CITY OF PHILADELPHIA
PENNSYLVANIA

OFFICE OF THE CONTROLLER

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**REPORT ON INTERNAL CONTROL
AND ON COMPLIANCE AND
OTHER MATTERS**

**SCHOOL DISTRICT OF
PHILADELPHIA**

FISCAL 2010

City Controller
ALAN BUTKOVITZ

CITY OF PHILADELPHIA

OFFICE OF THE CONTROLLER
1230 Municipal Services Building
1401 John F. Kennedy Boulevard
Philadelphia, PA 19102-1679
(215) 686-6680 FAX (215) 686-3832

ALAN BUTKOVITZ
City Controller

GERALD V. MICCIULLA
Deputy City Controller

May 25, 2011

Robert L. Archie, Jr., Esq., Chair
and Members of the School Reform Commission
440 N. Broad Street
Philadelphia, PA 19130

Dear Chairman Archie and Members:

In accordance with the Philadelphia Home Rule Charter, the Office of the City Controller conducted an audit of the basic financial statements of the School District of Philadelphia, Pennsylvania as of and for the fiscal year ended June 30, 2010, and has issued its Independent Auditor's Report dated January 28, 2011.

In planning and performing our audit, we considered the School District of Philadelphia, Pennsylvania's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the School District of Philadelphia, Pennsylvania's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the District's internal control over financial reporting.

Attached is our report on internal control over financial reporting and on compliance and other matters, dated January 28, 2011 and signed by my deputy who is a Certified Public Accountant. The findings and recommendations contained in the report were discussed with management at an exit conference. We included management's written response to the findings and recommendations and our comments on that response as part of the report. We believe that, if implemented by management, these recommendations will improve the School District of Philadelphia, Pennsylvania's internal control over financial reporting.

We would like to express our thanks to the management and staff of the School District of Philadelphia for their courtesy and cooperation in the conduct of our audit.

Respectfully submitted,

ALAN BUTKOVITZ
City Controller

cc: Arlene C. Ackerman, Ed.D., Chief Executive Officer
Michael J. Masch, Chief Financial Officer
Marcy Blender, Comptroller

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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, 2010, which collectively comprise the School District of Philadelphia, Pennsylvania's basic financial statements and have issued our report thereon dated January 28, 2011. Our report was modified to include a reference to the adoption of a new accounting pronouncement. 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 as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the School District of Philadelphia, Pennsylvania’s internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the School District of Philadelphia, Pennsylvania’s internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies, or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as discussed below, we identified a combination of deficiencies in internal control over financial reporting that we consider to be a material weakness and another combination of deficiencies that we consider to be a significant deficiency.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the following combination of deficiencies described in the accompanying report to be a material weakness:

- Inadequate design or operation of controls over the financial reporting process included (1) management decisions regarding the application of accounting principles to significant transactions were not always adequately documented; (2) review of the fund financial statements was not always documented and performed in a timely manner; (3) review procedures for accounting entries did not always detect significant errors; and (4) procedures for preparation and review of the financial statements had not been formally established and disseminated.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following combination of deficiencies described in the accompanying report to be a significant deficiency:

- Inadequate design or operation of controls over capital asset accounting included (1) an inappropriate policy for transferring costs from construction in progress which resulted in untimely transfers and understated depreciation; (2) failure to sufficiently review maintenance payroll costs to determine whether they should be capitalized; and (3) an improper practice of not capitalizing equipment until it was tagged.

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.*

We noted certain conditions that are not required to be reported under *Government Auditing Standards*, but nonetheless represent deficiencies in internal control that should be addressed by management. These other conditions are listed in the table of contents and described in the accompanying report.

C I T Y O F P H I L A D E L P H I A
O F F I C E O F T H E C O N T R O L L E R

The School District of Philadelphia, Pennsylvania's written response to the material weakness, significant deficiency, and other conditions identified in our audit is included as part of the accompanying report. We did not audit the School District of Philadelphia, Pennsylvania's response and, accordingly, we express no opinion on it. We have also included our comments to the School District of Philadelphia, Pennsylvania's responses that we believe do not adequately address our findings and recommendations

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

Gerald V. Micciulla

January 28, 2011

GERALD V. MICCIULLA, CPA
Deputy City Controller

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FINANCIAL REPORTING PROCESS WEAKNESSES

Our audit of the School District of Philadelphia's (District) Comprehensive Annual Financial Report (CAFR) revealed that District accounting management needs to improve internal controls over the financial reporting process. Audit work we performed disclosed several instances of significant errors. District accountants failed to prevent or timely detect and correct these errors during the performance of their regular financial reporting duties. We believe the following deficiencies in the District's financial reporting process contributed to the detected errors:[1]

- District accounting management did not always adequately document their decisions regarding the application of accounting principles to significant transactions;

- Review of fund financial statements was not always documented and performed in a timely manner;

- District review procedures for accounting entries did not always detect significant errors; and

- The District had not formally established and disseminated to its accountants written policies and procedures that governed preparation and review of its CAFR.

Each of these deficiencies is discussed in more detail below.

<u>Documentation of Accounting Treatment for Significant Transactions</u>

Generally accepted accounting principles (GAAP) allow entities a certain degree of judgment when applying these principles to their financial information. Therefore, it is essential that an entity document its decision-making process when applying GAAP in order to support that transactions were properly recorded. Our audit found that District accounting management did not always adequately document the basis of its decisions regarding the application of appropriate accounting principles to significant transactions. Consequently, we were unable to determine the reasons for errors that we identified in the application of certain accounting principles.

For example, we questioned the validity of a reported $15.3 million interfund loan from the general fund to the food service fund. The collectibility of this loan was highly doubtful because (1) the loan had increased 41 percent from the prior year; (2) the food service fund had experienced deficits over the past several fiscal years; and (3) the District had not established any formal repayment terms for the loan. Governmental accounting guidance requires that, if an interfund loan is not expected to be repaid within a reasonable time, the entity should eliminate the loan balance and record the transaction as an interfund transfer.[2] Despite the materiality of this loan to the food service fund (representing 67 percent of reported liabilities), District accounting management did not provide sufficient documentation to support their decision to report this transaction as an interfund loan rather than an interfund transfer.

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[1] Once we brought these errors to management's attention, they made the appropriate adjustments to correct them.

[2] Governmental Accounting Standards Board (GASB) Statement No. 34, paragraph 112a(1) and GASB Comprehensive Implementation Guide 2010-2011, question 7.82.1 provide guidance for interfund loans.

On November 30, 2010, we met with District management to express our concerns regarding the validity of the interfund loan, which we believed the food service fund would be unable to repay. Rather than providing us with documentation supporting its decision, management tried to demonstrate the validity of the loan by preparing and presenting us with a five-year projection of food service fund operations from fiscal year 2011 through 2015. However, this projection forecasted continued operating losses and only a $1.6 million reduction of the loan balance over the five-year period, which was to be achieved solely through general fund contributions to the food service fund. In our opinion, this projection did not demonstrate the food service fund's ability to repay the interfund loan within a reasonable time, and we proposed that the interfund loan be eliminated and reported as an interfund transfer.

In response, District management then developed and presented us with a proposed repayment plan on December 28, 2010. Under this plan, the loan will be incrementally repaid from fiscal year 2010 through 2015 through a reduction of the indirect costs charged by the general fund to the food service fund. The District's repayment plan was formalized through a resolution adopted by the School Reform Commission on January 19, 2011. The District adjusted its fiscal year 2010 preliminary financial statements to reflect this repayment plan, reducing the general fund indirect cost charge to the food service fund by $3.2 million and thereby decreasing the interfund loan amount to $12.1 million.

At the exit conference, District officials claimed that they would have taken action to address the interfund loan, even if we had not initially questioned its validity. Despite this claim, management has never offered any documentation which adequately supported its initial decision to report this transaction as an interfund loan rather than an interfund transfer when there was no formal repayment plan in place.

Another example of the inappropriate application of accounting principles was the District's accounting treatment for a $42 million transaction related to the implementation of Governmental Accounting Standards Board (GASB) Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*. GASB Statement No. 53 required that this transaction be reported as a restatement of beginning net assets (i.e. prior period adjustment). Instead, District accountants recorded it as investment revenue based on a suggested entry from an outside consultant hired to assist with GASB Statement No. 53 implementation. We noted that, while the consultant's entry for this transaction recorded it as investment revenue, the consultant's description for the entry stated "to restate the beginning net assets". We informed District accountants of this error on January 10, 2011 – only three weeks before the District was required to submit its CAFR to the Government Finance Officers Association's (GFOA) Certificate of Achievement for Excellence in Financial Reporting Program. After we notified District accountants of the error, they revised the CAFR to report the $42 million transaction as a prior period adjustment.

When we met with District accounting management in March 2011, they then asserted that the $42 million transaction was recorded as investment revenue rather than a prior period adjustment because they concluded that the transaction was immaterial to the governmental activities opinion unit. However, District accounting management did not offer this explanation at the time we proposed the adjustment in January 2011 and never provided any written documentation of this decision. Since the District had already booked a $76,000 prior period adjustment to beginning net assets, District accountants appeared inconsistent in the application of a materiality standard in their decisions regarding the recording of prior period adjustments.

Recommendations:

To improve the District's controls for the application of accounting principles, we recommend that, for future significant financial statement transactions, District accounting management document in writing their reasons for the accounting treatment they apply to the transactions [600110.01].

With regard to the interfund loan between the general fund and food service fund, we recommend that, until the loan is completely repaid, District management monitor compliance with the repayment plan. If the terms of the repayment plan are unable to be met in the future (e.g. because of unanticipated additional food service fund deficits), the District should eliminate the balance of the interfund loan and report the remaining amount as an interfund transfer [600110.02].

Review of Fund Financial Statements

We observed there was an independent supervisory review of the accounting entries which converted the fund financial statements to the single, integrated presentation of the District-Wide statements. Also, we noted that District accounting management performed various review procedures on the governmental fund financial statements, such as reconciling balances to the District's accounting system. However, there was no evidence suggesting that a detailed, independent review of financial statements for the proprietary funds and agency funds was performed. In addition, District accounting management did not always complete their review of the financial statements in a timely manner.

With no detailed, independent financial statement review, material errors in the agency funds financial statements were not detected – a $6 million (16 percent) understatement of both reported assets and liabilities. Because of an improper journal entry (discussed in more detail below), the payroll clearing fund[3] had erroneous balances in two accounts – a $6 million credit balance in equity in pooled cash and investments asset (normally a debit balance account) and a $6 million debit balance in liabilities (normally a credit balance account). Based upon prior years' activity in the payroll clearing fund and the application of basic accounting principles, these balances should have appeared highly unusual to the financial statement preparer and warranted further investigation. Instead, the preparer improperly deducted $6 million to arrive at the CAFR reported amounts for both the agency funds' equity in pooled cash and investments asset and the payroll deductions and withholdings liability. Consequently, the reported amounts for both accounts were understated by $6 million.

