blended the status of some prior-noted conditions with new observations and reported upon these matters in the previous sections of this report.

Incorrect Estimated Asset Life Assignments

In our prior year reports, we noted that capital assets, such as personal property and real property, were not depreciated in accordance with recommended estimated useful life tables. Calculating depreciation using incorrect useful lives can significantly misstate depreciation expense and accumulated depreciation on the financial statements.

The District believed that the effort required to correct the recorded lives of older assets outweighed the benefit. As such, we recommended that they at least be adjusted for property that is being disposed so that any gain or loss is properly reflected in the financial statements.

Our current year testing disclosed disposed personal property assets that were not identified by the appropriate asset class within the District's capital asset system (FASGOV), thereby distorting the computation of depreciation expense and the loss on disposal. Specifically, we found disposed computers with a life of 5 years, depreciated over 20 years. We recalculated depreciation expense for these disposed computers and found that the accumulated depreciation was understated by $367,485, resulting in an overstatement of the Loss on the Disposal of Capital Assets in the same amount.

In response to our previous report, the District acknowledged our recommendation. It stated, however, that although its policy was revised during fiscal 2006, retroactively restating asset lives would be impractical to implement and far outweigh the benefit. Accordingly, any gain or loss on the disposition of assets may be misstated because the value could be less than the inaccurately recorded book value. Because our testing did not disclose a recurrence of incorrectly assigned useful lives for newly acquired assets, we consider this finding resolved. However, we will continue to monitor the situation for any material effect that asset dispositions may have on the financial statements. [60104.02].

Inconsistent Depreciation Charges

In our prior year reports, we noted that real and personal property assets were not depreciated on a consistent basis. Failure to depreciate assets on a consistent basis could result in misstated expenditures and capital asset balances on the financial statements.

We recommended that the District ensure that all capital assets are consistently depreciated by following an established policy. Our current year audit disclosed that the District revised its capital asset policy (which has not been formally adopted by the SRC) to require all personal property assets to be depreciated one-half year in the year of acquisition regardless of the acquisition date. Therefore, we consider this finding resolved. [60104.03]

Improper Accounting for Education Center Acquisition Not Disclosed by Reconciliation Procedures

In our prior year report, we noted that the District failed to adequately reconcile the general ledger balances for equity in pooled cash and investments to the respective bank balances. Had the District adequately performed this reconciliation, it is likely that a significant error in recording the acquisition of its new administration building would have been discovered before our audit. In order to strengthen controls over financial reporting, we recommended that the District establish procedures to ensure that final book balances are reconciled to bank balances and noted differences are thoroughly investigated and properly disposed. We also commented that an additional adjustment would be required to correct fiscal 2006 transactions.

Our current year testing disclosed that the District prepared a correcting entry related to the fiscal 2006 transactions, and that an immaterial difference existed between the general ledger and respective bank balances at June 30, 2006. Therefore, we consider this finding resolved. [60104.05] However, we will continue to monitor this condition to determine its reoccurrence.

Under-Collateralized Investment

In our prior year report, we noted that a repurchase agreement totaling $453.7 million was not collateralized at the required amount. We recommended that the District develop procedures to ensure that the value of all securities held as collateral for repurchase agreements are maintained at or above the margin percentage requirement of 102% of the investment.

Our current year testing disclosed that all repurchase agreements were properly collateralized at June 30, 2006. Therefore, we consider this finding resolved. [60105.02]

Non-Compliance With Filing Requirements for Statement of Financial Interest Form

In our prior year report, we noted that 84 of 448 (19%) employees responsible for annually completing the Statement of Financial Interests (SFI) as required by the Pennsylvania Public Official and Employee Ethics Act (PA Act 93 of 1998) failed to complete and file the SFI with the District's Office of Human Resources. At the exit conference, District management informed us that they would issue a directive informing employees of the importance of completing the SFI and the possible imposition of sanctions by the Commonwealth for non-compliance.

During our current year audit, we noted that the number of SFI non-filers had decreased to 19 of 485 (4.0%) employees. Although we believe that all required employees should comply with the SFI filing requirements, we consider this finding resolved. However, we will continue to monitor this condition to determine whether the number of non-filers increases significantly. [60105.07]

Employees Receive Pay After Termination

During fiscal 2005, the District terminated a number of high level employees and continued to pay the individuals their salaries and provide fringe benefits for some time after employment ended. We recommended that the District refrain from these practices because no work was performed by the individuals cited.

