CITY OF PHILADELPHIA
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REPORT ON INTERNAL CONTROL AND ON COMPLIANCE AND OTHER MATTERS

SCHOOL DISTRICT OF PHILADELPHIA

FISCAL 2011

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

June 29, 2012

Pedro A. Ramos, Esq., Chairman
and Members of the School Reform Commission
440 N. Broad Street
Philadelphia, PA 19130

Dear Chairman Ramos 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, 2011, and has issued its Independent Auditor's Report dated February 10, 2012.

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 February 10, 2012 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: Thomas E. Knudsen, Chief Recovery Officer and
Acting Superintendent
Marcy F. Blender, Deputy Chief Financial Officer

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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 (School District), a component unit of the City of Philadelphia, Pennsylvania, as of and for the year ended June 30, 2011, which collectively comprise the School District's basic financial statements and have issued our report thereon dated February 10, 2012. Our report was modified to include explanatory paragraphs regarding certain conditions which raise substantial doubt about the School District's ability to continue as a going concern and 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

Management of the School District is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the School District'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's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the School District's internal control over financial reporting.

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.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above. However, we identified the following deficiencies in internal control over financial reporting, described in the accompanying report, that we consider to be significant deficiencies in internal control over financial reporting:

- The District processed its bi-weekly payroll regardless of whether administrators had approved their units' online payroll entries as required by established procedures.

- Capital asset accounting procedures did not always ensure that (1) completed projects were transferred out of construction in progress on a timely basis and (2) all eligible capital projects fund costs were recorded as capital assets in the year of acquisition.

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.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the School District'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 also 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.

The School District's written response to the significant deficiencies and other conditions identified in our audit is included as part of the accompanying report. We did not audit the School District's response and, accordingly, we express no opinion on it. We have also included our comments to the School District'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, the School Reform Commission, and others within the entity, and is not intended to be and should not be used by anyone other than these specified parties.

Gerald V. Micciulla

February 10, 2012

GERALD V. MICCIULLA, CPA
Deputy City Controller

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DISTRICT PROCESSED PAYROLL WITHOUT ENSURING PROPER APPROVALS

Our review of the School District of Philadelphia's (District's) controls over its $1.3 billion payroll disclosed a weakness in its payroll processing procedures that increased the risk of undetected errors and fraud. Specifically, our audit revealed that the District processed its bi-weekly payroll regardless of whether administrators had approved their units' online payroll entries as required by established procedures. District management asserted this practice was necessary because of payroll processing time constraints, staffing shortages, and system limitations. However, the District had not implemented any monitoring procedures to identify those administrators failing to approve payroll and take appropriate action to ensure compliance. As a result, we found that payroll was not being approved for a significant number of District employees each pay period.

Payroll Was Processed Regardless of Whether Approved by Unit Administrators

The District's established payroll authorization process required unit administrators to review online payroll entries to verify their completeness, accuracy, and agreement with employee sign-in records. Upon completion of this review, unit administrators were directed to apply their online approval. This control provides oversight over payroll entries to minimize undetected errors and fraud in employees' pay and leave balances and promotes accountability for recorded payroll transactions. However, our audit disclosed that, prior to processing the payroll, the District's Payroll Department did not follow up with unit administrators who had failed to approve payroll. Instead, the District's computerized payroll system automatically approved the payroll entries for those units with no administrator approval. The District's practice of processing the bi-weekly payroll without ensuring that all responsible administrators approved their units' payroll entries circumvented the established payroll authorization process.

District Asserted This Practice Was Necessary

According to our discussions with District management, time constraints with the District's payroll processing schedule and Payroll Department staffing limitations precluded follow-up with non-complying administrators prior to the processing of payroll. The District closes its payroll on the last day of the pay period (Friday), with units having until the close of business on that day to enter and approve payroll entries. Payroll processing begins shortly thereafter on the same evening to allow sufficient time for pre-audit of the payroll file, bank processing, check printing, and direct depositing or mailing of paychecks so employees receive their wages when due on the next Friday. District management stated the current payroll schedule was established to meet legal requirements which dictate the timely payment of wages.[1] District management asserted that, given this compressed timeline, the large volume of District pay locations (over 300 locations), and Payroll Department staffing shortages (currently only nine employees), it was not feasible to track down non-complying administrators prior to closing payroll.

[1] Applicable legal requirements which dictate the timely payment of wages include the District's collective bargaining agreements with labor unions and the Public School Code of 1949 (Pennsylvania Consolidated Statutes, Title 24, Section 11-1155).

District management informed us that the computerized payroll system's automatic approval feature prevented certain payroll processing problems. If the automatic approval feature was not in place, the system was designed to purge all payroll entries for units with no administrator approval so these entries would not be included in employee paychecks and leave balances. For full-time employees, the District's payroll system assumed employees were present and paid them for all scheduled workdays unless an absence was entered. Therefore, the automatic approval feature allowed absence entries to be reflected in employees' pay and leave balances to reduce instances of overpayments and inaccurate leave balances. While the system had the ability to capture purged payroll entries, staff would have to manually re-enter the absence data into the system, which District management deemed not practical given limited staffing resources.

In addition, there was a smaller group of employees (largely substitute teachers) who were only paid if their attendance information was entered into the system. If the attendance data was purged for this group of employees, then the Payroll Department would have to manually produce paychecks for these employees, which District management stated was not feasible due to staffing shortages and legal requirements for paying wages when due.

District's Lack of Monitoring Resulted in a Significant Level of Unapproved Payrolls

While District management asserted the above practice was necessary, we inquired as to whether the District had instituted monitoring procedures to identify any systemic payroll approval problems and take necessary corrective action. Our review found that the District's payroll system generated a report for each pay period which listed by location all employees whose payroll entries were not approved. However, District Payroll Department management informed us that no one reviewed this report to identify the locations where there had been repeated instances of failure to approve payroll. Also, since the report was sorted by location and did not list responsible unit administrators, it did not appear to be properly designed to facilitate follow-up with non-complying administrators.

The District's lack of monitoring resulted in a significant number of employees whose payroll was not approved. Our analysis of the unapproved payroll reports for fiscal year 2011 revealed that, on average for each pay period, unit administrators did not approve payroll for approximately 4,200 (18 percent) of 24,000 District employees. Pay period totals for the number of employees whose payroll was not approved ranged from a low of 2,132 employees to a high of 8,907 employees in fiscal year 2011.

As part of our testing of selected payroll transactions, we obtained employee sign-in attendance records and determined whether they were approved by unit administrators. We also verified whether payroll data entry agreed with sign-in attendance records. While our testing found no material errors, we believe this weakness increased the risk for undetected errors and fraud in employees' pay and leave balances.

Recommendations:

To improve payroll controls and reduce the risk of undetected errors and fraud, we recommend that District management institute procedures to identify those unit administrators who repeatedly fail to approve payroll and take appropriate action to ensure compliance with the established payroll authorization process. Because the unapproved payroll report did not list the responsible unit administrators, the District should consider developing a report which identifies the non-complying administrators to facilitate follow-up with those individuals. The District should also assess its current payroll approval structure to determine whether changes are necessary to reduce occurrences where payroll is not approved [600111.01].

CAPITAL ASSET ACCOUNTING DEFICIENCIES

Our audit continued to note deficiencies in the District's capital asset accounting system that misstated reported capital asset and related depreciation amounts. Specifically, our testing disclosed that the District's capital asset accounting procedures still did not always ensure that (1) completed capital project costs were properly transferred out of construction in progress (CIP) and into the respective long-term asset account; and (2) all eligible capital project fund costs that should be capitalized were recorded in the year of acquisition. These deficiencies are discussed in more detail below.

Completed Project Costs Improperly Remained in the CIP Account

Previously, we reported on a deficiency in the District's policy for transferring improvement costs from its CIP account where transfers were made upon final payment on a project's contract rather than when the project was completed and ready for use. Consequently, our prior audit testing noted numerous instances of CIP transfers that should more appropriately have been transferred out of CIP and depreciated in a prior fiscal year.

Our current audit noted the District had taken certain corrective actions. The District changed its criteria for transferring improvement costs out of CIP from final payment date to project completion date. The District's fixed asset accountant obtained project completion date information from the District's Office of Capital Programs and used this data to analyze the accumulated costs in the CIP account to identify completed projects for transfer. Consequently, transfers out of CIP increased from $168 million in fiscal year 2010 to $233 million in fiscal year 2011. Therefore, the condition regarding the District's policy for transferring improvement costs out of CIP is considered resolved [600110.06].

Despite the improvement noted, our testing of selected projects from the CIP account still found several instances of completed project costs totaling $69.5 million that improperly remained in CIP.[2] This condition was principally caused by the following factors:

- The District's fixed asset accountant asserted that $36.4 million in costs for a new elementary school which opened in September 2010 was missed during his review of the CIP file for completed projects due to a computer program error in sorting projects by location number. A review procedure analyzing the CIP account for projects with high dollar cost amounts should have identified this asset, which is how our audit testing caught this item.

[2] Once we brought these errors to management's attention, they booked an adjustment to transfer out of CIP $36.4 million of costs related to the new elementary school.