An example of an error which should have been detected by a timely review of the financial statements was the District's failure to report the amount of a long-term interfund receivable not expected to be repaid within one year as reserved fund balance, as required by governmental

[3] The payroll clearing fund is one of several agency sub-funds, the activity for which is combined to arrive at CAFR reported amounts for agency funds.

accounting guidance.[4] As a result, the general fund's unreserved fund balance was overstated by $11 million. District accounting management asserted that their comparison of the GFOA's School District Preparer Checklist against the financial statements would have detected the error, but they had not completed their review when we brought the error to their attention. We informed the District accountants of the error on January 17, 2011 – two weeks before the District was required to submit its CAFR to the GFOA's Certificate of Achievement for Excellence in Financial Reporting Program. In our opinion, the District's review process needs to be completed more timely.

Recommendation:

To strengthen the District's controls for detecting and correcting financial statement errors, we recommend that the District's accounting management institute an independent, detailed review of the financial statements for proprietary funds and agency funds. The review should include such procedures as comparing reported CAFR amounts to supporting calculations and source documentation (e.g. District accounting system reports). Performance of these review procedures should be documented on a written form signed by the responsible District official, attesting that the financial statements have been reviewed and approved. In addition, District accounting management should revise its timetable for the review of financial statements to ensure that any necessary adjustments are completed in a timely manner [600110.03].

Review of Accounting Entries

The District has a formal, documented process for preparing and reviewing journal entries. However, our audit testing disclosed incorrect journal entries that had been approved, which led to financial statement errors, suggesting that the review procedure required strengthening.

For example, the $6 million understatement of agency funds' assets and liabilities (discussed in more detail above) originated from an incorrect journal entry. An employee in the District's Office of Management and Budget (OMB) prepared a journal entry to transfer out of the payroll clearing fund $6 million of accrued salary and benefit expenditures that should have been charged to fiscal year 2011 instead of fiscal year 2010. When preparing the journal entry, the OMB employee debited the wrong liability account. While this non-routine journal entry was sent to both OMB and accounting management for review prior to its posting to the accounting system, the error was not detected, and an erroneous debit balance in the payroll clearing fund's liabilities was created.

In another instance, although there was an independent supervisory review of the accounting entries that converted the fund financial statements to the single, integrated presentation of the District-Wide statements, our audit testing found an entry which did not conform to the guidance prescribed by GASB Statement No. 53. As a result, we found that expenses had been overstated and assets understated both by $26 million. This error occurred even though the entry was marked as having been reviewed, as evidenced by the initials of the manager responsible for the review. We informed District accountants of this error on January 10, 2011 – three weeks before the District was required

[4] Guidance for the reporting of reserved fund balance is contained in the Government Finance Officers Association's (GFOA) 2005 *Governmental Accounting, Auditing, and Financial Reporting* (GAAFR), pages 174 and 175, and National Council on Governmental Accounting (NCGA) Statement No. 1, paragraphs 118 through 122.

to submit its CAFR to the GFOA's Certificate of Achievement for Excellence in Financial Reporting Program.

Recommendation:

To reduce the occurrence of errors in accounting entries, we recommend that District management issue a directive to personnel responsible for review of entries emphasizing the need to more diligently assess the accuracy of accounting entries, in particular ensuring that non-routine entries are posted to the correct accounts and entries conform to governmental accounting guidance [600110.04].

CAFR Preparation and Review Procedures

Our review disclosed the District had not formally established and disseminated to its accountants formal, written policies and procedures that governed the preparation and review of its CAFR. District accounting management informed us that they had worked with an outside consultant to develop a manual containing such policies and procedures. However, it was apparent that the manual had not been formally approved, finalized, and disseminated to accounting staff. When we requested a copy of the manual, various top accounting management personnel could not provide the document, which suggested it had not been disseminated amongst accounting staff. Instead, they referred us to an accounting manager, who on presenting the manual to us stated he had received it approximately 18 months earlier.

Our review of the manual disclosed that it did not contain detailed procedures for preparing financial statement information for certain funds, such as the District's agency funds and categorical funds. Also, the manual did not include any procedures describing the specific steps that an independent, detailed review of the financial statements should entail.

The lack of formal, written policies and procedures for CAFR preparation and review increases the risk that District accountants may not be aware of the proper steps to perform when preparing and reviewing financial statements. This risk is heightened further in the event of staff turnover. Therefore, there is an increased risk that financial statement errors can occur and not be detected and corrected.

Recommendation:

To lessen the increased risk of errors when preparing and reviewing the CAFR, we recommend that District management take the necessary actions to complete the existing manual. The manual should be revised to include detailed procedures on preparing financial statement amounts for all funds and specific review procedures to be performed by supervisory personnel. Once the manual has been completed and formally approved, management should ensure that each member of the accounting staff receives a copy [600110.05].

CAPITAL ASSET ACCOUNTING DEFICIENCIES

Our audit identified deficiencies in the District's capital asset accounting policies and procedures that misstated reported capital asset and related depreciation amounts. Specifically, our review disclosed (1) a deficiency in the District's policy for transferring costs from its construction in progress (CIP) account; (2) a failure of District accountants to sufficiently review maintenance employees payroll to determine if the costs were related to construction of a capital asset; and (3) an inappropriate practice of not capitalizing the cost of equipment in use until it is tagged with a District identification label. Each of these deficiencies is discussed more thoroughly below.

Policy for Transferring Costs from CIP Account

The CIP account accumulates capital asset costs until the asset is placed in service, at which time the asset costs should be transferred into the respective long-term capital asset accounts, such as buildings and improvements. Depreciation of a capital asset should start in the year the asset is placed into service.

For improvements to existing District buildings, the District's policy is to transfer costs from CIP when the final payment on the project's contract is made, rather than when the project is completed and ready for use. District management asserted this accounting practice was more efficient because a project's total cost is then transferred out of CIP all at once. However, because there can be a considerable time lag between completing construction and making final payment, the District's practice increases the risk that costs will not be transferred to long-term capital assets and depreciated on a timely basis.

We identified numerous CIP transfers recorded in fiscal year 2010 that should more appropriately have been transferred out of CIP and depreciated in a prior fiscal year. For example, one project, in which the District renovated a former middle school building to house a new high school, was completed and placed into service during the first half of fiscal year 2009. However, because the final payment on the project's contract was not made until fiscal year 2010, the project's accumulated costs were not transferred out of CIP until fiscal year 2010.

There were also several instances where the District was inconsistent in applying its own stated CIP transfer policy for improvements. We observed three other improvement projects with a final payment date in fiscal year 2009 for which the District did not transfer accumulated costs out of CIP until fiscal year 2010. If the District had followed its stated policy of transferring costs from CIP upon final payment date, then the costs for these three improvement projects should have been transferred out of CIP in fiscal year 2009.

In addition, the District did not always follow its CIP transfer policy with respect to newly constructed school buildings. The District's policy for a new school building is to transfer costs upon receipt of a certificate of use and occupancy from the city's Department of Licenses and Inspections. However, we found that the costs for one new school with a certificate of use and occupancy dated August 30, 2007 were not transferred to long-term capital assets until fiscal year 2010.

Because the District did not transfer costs out of the CIP account on a timely basis, our testing of sampled fiscal year 2010 CIP transfers disclosed that current year depreciation expense and accumulated depreciation were understated by $1.4 million and $4.6 million, respectively. The $4.6 million understatement of accumulated depreciation will carry forward every year until the assets are fully depreciated many years later. If this condition is not corrected, there will be additional understatements of accumulated depreciation occurring every year, the cumulative effect of which over several fiscal years could become material.

Recommendation:

To ensure that costs are transferred to long-term capital assets and depreciated on a timely basis, we recommend that the District change its criteria for transferring improvement costs out of CIP from final payment date to project completion date. District accounting personnel should obtain project completion date information from the District's Office of Capital Programs and use this data to analyze the accumulated costs in the CIP account to identify completed projects for transfer. Due to the additional time and effort this change in practice may involve, District accounting personnel may consider establishing a dollar threshold to limit this analysis to significant capital projects [600110.06].

Payroll Costs of Maintenance Employees

In the prior audit, we reported that the District's existing capital asset systems and practices were not adequately designed to capture all eligible capital projects fund costs that should be capitalized. For fiscal year 2009, a significant amount of capital expenditures were incorrectly expensed instead of capitalized because the District could not determine the specific capital projects to which they pertained.

Our current year audit revealed improvement in this condition. The District developed an allocation methodology to distribute to the applicable capital projects, in-house payroll costs related to construction activity and payments made to an outside project manager. Similar costs were expensed in prior years because they could not be assigned to specific capital projects.

Based on our review of fiscal year 2010 expensed capital costs information provided by the District at the time of our fieldwork, we noted $2.8 million of overtime payments to maintenance staff who worked on capital projects. The District's Office of Capital Programs kept records of the projects on which the maintenance employees worked. However, District accountants did not utilize this data to determine whether these costs related to the construction of capital assets and, therefore, should have been capitalized. The District's failure to capitalize all eligible capital projects fund costs increases the risk that reported capital assets are understated and expenses are overstated.

Recommendation:

To ensure that all eligible capital projects fund costs are appropriately capitalized, District accounting personnel should work with the Office of Capital Programs to identify maintenance staff overtime costs that should be capitalized.

At the exit conference, District management asserted that the additional work involved in implementing this recommendation was not warranted from a cost-benefit perspective because of the relative immateriality of the maintenance overtime costs. We recommend that management annually review the amount of maintenance overtime costs to ensure its immateriality in future years [600110.07].

Capitalization of Equipment

The District did not capitalize the cost of equipment until it was tagged with an identification label. This practice was not in accordance with GAAP, which require that capital assets be recorded in the year of acquisition.

Our review of fiscal year 2010 capital costs expensed by the District noted $1.3 million of equipment expenditures that were expensed in fiscal year 2010 because they were not tagged. As of March 2011, $714,000 of this equipment was subsequently tagged and inappropriately capitalized in fiscal year 2011.

Recommendation:

To ensure that equipment is properly reported in the year of acquisition, we recommend that District accountants include the balance of untagged equipment in reported capital asset amounts.

At the exit conference, District management expressed its belief that the extra effort to implement this recommendation was not justified from a cost-benefit perspective because the cost of the remaining untagged personal property was immaterial. We recommend that management annually review the amount of untagged personal property costs to ensure its immateriality in future years [600110.08].

PERSONAL PROPERTY CONTROL DEFICIENCIES

The District maintains a personal property inventory with an original cost of $283.7 million. Our prior year testing disclosed that safeguarding and recordkeeping over these assets was inadequate. Numerous items selected from the District's inventory listing of personal property could not be observed, and items observed in schools could not be traced to the listing.

The current year audit found that these inadequate conditions remained uncorrected. Audit testing disclosed 20 of 50 (40 percent) items of equipment haphazardly chosen from the District's personal property listings for seven selected schools could not be observed. These items, which cost $48,314, included computers, audio visual equipment, athletic equipment, musical instruments, and a microscope. Also, 20 of 47 (43 percent) tagged personal property items selected from observation at the same seven schools – primarily computers and office furniture – could not be traced to the District's personal property listings for the schools where observed.

Our audit disclosed the following deficiencies which contributed to our inability to observe sampled assets and trace selected equipment to the District's personal property listing:

- District personnel frequently failed to ensure that personal property was properly tagged;

- School personnel did not always comply with District policies regarding the removal of computers from school premises;

- School officials did not always prepare the required documentation for equipment dispositions; and

- Certain schools failed to submit complete physical inventory reports for the personal property located at their facilities.