During our fiscal 2006 audit, no arrangements such as those described above were noted. We therefore consider this finding resolved. [60105.10][4]

Use of Property Sale Proceeds

In our prior year report, we noted that the District had sold several properties for a net of $27.8 million in proceeds. Rather than applying these funds to pay the debt that remained outstanding on these properties, an SRC resolution made this amount available in $5 million increments to fund the operating budgets for fiscal years 2005 through 2009.

In light of the District's recently disclosed deficit, we consider the decision to apply sale proceeds to operations an acceptable alternative and therefore consider this finding resolved. [60105.11]

[4] Subsequent to completion of audit fieldwork, the School District entered into an agreement with a cabinet-level official for salary and fringe benefit continuation beyond the last date of employment.

THE SCHOOL DISTRICT OF PHILADELPHIA
CHIEF FINANCIAL OFFICE
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JAMES DOOSEY
INTERIM CHIEF FINANCIAL OFFICER

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September 7, 2007

Via Hand Delivery
Honorable Alan Butkovitz, City Controller
City of Philadelphia
Office of the City Controller
12th Floor, Municipal Services Building
1401 John F. Kennedy Boulevard
Philadelphia, PA 19102

RE: Response to City Controller's Report on Internal Control and on Compliance and Other Matters for The School District of Philadelphia – Fiscal Year Ended June 30, 2006

Dear Mr. Butkovitz:

I would like to take this opportunity to first thank you and your staff for all of your efforts with respect to the above referenced matter.

As indicated in and acknowledged by your Report on Internal Control and on Compliance and Other Matters, there were no instances of non-compliance or material weaknesses found during the audit of The School District of Philadelphia's ("School District") Comprehensive Annual Financial Statements for the Fiscal Year ended June 30, 2006. All "Reportable Conditions" and "Other Conditions" are meant to further assist executive and senior management staff with their continued reform efforts here at the School District.

With that said, the attached document will summarize the School District's formal responses to all matters contained in your audit report. As always, I remain,

Respectfully,

James P. Doosey
Interim Chief Financial Officer

cc: Albert F. Scaperotto, Deputy City Controller, City of Philadelphia
Fred Wise, Audit Administrator, City of Philadelphia
Thomas M. Brady, *Interim* Chief Executive Officer, School District
Marcy Blender, Comptroller, School District

THE SCHOOL DISTRICT OF PHILADELPHIA

FORMAL RESPONSES TO

REPORT ON INTERNAL CONTROLS OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS

FOR FISCAL YEAR ENDING JUNE 30, 2006

BY THE OFFICE OF THE CITY CONTROLLER
CITY OF PHILADELPHIA

SUBMITTED BY:
JAMES P. DOOSEY
***INTERIM* CHIEF FINANCIAL OFFICER**
THE SCHOOL DISTRICT OF PHILADELPHIA
September 7, 2007

School District of Philadelphia's Responses to Report on Internal Control and on Compliance and Other Matters - Fiscal Year Ended June 30, 2006
From the Office of the Controller, City of Philadelphia

REPORTABLE CONDITIONS

CAPITAL ASSET ACCOUNTING DEFICIENCIES

General
Summary of Findings and Recommendations:

- Lack of a Comprehensive Capital Asset Policies and Procedures.

School District's Response:

- As noted in previous audit responses, the School District prepared and implemented a comprehensive Capital Asset Policy along with accompanying guidelines and procedures that are consistently applied and used by those in the Capital Improvement Program. After a comprehensive investigation, the School District is unaware of any legal requirement mandating the adoption of these procedures by the School Reform Commission. During this last fiscal year, the School District updated applicable processes and posted these procedures to its main website. In further response to this finding, however, the School District will notify employees that applicable processes and procedures for accounting and reporting of all capital assets will be available on its main website and will rename the policy statement "Capital Asset Procedures."

Summary of Findings and Recommendations:

- Inaccurate Capital Asset Recordkeeping.

School District's Response:

- After a thorough investigation and prior to the publishing of the School District's financial statements for the fiscal year ending June 30, 2006, the School District made appropriate adjustments to its fixed asset accounting system of record or FASGOV as suggested by the auditors. It should be noted, however, that the discrepancies identified during this most recent audit date as far back as 2002 and pre-date the School's District's implementation of corrective actions and the permanent hiring of a Senior Fixed Asset Accountant.