- With regard to $11 million in payments to outside project managers, mostly incurred during fiscal years 2006 through 2008, District accounting personnel informed us the consultants' invoices did not identify the specific capital projects for these charges. Starting in fiscal year 2010, the District developed an allocation methodology to distribute outside project manager costs across applicable capital projects. However, District accounting personnel had not made an adjustment to transfer the prior year outside project manager costs out of CIP. District accounting management informed us they were aware that the prior year outside project manager costs were still in CIP, but the preparation of the adjustment to transfer those costs out of CIP had been deferred because of limited staffing resources.

- For approximately $11 million in communication system upgrade costs from fiscal years 2005 through 2007 that remained in CIP, the fixed asset accountant asserted that thousands of invoices would have to be reviewed to identify the related assets over which to distribute these costs. Limited staffing resources had delayed this extensive research.

As a result of the above uncorrected errors, current year depreciation expense and accumulated depreciation were understated by $1.2 million and $4.3 million, respectively.

Recommendations:

To ensure that costs related to significant completed projects are transferred to long-term capital assets and depreciated on a timely basis, we recommend that District accounting personnel include, as part of their procedures for identifying completed capital projects, a review for projects with high dollar cost amounts [600111.02].

With regard to the prior year outside project manager and communication system upgrade costs still remaining in CIP, given their immateriality in relation to the total net book value of District capital assets (approximately $2 billion), we recommend that the District allocate these costs across existing assets. The District should book this allocation as a prior period adjustment to beginning net assets in its fiscal year 2012 financial statements [600111.03].

Eligible Costs Were Not Always Capitalized

The District's capital asset accounting system did not always ensure that all eligible capital project fund costs were capitalized in the year of acquisition, as required by generally accepted accounting principles. As a result, capital assets were understated, and current year expenses were overstated.

Our audit found $10.3 million of fiscal year 2011 capital costs improperly expensed by the District, detailed as follows:

- Real property costs totaling $7 million were not capitalized primarily because the related assets could not be identified. The vast majority of these costs related to a surveillance system installation project involving various schools. Since this project's purchase order was set up in the District's accounting system under the location code for the unit overseeing the project instead of being broken out by individual school, a cost breakout by asset location was not readily available. The District's fixed asset accountant informed us that, despite repeated requests, the responsible unit did not provide a distribution of the costs by asset location.

- Personal property expenditures of $3.3 million were expensed because they were not tagged with an identification label. It is the District's practice to not capitalize equipment until tagged. As of February 2012, $1.4 million of this equipment was subsequently tagged and inappropriately capitalized in fiscal year 2012 instead of fiscal year 2011. District accounting personnel attributed some of the tagging delays to the extra research required when purchase orders did not contain sufficiently detailed descriptions of the equipment purchased and breakdowns of the individual components of bulk equipment orders. Our discussion with management from the District's Office of Procurement Services indicated the problem with insufficiently detailed purchase orders occurred because the District had not established a formal directive for requesting units to follow when entering purchase requisition details into the District's accounting system.

<u>Recommendations:</u>

To ensure District accounting personnel have all necessary information to enable them to report capital assets in the year of acquisition, we recommend District management establish a directive requiring that purchase orders for capital projects involving multiple asset locations be broken out by individual location. If not feasible in certain cases, the directive should then instruct responsible personnel to promptly forward a distribution of project costs by asset location to District accounting personnel [600111.04].

To reduce delays in tagging and capitalization of equipment, we recommend District management establish guidelines for requesting units to follow when entering purchase requisitions into the District's accounting system. These guidelines should include instructions on providing detailed equipment descriptions and breakdowns of the individual components of bulk equipment orders. Once implemented, the District's Office of Procurement Services should monitor the requesting units' compliance with the guidelines [600111.05].

District management asserted that the extra effort to include the balance of untagged equipment in reported capital asset amounts was not warranted 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].

DEFICIENCIES IN CONTROL OF SCHOOL FURNITURE AND EQUIPMENT

The District maintains a furniture and equipment inventory with an original cost of $294.5 million. Our prior year testing disclosed that safeguarding and recordkeeping over these assets were inadequate. Numerous items selected from the District's inventory listing of furniture and equipment could not be observed, and items observed at schools could not be found on the listing.

The current year audit found that these inadequate conditions remained uncorrected. Audit testing disclosed 56 of 100 (56 percent) items haphazardly chosen from the District's furniture and equipment listings for ten selected schools could not be observed. These items, which cost $107,135, included computers, printers, various audio visual devices, medical equipment, and musical instruments. Also, 11 of 100 (11 percent) tagged items – consisting of computers, office furniture, a video camera, and a printer – haphazardly selected from observations at the same ten schools could not be found on the inventory listings for the schools where we observed them.

Our audit disclosed the following deficiencies which contributed to our inability to observe sampled assets and find selected furniture and equipment on the District's inventory listings:

- For certain schools which relocated to newly constructed facilities, District personnel did not maintain adequate records to document what happened to equipment or furniture not moved to a new facility;
- District personnel frequently failed to ensure that identification tags were regularly affixed to equipment and furniture;
- Schools did not always prepare the required documentation for dispositions of equipment and furniture; and
- Certain schools failed to submit complete and accurate physical inventory reports for the furniture and equipment located at their facilities.

Each of these deficiencies is discussed in more detail below.

<u>Certain Schools Did Not Maintain Adequate Records to Document Dispositions of Furniture and Equipment During Relocation to New Facilities</u>

Two of the ten selected schools were high schools that had moved to newly constructed facilities in September 2009. We were unable to observe 19 of 20 items chosen from the District's furniture and equipment listings for these two high schools. Our inability to observe these assets appeared to result from District personnel's failure to maintain adequate records documenting the disposition of items from the former facility which had not been moved to the new building.

At one school, whose former building was now occupied by an elementary school, its staff asserted the equipment we could not locate had been left at the old building, transferred to other schools, or scrapped. However, school officials were unable to supply us with any documentation to support the disposition of the items in question.

The other high school's personnel asserted their belief that equipment and furniture from the former facility not moved to the new building had been transferred to other schools, scrapped, or demolished with the former facility. However, they were unable to provide any documentation to support this statement. We also made inquiries of the school facilities planner and a distribution manager from the District's Facilities and Operations Department who were responsible for coordinating and overseeing the school's relocation. Neither of these individuals had maintained any records documenting what equipment was not moved to the new building and what happened to those items. Additionally, the distribution manager informed us the District stored surplus equipment, including items from school relocations, at two closed school buildings. However, personnel in charge of overseeing the inventory at the two sites did not keep records listing the specific property identification tag numbers of equipment received by and transferred out of these locations.

The District's Office of General Accounting (General Accounting) supplied us with documents indicating that a District vendor who provided disposal services picked up various computer equipment from the high school's former building during its last month of occupation. While the established disposal procedure for technological equipment required schools to submit a T-31 form (the form required to document all equipment dispositions) for disposed computer equipment, neither General Accounting nor school staff was able to furnish the T-31 form listing the specific computer equipment picked up for disposal. In addition, General Accounting provided us with furniture transfer forms showing quantities of various furniture items transferred from the high school to other schools during the former building's last month of occupation. However, a listing detailing the specific identification tag numbers for the transferred furniture was not available.

The school support finance specialist assigned to this high school informed us that, several months after the relocation in an attempt to clean up its furniture and equipment listing, school personnel performed a physical observation of equipment in the new building to determine which items on the listing could not be located. For items not located, school personnel prepared and submitted a T-31 form to General Accounting. Our review of this T-31 form, which requested the deletion of 416 items costing over $536,000, found the school's principal did not sign the form as required. Among the requested deletions were five of the selected equipment items we were unable to observe. We noted that District accountants removed these five items from the school's furniture and equipment list in May 2011, subsequent to when accounting personnel had furnished us with the listings we used for our testing.

District Personnel Frequently Failed to Ensure Furniture and Equipment Were Tagged

District Policy 750.0, which establishes procedures over equipment security, requires that all District-owned equipment be properly identified by affixing a standard property identification tag to it. For 10 of the 56 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 identification tags affixed to them. Additionally, at one high school we visited in June 2011, we observed a bag containing 324 property identification tags which were not affixed to any equipment. Our audit testing revealed these tags pertained to various office furniture costing $220,000 that had been purchased in fiscal year 2010 for the high school's newly constructed facility, which opened in September 2009.

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 to General Accounting to report all changes to the furniture and equipment inventory assigned to the location, including transfers, disposals, trade-ins, and thefts. However, school officials did not always submit the required documentation for dispositions. For example, with regard to a television system we could not observe, a school official informed us it had been disposed of several years ago. Since the school never submitted the required T-31 form to General Accounting, the television system was not removed from the District's furniture and equipment listing.

Not submitting the required T-31 forms also contributed to our inability to trace several items selected from observations to the District's furniture and equipment listing for the schools where we had observed the items. In one case, the item – a computer – was eventually located on the listing under a different school location. For six items selected from observations at three schools, General Accounting informed us that there was no record for the items in the District's computerized database of furniture and equipment. School personnel had failed to report the existence of these items to General Accounting through the submission of a T-31 form.