Each of these deficiencies is discussed in more detail below.

<u>District Personnel Frequently Failed to Ensure Personal Property Was Tagged</u>

District Policy 750.0, which establishes procedures over personal property security, requires that all District-owned equipment be properly identified by affixing a standard property tag to it. For 11 of the 20 items which could not be observed, school officials showed us an item similar in description to the sampled asset. However, we could not definitively identify these items as the sampled assets because there were no property tags affixed to them. School personnel at one location told us that property tags were never received for a laptop computer and audio visual equipment. At another school, where all seven of the sampled assets could not be observed, we identified two other items (a computer and an interactive whiteboard) which were also not tagged. These two items were not part of our original sample.

District Policies for Removal of Computers from School Premises Were Not Always Followed

School officials told us three of the laptop computers that we could not observe were assigned to teachers or other District personnel who removed them from the school premises. According to District Policy 750.1, when computers are removed from a school, employees must prepare and submit specific documentation to the principal, who is required to retain it. However, no such documentation was available for our inspection at the time of our testing. At one school, the laptop was assigned to a special education liaison who used the computer at home. At another location, the laptop was in the possession of a teacher who had recently resigned from the school. In the third instance, the principal informed us that the computer was at her home.

School Officials Did Not Always Submit Required Documentation for Equipment Dispositions

The Principal's Financial Training Manual requires that each District location submit the T-31 form (Personal Property Inventory Transactions) to the District's Office of General Accounting (General Accounting) to report all changes to the personal property inventory assigned to the location, including transfers, disposals, trade-ins, and thefts. With regard to a treadmill we could not observe, a school official informed us that it had been damaged and subsequently scrapped. However, the school did not submit the required T-31 form to General Accounting so the treadmill could be removed from the District's personal property listing.

School officials' failure to submit the required T-31 forms also contributed to our inability to trace several items selected from observation to the District's personal property listings for the schools where observed. Four of the 20 items not traced to the District's personal property listing were eventually located on the listing under a different location. For three of the 20 items not traced to the District's personal property listing, District accountants had previously deleted the items from the listing. These three items had been recorded on the District's personal property listing under incorrect school locations, which then directed General Accounting to delete the items since the equipment was not present at the schools. In all of these instances, school officials failed to submit the required T-31 forms so that the District's personal property listing could be updated to reflect the assets' correct locations.

Certain Schools Did Not Always Submit Complete Physical Inventory Reports

Principals are directed to perform a yearly inventory of personal property physically located at the school facilities. For the seven schools where we conducted audit testing, one school never submitted its physical inventory report while another school's report was asserted not to be located.

Additionally, when performing physical inventories of personal property, school officials are required to record a disposition for each item listed on the physical inventory report. This is done by either placing a check mark by an item physically observed or indicating that the item should be deleted. However, we observed that one school did not record any entry for 195 of 747 items listed on its inventory report, and another school recorded no disposition for 50 of 341 listed items.

Since these schools did not submit a complete physical inventory report, District accountants could not properly update the District's personal property listing. Consequently, this situation increases the risk of inaccurate records and enables the possibility of misappropriation.

Recommendations:

To improve the safeguarding and recordkeeping over personal property assets, we recommend that District management contact the principals at the affected schools and work with them to reconcile the differences noted during our testing.

Management should send principals a directive (1) requiring them to contact General Accounting to request personal property tags for untagged equipment; (2) reminding them of the requirements of District Policy 750.1 regarding the removal of computers from school premises; (3) instructing them of the requirement to submit T-31 forms to document changes in inventory; and (4) emphasizing the need to comply with established District personal property inventory procedures in submitting a complete yearly physical inventory report. The school finance support specialists must be active in monitoring schools' compliance with established personal property policies and procedures [600108.01].

INADEQUATE ARTWORK INVENTORY RECORDS AND PROCEDURES

In fiscal year 2008, the District completed a comprehensive inventory of its $8.3 million artwork collection which included $242,350 of items listed as "Not Observed" because they were located in closed school buildings, and $250,950 of items that the District listed as "Can Not Locate". Corrective actions taken to date have not been effective in reducing the value of items in these two classifications.

During our current year audit, we were informed that the District had still not observed the artwork in the closed school buildings. As a result, the only action taken by the District since fiscal year 2008 with regard to these items was the removal from inventory of one item valued at $3,500. The item was removed based upon the necessary paperwork submitted by personnel from a charter school that now occupies the building at which District inventory records listed the item as being located.

In the prior fiscal year, 21 "Can Not Locate" items valued at $71,000 were removed from the artwork inventory. During fiscal year 2010, five additional items, valued at $5,800, were removed from this classification. According to the District employee who maintains the artwork inventory records, the authorization to remove these items from inventory is based solely upon paperwork received from the school locations.

Because of the risk inherent in an artwork collection, we selected a sample of 15 items from the District's artwork inventory for testing during our current audit. Two of the items selected were previously identified as "Can Not Locate" on the District artwork records, and one as "Destroyed". We were unable to locate the "Destroyed" item; however, auditors observed one of the "Can Not Locate" items, an antique curio cabinet, at a District school location. Of the 12 remaining items, four could not be found, and two of the items that were located did not have personal property tags, identifying them as District property.

When we brought these findings to the attention of the District employee who maintains the artwork inventory records, he informed us that these items remained on the inventory because the necessary paperwork to remove them had not been processed by principals at the school locations. As a result, the District's reported artwork inventory continued to include $238,850 of items listed as "Not Observed" and $174,150 of inventory items that could not be located.

Recommendations:

To improve the accuracy of its artwork inventory records, we continue to recommend that the District:

- Observe the artwork in its closed school buildings. Authorization to remove items previously listed as "Not Observed" should be based upon the observation and investigation of responsible District personnel.

- Continue using the school finance support specialists to assist in the annual artwork inventory and reinforce to the principals the importance of completing the proper paperwork authorizing the removal of "Can Not Locate" items from the inventory.

- Require personnel who take the annual inventory to report on the inventory sheets any artwork items which do not have a personal property tag affixed [60106.01].

STUDENT ACTIVITY FUNDS CONTROL DEFICIENCIES

Previously, we reported upon control deficiencies noted during a special audit of student activity funds conducted at 15 sampled high schools from May through September 2008. Although the District had developed a comprehensive School Funds Manual for student activity funds (Manual), which provided very specific responsibilities and detailed procedures, we found non-compliance with the Manual to be a common occurrence at the schools we visited.

During the current audit, we performed a limited review of student activity funds at two high schools and continued to note non-compliance with the Manual and deficiencies in controls over student activity funds, which totaled $5.2 million for all schools at May 31, 2010. Specifically, we found (1) failure to comply with school store inventory procedures; (2) inadequate controls over cash collections; (3) improper use of student body activities account funds; (4) failure to close inactive account balances; (4) long outstanding reconciling items being carried on bank reconciliations; (5) failure to establish finance committees; and (6) no budgets being prepared by activity sponsors. Each of these deficiencies, which are discussed below, increases the risk for fraud to occur at the schools and not be timely detected.

School Store Inventory Procedures Were Not Followed

The Manual requires the school store's manager to conduct a physical inventory at the end of the school year and prepare a report listing all merchandise on hand and their cost, a copy of which is to be filed with the principal. For one of the high school stores we visited, school officials were unable to provide a physical inventory report or any other inventory records of the store's merchandise. Consequently, in our opinion, there was an increased risk for misappropriation of merchandise. In fact, the store manager asserted to us that, when he returned at the start of the school year to open the store, he noticed several missing items.

Schools Did Not Establish Adequate Controls Over Cash Collections

With regard to this same school store, school officials were also unable to provide the school store financial records required by the Manual to safeguard against misappropriation of cash. While the manager used a cash register for store sales, he did not prepare the required store manager's report (form H-216) documenting each day's ending register reading, which was to be reconciled against the daily counts of cash in the register drawer. Additionally, the manager did not prepare the required year-end school store financial statements (form H-217).

At another high school, its food production program[5] had not established adequate controls over the receipts from its food sales. Our audit found that, while the activity sponsors used a cash register to process sales, they did not reconcile the register reading to their count of cash in the register drawer. Consequently, since the cash in the drawer was not matched to food sale amounts, misappropriations of cash would not be detected. The activity sponsors were unable to provide any cash register tapes or customer receipt forms to support food sale deposits, which totaled $17,309 for fiscal year 2010 (through June 7, 2010).

While the Manual does not contain specific requirements for food production program sales, it is a standard business practice to control cash receipts through the use of cash registers, pre-numbered receipt forms, or similar control devices. The information from such a control device should then be reconciled to the counted cash to ensure that all cash collected is submitted for deposit.

Student Body Activities Account Was Improperly Used

While the Manual requires that funds included in the student body activities account be spent for the general welfare of the student body, we found disbursements from one school's account that appeared questionable. For instance, we noted $311 in expenditures for emergency tires for a security cart, a magazine subscription, and refreshments for a home and school association meeting.

Inactive Account Balances Were Not Closed

At both high schools, we noted 31 accounts totaling $24,673 for which there was no activity during the school year. The existence of long dormant balances provides the opportunity to use funds for unauthorized purposes and has been addressed in the Manual. According to this guidance, student groups are to designate the use of any funds remaining after each program's conclusion. In the absence of such designation, excess funds are to be transferred to each school's student body activities account and used for the general benefit of students.

Old Reconciling Items Were Carried on Bank Reconciliations for Years

The Manual instructs both the principal and school operations officer to monitor outstanding checks and deposits in transit as part of the bank reconciliation process. However, bank reconciliations at both schools listed checks that had been outstanding for long periods of time (some over eleven years). The bank reconciliation at one school also listed a $2,011 deposit in transit from July 2001. The school operations officer was unable to provide an explanation or documentation for this old reconciling item. Failure to properly resolve long outstanding checks and deposits in transit

[5] The food production program is part of a culinary class-provided lunch to school faculty who are required to pay a fee.

unnecessarily complicates the bank reconciliation process, provides opportunities for irregularities, and represents an instance of non-compliance with the state's escheat laws.[6]

Schools Did Not Establish Finance Committees

Student activity fund balances at the two high schools visited totaled $359,364 at May 31, 2010. Because of the significance of these amounts, the Manual requires principals to establish finance committees that advise them on investing cash in excess of current needs. Despite this requirement, neither high school had established a finance committee.

Activity Budgets Were Not Prepared

Budgets that disclose anticipated income and expenditures were not established for student activity funds at the two high schools visited. According to the Manual, budgets should be constructed as a fiscal management tool for each activity by sponsors, working with student representatives and principals.

Recommendations:

We continue to recommend that principals and school operations officers take steps to comply with guidance described in the Manual to strengthen controls and prevent misuse of funds. In addition, school finance support specialists must be active in monitoring student activity funds. The frequency of reviews should be increased so that transactions within each activity are examined in order to highlight inappropriate use and control deficiencies [600108.03].

In addition, we recommend principals require that any activity which generates cash sales throughout the year establish controls over the cash receipts from these sales. Activity sponsors should control cash receipts through the use of a cash register or pre-numbered receipts, the information from which should then be reconciled to the counted cash. Documentation of this reconciliation should be retained by the activity sponsors and periodically reviewed by the principal [600110.09].