In response to a similar finding last fiscal year, the School District implemented the following additional internal controls to further strengthen capital asset accounting and reconciliation: (i) management review of current capital expenditures (bi-monthly bond fund reports) to ensure proper use of funds; (ii) access to the construction databases and project management systems was provided to managers within the Office of General Accounting Services; (iii) a year-end report of capital expenditures is produced by the Capital Financial Management unit and detailed reconciliations to individual projects

School District of Philadelphia's Responses to Report on Internal Control and on Compliance and Other Matters - Fiscal Year Ended June 30, 2006
From the Office of the Controller, City of Philadelphia

are now performed; (iv) all resolutions to be considered by the School District's governing body are now reviewed for capital assets; and (v) a management review of PlanCon submissions to ensure proper reimbursements of capital project expenditure is now performed. Notwithstanding the continued improvements made over the last fiscal year, the School District accepts this finding of the City Controller and will continue to monitor all processes in order to identify further efficiencies and other opportunities to strengthen internal and other financial controls.

Summary of Findings and Recommendations:

- Capital Expenditures Not Effectively and Timely Reconciled.

School District's Response:

- As noted in previous audit findings and responses, the School District continues to acknowledge the need for further improvement in this area but has materially improved internal control processes during the last fiscal year. Although the School District recognizes the importance of a complete reconciliation of all capital expenditures, there are many challenges that preclude management's ability to achieve 100% accuracy in this area of accounting. For instance, the School District agreed to and implemented a thorough capital expenditure reconciliation process to the general ledger as part of the fiscal year end close process in 2006 as previously recommended by auditors. This reconciliation process is now a standard component of the School District's annual close process.

More specifically, personal property assets, comprising approximately 12% of total recorded assets, represent the greatest challenge to the School District. The volume of personal property transactions that are processed (over 30,000 line items in fiscal year 2006 alone) through the Capital Fund makes a complete reconciliation time prohibitive. In addition, management concluded that the anticipated benefit gained in terms of more accurate financial reporting was deemed to be immaterial or de minimis. For example, one payment voucher may contain a number of different items, some of which are capital eligible while others are not, creating challenges when accountants attempt to reconcile amounts to different fiscal years. Likewise, there are timing differences between when the expenditure is made and when the personal property asset is tagged for inventory which causes additional reconciliation complexities given the School District's personal property system limitations. The possible misstatement of capital assets, including the misclassification of non-capital items, is mitigated, however, since the majority of capital assets relate to real property expenditures where reconciliations are far more accurate. Notwithstanding the above, the School District accepts this finding of the City Controller and will continue to monitor this process to identify further efficiencies and other opportunities to strengthen internal and other financial controls.

School District of Philadelphia's Responses to Report on Internal Control and on Compliance and Other Matters - Fiscal Year Ended June 30, 2006
From the Office of the Controller, City of Philadelphia

Summary of Findings and Recommendations:

- Inadequate Artwork Inventory Records and Procedures.

School District's Response:

- With regard to policy and procedure deficiencies noted in this most recent Audit Report, artwork is subject to the same record keeping, safeguarding, and inventory procedures as all other personal property of the School District. The School District acknowledges, however, that there is no specific policy on the proper care, display or curriculum use of its artwork and artifacts and is creating procedures and guidelines before any artwork is returned to schools or offices. More specifically, the School District believes that implementation of several corrective measures will result in a more complete and accurate financial statement of its art collection in fiscal year 2007 and beyond.

During fiscal year 2007, for example, the School District implemented an initiative to verify the status of all artwork cataloged by an outside consultant completed in fiscal year 2004. Namely, a project consisting of a physical art inventory was initiated in May of 2007 which provided locations with an artwork listing based on the contents of the original catalog. Each location is required to physically count each artwork piece in accordance with the prior audit recommendation. Appropriate forms are required to be completed, signed and returned by each location to the Office of the Comptroller once the physical inventory is concluded. This project will be completed by early September of 2007 for all schools and administrative offices.

Upon completion of these physical inventories, all appropriate data files contained in PPIS (personal property data system) and FASGOV (fixed asset data system) will be updated to reflect a more current inventory and financial accounting of all of the School District's artwork and artifacts. Similarly, a physical inventory of all artwork stored at an off-site warehouse will also be conducted during fiscal year 2008 and management will fully investigate items whose locations are not properly identified and verified during both physical inventories.

The School District, however, objects to the subjective statements made with respect to its refusal to allow auditors unfettered access to the off-site storage facility without agreeing to a "restrictive confidentiality agreement." As evidenced by the documents provided to auditors, the School District's request for a confidentiality agreement was a condition imposed by the storage facility to avoid disclosure of its confidential location and the identity of the valuable artwork it houses on behalf of other clients. As indicated on several occasions, the School District will gladly support the City Controller's efforts to visit the warehouse in order for it to obtain assurances regarding inventory counts; *provided however*, that a confidentiality agreement is in place.

School District of Philadelphia's Responses to Report on Internal Control and on Compliance and Other Matters - Fiscal Year Ended June 30, 2006
From the Office of the Controller, City of Philadelphia

Summary of Findings and Recommendations:

- Communicating Capital Acquisitions.