Additionally, we continued to note that school officials did not always prepare and submit the required documentation when removing computers from 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. At one school, its operations officer informed us that a laptop computer we could not observe had been assigned to her and removed from the school premises. However, the required documentation was not available for our inspection at the time of our testing.

Certain Schools Did Not Always Submit Complete and Accurate Physical Inventory Reports

School principals are directed to perform a yearly inventory of furniture and equipment physically located at their facilities. To document the performance of this inventory, principals are required to submit a physical inventory report, which should be signed by the principal. For the ten schools where we conducted audit testing, four schools did not submit their physical inventory reports for fiscal year 2011. One of these schools had not submitted a physical inventory report since fiscal year 2008. Also, the principals for two of the six schools that submitted physical inventory reports did not sign the reports.

Additionally, when performing physical inventories of furniture and equipment, 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 42 of 1,918 items listed in its inventory report, and another school recorded no disposition for 10 of 657 listed items.

Also, findings from our test of tagged furniture and equipment items chosen from observations at the ten selected schools suggested that schools did not always exercise appropriate care when conducting the physical inventory and accounting for equipment. For example, we could not find on school furniture and equipment listings four items we physically observed because District accountants had previously deleted the equipment from the listings based upon either physical inventory paperwork or T-31 forms submitted by the schools in prior fiscal years. Carefully conducted physical inventories of equipment located at the schools should have detected and reported these items in order for the District's furniture and equipment records to be updated to reflect their existence.

During January and February 2012, General Accounting removed from the District's furniture and equipment listing 9 of the 56 equipment items we were unable to physically observe. The basis for seven of these nine asset removals was requested deletions submitted by schools as part of the year-end physical inventory; however, General Accounting was unable to locate the documents supporting the remaining two deletions.

Recommendations:

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

Management should send principals a directive (1) requiring them to contact General Accounting to request identification tags for untagged equipment; (2) instructing them to immediately affix identification tags to all equipment once received; (3) reminding them to promptly submit the required documentation to report changes in inventory; (4) advising them of the requirements of District Policy 750.1 regarding the removal of computers from school premises; and (5) emphasizing the need to comply with established District furniture and equipment procedures for submitting a complete and accurate yearly physical inventory report [600108.01].

In order to properly account for equipment dispositions during school relocations, we recommend the District establish procedures requiring school personnel and other District staff conducting the relocation to maintain records of the furniture and equipment which is not moved to the school's new facility. These records should list the items by identification tag number and indicate the final disposition of the items, whether scrapped or transferred to another school [600111.06].

With regard to the sites where surplus equipment is stored, we recommend management require District personnel in charge of this inventory to maintain records identifying, by identification tag number, equipment on hand, items received, and property transferred to other locations [600111.07].

WEAKNESSES IN CONTROLS OVER STUDENT TRANSPASS ACTIVITY

Starting in fiscal year 2008, the District began its student TransPass program, which provided free transportation to Philadelphia public and non-public students by issuing weekly student TransPasses to students living 1.5 or more miles from school, special education students, students participating in desegregation programs and living one mile or more from assigned schools, and students who must cross hazardous roads on their commute.[3] From May through July 2008, we conducted a special audit of the District's control procedures for the TransPass program at 15 high schools. This prior review found the District had not established comprehensive policies and procedures for TransPass activity, which resulted in a lack of controls over the distribution and accounting for student TransPasses at individual schools. During the current audit, we performed a limited review of TransPass procedures at four high schools and found that problems continued in this area. As a result, student TransPasses, which cost $33.1 million in fiscal year 2011, were at an increased risk for theft and abuse.

The current audit disclosed that the District has established formal, written procedures addressing distribution and accounting for TransPasses.[4] Schools receive a delivery of the entire month's TransPasses from the District's Transportation Services Department. Established procedures required that school personnel obtain the list of students eligible for free TransPasses from the school computer network and use this eligibility list for weekly distributions of TransPasses. When giving out each week's TransPasses to students, school employees were directed to observe student identification cards and check off each name on the eligibility list as students were given their TransPasses. As verification that those students whose names were checked off actually received student TransPasses, school employees were instructed to sign and date the bottom of the eligibility list. At the end of each month, school personnel were required to prepare a Summary of Free Student TransPasses report, which summarized the number of TransPasses received, distributed, and returned for the month. Both the preparer and school principal were required to sign and date the Summary of Free Student TransPasses report.

Our review of the actual TransPass practices at four selected high schools revealed non-compliance with established procedures for TransPass activity. At all four schools, our testing noted the vast majority of TransPass distribution listings were not signed by the employees who gave out the passes to attest that all students whose name was checked off actually received passes. Also, we observed one school's Summary of Free Student TransPasses report was not signed and dated by the principal. Furthermore, at two of the four schools we visited, personnel who prepared the monthly Summary of Free Student TransPasses report informed us that the reported number of TransPasses distributed was derived by calculating the difference between the number received and the count of TransPasses to be returned instead of determining the amount of TransPasses actually given out by reviewing the distribution listings.

For the four schools visited, we reviewed TransPass activity for one selected week and compared the reported number of TransPasses distributed with our count of the actual number of TransPasses given out based on distribution listings provided by school personnel.[5] Table 1 on the next page

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[3] The District purchases student TransPasses from the Southeastern Pennsylvania Transportation Authority (SEPTA).

[4] The District's Transportation Services Policy and Procedure Manual includes guidelines addressing the distribution and accounting for student TransPasses.

[5] We selected the week of April 11, 2011 through April 15, 2011 for testing, except for school #1 where we reviewed records for the week of December 13, 2010 through December 17, 2010, which were the most recent available. The source of the reported number of TransPasses distributed was the monthly Summary of Free Student TransPasses report on file at the school. The actual number of TransPasses distributed represented the auditor's count of checkmarks and/or student initials or signatures appearing on the distribution listings provided by school personnel.

presents the results of our comparison. In total for all four schools, we could not account for 575 TransPasses, which were estimated to cost $9,545.[6] While officials at the four schools asserted that employees giving out TransPasses were required to document distribution by either checking off names on the eligibility lists or having students initial or sign the lists, this requirement did not appear to be followed on a consistent basis. As a result, we could not determine whether the unaccounted TransPasses were a result of improper recordkeeping or irregularities.

Table 1: Comparison of Reported Number of TransPasses Distributed to Auditor's Count of Actual Number of TransPasses Distributed (For One Selected Week)

School	Reported Number of TransPasses Distributed	Auditor's Count of Actual Number of TransPasses Distributed	Number of TransPasses Unaccounted
#1	1,072	593	479
#2	1,349	1,296	53
#3	309	271	38
#4	2,214	2,209	5
Total	4,944	4,369	575

Recommendations:

To improve internal controls over TransPass activity and reduce the risk of theft and irregularities, we recommend that the District monitor and enforce policies and procedures relating to the distribution and accounting for student TransPasses [600111.08].

To provide greater accountability over TransPasses, school personnel responsible for preparing the monthly Summary of Free Student TransPasses report should be instructed to determine the number of TransPasses actually given out by reviewing the distribution listings, rather than deriving that number as the difference between the number received and those to be returned. Any unaccounted passes detected from this review should immediately be brought to the attention of the principal and investigated promptly [600111.09].

STUDENT ACTIVITY FUNDS CONTROL DEFICIENCIES

Previously, we reported upon control deficiencies noted during our review of student activity funds at selected high schools. Although the District had developed a comprehensive School Fund 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 four high schools. In addition, for the 20 schools with the largest reported cash balances, we examined the

[6] The estimated cost figure of $9,545 was calculated by multiplying the price of a five-day student TransPass by the number of unaccounted passes. According to the District's Transportation Services Department, the price of a five-day student TransPass in fiscal year 2011 was $16.60.

fiscal year-end student activity funds financial reports on file in the District's Office of General Accounting. Our testing continued to note non-compliance with the Manual and deficiencies in controls over student activity funds, which totaled $5.5 million for all schools at May 31, 2011. Specifically, we found (1) inadequate controls over a school store's cash collections; (2) non-compliance with bidding requirements; (3) failure to establish finance committees; (4) budgets not being prepared by activity sponsors; (5) activities with negative account balances; (6) improper retention of school related funds; (7) failure to close inactive account balances; and (8) long outstanding reconciling items being carried on bank reconciliations. Each of these deficiencies, which are discussed below, increases the risk for fraud to occur at the schools and not be timely detected.

Controls Over One School Store's Cash Collections Were Inadequate

At one of the high schools we visited, we found inadequate controls over its store's cash collections which, according to deposit records, totaled $34,420 in fiscal year 2011. School personnel were unable to provide the 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 was unable to provide the required year-end store financial statements (form H-217). Also, while the Manual requires that store funds be kept in the school safe at night and on weekends, the store manager informed us that he left cash overnight in the register drawer although he asserted both the register drawer and the door to the school store were locked. Lastly, although the Manual directs that cash collections be remitted daily to the school operations officer for deposit, we were told by the store manager that he usually only remitted collections weekly. We believe these conditions created opportunities for the misappropriation of cash.