PETTY CASH FUNDS CONTROL DEFICIENCIES

In the prior year audit, we reported numerous control weaknesses and instances of non-compliance with established control procedures involving the operation of the District's petty cash accounts. Our current year testing found that problems continued in this area. We believe the following weaknesses and questionable practices adversely affect the District's ability to properly safeguard and account for its $663,636 in petty cash funds.

- In fiscal year 2008, District management announced plans to reduce the authorized amount of the petty cash imprest funds held at various schools. To reduce each school's authorized amount, management decided it would process but not repay the schools' petty cash reimbursement requests until the accounts' balances equaled the revised lower amounts. This practice was ineffective in achieving the planned petty cash reductions

[6] The Commonwealth of Pennsylvania's escheat laws require that unclaimed property (other than payroll checks) be turned over to the state after remaining unclaimed for five years.

because of the large number of petty cash accounts with low turnover. In November 2009, District management issued a directive instructing principals at those schools to draw and submit checks to the accounts payable unit in the amount needed to bring their authorized amounts in agreement with the revised amounts. Despite management's efforts over the last three years, our review of the accounts payable unit's petty cash records in March 2011 revealed that there were still 61 schools where the petty cash account balance exceeded the revised authorized amount by a total of $93,600.

- Our testing disclosed various instances of non-compliance with the District's petty cash expenditure policy. For three schools visited, there were purchases totaling $1,844 for unallowable items such as food, registration fees for various activities, a barber license renewal, and a magazine subscription. Also, at one of the schools, we noted a transaction which exceeded the $200 transaction limit, a petty cash expenditure without a supporting receipt, and reimbursement requests which did not match amounts on the receipts.

- Cash overages and shortages were found at six of ten schools visited. Four accounts had shortages totaling $651 while two accounts had overages amounting to $194.

- At eight of ten schools visited, we noted insufficient segregation of duties, whereby the fund custodian maintained the checkbook and also reconciled the petty cash bank account.

- At one school, our review disclosed $300 of long outstanding checks from 2007 that were still carried as reconciling items on the bank reconciliation.

- One school's bank reconciliation was not signed by either the preparer or the principal, a practice which fails to fix accountability for the accuracy of the reconciliation with any particular District employee.

Recommendations:

For all school petty cash funds where the planned reduction in the authorized amount has not been completed, District management should enforce its November 2009 directive instructing school principals to reduce their petty cash accounts by paying those monies directly over to the District via a check drawn on the account.

To enhance internal controls and minimize the risk of undetected errors or misappropriation of petty cash funds, we again recommend that the District monitor and enforce policies and procedures relating to the management and reconciliation of all petty cash imprest funds [600108.04].

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.

As stated in our prior reports, 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.

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. Our calculations at June 30, 2010 indicate that a potential tax liability exceeding $19.7 million in principal and interest could result from successful challenges by the taxing authorities. We determined that this potential tax liability was not material to the District's fiscal year 2010 financial statements. Since the accumulated amount of the non-payment will eventually become material and affect our audit opinion, we recommended that District management request a Private Letter Ruling (PLR) from the Internal Revenue Service (IRS), citing the facts specific to its case.

In fiscal year 2008, the District submitted a PLR request to the IRS[7], but to date, management asserts it has not received a ruling. Should the District receive a favorable ruling from the IRS, there will not be any liability in connection with this matter. In the event of an unfavorable ruling, management has informed us that it will take the steps necessary to ensure that it will not incur any further future liability related to termination pay contributions to the 403(b) Plan.

Recommendation:

Although District management believes the possibility that it will be liable for any back taxes and related interest and penalties is remote, it has disclosed the matter in the footnotes to its financial statements. We will continue to monitor the materiality of the potential liability and recommend that management follow up with the IRS as to the disposition of the District's request for the PLR [60106.07].

UNCLAIMED TERMINATION COMPENSATION SHOULD BE ESCHEATED

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, the source of its annual termination compensation liability, included leave balances associated with a substantial number of former employees, some of whom had been separated from employment for several years.

Our current year review of District records indicated that as of June 30, 2010, approximately $8.7 million was owed to employees who had been separated for more than a year. This represents an increase of $1.1 million (14 percent) over the prior year total. Table 1 on the following page summarizes the termination compensation liability owed to separated employees.

Pennsylvania laws require that unclaimed wages be escheated to the state after two years. In prior reports dating back to fiscal year 2004, we have repeatedly recommended that termination pay for any former District employees who could not be located be escheated to the state as required. Through the end of the audit, the District had still not escheated the termination compensation.

[7] The Controller's Office had previously asked for a copy of the PLR request made to the IRS, but District officials have refused to provide it.

Table 1: Employee termination compensation outstanding for more than one year (in millions)

Fiscal year of separation	Termination compensation owed
2009	$2.0
2008	1.9
2007	2.0
2006 and prior	2.8
Total	$8.7

An audit report issued by the Pennsylvania Treasury Department in October 2009 also found that the District had not complied with the state's escheatment laws. That report cited the District for failing to report and remit to the state $544,572 in uncashed payroll checks for calendar years 1996 through 2003, and recommended that the District escheat these funds to the state. While District management complied with the recommendation and escheated the monies to the state, it has not demonstrated its willingness to comply with the same escheatment laws pertaining to termination compensation.

At last year's exit conference in May 2010, District management informed us that some categories of termination pay included on the VPIL report were not subject to the escheatment requirement. Therefore, before escheating the termination payments to the state, the District wanted to first analyze the VPIL report and determine the amount of termination pay that should be escheated. In response to our inquiries in early March 2011, almost a year later, we learned that the District had not yet completed its analysis.

Recommendation:

To bring the District into compliance with Pennsylvania's escheat law, we recommend that management promptly complete its analysis of unclaimed termination pay and remit all funds that are due to the state Treasury Department. We will continue to monitor the District's implementation of this recommendation in subsequent years [600108.08].

INSUFFICIENT PROCEDURES FOR PROCESSING TERMINATION COMPENSATION

In our prior year report, we commented that the District had established formal, written procedures for processing termination compensation payments which we intended to review during the fiscal year 2010 audit. During this year's audit, we noted that there were certain control procedures performed by the District's Payroll Department (Payroll) that were not included in the written procedures.

In response to our inquiries, we learned that Payroll personnel send a listing of separated employees who have received their termination compensation to the District's Information Technology (IT) Unit quarterly. It is the responsibility of the IT Unit to delete the names and accumulated leave balances of the separated employees from the ADVANTAGE system, which is the source of the information that appears on the District's VPIL report. To ensure that all separated employees who received their termination compensation have been deleted by IT, Payroll personnel spot check selected employees to the ADVANTAGE system, but do not document the review. Although these controls were in effect, we noted that they were not included in the District's formal, written procedures for processing termination compensation.

We believe these control procedures are necessary to ensure that separated employees who received their termination compensation do not remain on the VPIL indefinitely, possibly resulting in the need to perform detailed, labor-intensive analyses of the VPIL report in the future. We also believe that all relevant control procedures should be formalized to mitigate the possibility that they will not be performed.

Recommendation:

We recommend that the District amend its procedures for processing termination compensation to include all procedures for removing separated employees and their accumulated leave balances from the ADVANTAGE system, as well as instituting a requirement to document the spot check as evidence that this control procedure was performed [600110.10].

INTEGRITY OF PAYROLL PASSWORDS COMPROMISED

Current year testing of the District's payroll system again disclosed that certain payroll secretaries, rather than principals and administrators, were approving attendance records at 7 of 70 (10 percent) school locations visited. This condition continued to exist because principals and administrators, in a breach of confidentiality, delegated the approval authority and disclosed the payroll closeout code to payroll secretaries. By doing so, principals and administrators improperly delegated 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 department. This practice could result in the falsification of payroll time and attendance with little chance of detection.

Recommendation:

We again recommend that management re-issue closeout codes to any principals or administrators who have shared their codes with other District personnel, continue to instruct principals and administrators of the necessity to maintain the confidentiality of their closeout codes, and consider establishing other mitigating control procedures [600108.07].

ENCUMBRANCE POLICY STILL NEEDS CLARIFICATION

Previously, we commented that District personnel failed to liquidate significant amounts of encumbrances that no longer represented valid purchase commitments at fiscal year-end. Out of $22 million in general fund and intermediate unit fund fiscal year-end open encumbrances tested, $16.9 million (77 percent) were unnecessary (invalid). This condition occurred because the District's encumbrance policy was neither clear nor adequately communicated to the responsible unit managers. While District management asserted it was the unit manager's responsibility to notify the District's Office of Management and Budget (OMB) to cancel an encumbrance, the District's encumbrance policy document instead indicated that the OMB would cancel any remaining fiscal year-end encumbrances.

Our current testing revealed significant improvement in the District's year-end encumbrance cancellation process. Out of $17 million in general fund and intermediate unit fund fiscal year-end open encumbrances tested, we identified only $637,171 (4 percent) as unnecessary.

District policy documents, however, remained unchanged and still contained conflicting information that did not clearly direct unit managers of their responsibility to notify OMB to cancel an encumbrance. The annual memorandum sent to unit managers regarding expenditure request cut-off dates was revised in fiscal year 2010. Instead of instructing unit managers of their responsibility to notify OMB to cancel an encumbrance, the memorandum stated that any year-end open encumbrances not cancelled by unit managers by a certain date "may be" cancelled by OMB.

Recommendation:

To further improve controls over the encumbrance liquidation process, we continue to recommend that District management formally revise the encumbrance cancellation policy to clarify the unit managers' responsibilities and disseminate this revised policy to unit managers [600109.02].

NON-COMPLIANCE WITH STATEMENT OF FINANCIAL INTEREST FILING REQUIREMENTS

The Pennsylvania Public Official and Employee Ethics Act (PA Act 93 of 1998) requires District employees responsible for taking or recommending official action of a non-ministerial nature to annually complete a Statement of Financial Interest (SFI). Examples of these employees include members of the School Reform Commission, District management (e.g. Chief Executive Officer and Chief Financial Officer), office heads, and principals.

In our prior report, we noted that 40 of 566 (7 percent) employees did not comply with the SFI filing requirements. Our current year review of the SFI records maintained by the District's Office of Human Resources revealed that the level of non-compliance increased significantly, noting 137 of 556 (25 percent) employees did not complete the required SFI forms.

In addition, although not required by law, we previously recommended that submitted SFI forms be reviewed to identify conflicts of interest or related party transactions, which may require financial statement disclosure. During the current audit, the District did not provide any documentation evidencing that such a review had been performed.

Recommendation:

In order to enforce compliance with the law, we recommend that the District inform employees in writing that the Commonwealth of Pennsylvania may impose a fine upon any person subject to the Act who fails to make a complete, accurate, and timely filing. In addition, we continue to recommend that management ensure that all SFIs submitted are independently reviewed to determine whether any financial statement disclosures are required [60107.05].