School District's Response:

- Since the last fiscal year, new processes and procedures were implemented by and between Capital Programs and the Office of General Accounting Services which include a system of checks and balances to ensure that acquisitions of all new capital assets are properly communicated and recorded by appropriate personnel as previously reflected in response to "Inaccurate Capital Asset Recordkeeping." Although the City Controller acknowledges that there is no reportable finding or any formal weakness in internal controls for the fiscal year ending June 30, 2006, the School District agrees to issue a directive to all operating departments reinforcing the importance and need to formally notify the Office of the Comptroller regarding all contract terms and requirements concerning the acquisition of any and all capital assets.

CAPITAL EXPENDITURES DEFICIENCIES

Summary of Findings and Recommendations:

- PILOT Bond Expenditures for Non-Eligible Athletic Uniforms.

School District's Response:

- Although the School District acknowledges that $365,173 or 1.1% of the total $32.8 million of PILOT Bond proceeds were spent on athletic uniforms (a non-capital eligible item), management did not agree to make this adjustment to its financial statements since it was and remains immaterial and these purchases were well under the 5% exclusion allowable under the bond transaction. In addition, it should be noted that since the purchase amount was only 1.1% of total bond proceeds, it had no real or material impact to useful life calculations. To prevent any future reoccurrence, however, the School District implemented enhanced procedures during fiscal year 2007 to ensure that capital funds will not be spent on non-eligible capital items or purchases. Furthermore, management dedicated a specific section in its Capital Asset Procedures that provides more guidance to employees on the type of assets that are and are not deemed proper capital expenditures.

**School District of Philadelphia's Responses to Report on Internal Control and on Compliance and Other Matters - Fiscal Year Ended June 30, 2006
From the Office of the Controller, City of Philadelphia**

Summary of Findings and Recommendations:

- Operating Payroll Charged to Capital Fund.

School District's Response:

- Although the School District agrees with the recommendation that additional reviews and safeguards should be implemented to ensure a regular review of payroll charges to the Capital Fund, the School District disagrees with the City Controller's subjective statement that management would have continued to improperly charge payroll costs for functions that are non-capital related without being prompted to review these charges by auditors. In fact and as part of the annual fiscal year end close process, the Office of the Comptroller obtains a listing of all payroll expenditures charged to the Capital Fund and determines if personnel were incorrectly coded and charged. As part of its own due diligence and independent review, payroll costs that are inappropriately charged to the Capital Fund are transferred to the General Fund by management within the Office of the Comptroller. Moreover, eligibility of all employees that are charged to the Capital Fund are now reviewed monthly by the Capital Programs Financial Management unit and all new employees are approved for coding before they are entered into the Payroll System in order to further strengthen this process. Lastly, an overall post audit review and analysis was performed in fiscal year 2007 of payroll costs charged to the Capital Fund to ensure that all salaries were and are currently properly charged. Accordingly, the School District respectfully disagrees with this finding and corrective actions were implemented for the audit period currently under review in this Audit Report.

PAYROLL AND FRINGE BENEFIT RELATED DEFICIENCIES

Summary of Findings and Recommendations:

- Payroll Procedures Not Documented.

School District's Response:

- The School District continues to respectfully disagree with this finding of the City Controller. As noted in prior audit years, the School District does, in fact, publish and disseminate an Advantage Payroll System Manual which contains vital payroll processes, procedures, policies and guidelines regarding proper payroll entry and coding. In addition to this manual, formal payroll training is offered to all payroll administrators by the Systems Administration Unit on a regular and consistent basis and is required for all new employees whose job responsibilities include payroll entry. This manual clearly outlines how to properly record and code payroll in the Advantage Payroll System. This information along with other pertinent human resource requirements are also posted to the School District's main website and are updated as necessary. More recently, the Office of Human Resources drafted a comprehensive internal procedures manual which

School District of Philadelphia's Responses to Report on Internal Control and on Compliance and Other Matters - Fiscal Year Ended June 30, 2006
From the Office of the Controller, City of Philadelphia

includes guidelines on payroll related activities as well as all critical human resource functions and requirements. Although not contained in a formal "procedures" manual, most, if not all, processes and policies required of the School District's Payroll Department are in written form and available on a secured shared data drive for easy reference by employees within the department. Furthermore, all relevant payroll and human resource financial policies and procedures are contained in the *Principal's Financial Training Manual.*

As in previous audit years, management continues to mail and post payroll requirements, including, but not limited to, the importance of signing the "TPER" sheet to all personnel district-wide. Nevertheless, management will produce a "formal" internal departmental manual of these processes and procedures for the Payroll Department and finalize the draft of the Human Resources Procedures Manual in fiscal year 2008. Because only formal board policies need to be adopted by resolution, these manuals are all considered procedural in nature which do not require formal adoption by the School District's governing body.