Non-Compliance With Bidding Requirements

One high school did not adhere to the Manual's bidding requirements, which direct school officials to obtain at least three competitive bids for any purchase exceeding $4,000 as well as all yearbook and photography contracts. When this high school awarded its yearbook contract, it solicited only one bid with an estimated price of $36,986. A school official informed us that only one bid was obtained because the activity sponsor was satisfied with the vendor's past performance. However, soliciting only one bid provides no assurance that the services are being obtained at a competitive price and gives the appearance that the selection process may have been intentionally biased to favor one vendor over others.

Schools Did Not Establish Finance Committees

Student activity fund balances at the four high schools visited totaled $1,171,848 at May 31, 2011. 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, three of the four high schools visited had not established a finance committee. School officials at the fourth high school asserted that there was a finance committee, but minutes were not prepared to document these meetings.

Activity Budgets Were Not Prepared

Budgets that disclosed anticipated income and expenditures were not established for student activity funds at two of the four high schools visited. School officials at the other two high schools informed us that budgets were not being prepared on a consistent basis for all activities. According to the Manual, budgets should be constructed as a fiscal management tool for each activity by sponsors, working with student representatives and principals.

Negative Activity Account Balances Improperly Created

Our review of the fiscal year-end financial reports indicated 12 of 20 schools reported negative balances for at least one activity. This negative equity ranged from ($18) to ($16,549) and totaled ($44,207). The existence of negative balances for individual activities means that expenditures were made even though there were insufficient funds to cover expenses. This is not permitted under Manual guidance.

School-Related Funds Were Improperly Retained

School-related funds represent amounts received by schools such as fees for transcripts, lost books, and identification card replacements. Schools deposit these funds in their student activity accounts and are required to establish separate ledgers to segregate them and facilitate their accounting. The Manual directs that schools remit these fees to the School District, who will credit the funds to each school's operating budget. Our review of the year-end student activity funds financial reports disclosed that, as of May 31, 2011, 16 of 20 schools had not forwarded to the School District $75,726 in fees related to transcripts, lost books, and identification card replacements.

Inactive Account Balances Were Not Closed

Based upon our examination of the year-end financial reports, we noted 19 of 20 schools had 248 accounts totaling $163,396 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 is 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, our review of bank reconciliations submitted with the year-end financial reports disclosed 12 of 20 schools listed checks that had been outstanding for long periods of time (some over twelve years old). In total for all 12 schools, we found 205 checks totaling $18,756 which had been outstanding for over one year. Additionally, our audit revealed that bank reconciliations for three schools listed several deposits in transit totaling $9,684 which had been outstanding more than one year. In one case, a $2,011 deposit in transit, which was cited in last year's audit report, had been outstanding since July 2001.

Failure to properly resolve long outstanding checks and deposits in transit unnecessarily complicates the bank reconciliation process, provides opportunities for irregularities, and represents an instance of non-compliance with the state's escheat laws.[7]

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. District management should reinforce the importance of compliance with Manual guidance at the annual training session for principals [600108.03].

Additionally, we again recommend that principals establish controls over collections for any activity that generates cash sales during the year. Activity sponsors should control cash collections 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. Also, activity sponsors should remit collections on a daily basis to the school operations officer for deposit and store cash register change funds or unremitted collections in the school's safe both overnight and on weekends [600110.09].

PETTY CASH FUNDS CONTROL DEFICIENCIES

In our last several audits, we reported numerous control weaknesses and instances of non-compliance with established control procedures involving operations of the District's petty cash funds. Our current year audit disclosed 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 $586,000 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 individual fund balances equaled the revised lower amounts. This practice was ineffective in achieving the desired petty cash reductions because of the large number of funds with low turnover. In November 2009, District management issued a directive instructing principals at schools with petty cash funds higher than desired to draw and submit checks to the Accounts Payable Unit in the amount needed to reduce the authorized balances. Despite management's efforts, as of March 2012 there were still 51 District locations where the petty cash account balance exceeded the desired authorized amount by a total of $70,710.

- For one school location visited, we found there was no evidence of principal approval on the Reimbursement Request / Fund Reconciliation form. Our review of this particular reimbursement request disclosed instances of non-compliance with the District's petty

[7] 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.

cash expenditure policy. The reimbursement request included $389 in expenditures for internet services, which District policy does not allow to be paid out of petty cash. In addition, we noted a purchase that exceeded the $200 transaction limit.[8]

- Although not material, cash overages and shortages were noted at three of five schools visited. These cash overages and shortages ranged from $62 to ($63).

- At all five 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 $275 of long outstanding checks dating back to fiscal years 2004 through 2008. These checks were still carried as reconciling items on the bank account reconciliation.

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

- Three of the five schools visited used their petty cash accounts very infrequently. For example, at one school with a $5,000 fund, there was only one $87 purchase made during the entire fiscal year 2011. At another school, whose petty cash balance was also $5,000, there were only four disbursements totaling $302 during fiscal year 2011.

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 funds by paying those monies directly over to the District via a check drawn on the fund's bank account. Additionally, the District should review the funds for infrequent activity and reduce the authorized amounts accordingly.

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].

INADEQUATE ARTWORK INVENTORY RECORDS AND PROCEDURES

In fiscal year 2008, the District completed a comprehensive inventory of its artwork collection (valued at $8.1 million as of June 30, 2011), which included $242,350 worth of items listed as "Not Observed" because they were located in closed school buildings, and $250,950 worth of items that the District listed as "Can Not Locate." Corrective actions taken to date have not been effective in determining the existence, condition, or actual value of the items in these two classifications.

[8] We noted that the District's Accounts Payable Unit disallowed the $389 of expenditures for internet services but chose to reimburse the purchase that exceeded the $200 transaction limit.

During our current year audit, we were informed that the District had still not observed the artwork in the closed school buildings. In previous fiscal years, the only action taken by the District with regard to these items was the removal from inventory of one item valued at $3,500. The removal of this item was based upon paperwork submitted by personnel from a charter school that occupied the building where District records listed the item as being located. In January 2012, District accounting personnel deleted seven murals, each valued at $30,000 for a total of $210,000, from the "Not Observed" category. These items were removed on the basis of accounting personnel's discussion with the facilities manager for the charter school now residing in the building where District records indicated the murals were. District accountants asserted that, according to their discussion with the facilities manager, the murals were painted over during renovation of the building's auditorium. However, they were unable to provide any written documentation to support these asset deletions.

During fiscal years 2009 and 2010, 26 "Can Not Locate" items valued at $76,800 were removed from the artwork inventory based solely upon paperwork received from the school locations. In the current fiscal year, no further action was taken with respect to the "Can Not Locate" artwork items.

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. We were unable to locate seven of the selected items. Four of these seven items were previously identified as "Can Not Locate" on the District artwork records while the other three items could not be found.

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 the principals at the school locations. As a result, the District's reported artwork inventory continued to include $28,850 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.

- Reinforce to principals the importance of completing the proper paperwork authorizing the removal of "Can Not Locate" items from the inventory [60106.01].

FINANCIAL STATEMENT REVIEW PROCEDURES STILL NEED ENHANCING

Previously, we reported on weaknesses in the District's financial statement review procedures. Specifically, our prior audit noted there was no documented review of the proprietary and agency funds financial statements and District accounting management did not always complete their review in a timely manner. Our current audit revealed improvement in the District's financial statement review process; however, we found that the review procedures still did not always detect errors.

District accounting management established a formal, written review process for its fiscal year 2011 Comprehensive Annual Financial Report (CAFR). First, either an accounting manager or senior accountant was assigned responsibility for preparing a fund's financial statements. In addition, an independent accounting manager was then designated as the reviewer of those statements. To document this check, the District developed a management review sign-off form which listed suggested procedures for the manager to perform, such as comparing reported amounts to the trial balance and examining significant and unusual journal entries as well as year-end transactions. Upon completion of the review, the accounting manager signed and dated the form. Our observation of the management review sign-off forms indicated that District accounting managers performed their statement reviews prior to providing us with the initial set of draft financial statements for audit. Therefore, we consider this condition resolved [600110.03].

While the District improved the documentation and timeliness of its financial statement review process, our current testing still found some instances of errors not caught by the District's review procedures.[9] For example, we noted a $14 million overstatement of the net assets invested in capital assets, net of related debt account, which resulted from calculation errors not detected by the accounting manager's review. While this net asset computation is very complex and involves numerous adjustments to arrive at the related debt amount, we saw no evidence of accounting management review.

Another example of an undetected error was the incorrect reporting of $18.4 million in an asset titled "funds on deposit" in the payroll liabilities agency fund instead of the general fund. The "funds on deposit" were held by the claims administrator for the District's self-insured healthcare program, a new activity for fiscal year 2011. While this error had no net effect on either fund's total assets, it resulted in an $18.4 million misclassification error between "funds on deposit" and "equity in pooled cash and investments" in both the general fund and the payroll liabilities agency fund.

<u>Recommendations:</u>

To further strengthen the District's controls for detecting and correcting financial statement errors, we recommend that District management emphasize to personnel responsible for the CAFR review the need to pay particular attention to accounts involving complex calculations and transactions related to new activity. In addition, accounting management's review of the calculation of net assets invested in capital assets, net of related debt should be evidenced on a written form (similar to the forms used for review of fund financial statements) signed by the responsible manager [600111.10].