LACK OF WRITTEN PROCEDURES FOR SCHOOL SECURITY CAMERAS

During our audit testing, we visited ten District high schools that were equipped with security cameras. Inquiries of District personnel at each location disclosed that there were no written procedures concerning the use of the camera systems. While we were told at several locations that there were informal policies regarding certain procedures such as safeguarding and storing the recordings, we believe these policies should be documented in writing. The written policies and procedures should, at a minimum, address:

- Restricting day-to-day access to tapes and recording devices, as well as real-time viewing of monitors to authorized personnel;
- Specifying who, and under what circumstances, may review recorded information;
- Using logs to provide a written record of all instances of access to, and use of, recorded material;
- Establishing separate retention policies for recorded information that includes serious incidents or potential crimes, and those which do not include such information;
- Requiring secured storage of tapes or other devices that are not in use;
- Labeling and dating used tapes and recordings sequentially; and,
- Disposing of old storage devices in such a way that the recorded information on them cannot be viewed.

Recommendation:

To ensure that the policies and procedures governing the use of security cameras at all District locations are standardized and uniformly applied, we recommend these policies and procedures be formalized in writing, approved by the School Reform Commission, disseminated to the appropriate parties, and periodically monitored for compliance [600110.11].

DEFICIENT CONTROLS OVER STUDENT DENTAL CARE EXPENDITURES

In our last several reports, we commented that internal controls over dental benefits paid through the District's Public Health Fund (the Fund) were inadequate, and required improvement. The Fund was established through private donations to pay for needy, eligible students' dental/orthodontic treatment, eye care, and hearing exams.

During our fiscal year 2009 review, we noted that the District did make changes to improve controls, such as requiring that dental-service providers submit invoices, which list for each student served, the date of service and amount billed. For each student listed on the invoice, the District also required the providers to submit a standard American Dental Association (ADA) billing claim form which indicates the date and type of service as well as the amount billed. However, we found that one provider, who was paid $54,800 in fiscal year 2009, did not submit the required ADA claim forms. Other deficiencies noted were the District's failure to obtain verification from the parent or guardian that the services billed were actually provided, and the lack of formal contracts with the dental-service providers.

The current year audit disclosed no improvements. The same dental-service provider, who in fiscal year 2009 did not provide the required ADA billing claim forms, once again did not submit these required forms but was paid $70,986 for services. Also, the District still did not obtain verification from the parent or guardian that the services billed were actually provided and failed to enter into formal contracts with the dental providers, who were paid a total of $242,916 during fiscal year 2010.

Recommendations:

To improve controls over dental benefits paid through the Fund, we continue to recommend that District management:

- Enforce the requirement that providers submit ADA claim forms to support invoiced amounts by holding back payments to the providers until the forms are submitted.
- Require verification from a parent or guardian that the services billed were actually provided.
- Enter into formal contracts with each of the providers in order to define each party's responsibilities. As an added control, agreements should include a provision requiring providers to notify the District should they become aware of the existence of private insurance [60106.10].

As part of our current review, we followed up on the conditions brought to management's attention during our last review. We routinely monitor uncorrected conditions and report on them until management takes corrective action or until changes occur that resolve our recommendations.

Our follow-up has disclosed that the District made progress addressing several prior issues. We commend the District on its efforts.

DOCUMENTATION OF MAINTENANCE PAYROLL CHARGED TO CAPITAL FUND NOW IMPROVED

In several prior year reports we noted that the District lacked procedures to routinely capture eligible payroll costs associated with capital projects work performed by the District's maintenance staff whose time is routinely charged to the general fund. As a result, substantial effort was required to gather, analyze, and summarize data from various sources in order to determine the nature of the work performed and its eligibility for the transfer of costs from the general fund to the capital projects fund.

During our fiscal year 2009 audit we tested the District's newly implemented methodology to directly charge salaries of maintenance employees to capital projects, subject to certain review and monitoring procedures, and noted that the District's methodology identified and properly charged the applicable payroll costs to the capital projects fund. However, we found that the documentation of the review and monitoring procedures needed to be strengthened.

Our fiscal year 2010 testing revealed that District personnel documented through correspondence from the facilities manager to the senior vice president of the Office of Capital Programs requests for approval before payroll costs were charged to a project. We also observed documentation that the director of the Capital Financial Management Unit reviewed all positions charged to the capital projects fund for propriety and agreement with current practices of the District on a monthly basis. We therefore consider this finding resolved [60107.03].

PAYROLL AND HUMAN RESOURCES PROCEDURES NOW DOCUMENTED

In previous reports, we noted that the District had neither formal written procedures for payroll, nor a current human resources policies and procedures manual. The disposition of each of these issues is discussed below.

<u>Payroll Procedures</u>

During our current year testing of payroll at various school locations, we were informed by school personnel that a "Secretary's Reference Manual" existed, and contained the procedures to be performed before entering payroll into the ADVANTAGE system. After obtaining and reviewing a copy of the manual from the Office of School-Based Resource Support, we were satisfied that the design of procedures for entering payroll, when applied in conjunction with the procedures for payroll approval as portrayed in the payroll section of the Principal's Financial Training Manual, were satisfactory. We therefore consider this finding resolved [600108.06].

Human Resources Policies and Procedures Manual

Previously, we commented that there were no written policies and procedures covering the required documentation and authorizations for adding and removing employees from the payroll system. After the prior audit, the District provided us with a copy of a Human Resources policies and procedures manual ("Job Requisition requestor User Guide") that described these processes. Our review of the document determined that the procedures described in the manual were satisfactory. We therefore consider this finding resolved [600108.06].

DISTRICT-WIDE FINANCIAL STATEMENT MISCLASSIFICATIONS CORRECTED

During our prior audit, we observed that in the presentation of the District-Wide financial statements as well as the related reconciliations, management did not conform to classifications of accounts and reconciling items as prescribed by governmental accounting guidance. These misclassifications totaled $490 million. Our audit of the statements and related reconciliations for fiscal year 2010 disclosed that District management had properly accounted for all the classifications. Accordingly, we consider this condition resolved [600109.01].

THE SCHOOL DISTRICT OF PHILADELPHIA
Office of the Chief Financial Officer
440 N. BROAD STREET, SUITE 304
PHILADELPHIA, PENNSYLVANIA 19130

Michael J. Masch
Chief Financial Officer

TELEPHONE: (215) 400-4500
FAX: (215) 400-4501

May 13, 2011

Mr. Alan Butkovitz, City Controller
City of Philadelphia
Office of the City Controller
12th Floor, Municipal Service 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 – Fiscal Year 2010

Dear Mr. Butkovitz:

The attached document contains the School District of Philadelphia's formal response to the issues raised in the audit report issued on May 2, 2011, with respect to internal control, compliance and other related matters. I would like to note the seriousness with which this administration treats the findings and recommendations made by the City Controller's Office in conjunction with the annual audit. To this end, I am pleased to note that actions have been taken by the School District regarding several important findings and recommendations from the fiscal 2009 audit sufficient for those issues to be considered resolved. In addition, the School District looks forward to implementing a number of actions that will resolve other outstanding issues.

I would like to thank you and your staff for your efforts with respect to this audit and the many other issues on which we collaborate.

Sincerely,

Michael J. Masch

Michael J. Masch
Chief Financial Officer

C: Robert F. Archie, Esq., Chairman and Members of the School Reform Commission
Dr. Arlene C. Ackerman, Chief Executive Officer and Superintendant of Schools
Gerald V. Micciulla, Deputy City Controller, City of Philadelphia
Harvey Rice, Deputy City Controller, City of Philadelphia
Kathleen Duggan, Audit Administrator, City of Philadelphia
Ellen Steiker, Deputy Chief Financial Officer
Marcy F. Blender, Comptroller

FORMAL RESPONSES TO

REPORT ON INTERNAL CONTROL AND ON COMPLIANCE AND ON OTHER MATTERS

FOR FISCAL YEAR ENDING JUNE 30, 2010

BY THE OFFICE OF THE CITY CONTROLLER
CITY OF PHILADELPHIA

SUBMITTED BY:
MICHAEL J. MASCH
CHIEF BUSINESS OFFICER
THE SCHOOL DISTRICT OF PHILADELPHIA
May 13, 2011

School District of Philadelphia's Responses to Report on Internal Control and on Compliance and Other Matters – Fiscal Year Ended June 30, 2010
From the Office of the Controller, City of Philadelphia

MATERIAL WEAKNESSES

FINANCIAL REPORTING PROCESS WEAKNESSES

The School District of Philadelphia (SDP) wishes to note that there was a change in the audit protocol methodology for the fiscal year 2010 audit period which was not conveyed to the School District prior to the commencement of the audit or during the audit period. For many years, the past practice was that the SDP provided preliminary information to the auditors wherever possible to expedite the audit process and allow the District to timely and accurately complete the CAFR and timely obtain an audit opinion from the City Controller. This practice facilitated the submission of the CAFR to the Government Finance Officers Association (GFOA) and the Association of School Business Officials (ASBO) in time to qualify the School District for receipt of the awards for excellence in financial reporting issued by these two national organizations. The School District has been the recipient of these awards since their inception.

Until this year, preliminary information that was date stamped by the School District and highlighted for changes was not considered final when provided to the City Controller by the School District unless indicated as such. For the current fiscal year, the protocol was changed and shared information was considered final and immediately subject to audit findings. In contrast to past practice, the Controller's Office has now informed the SDP that if the District discusses a preliminary accounting treatment under consideration with the auditors and concludes with the auditors that the matter should be reported differently and the District adjusts the preliminary financial statements before issuance, these matters will now be subject to material and significant audit findings.

Now that these changes in policy and practice have been more clearly articulated by the City Controller's Office and are fully understood by the School District, the District will work with the Controller's auditors to develop a revised calendar for the fiscal year 2011 audit period, and will provide only final information to the Controller's auditors wherever possible, and will clearly identify any accounting transactions which have outstanding items to address.

1. Documentation of Accounting Treatment for Significant Transactions

Summary of Findings and Recommendations:

District accounting management did not always adequately document the basis of its decisions regarding the application of appropriate accounting principles to significant transactions. Consequently, auditors were unable to determine the reasons for errors identified in the application of certain accounting principles.

School District's Response:

The School District does not concur with this finding and believes that adequate documentation and factual information exists to support its financial reporting decisions for

School District of Philadelphia's Responses to Report on Internal Control and on Compliance and Other Matters – Fiscal Year Ended June 30, 2010
From the Office of the Controller, City of Philadelphia

significant transactions, in particular the two cited in the audit report.

At the same time, the School District recognizes that there is always room for improvement and the SDP will reinforce to accounting managers that formal documentation of significant accounting transactions is necessary and required.

The Controller's Office cites two specific examples in support of this finding. The first example refers to a $15.3 million interfund loan from the general fund to the food service fund. The Controller's report states that the School District had not established any formal repayment terms for the loan and cites accounting principles that require elimination of such loans through interfund transfers when amounts are not expected to be repaid "within a reasonable time." The report states that, because of the absence of a formal repayment plan, accounting management did not provide documentation to support the decision to report the amount as a loan rather than eliminate it through an interfund transfer.

School District management has been aware of and closely monitoring the amount owed by the food service fund to the general fund. This is demonstrated by the fact that steps had been taken in prior fiscal years, as recently as fiscal year 2009, to reduce the loan balance through operating transfers. Upon review of its preliminary fiscal year 2010 financial statements in October 2010, management saw that further action was required and brought to the attention of the auditors that the food service fund continued to run a deficit. The District established a repayment plan in December 2011 that was formally adopted by the School Reform Commission on January 19, 2011.