Summary of Findings and Recommendations:

- Integrity of Payroll Passwords Compromised.

School District's Response:

- Although significant improvements to internal controls and procedures were implemented in fiscal year 2007, the School District continues to accept the findings and recommendations of the City Controller. Despite the decrease in the number of violations found and management's best efforts, the School District continues to find violations in this area when conducting its own desk compliance checks and internal audit reviews. For example and during fiscal year 2007, the Office of Internal Audit Services increased the number of internal audits focusing on fiscal and accounting controls at schools and placed violators on corrective action plans. Management will continue to monitor this area for repeat violations and recommend disciplinary action in accordance with collective bargaining agreements when appropriate. In addition, the School District will continue the current practice of issuing new passwords if and when it is found that a confidential password was shared with a payroll secretary.

School District of Philadelphia's Responses to Report on Internal Control and on Compliance and Other Matters - Fiscal Year Ended June 30, 2006
From the Office of the Controller, City of Philadelphia

Summary of Findings and Recommendations:

- Insufficient Employee Compensation Processing Procedures – Unpaid Termination Compensation Balances.

School District's Response:

- The School District has no intention of including non-supportable termination pay liabilities in its financial statements as noted in previous audit responses, however, management continues to make necessary improvements to termination compensation processing. For instance, a Termination Pay Working Group, consisting of representatives from various departments including payroll, human resources, retirement, information technology, treasury operations and accounting (the "Working Group"), was convened in fiscal year 2005 and continues to meet on a periodic basis to identify efficiencies and determine necessary corrective actions to address the backlog. More recently, the Working Group embarked on developing guidelines to determine the amount, if any, required and subject to state escheat laws.

Additionally, an internal report was developed by the Office of Information Technology and the Office of the Comptroller categorizing each status code of employees within the liability being carried on the School District's books and records, i.e. charter school leave, laid off, inactive, extended leave without pay, extended maternity leave, deceased, etc. During fiscal year 2007, this list was provided to both the Office of Human Resources and the Payroll Department for each to research the status of all employees in the report in order to determine appropriate action for the liability recorded. Unfortunately, limited staff resources have delayed completion of this initiative in both fiscal years 2006 and 2007 and have served to increase the backlog of the issuance and release of termination payments. Consequently, resources were devoted to decreasing the backlog as opposed to researching dated items. As noted in this most recent Audit Report, some progress was made in the reduction of older liabilities contained in its books and records.

Despite these challenges, a new procedure was recommended by the Working Group and implemented in fiscal year 2007 which consists of zeroing out the balances of employees who leave the School District. In addition, the written communication sent to families of deceased employees will be amended to inform them of the procedure to escheat unclaimed monies to the state as recommended in this Audit Report. The Office of Human Resources also drafted an amendment to their internal policy regarding the issuance of termination pay to furloughed employees and now intends to automatically send termination pay to employees versus the current practice of waiting for the employee to request it. Notwithstanding the above, the School District accepts this finding and, upon completion of this initiative, any non-validated amounts will be escheated to the state as required by law.

School District of Philadelphia's Responses to Report on Internal Control and on Compliance and Other Matters - Fiscal Year Ended June 30, 2006
From the Office of the Controller, City of Philadelphia

FOOD SERVICES FUND DEFICIENCIES

General
Summary of Findings and Recommendations:

- Contract Administration Deficiencies;
- Expenditure Review Deficiencies; and
- Growing Deficit in the Enterprise Fund.

School District's Response:

- As noted in this Audit Report and beginning in fiscal year 2006, a significant portion of the School District's food service operations was administered through an outside vendor. This action was taken by the School District in order to establish enhanced controls and operating efficiencies over cafeteria operations including, implementation of a point of service system. Under the terms of the contract, the vendor is responsible for day-to-day operations such as ordering and paying for food and supplies and collecting student payments. More specifically, the deficit realized in the Food Service Enterprise Fund can be attributed to the increase in wages and benefits paid to employees, increased indirect costs and charges for breakfast aides. Additionally, a more accurate accounting of the number of meals served resulted in a reduction in the number reported and corresponding federal and state reimbursements during fiscal year 2006. Furthermore, the School District's compliance with more stringent federal nutritional guidelines resulted in decreased purchases by students which subsequently reduced projected revenues. Consequently, the Food Service unit is in the process of researching ways to enhance programs in order to increase participation and reduce administrative expenditures.