CAFR PREPARATION PROCEDURES STILL REQUIRE IMPROVEMENT

Our prior report disclosed that the District had not established and disseminated to its accountants formal, written policies and procedures that governed the preparation and review of its CAFR. District accounting management had worked with an outside consultant to develop a manual

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

containing such policies and procedures. However, it was apparent that the manual had not been formally approved, finalized, and disseminated to accounting staff. Also, our review of this manual revealed 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. Lastly, the manual did not include procedures describing the specific steps that an independent, detailed review of the financial statements should entail.

During the current audit, we noted that District accounting management disseminated a revised manual to accounting staff in November 2011. The revised manual incorporated the new financial statement review procedures implemented for the fiscal year 2011 CAFR, as described in a previous section of this report.[10] While our review of the revised manual revealed the inclusion of more detailed procedures for preparing financial statement information for governmental funds, it still did not contain such detailed procedures for the District's proprietary funds, agency funds, and private purpose trust funds. For these funds, the manual stated that the financial statement information should be obtained from the preparer so the data could be incorporated into the CAFR. However, the manual did not detail how the financial statement information was prepared.

The lack of formal, written procedures for preparing certain funds' financial statement information increases the risk that District accountants may not be aware of the proper steps to perform when preparing financial statements. This risk is heightened further in the event of staff turnover. As a result, there is an increased risk that financial statement errors could occur.

Recommendation:

To lessen the risk of errors when preparing the CAFR, we recommend that District management revise the manual to include detailed procedures on preparing financial statement amounts for all funds [600110.05].

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, 2011 indicated that a potential tax liability exceeding $25.3

[10] See page 17 of this report.

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 2011 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 initially submitted a PLR request to the IRS.[11] In October 2011 the District received a letter from the IRS in response to its PLR request. In this letter, the IRS explained it could not rule on the District's PLR request because it would require an initial determination that the District's 403(b) plan satisfied the requirements of Section 403(b) of the Internal Revenue Code, which IRS procedures prohibit.[12] Instead, the IRS informed the School District that, since the District's PLR request was under examination by the IRS and an answer to the PLR request was pertinent to the examination, the IRS anticipated the PLR request would be answered through the examination process. Through the end of our fieldwork, District management asserted it had not received an answer from the IRS.

Should the District receive a favorable decision from the IRS, there will not be any liability in connection with this matter. In the event of an unfavorable decision, 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 continues to believe that the possibility 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 status of the IRS' examination of the District's PLR request [60106.07].

UNCLAIMED TERMINATION COMPENSATION SHOULD BE ESCHEATED

The District annually reports in its financial statements a liability for termination compensation (termination pay). 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 pay 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, 2011, approximately $6.4 million was owed to employees who had been separated for more than a year. Table 2 on the next page summarizes the termination pay liability owed to these separated employees.

[11] 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.

[12] IRS Revenue Procedure 2011-4 Section 6.02(1) states that PLRs will not be issued with respect to whether the form of a 403(b) plan satisfies the requirements of Section 403(b) of the Internal Revenue Code.

Table 2: Employee termination pay outstanding for more than one year (in millions)

Fiscal year of Separation	Termination pay owed
2010	$0.8
2009	1.1
2008	1.3
2007 and prior	3.2
Total	$6.4

Pennsylvania escheat laws require that unclaimed wages revert 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. However, as of March 2012, the District had still not escheated any unclaimed termination pay to the state.

With regard to the $6.4 million in unclaimed termination pay outstanding for more than one year, District officials asserted that the portion of these unclaimed funds which pertain to former employees who severed employment at age 55 or older are not subject to Pennsylvania escheat laws. Because the District's 403(b) plan required termination pay for employees age 55 or older at separation to be directly deposited into 403(b) plan accounts as employer contributions, the District has taken the position that such unclaimed amounts represent 403(b) plan assets and thus are not escheatable. However, our audit disclosed that District management had not contacted the state Treasury Department to obtain its opinion on the District's position.

In its response to last year's audit report, management indicated that, during fiscal year 2011, the District's 403(b) plan providers followed up with former employees who had not established 403(b) plan accounts and assisted those individuals in setting up the accounts. Termination payments were then forwarded to these 403(b) accounts. For the former employees who had not responded to contact efforts to set up 403(b) accounts, the District planned to transfer their unclaimed termination pay to accounts established by the plan providers. As of March 2012, this planned transfer had not yet occurred.

Recommendations:

To bring the District into compliance with Pennsylvania's escheat law, we continue to recommend that management remit all unclaimed termination pay funds that are due to the state Treasury Department [600108.08].

With regard to the District's position that unclaimed monies related to termination pay owed to former employees age 55 or older at separation cannot be escheated because they represent 403(b) plan assets, we recommend that the District contact the state Treasury Department to obtain its opinion on the District's position [600111.11].

CONTROL PROCEDURE FOR PROCESSING TERMINATION COMPENSATION STILL NOT DOCUMENTED

In our prior year audit, we noted certain deficiencies in the District's procedures for processing compensation for termination payments. Each quarter, Payroll Department (Payroll) personnel sent a listing of separated employees who received their termination pay to the District's Information Technology (IT) Unit. The IT Unit deleted 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 the separated employees who received their termination pay had been deleted by IT, Payroll personnel spot checked selected employees to the ADVANTAGE system. Although these controls were in effect, they were not included in the District's formal, written procedures for processing the termination payments. In addition, Payroll personnel did not document the selected employees they spot checked.

Our current review disclosed that, effective March 2011, the ADVANTAGE system began automatically eliminating all accumulated leave balances for separated employees who received termination pay. Also in March 2011, the District revised its written procedures for processing termination pay to include a requirement that Payroll personnel verify that accumulated leave balances for separated employees were zeroed out in the ADVANTAGE system. However, Payroll personnel still did not document this review. These spot checks are necessary to ensure that separated employees who received their termination pay 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 this control procedure should be formalized to mitigate the possibility that it will not be performed.

Recommendation:

We continue to recommend the District amend its procedures for processing termination pay to include a requirement that Payroll personnel document their spot checks of selected employees [600110.10].

INTEGRITY OF PAYROLL PASSWORDS COMPROMISED

Current year testing of the District's payroll system again disclosed that certain payroll secretaries and other unauthorized personnel, instead of principals and administrators, were approving attendance records at 5 of 76 (7 percent) District 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 and other unauthorized personnel. By doing so, principals and administrators improperly delegated the authority for attesting to the accuracy of time and attendance entries and the authenticity of employees. Additionally, at two other locations visited, we found that the principal or administrator authorized to approve payroll for the location also entered the unit's time and attendance entries into the payroll system.

These conditions seriously compromise the integrity of the payroll system by not ensuring an independent review of the payroll prior to its submission to the Payroll Department. As a result, there is an increased risk that falsification of payroll time and attendance could occur and not be detected.

Recommendation:

We again recommend that management (1) re-issue closeout codes to any principals or administrators who have shared their codes with other District personnel, (2) continue to instruct principals and administrators of the necessity to maintain the confidentiality of their closeout codes, and (3) consider establishing other mitigating control procedures. Management must emphasize to principals and administrators the importance of segregating the incompatible duties of entering and approving the payroll [600108.07].

ENCUMBRANCE POLICY STILL NEEDS CLARIFICATION

During the fiscal year 2009 audit, we commented that District personnel failed to liquidate significant amounts of encumbrances that no longer represented valid purchase commitments at fiscal year-end 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 documents instead indicated that the OMB would cancel any remaining fiscal year-end encumbrances.

Our fiscal year 2010 audit revealed significant improvement in the District's year-end encumbrance cancellation process, noting a greatly reduced amount of unnecessary encumbrances. However, District encumbrance policy documents remained unchanged and still contained conflicting information that did not clearly direct unit managers of their responsibility to notify OMB to cancel an encumbrance.

Our current audit testing of year-end encumbrances noted continued improvement in the District's encumbrance liquidation process, finding no significant instances of invalid encumbrances. However, the District still had not revised its written encumbrance cancellation policy to clarify unit managers' responsibilities.

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), (Act), 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. The Commonwealth of Pennsylvania may impose penalties, such as a fine and/or imprisonment, upon any person subject to the Act who fails to make a complete, accurate, and timely filing.

In our prior report, we noted that 137 of 556 (25 percent) employees did not comply with the SFI filing requirements. The current audit disclosed that, in February 2011, the District's Office of Human Resources (OHR) sent a written notification to employees and former employees required to submit SFI forms, informing them of their filing responsibility and possible penalties for non-compliance. In April 2011, the OHR sent a written reminder to those individuals who had not yet submitted their SFI forms. Our review of the calendar year 2010 SFI forms on file at the OHR revealed that 36 of 572 (6 percent) employees did not complete the required SFI forms, which was a significantly improved level of compliance. However, among the employees who did not file the required SFI forms were such top management officials as the District's budget director and executive director of procurement services.

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. District management informed us that such a review had not been performed in fiscal year 2011 although the District intends to implement a review process during fiscal year 2012.