As was explained to the Controller's auditors by the SDP's Chief Financial Officer, the School District was unable to formulate and implement a repayment plan until the late fall of 2010, when the U.S. Congress approved the reauthorization of the federal Child Nutrition Act and gave the Department of Agriculture the authority to continue the universal feeding program under which the School District's food service plan operates. Until the continuing availability of this funding stream was confirmed, the SDP could not construct a credible, sound loan repayment plan. Once the plan was formulated, accounting management reported $15.3 million as an interfund loan in accordance with principles established by the Governmental Accounting Standards Board (GASB). This amount was not erroneously reported, as the audit report states. Nor was any audit adjustment required to reclassify the interfund loan to an interfund transfer. The accounting treatment for the loan, along with supporting documentation was also presented to representatives of both the GASB and the GFOA, who concurred with the reporting treatment presented by the SDP. Per the auditor's recommendation, the District will continue to monitor compliance with the repayment plan.

The second example cited by the Controller's auditors involved the reporting of $42 million related to the implementation of GASB Statement 53, *Accounting and Financial Reporting for Derivative Instruments*. It should be noted that School District accounting management constructed and followed a comprehensive and well-documented plan to implement

GASB Statement 53, including: reviewing and analyzing the accounting requirements, scheduling and attending an implementation seminar, engaging an outside consultant to assist in implementation and conferring with the GFOA regarding implementation issues. The issue raised in the Controller's report refers to the GASB Statement 53 guidance regarding certain transactions that are to be reported as adjustments to beginning balances. The SDP notes that the GASB Statement also states that its requirements need not be applied to immaterial amounts. SDP accounting management chose to follow this criteria regarding the transaction in question, reporting it as current year investment revenue rather than an adjustment to the beginning net asset balance, since the amount was not material to the District's financial statements. This is the same reporting treatment suggested by the consultants engaged to assist the District with implementation of GASB 53, and whose report was provided to the auditors. The SDP notes that each method of reporting has the same effect on the financial statements and that the District made the reclassification of the entry based on the auditor's recommendations before publication of the CAFR.

The audit report also states that the manner chosen to report the transaction in question appears to be inconsistent with the treatment of other transactions for lesser amounts that were shown as adjustments to beginning balances. The SDP responds that these other minor transactions involved adjustments to accumulated depreciation for buildings and improvements that occur every year and which have routinely been treated in this manner in prior periods.

2. **<u>Review of Fund Financial Statements</u>**

Summary of Findings and Recommendations:

There was no evidence suggesting a detailed, independent review of the fund financial statements for the proprietary and agency funds. In addition, accounting management did not always complete its review of the financial statements in a timely manner.

School District's Response:

The School District does not concur that there is a material weakness in its review of fund financial statements.

The School District's year-end closing procedures include steps to ensure that reported CAFR amounts are compared to source documentation, such as accounting system reports. Any revisions to the draft statements are compared to trial balance updates, taking adjustment amounts into consideration. Accounting management is assigned to review each of the SDP funds reported in the financial statements according to a detailed calendar.

The SDP acknowledges that turn-over of accounting management responsible for the review of the proprietary and agency funds caused some small transition issues at the District, but only temporarily and only for those two funds.

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The SDP experienced multiple revisions by the City of Philadelphia this year to local tax revenue numbers, the final revision as late as January 20th. This caused delays in the ability of SDP to complete the financial statements and resulted in later than anticipated accounting management review of certain sections of the final report. The District will make every effort in the future to adhere to the time-line set forth in its calendar while recognizing that unforeseen and non-controllable events may cause unavoidable delays. In addition, a more formal process of written sign-off by the reviewer will be implemented.

The audit report cites two cases in support of its findings and recommendations regarding financial statement review procedures.

The first of these involves a $6 million credit balance for cash and investments in the payroll clearing fund that the report states should have warranted further investigation. The statement preparer was aware of the unusual liability balance and adjusted the fiscal year 2011 accounting records, but neglected to do so for fiscal 2010.

The other example cited involves $11 million related to the general fund interfund loan to the food service fund. The amount was initially reported as unreserved fund balance and subsequently reclassified through an audit adjustment as reserved fund balance in accordance with accounting principles.

The auditors discovered the need for this adjustment while completing the GFOA's financial statement Preparer's Checklist two weeks prior to the required submission of the CAFR to the GFOA. This is the same control procedure performed by School District accounting management. Because the auditors were able to complete their review before the District finalized its own review, they question the timeliness of the procedure, not the fact that there are sufficient controls in effect to assure financial statement conformance to accounting principles.

School District management would have preferred that the fiscal year 2010 Preparer's Checklist be completed sooner. However, because of numerous financial statement revisions made as a result of numerous and last minute corrections by the City of Philadelphia to real estate tax amounts collected for the District, the Preparer's Checklist was completed later in the CAFR process than usual. Nevertheless, management believes that completing the Preparer's Checklist two weeks prior to the required CAFR submission is more than sufficient time to allow for any resulting financial statement corrections.

3. Review of Accounting Entries

Summary of Findings and Recommendations:

Incorrect journal entries were approved, leading to financial statement errors. While the School District does have procedures for the review and approval of journal entries, auditors believe that the review procedure was not adequately performed.

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School District's Response:

The School District does not concur that there is a material weakness in the review of accounting entries.

As stated in the report, the District has written review and approval procedures for the journal entries and these procedures are followed by the very few SDP departments which have the authority to prepare journal entries. The audit report discusses two unusual one-time instances as support for this finding. The School District does not agree that either of these cases represents a material weakness in its accounting control process.

In the first instance, although review procedures were in place and performed, a onetime unusual non-recurring entry in the agency fund resulted in an oversight of the resulting impacts to the SDP cash account balance. The report describes one journal entry for $6 million made to the payroll clearing account by the SDP Office of Management and Budget (OMB) to transfer liabilities from fiscal year 2010 to 2011 for 10 month employees who were converted to 12 month service.

As a result of the complexity of this non-routine transaction, the adjustment reduced the incorrect liability account and the error was not discovered as part of the internal review process. By itself, this error had no effect on the financial statements because both accounts reflect liabilities. However, when the accountant responsible for preparation of agency fund financial statements discovered the unexpected liability balance, it was unknown that the ensuing adjusting entry also affected equity in pooled cash and investments due to an unknown nuance in the accounting system when a particular object code is entered. Now that the impact is known, the SDP has informed the accounting staff of the effect on cash of charging the object code to avoid a future error of this nature.

The audit report cites one other instance regarding the review of accounting entries.

In this case, the report describes a year-end entry for $26 million associated with the termination of derivative instruments that did not conform with the new requirements of GASB Statement No. 53. The entry in question was included in the draft financial statements only so that they would balance; documentation exists to show that the proper accounting for this transaction remained to be resolved and this was communicated to the auditors as early as August 1, 2010.

District accountants contacted the GFOA regarding proper reporting of the transaction in the fund financial statements and provided the auditors with its resolution. When the question of its reporting in the full-accrual basis statements arose, the auditors responded to the District on October 1, 2010 that they were not yet prepared to discuss its resolution and there was no further contact on this issue until January 10, 2011. Because of the delay in resolving this matter, the District decided on December 8, 2010 to temporarily record the transaction as a place holder until the matter could be resolved. Since the entry initially recorded on the *preliminary* statements was not in compliance with the new GASB requirements, it became a material audit finding. The accounting for the transaction was resolved with the auditors and the final published statements had the proper recording of this item.

4. **CAFR Preparation and Review Procedures**

Summary of Findings and Recommendations:

The School District had not formally established and disseminated to its accountants formal, written policies and procedures that governed the preparation and review of its CAFR. The current manual has not been formally approved, finalized, and disseminated to accounting staff.

School District's Response:

The audit report's characterization of the School District's CAFR preparation manual is not accurate. District accounting management has long believed in the importance of documenting its CAFR preparation process. For this reason it engaged a consultant to assist in the preparation of such a manual. The SDP acknowledges that some additional sections need to be added to fully complete the manual and document some components of the process, but notes that the manual is nevertheless factual and accurate with respect to all of the topics currently included. In addition, the District notes that the manual had been fully disseminated to all accounting staff involved in the CAFR preparation well before the fiscal 2010 closing process began. The District agrees with the recommendation that it should take the necessary actions to complete the existing manual by adding the missing sections and adding a new section on review procedures.

SIGNIFICANT DEFICIENCIES

CAPITAL ASSET ACCOUNTING DEFICIENCIES

The District has implemented several improvements over the past two fiscal years related to the accounting for capital assets. All recommendations, wherever practical, found in recent audit reports have been implemented. This includes a more complete reconciliation process, detailed capital reporting policies and procedures, a focused effort on tagging and capitalizing assets before June 30th, and development of an allocation methodology for distributing overarching costs to capital projects.

As more fully described in the specific responses to each of the capital related findings below, the District believes that the new audit findings found in the report are immaterial in dollar value and have no significant or material impact on the reporting of capital assets within the financial statements. The findings are related to constraints created by the District's existing personal property system and fixed asset reporting system. Implementing the Controller's recommendations would require a large amount of added work effort under these operational constraints, an effort that would not be justified by the benefit that would be achieved in financial reporting accuracy, based on appropriate measures of materiality.

1. Policy for Transferring Costs from CIP Account

Summary of Findings and Recommendations:

The School District's policy is to transfer costs from construction in progress to fixed assets only after final payments are processed rather than when projects are completed and ready for use. This can cause delays in recording depreciation expense.

School District's Response:

The School District transfers costs from construction in progress (CIP) to fixed assets upon final payment because of the volume of transactions that still occur after the Capital Programs Office officially "closes out" projects. In most circumstances, final payments and the transfer of costs to fixed assets occur the year after projects are completed and ready for use.

The audit report cites only one case where the transfer of costs from CIP did not occur in the year following the project completion. The audit report reference is to the Juniata Park School. From reviewing the records for this project, it appears that the delay in transferring costs was due to miscoding of the school name, which was formerly listed as G and Hunting Park. It should also be noted that $15 million of the $22.2 million in total project costs included under the G and Hunting Park description were capitalized in fiscal 2008, when the building was placed in service. Based on these facts, School District management believes the delay in capitalizing the $7.2 million balance of costs associated with the Juniata Park School should be considered an isolated instance and not indicative of the manner in which transactions are usually processed.

Other than the case involving the Juniata Park School, the audit report did not cite any other cases where capitalization of completed projects was delayed by more than one year. Any misstatement would therefore equal only one year's depreciation expense for any projects whose cost was not transferred. The accumulated depreciation balance would also be misstated by only one year of depreciation expense. For this reason, School District management does not believe that its current practice could result in a material misstatement of the financial statements.

As recommended, the District will obtain project completion dates from the SDP Office of Capital Programs based on substantially complete definitions and will set a dollar threshold to transfer significant projects from CIP to completed projects.

2. Payroll Costs of Maintenance Employees

Summary of Findings and Recommendations:

The School District accounting staff did not avail itself to records that provide information as to the type of projects on which maintenance staff worked. Such a review may have resulted in capitalization of a portion of fiscal year 2010's $2.8 million in overtime cost.