The School District, however, agrees with the finding of the City Controller that \$4.0 million of the \$5.7 million loss is attributable to the requirements of the contract with the outside vendor. As is typical of all Food Service Management Company ("FSMC") contracts, there are a number of conditions which require minimums and other guarantees that must be met in order to seek reimbursement from the FSMC. The current vendor contract does not stipulate a minimum number of meals; however, projections were based upon estimates which included scheduled early dismissals, class trips, holidays, etc. These conditions were stipulated in the contract and a budget was agreed upon based on conditions remaining essentially consistent. These conditions do include the number of students in attendance to receive meals and the number of school days. The \$4.0 million deficit in fiscal year 2006 can be attributed to the vendor's failure to meet projected revenue increases and failure to meet projected labor decreases. The School District is in the process of renegotiating this contract for the upcoming school year and will seek to strengthen contract reporting requirements to mitigate the risk of any material discrepancies between projected and actual contract costs.

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Regarding expenditure review, the City Controller acknowledges that no irregularities were found in the sampling of over $37.7 million worth of invoices. The School District agrees with this recommendation to strengthen internal procedures as they relate to verification of vendor expenses and invoices prior to the processing of payments. In fact, the School District implemented new processes and internal controls in fiscal year 2007 to validate monthly expenses reported by the vendor. The $37.7 million of invoices identified in this Audit Report, however, represent the total full service cafeteria operating expenses. The direct vendor expenses represented only $10.7 million of the $37.7 million while the balance related to School District payroll, government commodity transactions and other School District direct and indirect costs. These types of expenses are subject to the same level of internal controls and policies and procedures as all School District expenditures.

OTHER CONDITIONS

General
Summary of Findings and Recommendations:

- Improper Revenue Recognition in the Debt Service Fund.

School District Response:

- As reiterated on a number of different occasions, 96% of the $7.6 million in question represents reimbursements for eligible expenditures already disbursed, not only in fiscal year 2006, but in previous fiscal years ended on June 30, 2003, 2004 and 2005. Final notification of the receipt of these funds was received from the Commonwealth in late September of 2006. Although auditors requested that an adjustment be made to its financial statements, the School District determined that to report these revenues in fiscal year 2007 would distort actual results and opined that it met the requirements of "highly unusual circumstances" according to generally accepted accounting principles. The School District continues to contend that there were extraordinary circumstances surrounding the lateness of the receipt of these revenues which were certain to be collectible and measurable. Accordingly, the School District respectfully disagrees with this finding and recommendation of the City Controller.

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Summary of Findings and Recommendations:

- Incorrect FICA Tax Withholding for Termination Payments.

School District's Response:

- As acknowledged in this Audit Report, the School District sought the advice of outside legal counsel with tax law expertise to determine the proper tax treatment when it implemented a change in its direction and accounting of termination payments. The School District relied on this opinion to determine the appropriate tax withholdings for these payments in fiscal year 2006 when it established a new 403(b) Plan to deposit termination compensation that meets certain conditions as set forth in the legal opinion. Accordingly, the School District respectfully disagrees with this finding and recommendation of the City Controller. The City Controller has not provided any legal authority that contradicts or undermines the legal opinion on which the School District has relied upon. In an effort to resolve this issue, however, the School District agreed to present and seek authorization from its governing body to request a formal Private Letter Ruling ("PLR") from the Internal Revenue Service. Recognizing that receipt of a PLR will realistically take 1 to 2 years, the School District will nevertheless continue to footnote the tax treatment of the 403(b) Plan and estimate the contingent liability in accordance with generally accepted accounting principals.

Summary of Findings and Recommendations:

- No Formal Debt Management Policy.

School District's Response:

- The School District is not required by any state statute, or by any state regulatory, advisory board or agency to adopt a formal Debt Management Policy as stated in previous audit responses and adoption of such a policy continues to be only a recommendation of the Government Finance Officers Association ("GFOA"). In fact, the School District is only required by the Local Unit Government Debt Act to have a written Interest Rate Management Plan ("Plan"). The School District's Plan contains provisions that govern the use of derivative debt instruments including, but not limited to, the type of derivatives that may be employed, the conditions under which derivative instruments should be utilized, measuring, evaluation, specific reporting requirements and the management of risks associated with each. The Plan addresses most, if not all, of the concerns cited by auditors in this instance and was formally adopted by the School District's governing body.

Notwithstanding the above, the School District previously agreed to draft a formal Debt Management Policy and present it to its governing body for formal adoption. Subsequently, management engaged an outside consultant to work with the School

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District to draft this policy. Because of a change in the consultant's scope of work, this initiative has not yet been completed. The School District remains committed, however, to formalizing its debt practices and policies (as currently described in individual Official Statements when debt is issued) and will resume this work with the assistance of an outside financial advisor. The absence of a formal debt policy, however, does not diminish the School District's adherence to sound financial management of its long-term debt and sizing of its debt service payments.