> Recommendation:
>
> We recommend that the District continue its efforts to achieve full compliance with SFI filing requirements, particularly with regard to top District management. In addition, the District should follow through with the planned review of the submitted SFI forms to determine whether any financial statement disclosures are required [60107.05].

PROCEDURES FOR SCHOOL SECURITY CAMERAS REQUIRE FORMAL APPROVAL

In our prior year audit, our visits to various District high schools equipped with security cameras revealed that there were no written procedures concerning the use of the camera systems. We recommended that the District establish such written procedures which, at a minimum, should 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.

Our current year review disclosed that, effective November 2011, the District's Office of School Safety established a written usage and care policy governing security camera systems at District locations. Our review of this written policy found that it incorporated all of the recommended items listed above except the requirement to label and date used tapes and recordings sequentially. However, we noted that the policy was neither formally approved in writing by the chief inspector for the Office of School Safety nor was it incorporated into the office's set of formal directives.

Recommendation:

While we commend the District for establishing a written policy governing the use of security cameras, we recommend that the policy be formally approved in writing by the chief inspector for the Office of School Safety and incorporated into the office's formal directives. The formally approved directive should then be disseminated to the appropriate parties. Also, to further improve procedures for camera systems, we recommend that the District amend the policy to include a requirement to label and date used tapes and recordings sequentially [600110.11].

With regard to monitoring for compliance with the policy, since the policy was only recently established, we will review the District's monitoring procedures and individual units' compliance with the policy in a future audit.

DEFICIENT CONTROLS OVER STUDENT DENTAL CARE EXPENDITURES

In several prior 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 the District made 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, both the fiscal year 2009 and 2010 audits found that one provider did not submit the required ADA 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 previous fiscal years did not provide the required ADA billing claim forms, once again did not submit the required forms but has been paid $134,786 over the last three fiscal years. Also, the District still did not obtain verification from the parent or guardian that the services billed were actually provided. In November 2010, District personnel attempted to verify the provision of services for a sample of 15 students selected from vendor invoices through telephone calls. However, District personnel were only able to verify services for 6 of 15 students (40 percent) and received no response for the other students. Lastly, the District still had not entered into formal contracts with the dental providers, who were paid a total of $130,410 during fiscal year 2011.

Recommendations:

To improve controls over dental benefits paid though 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. For the one vendor that refuses to comply we suggest the District consider ending its relationship with this vendor.

- 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 year issues. We blended the status of some corrected prior-noted conditions[13] with new observations and reported upon these matters in the previous sections of this report. Other resolved prior year issues are discussed below. We commend the District on its efforts.

DOCUMENTATION OF ACCOUNTING TREATMENT FOR SIGNIFICANT TRANSACTIONS NOW IMPROVED

In our prior report, we commented that District 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. One example noted in the prior audit was a reported $15.3 million interfund loan from the general fund to the food service fund. We questioned the validity of the loan since its collectibility was highly doubtful given the continuing deficits in the food service fund and the lack of any formal repayment terms. District accounting management did not sufficiently document their decision to report this transaction as an interfund loan rather than as an interfund transfer.[14] In response to our proposed adjustment to eliminate the loan and report it as an interfund transfer, District management developed a repayment plan where the loan would be repaid from fiscal years 2010 through 2015 through a reduction of the indirect costs charged by the general fund to the food service fund. After the District adjusted its fiscal year 2010 financial statements to reflect the repayment plan, the balance of the interfund loan was $12.1 million.

The current review noted the District has made considerable improvement in documenting the accounting treatment for significant transactions. District accounting management provided us with written descriptions documenting the basis of their decisions regarding significant fiscal year 2011 accounting issues, such as the reporting of the food service interfund loan, the implementation of the Governmental Accounting Standards Board Statement No. 54 fund balance classifications, and the entries recording the activity for the new healthcare self-insurance program. Accordingly, we consider this condition resolved [600110.01].

With regard to the interfund loan between the general fund and food service fund, we suggested that, until the loan is completely repaid, District management monitor compliance with the repayment plan. If the terms of the repayment plan are not met in the future, we recommended that the District eliminate the balance of the loan and report the remaining amount as an interfund

[13] The corrected prior-noted conditions involved a deficiency in the District's policy for transferring costs out of its construction in progress account and weaknesses in financial statement review procedures.

[14] Governmental Accounting Standards Board (GASB) Statement No. 34, paragraph 112a(1) and GASB Comprehensive Implementation Guide 2010-2011, question 7.82.1 require 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.

transfer. During fiscal year 2011, we observed that $1.5 million of the loan was repaid in accordance with the plan. Therefore, we consider this finding resolved. We will, however, continue to monitor the District's compliance with the terms of the repayment plan for the food service interfund loan in future audits [600110.02].

REVIEW OF ACCOUNTING ENTRIES NOW IMPROVED

We previously reported that the District's review procedures for accounting entries required strengthening. Although the District had a formal, documented process for preparing and reviewing journal entries, prior audit testing disclosed incorrect journal entries that had been approved, which led to significant financial statement errors.

The current review noted the District took corrective action to improve the review process for accounting entries. District accounting management instituted a new procedure for year-end journal entries which required two accounting managers to review each entry. The procedure instructed both managers to compare the entry to supporting records and verify the accuracy of the affected funds and accounts. Both accounting managers documented their reviews by initialing and dating a written form. Also, our current audit testing of journal entries revealed no significant errors. We, therefore, consider this finding resolved [600110.04].

DISTRICT DEEMED ANALYSIS OF MAINTENANCE OVERTIME NOT COST BENEFICIAL

In the prior audit, we reported that, although the District's Office of Capital Programs kept records of the projects on which maintenance employees worked, District accountants did not utilize this data to determine whether overtime payments to maintenance staff related to the construction of capital assets and, therefore, should have been capitalized.

In its response to the prior audit report, District management took the position that the cost of analyzing the nature of each of the many projects completed by maintenance staff would outweigh the benefit given the relative immateriality of the maintenance overtime costs. Our current review disclosed that maintenance overtime costs charged to the capital projects fund decreased from $2.8 million in fiscal year 2010 to $1.6 million in fiscal year 2011 and amounted to only $438,000 in fiscal year 2012 as of February 2012. Given the steady decrease in maintenance overtime costs and its immateriality to the total net book value of District capital assets (approximately $2 billion), we will no longer report on this finding. We will, however, continue to monitor the amount of maintenance overtime costs in future audits to ensure its immateriality [600110.07].

THE SCHOOL DISTRICT OF PHILADELPHIA
OFFICE OF THE SUPERINTENDENT
440 N. BROAD STREET, SUITE 301
PHILADELPHIA, PENNSYLVANIA 19130

THOMAS E. KNUDSEN
CHIEF RECOVERY OFFICER
ACTING SUPERINTENDENT

TELEPHONE (215) 400-4100
FAX (215) 400-4103

May 18, 2012

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 2011

Dear Mr. Butkovitz:

The attached document contains The School District of Philadelphia's formal response to the issues raised in the Fiscal Year 2011 Audit Report issued on May 10, 2012 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 financial audit. I am pleased to note that actions have been taken by the School District regarding several important findings and recommendations from the Fiscal Year 2010 audit sufficient for those issues to be considered resolved. In addition, the School District has already taken action or is in the process of implementing a number of actions that will resolve other audit findings.

I would like to thank you and your staff for your efforts with respect to this audit.

Sincerely,

Thomas E. Knudsen

c: Pedro Ramos, Chairman and Members of the School Reform Commission
Gerald V. Micciulla, Deputy City Controller, City of Philadelphia
Harvey Rice, Deputy City Controller, City of Philadelphia
Kathleen Duggan, Audit Administrator, City of Philadelphia
Marcy F. Blender, Deputy CFO, Accounting Services and Audit Coordination

FORMAL RESPONSES TO

REPORT ON INTERNAL CONTROL AND ON COMPLIANCE AND OTHER MATTERS

FOR FISCAL YEAR ENDING JUNE 30, 2011

BY THE OFFICE OF THE CITY CONTROLLER CITY OF PHILADELPHIA

SUBMITTED BY:
THOMAS E. KNUDSEN
CHIEF RECOVERAY OFFICER
ACTING SUPERINTENDENT
THE SCHOOL DISTRICT OF PHILADELPHIA
May 18, 2012

School District of Philadelphia's Responses to Report on Internal Control and on Compliance and Other Matters – Fiscal Year Ended June 30, 2011
From the Office of the Controller, City of Philadelphia

SIGNIFICANT DEFICIENCIES:

DISTRICT PROCESSED PAYROLL WITHOUT ENSURING PROPER APPROVALS

Summary of Findings and Recommendations:

The District processed its bi-weekly payroll regardless of whether unit administrators had approved their units' online payroll entries as established by procedures. Recommendations are that the District institute procedures and develop a report to identify those unit administrators who repeatedly fail to approve payroll and take appropriate actions to ensure compliance. The District should assess its current payroll approval structure to determine whether changes are necessary to reduce occurrences where payroll is not approved.