School District's Response:

As indicated in the report, the District implemented a new process in fiscal year 2010 to allocate to the project level $13.3 million of allowable salary costs which were previously expensed within the capital fund. This was a significant improvement in the reporting of project expenditures within the capital fund and resolved a prior audit finding.

As a new finding in fiscal year 2010, the audit report cites $2.8 million of overtime payments to maintenance staff who "may" have worked on capital projects. In fact, a significant portion of maintenance staff overtime was devoted to projects that may not have been capital in nature. Current analysis shows that, as of March 2011, maintenance staff overtime costs for the current fiscal year amounted to less than $500,000. Therefore, it is the School District's position that the cost of analyzing the nature of each of the multitude of projects completed by maintenance staff would outweigh the benefit and there would be no material effect on reported capital asset amounts. The District will continue to monitor the level of maintenance staff overtime to assure there is no change in the present lack of materiality in future periods.

3. Capitalization of Equipment

Summary of Findings and Recommendations:

Not all eligible personal property purchases were tagged and capitalized before year end. Approximately $714,000 of the $1.3 million of capital-eligible expenditures were tagged and included in capital assets as of March 2011.

School District's Response:

The District currently reviews all purchases at year-end in order to have as many personal property items as possible tagged and capitalized. The auditors' findings that only $1.3 million of total fiscal 2010 purchases of $17.1 million were not capitalized at June 30, 2010 and that, of this amount, $714,000 was tagged and included in capital assets as of March 2011, indicates that the District's procedures are adequate and result in capitalization of the material portion of equipment in the year of purchase. In addition, an upgraded personal property inventory system will incorporate features that will further address the issue of timely tagging and capitalization.

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OTHER CONDITIONS

PERSONAL PROPERTY CONTROL DEFICIENCIES

Summary of Findings and Recommendations:

Inadequate safeguarding and recordkeeping over personal property assets exists.

School District's Response:

The District has established procedures designed to safeguard and control its personal property assets. These procedures are provided through the District's website, on both the General Accounting site-map and under the heading "Principals' Procedures Manual." The findings described in the audit report are the result of non-compliance with established procedures. While the District believes that the instances cited do not indicate wide-spread non-compliance, the SDP agrees that continued actions should be taken to address the shortcomings.

To this end, individual findings have been communicated with respective schools and offices, and follow-up will be performed by School Financial Support Specialists (SFSS). In addition, on May 3, 2011 a request was submitted for a posting to the Principals' Bulletin Board informing them that annual personal property inventory listing would be forthcoming and referring them to the posting on February 18, 2011 for helpful tips and required procedures in completing and maintaining the inventory at their locations.

The District will also continue to reinforce the need to adhere with established procedures including:

1) the requirement that all personal property is tagged,
2) the requirement that a form is completed and approved for property taken off site and that the property is returned to the District,
3) the requirement that stolen or missing items are reported timely,
4) the requirement that T31 Forms are completed for all transferred, disposed, missing and obsolete items, and
5) continued emphasis on the need for adherence and accountability to personal property policies and procedures during the next round of Principals and Administrators Financial Training which is anticipated for the summer of 2011.

The District notes that it has implemented system enhancements to improve its Personal Property Inventory system, allowing on-line access to inventories and submission of transfers and deletions electronically. These system enhancements are in test and will be implemented for the 2011/2012 school year.

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INADEQUATE ARTWORK INVENTORY RECORDS AND PROCEDURES

Summary of Findings and Recommendations:

The District should observe artwork located in closed buildings. Also, artwork which has not been located should be removed from inventory.

School District's Response:

The District will step up its efforts to gain access to closed buildings in order to verify items' existence. The District will also identify the locations of artwork noted as "cannot locate" and follow-up through SFSSs. Artwork which personnel at various buildings have not been able to locate will continue to be removed from inventory when established procedures have been properly followed.

STUDENT ACTIVITY FUNDS CONTROL DEFICIENCIES

Summary of Findings and Recommendations:

Principals and School Operations Officers should take steps to comply with School Funds Manual procedures designed to provide controls over $5.2 million in total School District student activity funds.

School District's Response:

In general, the District believes that procedures are in place to adequately control and safeguard student activity funds. Nevertheless, the District acknowledges that action is necessary in order to assure further compliance with policies and procedures for administering its student activity funds that are provided in the School Funds Manual. Along those lines, the District will continue to require quarterly reporting and reconciliations to the central accounting office, post audit findings on the Principals Bulletin Board to reinforce compliance issues, hold Principals and their financial designees accountable for compliance at their schools, conduct desk compliance checks and audits in this area similar to the March 2011 audit issued by the SDP Office of Audit Services.

The SDP's internal audit reported findings similar to those of the City Controller. The findings of both audits have been provided to the assistant superintendents, principals and financial designees, and SFSSs in each relevant Academic Division so that appropriate action, including compliance reviews and staff training, can be taken. In addition, training similar to that provided in August 2010 at the summer symposium held for principals and other administrative and financial support personnel will continue to be held in order to enforce the importance of compliance with provisions of the School Funds Manual.

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PETTY CASH FUNDS CONTROL DEFICIENCIES

Summary of Findings and Recommendations:

Weaknesses and questionable practices were noted which adversely affect the District's ability to properly safeguard and account for petty cash funds. The planned reduction in petty cash balances should be addressed by enforcing the November 2009 directive instructing school principals to draw checks payable to the District for the reduction amount.

School District's Response:

The District does not agree with the findings' conclusion that petty cash funds are not adequately safeguarded but agrees that compliance with controls can be strengthened. To address this, the District will continue to follow its control procedures, including: desk compliance checks and internal audits, review of fund reconciliations during the petty cash reimbursement process, and review of audit findings and control procedures during training sessions.

In its efforts to reduce petty cash balances, the District has, in fact, followed-up on the November 2009 directive instructing principals to draw petty cash checks for reduction amounts and submit them Central Office accounts payable operations. As of March 31, 2011, 221 of 268 school petty cash accounts were either reduced or closed.

FICA TAX WITHHOLDING FOR TERMINATION PAYMENTS (TO BE FINALIZED AFTER HEARING FROM LIZ GUTMAN RE: STATUTE OF LIMITATIONS)

Summary of Findings and Recommendations:

Similar to the previous fiscal year, the audit describes the District's practice of treating employee termination payments deposited directly to a qualified 403(b) retirement plan as employer contributions, not subject to FICA tax. The report states that these deposits should be treated instead as employee compensation that is subject to the FICA tax. Because there may be a point in the future when a material liability for the payment of FICA tax will exist, the auditors have recommended in the past that the District seek a formal Private Letter Ruling (PLR) from the Internal Revenue Service (IRS) as to the legality of this practice. The current report notes that a PLR ruling has been requested and recommends that this matter be disclosed in the footnotes to the District's financial statements.

School District's Response:

As acknowledged again in this year's report, commencing in fiscal year 2006, the District established the School District of Philadelphia 403(b) Plan ("403(b) Plan") to which employees currently may make pre-tax and post-tax contributions and to which the District contributes employee termination payments for employees who sever employment in the calendar year in

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which they attain age 55 or older. The District sought the advice of outside legal counsel with tax law expertise to determine the proper tax treatment for employer contributions of termination payments to the 403(b) Plan. The District relied on this opinion to determine the appropriate tax withholdings for these payments in fiscal years 2006 through 2009. Accordingly, the District respectfully continues to disagree with the auditors that there is a FICA tax liability in connection with the employer contributions of termination pay for employees who sever employment in the calendar year in which they attain age 55 or older to the 403(b) Plan. The auditors have not provided any legal authority that contradicts or undermines the legal opinion on which the District has relied. In an effort to resolve this issue, however, the District has submitted a request to the Internal Revenue Service for a Private Letter Ruling ("PLR") on this issue in June, 2008. Realizing that receipt of a PLR requires an extended period of time, the District will continue to describe this matter in the footnotes to its financial statements.

UNCLAIMED TERMINATION COMPENSATION SHOULD BE ESCHEATED

Summary of Findings and Recommendations:

The School District should complete its analysis of unpaid termination pay and remit unclaimed amounts to the state Treasurer.

School District's Response:

The School District agrees with this recommendation and has taken steps to conduct the necessary analysis of old outstanding termination pay amounts. The analysis includes: conducting normal search procedures for correct addresses in cases where payments have been returned, verifying that payments have not previously been made and records not updated, following-up with individuals over age 55 to determine that 403(b) deferred compensation accounts have been established.

With regard to the last step described, it should be noted that the School District is not free to escheat payments related to former employees who were over the age of 55 at the time of termination. Such amounts are actually 403(b) plan assets. Procedures have been developed and put in place in fiscal year 2011 whereby the School District furnishes 403(b) plan providers with the names of former employees who have not established plan accounts. Providers then assist in completing information necessary to establish accounts. Termination payments are then forwarded to plan accounts. For cases where former employees have not responded to contact efforts, the School District forwards termination payments to accounts established by providers and any unclaimed funds will be escheated to the state after retirement age is reached.

INSUFFICIENT TERMINATION COMPENSATION PROCESSING PROCEDURES

Summary of Findings and Recommendations:

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In order to ensure the accuracy of termination liability records, the School District's Payroll Department spot checks its listing of former employee who have received payment against the ADVANTAGE system to see that those individuals' records have been deleted. This control feature should be included in the District's formal, written procedures for processing termination pay.

School District's Response:

The School District agrees with this recommendation and will take steps to amend its formal procedures to include this control step.

INTEGRITY OF PAYROLL PASSWORDS COMPROMISED

Summary of Findings and Recommendations:

The audit disclosed that at 7 of 70 school locations visited payroll secretaries, rather than principals, approve employees' attendance records and submit payroll for processing. The School District should take action to prevent circumvention of controls designed to provide integrity over the payroll process.

School District's Response:

The District accepts this finding and on May 3, 2010 initiated steps to have the I.D.'s and passwords for the respective individuals rescinded and reissued. Efforts will continue to monitor adherence with control procedures. When appropriate, disciplinary action will be recommended in accordance with collective bargaining agreements.

ENCUMBRANCE POLICY STILL NEEDS CLARIFICATION

Summary of Findings and Recommendations:

While School District management asserted that it is the responsibility of unit managers to notify the Office of Management and Budget of unnecessary encumbrances, its policy document instead indicated that OMB would take steps to cancel any open encumbrances at year-end.

School District's Response:

District management reserves the authority to cancel year-end obligations when appropriate, as described in the SDP's encumbrance policy. The year-end close memo distributed to all unit managers notifies them of their responsibility in the year-end close-out process to review open encumbrances and work with the Office of Management and Budget (OMB) to cancel as appropriate by the dates indicated. The memo also informes managers that

OMB "may" decide to cancel open encumbrances. For fiscal year 2010, the District conducted an enhanced review process for open encumbrances led by General Accounting and OMB and canceled those encumbrances warranting cancelation. The success of this enhanced process is noted in the audit report.

NON-COMPLIANCE WITH STATEMENT OF FINANCIAL INTEREST FILING REQUIREMENTS

Summary of Findings and Recommendations:

137 of 556 employees did not complete required Statement of Financial Interest (SFI) forms. The District should review SFI forms to identify potential conflicts of interest.