Summary of Findings and Recommendations:

- Write-Off of Employee Receivables.

School District's Response:

- Although the School District agrees that a decision was made by executive management to write-off employee receivables as uncollectible, management respectfully disagrees that there was any internal control or accounting shortfall in researching and rendering this decision. At the time the receivable was originally recorded, an "Accounts Receivable" account was debited and the contra account "Allowance for Doubtful Accounts" was credited; therefore, the reversal of this entry had no revenue or operating fund balance impact in fiscal year 2006.

In addition and in prior years, there was a concerted effort by the School District to recover all employee payroll overpayments which were primarily caused by the conversion to the new Advantage system in 2000. The un-recovered balance of $1.2 million remained on the School District's books and records until it was written-off in fiscal year 2006. In an effort to comply with accounting standards which require that receivables are to be written-off if they are determined to be uncollectible, management carefully researched and reviewed all available documentation. Because a decision was made by the Accounting Director and approved by both the Comptroller and the Chief Financial Officer of the School District, to write the receivables off, the School District views this as sound fiscal management and adherence to internal controls. The School District, however, will continue to pursue recovery of these receivables if it is discovered that employees subsequently returned to work. While the School District agrees that there are some employees who returned to service as found in the sampling conducted by auditors, there is insufficient supporting documentation available to withhold funds from employee paychecks at this time.

There is no legal requirement to have accounting procedures regarding the write-off of accounts receivable approved by the School District's governing body as recommended in this Audit Report. The School District maintains that appropriate approvals of senior finance and executive management were obtained before taking this action and generally accepted accounting principles and guidelines were adhered to. Nonetheless and as a further control measure, the School District will document the

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approval process and guidelines for writing off receivables as part of the update to the Accounting Procedures Manual currently underway.

Summary of Findings and Recommendations:

- Student Activity and Petty Cash Funds Control Deficiencies.

School District's Response:

- The School District is pleased to report that management's concerted efforts to communicate procedures to and take disciplinary actions taken against Principal's who violate district-wide policies has resulted in improvements to the control environment over student activity funds. In June of 2007, the School District went live with a dedicated portion of its main website which placed the student activity fund manual online and made it user friendly for easy reference and guidance on all topics. The website also provides detailed guidance on how to launch and use QuickBooks, the preferred bookkeeping and reconciliation method for student activity funds (and petty cash accounts) and provides direction on how to prepare bank reconciliations and quarterly student activity reports required by the School District for submission to the Office of the Comptroller. Guidance on Student Activity Funds is also provided as part of the annual comprehensive financial training afforded to principals and administrators and will occur again in the Fall of 2007. In addition to publishing this information on its main website, the Office of Internal Audit Services placed an emphasis on performing school-based audits during fiscal year 2007. For example, 22 audits that tested reporting and compliance with internal financial controls and accounting with 41% based in schools across the district.

The School District reinforced the petty cash policy in fiscal year 2007 during the numerous mandatory Financial Policy and Administrative Processing Training sessions. Despite this continued concerted effort and emphasis, it is reported that compliance with internal controls concerning petty cash still exists. To further strengthen these controls and, effective September 4, 2007, management revised polices and practices relating to petty cash accounts to ensure better alignment with financial and internal accounting standards. Highlights of these changes include:

- Petty cash accounts must be used for small and/or emergency purchases only;
- Expenditures cannot exceed $200 per transaction or vendor payment (a reduction from the $500 previously authorized);
- Petty cash allotments will be reduced on average by 50%;
- Petty cash accounts can no longer be used to pay for telephone bills, food, bus transportation, travel reimbursements, professional development fees, professional services, life skills programs or large purchases for vocational programs; and

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- Administrators will be responsible for submitting petty cash envelopes with original receipts and processing a payment voucher approval in the Advantage System.

All other policies and procedures concerning petty cash remain unchanged including the requirement for monthly bank reconciliations. To coincide with the start of the new academic year, these policy enhancements were again communicated and the detailed Petty Cash Policy was disseminated to all schools and regional offices to remind school-based staff of the changes. These changes were also sent to all administrators district-wide via a dedicated email and posted on the School District's main website. Accordingly, the School District agrees with this finding and recommendation of the City Controller and will continue to monitor this area of compliance to identify further improvements.

Summary of Findings and Recommendations:

- Payments to Tax Delinquent Vendors.