School District's Response:

The new District administration has already begun to institute immediate and decisive corrective actions to remedy this condition. The new Chief Recovery Officer and Acting Superintendent of the School District is fully committed to assessing the current process and the implementation of corrective actions has already begun. This includes: 1) instituting several monitoring protocols, 2) identifying any instances in which there appears to be systematic payroll approval problems, 3) assessing the current structure of approval and changing where needed, and 4) identifying and holding accountable any non-complying administrators. The Finance Office will work with any non-complying administrators to correct the issues and take appropriate action if non-compliance continues.

As noted in the Audit Report, the current process ensures that exception pay absences (the payroll system assumes employees are present unless coded otherwise) are processed and that employees leave and sick banks are correct and employees are not overpaid for time they are not entitled to receive compensation on. The District is also required to fulfill applicable legal requirements which dictate the payment of wages owed to employees when due and compliance with collective bargaining agreements. Due to the current time-line required to process payroll and allow sufficient time for pre-audit of the payroll file and bank processing/check printing, it is not practical to track down managers throughout the District (over 300 pay locations) in order to have them approve payroll before the close of the bi-weekly payroll cycle at the end of the business day on the payroll Friday. Therefore, counter-balancing monitoring and control procedures to prevent errors occurs in the following week. The auto-approve process also prevents the Payroll Department from having to produce an abundance of manual checks.

The Audit Report identifies that a significant number of District employees were not being approved in the "system" each pay-period and they identified on average 4,200 employees. It should be recognized that 4,200 is the number of employees, and that the number of administrators not approving payroll in the "system" for their agencies each pay period is a much smaller number. It should also be noted that audit testing did not identify any material weaknesses; what was identified was an increased future risk potential.

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For example, the Central Facilities Office and Central Transportation Office are responsible for the payroll approval of an average of 1,800 and 580 employees respectively who are located in the field. There is a paper review and approval process by both the supervisors in the field and the Central Office. Central Office mistakenly did not go into the "system" to approve the bi-weekly payroll which was entered centrally because they believed that the auto-pay process was sufficient for processing. This was corrected immediately when this was brought to their attention and has significantly reduced the average number of employees not having their payroll approved in the system (a 65 % improvement of the average total number of employees).

New bi-weekly reports have been developed to group employees with administrators responsible for their payroll approval, allowing for a more efficient monitoring process. Guidance and notification has been sent by the Chief Recovery Officer and Acting Superintendent to all administrators in the District who may not have approved their payroll for a variety of reasons (e.g., due to absence) notifying them of the policy to approve payroll in the system and holding them accountable for any future non-compliance. This report will be re-run each payroll cycle to confirm corrective action has been taken. In addition, a general memorandum was recently distributed to all Administrators reinforcing the District's mandatory payroll approval policies and procedures.

CAPITAL ASSET ACCOUNTING DEFICIENCIES

Summary of Findings and Recommendations:

Capital asset accounting procedures did not always ensure that: 1) completed projects were transferred out of construction in progress on a timely basis, and 2) all eligible capital projects fund costs were recorded as capital assets in the year of acquisition. The recommendation is to review capital projects with high dollar cost amounts and to allocate costs of prior year's project management costs and communication upgrade costs across existing assets. Another recommendation is to issue a directive that purchase orders be broken out by individual location.

School District's Response:

1) **Completed Projects Improperly Remained in the CIP Account:** As noted in the Audit Report, the District implemented corrective actions to change the criteria date for transferring assets from CIP to completion which resulted in the resolution of the prior year's condition. The School District agrees with the new recommendation to further improve this process by adding a control procedure to review high dollar cost projects. The School District was aware that certain groups of assets purchased in prior years dating from 2005 – 2008 (which related to outside project managers costs and communication system upgrades) were being carried on the books as lump sum expenditure amounts in the Capital Fund because complete assignment to individual projects was not always possible. The School District will implement the proposed methodology to allocate these costs across all depreciable assets. Both recommendations will be in place for the upcoming audit period.

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2) Eligible Costs Were Not Always Capitalized: The District agrees with the finding on real property which is primarily caused by the inability to identify assets bought centrally by location if sufficient detail is not provided by the purchasing organization. Guidance has recently been issued to reinforce purchasing guidelines for real property purchased centrally and personal property which require locations and descriptions be provided in enough detail to allow identification of the assets to capitalize and depreciate them timely. Personal property tagging is a manual process within the current system available at the District and therefore the volume and review time results in immaterial timing differences between fiscal years in which depreciation begins. The District will continue to monitor the untagged dollar amount to assure that the amount remains immaterial.

OTHER CONDITIONS

DEFICIENCIES IN CONTROL OF SCHOOL FURNITURE AND EQUIPMENT

Summary of Findings and Recommendations:

There were inadequate controls over the schools' furniture and equipment inventory which included the following conditions: 1) adequate inventory records were not maintained for relocated schools' furniture and equipment, 2) identification tags were not consistently affixed to the assets, 3) required documentation for dispositions of assets was not always completed, and 4) some schools failed to complete and submit accurate inventory reports for their locations.

School District's Response:

The District, beginning in January 2012, implemented a new on-line personal property management and reporting tool which improves compliance and controls at each location. Every location was required to appoint an "Inventory Designee" with accountability for accurately maintaining the inventory records at their location. Extensive mandatory training sessions were held for all "Inventory Designees" January through March 2012 and written policies and procedures were provided and are posted on the District's web-site. In addition there are now on-line reports available in Advantage Reports which allow daily retrieval and updates to inventory at each location.

A memorandum was recently issued indicating mandatory personal property inventory policies and procedures including a user's guide and directions to conduct a physical inventory and submit the information along with required documentation to Accounting Services. Inventory Designees were also instructed to clean-up their inventory using the new on-line system before submission. Accounting Services will follow-up as part of the year-end close process to ensure compliance.

It is the school district's policy that each location's "Inventory Designee" has responsibility for tracking within the Advantage Personal Property Inventory System when personal property assets are disposed, transferred to another location, lost, scrapped etc., and to complete the required paperwork. This policy also applies to relocations, Renaissance Charter Schools and

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school closings. In addition, a relocation team consisting of representatives from the school, academic office, facilities and accounting are assigned to each school relocation or closing. The District will reinforce to "Inventory Designees" of both the relocations/closing locations and the receiving locations (including storage and surplus warehouses) and their managers the mandatory policies and procedures for inventory tagging, tracking, reporting and physical inventories.

Accounting Services has received the detailed audit findings and is in the process of contacting the Principals at the affected schools where there was non-compliance and notifying them of the mandatory personal property policies and procedures. They are being instructed to implement corrective actions with the goal of coming into compliance for the fiscal year 2012 physical inventory process now underway. Storage and surplus warehouse facilities managers will be required to bring their inventory into compliance as well.

WEAKNESSES IN CONTROLS OVER STUDENT TRANSPASS ACTIVITIES

Summary of Findings and Recommendations:

Formal written policies and procedures were provided to schools for the distribution and reporting of transpasses. The audit disclosed that at the four schools in the audit sample there were instances of non-compliance with these established procedures.

School District's Response:

As part of on-going Principals' training the District will reinforce the importance to adhere to the written transpass policies and procedures. In addition, the District will add this topic to the mandatory Principal Financial Planning agenda anticipated for this summer. The policies and procedures will also be re-posted to the Principal Bulletin Board with directions that the number of transpasses not given out should not be a derived number.

STUDENT ACTIVITY FUNDS CONTROL DEFICIENCIES

Summary of Findings and Recommendations:

Although a comprehensive School Fund Manual was developed for student activity funds policies and procedures, non-compliance with the Manual was a common occurrence at the schools visited and the sample of schools quarterly student activity account reports on file at the central offices. Examples of findings included: controls over cash collections, non-compliance with bidding requirements, no finance committees, no activity budgets, negative activity account balances, school-related funds improperly retained, inactive account balances were not closed, and old reconciling were carried on the records.

School District's Response:

The turn-over of Principals and School Operations Officers/Financial Designees has led to the need to provide training in the policies and procedures contained in the School Fund Manual. Hands-on training was offered on three separate occasions in May 2012 and well attended.

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The District intends to have on the agenda at the mandatory summer Principal Financial Training the topic of Student Activity Funds. Controls over cash collections will be emphasized as part of the training.

Detailed documentation of all schools identified as being non-compliant was obtained from the auditors work papers and will be distributed to the Principals of the schools identified. The Principals will be provided with a copy of the School Fund Manual (which is also on the District's web-site) and instructed to take corrective actions which will be monitored for compliance.

PETTY CASH FUNDS CONTROL DEFICIENCIES

Summary of Findings and Recommendations:

The last several audit reports have identified numerous control weaknesses and instances of non-compliance with established control procedures involving operations of the District's petty cash funds. These conditions continue to exist.

School District's Response:

Although recognized as immaterial amounts, the District takes seriously controls over Petty Cash Funds. The District intends to have on the agenda at the mandatory summer Principal Financial training the topic of Petty Cash Accounts and to redistribute the written policies and procedures which are also on the District's web-site. Central administration will again send a correspondence to Principals and Administrators who have Petty Cash Accounts to require them to send a check to reduce their funds to the authorized limit. In addition, Accounting Services will review the funds with infrequent activity and reduce the authorized amounts accordingly and close bank accounts which have little activity.