School District's Response:

The District partially agrees with this finding. The following procedures have been developed to inform employees of the need to complete SFI forms and ensure their submission:

The Office of Talent & Development sent a letter by U.S. Mail to employees and former employees who may be required to file the forms at the end of January 2011 enclosing a paper copy of the form. The letter advises that the form may be completed and printed on-line at the State Ethics Commission's website. A School District employee in the Office of Talent & Development maintains and updates a database of the names of employees who submit the form and the date submitted. A follow-up letter was sent on or about April 1, 2011 to those on the list who had not yet responded.

Beginning around April 15, 2011, representatives of the Office of Talent & Development and the Office of General Counsel initiated telephone and personal reminders to those who had not yet filed the document. Department heads will be asked to remind their staff members who are required to submit the forms. An attorney in the Office of General Counsel is available by telephone to advise callers regarding the requirements of the law and the forms.

Regarding review of SFI forms, the District continues to believe that review of these documents would not reveal any information related to conflicts of interest.

LACK OF WRITTEN PROCEDURES FOR SCHOOL SECURITY CAMERAS

Summary of Findings and Recommendations:

There are no formal, written procedures for the use of security cameras that have been installed in District schools.

School District's Response:

Recognizing the enormous potential for merging advanced technology with solid and sound practices for school safety, the District is utilizing the Digital Security and Surveillance Initiative. This initiative will ultimately provide all facilities with a full complement of interior and exterior camera systems, digital monitoring and recording equipment. With 5,840 new digital surveillance cameras blanketing 224 school facilities, this technology enabled the District to redeploy 40 police officers to other schools and helped reduce the number of serious incidents by 14% in and around schools. The District has also established a centralized monitoring command center at the Education Center on North Broad Street, providing real-time access to more than 96 school-based surveillance systems. This had proved to be an effective tool for raising the level of safety for our students, staff and school buildings.

In implementing its Digital Security and Surveillance initiative, the District has drafted policies and procedures covering the use of security cameras. Once approved, these policies and procedures formalize matters such as: day-to-day access to taped information, who may review information, retention policies, recording instances when information was accessed and by whom.

DEFICIENT CONTROLS OVER STUDENT DENTAL CARE EXPENDITURES

Summary of Findings and Recommendations:

Controls should be improved by enforcing the use of American Dental Association (ADA) claim forms, requiring verification of services, and entering into formal contracts with service providers.

School District's Response:

As noted in the report, the District made certain changes that improved controls over administration of the Public School Health Fund. Further actions are planned for the 2011-2012 school year including:

- The SDP will issue a Request for Proposals (RFP) for orthodontia services. Orthodontia providers selected under the formal RFP process will then be required to enter into a formal contract with the School District. Providers will understand that as part of their contract, they will be required to submit an invoice on a standard ADA invoice form, which is a universal form used by dental providers when they are requesting payment from private insurance carriers.
- The ADA invoice form submitted to the School District must list the date(s) of service, description of service provided, the amount being billed, and have parental/guardian

signature(s) that will confirm services provided. Signatures on invoices can be compared to those on the original Public School Health Fund applications for authenticity.

- Any provider who does not submit invoices in the format listed above will not receive payment until they are in compliance with the required procedures, or will be responsible for reimbursing the School District for any monies received.

Government Auditing Standards require auditors to report instances where the auditee's comments to the auditor's findings, conclusions, or recommendations are not, in the auditor's opinion, valid or do not address the recommendations. We believe this to be the case with certain statements made in the School District of Philadelphia, Pennsylvania's (District) response regarding the following:

- An alleged change in audit protocol methodology.
- Actions taken by the District to address the food service interfund loan.
- Timeliness of the District's review of fund financial statements.
- Cause of the $6 million error in agency funds' equity in pooled cash and investments.
- Responsibility for determining proper accounting treatment of a $26 million transaction involving the termination of derivative instruments.
- Dissemination of the District's Comprehensive Annual Financial Report (CAFR) preparation manual to accounting staff.
- Financial statement effect of untimely transfers from construction in progress.

Alleged Change in Audit Protocol Methodology

In its response, on page 26, management contends there was a change in the audit protocol methodology for fiscal year 2010 not conveyed to them. The response states that, in contrast to past practice, if the District discussed a preliminary accounting treatment under consideration with the auditors, concluded with the auditors that the matter should be reported differently, and then adjusted the preliminary financial statements before issuance, these matters were now subject to material and significant audit findings.

We disagree with the District's contention that there was a change in audit protocol methodology. As in previous years, we received preliminary financial statements in early October and, from that time through the opinion date of January 28, 2011, the District made numerous changes to those financial statements. We have always accepted these changes to expedite the audit process and permit the District to meet its submission deadline for the Government Finance Officers Association's (GFOA) Certificate of Achievement for Excellence in Financial Reporting Program. However, if we found a financial statement error resulting from a material weakness or a significant deficiency in the District's internal controls, we proposed an audit adjustment and commented on the condition in the Report on Internal Control. If the District booked the adjustment, we acknowledged the correction in the audit report, but still reported the control deficiency that caused the misstatement.

The errors cited in the Financial Reporting Process Weaknesses section of the current report – two of which were material to the affected opinion unit – occurred because the District's controls over the financial reporting process failed to prevent or detect and timely correct the misstatements. While we are willing to accept the District's changes to the financial statements during the course of the audit, these errors were not detected by District personnel and changes were not forthcoming until we proposed audit adjustments. Most of the reported errors were found by us within the three-week period prior to the District's GFOA submission deadline. Given these circumstances, we believe that the deficiencies in the District's financial reporting process met the Statement on Auditing Standards No. 115 criteria for classification as a material weakness.

Actions Taken by the District to Address the Food Service Interfund Loan

In addressing the $15.3 million interfund loan from the general fund to the food service fund in its response, on page 27, management asserts that, upon review of its preliminary financial statements in October 2010, it "saw that further action was required and brought to the attention of the auditors that the food service fund continued to run a deficit." Furthermore, management states that neither was the interfund loan erroneously reported nor was any audit adjustment required to reclassify the loan as an interfund transfer.

The District's chief financial officer failed to discuss any food service related issues with the auditors until the pre-exit conference on March 17, 2011, almost two full months after the conclusion of the audit. The auditors, and not District management, initiated discussion of the food service fund's continuing deficit when we questioned the District's comptroller regarding the validity of the interfund loan. In another meeting on November 30, 2010, District management attempted to demonstrate the food service fund's ability to eventually repay the loan by presenting a five-year projection of food service fund operations. However, since the projection forecasted continued operating losses with a minimal loan repayment achieved solely through general fund contributions, we concluded that the loan was not valid and proposed an audit adjustment to eliminate the loan and report it as an interfund transfer. Only after management expressed its reluctance to book the audit adjustment because of its negative effect on the general fund's financial position, did the District then establish a formal repayment plan.

Timeliness of the District's Review of Fund Financial Statements

In its response, on page 29, District management asserts that multiple revisions to local tax revenue amounts caused delays in the completion of the financial statements and resulted in later than anticipated accounting management review of certain sections of the CAFR. Management also infers that these two conditions resulted in financial statement errors going undetected.

The errors cited in the audit report involved an incorrect entry in one of the District's agency funds and the District's failure to establish a reservation of fund balance in the general fund for the interfund loan discussed above. The financial statement revisions required by changes to the local tax revenue amounts should not have precluded the District from completing its review or detecting these errors on a timely basis, because neither error involved revenue amounts.

In its response, on page 29, the District also stated its belief that completing the GFOA's School District Preparer Checklist two weeks prior to the required CAFR submission is more than sufficient time to allow for any financial statement corrections. Despite this assertion, District management admitted in its response that it had still not completed its financial statement review using the GFOA checklist two weeks prior to the opinion date at which time the auditors informed management of the error involving the fund balance reservation. Due to this admitted contradiction, we stand by our stated position questioning the timeliness of the District's review procedures.

Cause of Error in Agency Funds' Equity in Pooled Cash and Investments

In discussing the cause of the undetected $6 million error in agency funds' equity in pooled cash and investments, management states in its response, on page 30, "It was unknown that the ensuing adjusting entry also affected equity in pooled cash and investments due to an unknown nuance in the accounting system when a particular object code is entered."

We disagree with the District's allegation that an "unknown nuance" in its accounting system caused this error. Our audit work determined the $6 million cash error occurred because District personnel prepared and entered an incorrect journal entry that failed to address the erroneous debit balance in the payroll clearing fund's liabilities. The incorrect entry was reviewed and approved by supervisory personnel who did not detect the error.

Responsibility for Determining Proper Accounting Treatment

With regard to determining the proper accounting treatment in the District-Wide statements for a $26 million transaction associated with the termination of derivative instruments, the District's response on page 30 states the following: "The auditors responded to the District on October 1, 2010 that they were not yet prepared to discuss its resolution and there was no further contact on this issue until January 10, 2011. Because of the delay in resolving this matter, the District decided on December 8, 2010 to temporarily record the transaction as a place holder until the matter could be resolved."

District management is responsible for selecting and applying appropriate accounting principles. The auditors' responsibility is to express an opinion on whether the District's basic financial statements are fairly presented in accordance with generally accepted accounting principles and, as such, the auditors cannot be part of the entity's controls over the financial reporting process or make decisions on accounting treatment. District accountants never communicated to us that their accounting entry for the $26 million transaction was a temporary "place holder" pending resolution. As stated on page 4 of our report, the accounting entry was marked as having been reviewed, as evidenced by the initials of the manager responsible for review. The District's alleged "place holder" entry remained unchanged until we informed the District of the error on January 10, 2011 – only three weeks before the District was required to submit its CAFR to the GFOA's Certificate of Achievement for Excellence in Financial Reporting Program.

Dissemination of the District's CAFR Preparation Manual to Accounting Staff

In its response on page 31, management states that "the audit report's characterization of the School District's CAFR preparation manual is not accurate." The District asserts that this manual was fully disseminated to all accounting personnel well before the start of the fiscal year 2010 closing process.

We stand by our statement that the CAFR preparation manual was not disseminated to accounting staff. We requested a copy of the manual from various top accounting management – the comptroller, the assistant accounting director, and an accounting manager – none of whom were able to provide the manual to us. The comptroller stated that another accounting manager, who was on vacation at the time, would provide us with the manual upon his return. We eventually obtained a copy of the manual from this accounting manager.

Financial Statement Effect of Untimely Transfers from Construction in Progress

In discussing the financial statement effect of the untimely construction in progress (CIP) transfers in its response, on page 32, the District stated that the audit report only cited one case where the untimely CIP transfer was delayed by more than one year. The District, therefore, concluded that the accumulated depreciation balance would only be misstated by one year of depreciation expense. Consequently, management did not believe its current practice could result in a material misstatement of the financial statements.

The one instance of an untimely CIP transfer that was delayed by more than one year was detected through testing a sample of eighteen fiscal year 2010 CIP transfers rather than a 100 percent review of all CIP transfers. The District's current practice of transferring costs out of CIP upon final payment instead of project completion will result in additional untimely transfers and understatements of accumulated depreciation every year. Each year's understatement of accumulated depreciation will carry forward until the assets are fully depreciated many years later. The cumulative effect of multiple years' understatements could eventually result in a material misstatement of accumulated depreciation.