School District's Response:

- Since late 2003 and as contained in the Agreement for Services utilized by the School District, contractors must attest, represent and warrant that that it is not indebted to the City of Philadelphia for or on account of any delinquent taxes for which no written settlement agreement or payment with the locale has been executed and delivered. An update was made in July of 2006 to extend this representation and warranty to the Commonwealth of Pennsylvania. There is no formal way to independently verify this information and there is no coordination currently with appropriate departments and agencies within the City of Philadelphia.

As recommended in this Audit Report, the School District is agreeable to pursuing discussions with the City of Philadelphia to establish a tax delinquent program in order to help strengthen enforcement of tax regulations. It should be recognized, however, that the School District is not an instrumentality of the City of Philadelphia nor does it possess any of the collection mechanisms available to the City of Philadelphia despite its legal claim to a majority of the taxes in question. In fact, the School District does not possess the legal authority to offset monies owed to the City of Philadelphia against monies due from the School District to vendors or legally force satisfaction of tax claims levied by the City of Philadelphia.

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Summary of Findings and Recommendations:

- Audit Services Unit Should Report to the School Reform Commission.

School District's Response:

- Pursuant to management's recommendations to the School Reform Commission and as of August of 2007, both the Office of Internal Audit Services and the Office of the Inspector General report directly to the School District's governing body.

Summary of Findings and Recommendations:

- Severance Payable Adjustment.

School District's Response:

- As acknowledged in this Audit Report and reiterated during the Exit Conference, the School District engaged in appropriate corrective action in May of 2007 to ensure that the software problem which caused the initial error would not reoccur. The corrective action was implemented in time for fiscal year 2007 reporting.

Summary of Findings and Recommendations:

- Non-Compliance with Parking Tax Regulations.

School District's Response:

- Following recommendations by the City Controller in last years Audit Report, the School District investigated this matter and recently acknowledged its liability for these taxes. Consequently, the School District remitted and filed all required forms, calculated all appropriate taxes and paid the past amount due and owing to the City of Philadelphia. A process is now in place to ensure that all appropriate tax forms and payments are filed timely from this point forward.

Summary of Findings and Recommendations:

- Controls Over Student Dental Care Expenditures.

School District's Response:

- The School District acknowledges that, despite monthly billing and detailed reports concerning the progress of each student receiving services paid by the Public School Health Fund ("Fund"), additional verification, such as sign-in sheets from

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doctors' offices, can be implemented to confirm the actual attendance of students at doctors' appointments prior to approving payment requests from providers. The School District, however, objects to the finding and subjective statements made with respect to verification of providers billing the Fund and private insurance carriers for the same services. For Fiscal Year 2006, the School District did verify, through a comprehensive student application process, that providers were not previously paid by private insurance carriers. This process is extensive, requiring at a minimum, submission of parental income statements and other pertinent documentation. The focus of the services provided by this Fund is orthodontic work which is not covered by Medicaid. The Fund only provides services for students whose family incomes are equal to or below the national poverty limit and, thus, whose only insurance is Medicaid. This Fund does not cover general or routine dental work such as cleanings or x-rays which may be covered by Medicaid. Notwithstanding the above and as recommended by the City Controller, the School District is in the process of resolving several governance and administrative issues related to the Fund, including, but not limited to, entering into formal contracts with providers.

STATUS OF PRIOR YEAR FINDINGS

Incorrect Estimated Asset Life Assignments
Summary of Findings and Recommendations:

- This finding is considered resolved and closed since corrective measures were implemented.

Inconsistent Depreciation Charges
Summary of Findings and Recommendations:

- This finding is considered resolved and closed since corrective measures were implemented.

Improper Accounting for Education Center Acquisition Not Disclosed by Reconciliation Procedures
Summary of Findings and Recommendations:

- This finding is considered resolved and closed since corrective measures were implemented.

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Under –Collateralized Investment
Summary of Findings and Recommendations:

- This finding is considered resolved and closed since corrective measures were implemented.

Non-Compliance With Filing Requirements for Statement of Financial Interest Forms
Summary of Findings and Recommendations:

- This finding is considered resolved and closed since corrective measures were implemented.

Employees Receive Pay After Termination
Summary of Findings and Recommendations:

- This finding is considered resolved and closed since corrective measures were implemented.

Use of Property Sale Proceeds
Summary of Findings and Recommendations:

- Although both the City Controller and the School District consider this finding resolved and closed, the School District wishes to clarify that at no time was there any remaining or outstanding debt on the properties in question as suggested in previous audit reports. According to the provisions of the Local Unit Government Debt Act, the School District is aware that it would have been required to pay off the outstanding debt concerning these properties in lieu of reducing debt service expenditures.