INADEQUATE ARTWORK INVENTORY RECORDS AND PROCEDURES

Summary of Findings and Recommendations:

The District continued to have artwork inventory control issues for artwork which were listed as "not Observed" because they were located in closed schools and items which were listed as "Can Not Locate".

School District Response:

All valuable artwork was removed from their locations and has been placed in a safe, temperature controlled storage facility since fiscal year 2004. The artwork inventory related to this finding are pieces of art which were deemed not valuable by an outside art expert and therefore a decision was made to leave them in their original location.

As part of the year-end inventory process Principal's were instructed to complete the proper paperwork for "Can Not Locate" items so they can be removed from inventory. As far as "Not

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Observed Items", Accounting Services must rely on responsible managers of locations to validate that the assets are no longer at their original locations; in the future they will ask for validation of this in writing. Facilities Management will be requested to validate the artwork in closed buildings.

FINANCIAL REVIEW PROCEDURES STILL NEED ENHANCING

Summary of Findings and Recommendations:

Although the financial review process showed improvement, the review procedures still did not always detect errors.

School District's Response:

As noted in the Audit Report, enhanced formal review and documentation procedures were implemented for the 2011 fiscal year reporting requiring two levels of review by accounting managers; resolving the prior year finding.

The net asset computation is extremely complex and requires multiple spreadsheets to complete the computations. Although the spreadsheets were carefully reviewed by an accounting manager, a formula cell error was not detected and they did not formally document their review. Formal documentation of the review process will be implemented for the current fiscal year reporting period.

Accounting managers will be instructed to pay particular attention during their review process for complex and new transactions.

CAFR PREPARATION PROCEDURES STILL REQUIRE IMPROVMENT

Summary of Findings and Recommendations:

Although an Accounting Manual was updated and published for all governmental funds and the new review procedures; it did not have instructions for preparation of non-governmental funds.

School District's Response:

The Audit Report notes that the Accounting Manual was completed and distributed. In an effort to publish the Manual timely, a decision was made to exclude the non-major funds and proprietary funds. The Manual will be updated to include these additional funds for the upcoming reporting period.

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FICA TAX WITHHOLDING FOR TERMINATION PAYMENTS

Summary of Findings and Recommendations:

Effective June 1, 2005 the District based upon the advice of outside legal counsel redefined termination payments made to retiring employees 55+ as employer retirement compensation not subject to FICA taxes. The City Controller's position is that these retirement payments are employee compensation. Pending a decision by the IRS, the District will continue to disclose this treatment in the footnotes to the financial statements.

School District's Response:

The District believes that the treatment of termination pay for tax purposes is correct based upon outside legal opinion. To validate the 2005 opinion, the District recently engaged outside counsel to confirm this understanding; and continues to advise the proper treatment as employer compensation. The IRS is currently looking at this as part of a routine payroll audit and will determine the tax treatment as part of the audit.

UNCLAIMED TERMINATION PAY SHOULD BE ESCHEATED

Summary of Findings and Recommendations:

The District should complete its analysis of unpaid termination pay and escheat unclaimed amounts to the State.

School District's Response:

The District has a team of individuals who are researching prior year balances and liquidating banks as appropriate. This is a tedious, time-consuming process. The District has made significant progress from the prior fiscal year in researching and liquidating banks and reduced the previous balances by $3.1 million. It is important that this research is done so that the District does not escheat to the State money that is not owed for various reasons. As far as the 403(b) assets, they are by law not escheatable to the State Treasury Department. This treatment is being addressed by the IRS as part of their current audit, and therefore, there is no reason for State involvement at this time pending the outcome.

PROCEDURE FOR PROCESSING TERMINATION PAY STILL NOT DOCUMENTED

Summary of Findings and Recommendations:

Although controls and spot checks were in place for processing termination pay; they were not documented.

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School District's Response:

The District agrees that the procedures for processing termination pay will be revised to include a requirement that Payroll personnel document their spot checks of selected employees.

INTEGRITY OF PAYROLL PASSWORDS COMPROMISED

Summary of Findings and Recommendations:

The District should take action to prevent circumvention of controls designed to provide integrity over the payroll process whereby Principals and Administrators share their payroll passwords with their payroll secretaries.

School District's Response:

The District obtained the names of Principals and Administrators sharing passwords and took immediate steps to reinforce to these individuals and their managers the policies and procedures for payroll approval. All passwords of these individuals were reset. This will also be covered as part of Principals' Financial Training this summer and will be reinforced as part of the general payroll approval memorandum was recently issued.

ENCUMBRANCE POLICY STILL NEEDS CLARIFICATION

Summary of Findings and Recommendations:

Although there was continued improvement of prior year's findings regarding the cancellation of encumbrances; the District should formally revise the Encumbrance Policy.

School District's Response:

The Audit Report notes the significant improvements made in the District's encumbrance liquidation process with no significant instances of invalid encumbrances. This was a direct result of an enhanced year-end process to review all prior year open encumbrances and have managers justify the reasons if any are to remain open. The year-end memo to all managers reinforces that they are responsible for canceling encumbrances and that the Office of Management and Budget reserves the right to cancel open encumbrances. Although the formal encumbrance policy has not been updated, as noted, the prior audit findings have been corrected. The District will review the formal encumbrance policy and make the necessary updates.

NON-COMPLIANCE WITH STATEMENT OF FINANCIAL INTEREST FILING REQUIREMENTS

Summary of Findings and Recommendations:

Although the number of filings by District employee's increased significantly, some top management officials did not file. In addition, although not required by law, the District should review the forms to identify conflicts of interest.

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School District's Response:

The District will continue its efforts to reach full compliance and will follow through on the plans to review the submitted forms for conflict of interests. There will be a continuation of the improvements implemented during the current period which resulted in non-compliance of 25% reduced to 6%. Of the two management officials identified as not filing, one is no longer a District employee who was on leave at the time of the filing requirements, and the other has committed to filing timely in the future.

PROCEDURES FOR SCHOOL SECURITY CAMERAS REQUIRE FORMAL APPROVAL

Summary of Findings and Recommendations:

The Audit Report commends the District for writing and disseminating formal written policies and procedures for school security cameras. However, it is recommended that the policy be formally approved in writing by the Chief of the Office of School Safety. In addition, the policies should be updated to require that used tapes be labeled and dated.

School District's Response:

The School District agrees with this recommendation and has already implemented the recommended corrective actions. There are in actuality very few tapes to label because most systems are digital.

DEFICIENT CONTROLS OVER STUDENT DENTAL CARE EXPENDITURES

Summary of Findings and Recommendations:

Several prior reports have commented that internal controls over dental benefits paid through the District's Public Health Fund were inadequate and required improvement. Although some improvements were made, the overall condition still exists and should be addressed.

School District's Response:

As noted in the report, one provider, University of Pennsylvania, has not made the requested changes to the invoicing process. They have stated that they do not have the resources to do so. Due to the District's resource constraints, instead of sending correspondence to validate to every parent, the District intends to implement a sampling technique for each of the providers to validate the invoices. Moving forward contracts from orthodontia providers will not be necessary as the District will be moving in a different direction to provide prescription glasses to high school students.

AUDITOR'S COMMENTS ON AGENCY'S RESPONSE

Government Auditing Standards require auditors to report instances where the auditee's comments to the findings, conclusions, or recommendations are not, in the auditor's opinion, valid or do not address the recommendations. We believe that to be the case with certain statements made in the School District of Philadelphia, Pennsylvania's (District's) response to our comment on page 1 regarding the School District's payroll being processed without ensuring proper approvals over its $1.3 billion payroll.

In regard to the payroll system's automatic approval feature for units whose payroll is not approved, District management's response suggests that this feature ensures "employee leave and sick banks are correct and employees are not overpaid for time they are not entitled to receive compensation on." We do not believe this statement accurately depicts the purpose of the automatic approval feature. As described in the audit report, the automatic approval feature served as an efficiency measure to prevent certain payroll processing problems, not as a control to prevent and detect errors in employees' pay and leave balances. If the feature was not in place, the system would purge all unapproved payroll entries. District staff would then have to manually re-enter the employee absence data into the system, which management deemed not practical due to limited staffing. Therefore, the automatic approval feature allowed absence entries input by District personnel to be included in employees' pay and leave balances to reduce instances of overpayments and inaccurate leave balances. However, the automatic approval feature did not have the capability to ensure the accuracy of the absence data entered by District staff into the payroll system.

In its response to the City Controller's comment on page 1, District management asserts that "counter-balancing monitoring and control procedures to prevent errors occurs in the following week." Neither during the course of the audit nor at the exit conference did District management bring to our attention any such monitoring or control procedures that take place in the week following the pay period closeout which are designed to detect errors in payroll-entry input by District personnel. During the audit, management of the District's payroll department informed us that pre-audit procedures performed after closing out payroll entailed checking the accuracy of the system's bi-weekly pay calculation for selected employees. These procedures did not include a comparison of unit attendance records against online payroll entries. Therefore, these pre-audit procedures would not detect errors in payroll data input.