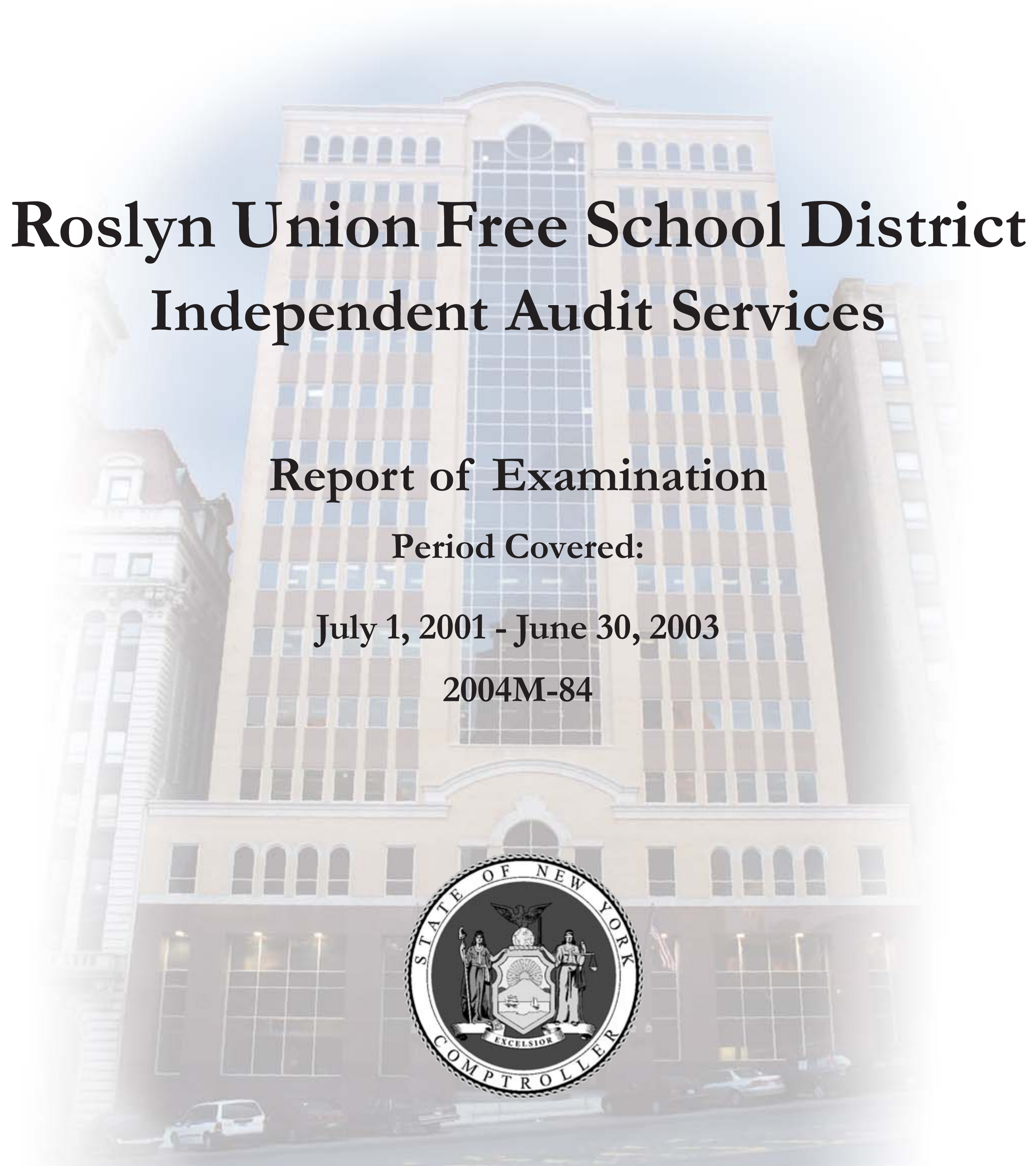
OFFICE OF THE NEW YORK STATE COMPTROLLER

DIVISION OF LOCAL GOVERNMENT SERVICES
& ECONOMIC DEVELOPMENT



Roslyn Union Free School District

Independent Audit Services

Report of Examination

Period Covered:

July 1, 2001 - June 30, 2003

2004M-84

ALAN G. HEVESI

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State of New York
Office of the State Comptroller

Division of Local Government Services
and Economic Development

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Dear School District Officials:

One of the Office of the State Comptroller's top priorities is to identify areas where local governments can improve their operations and provide guidance and services that will assist local officials in making those improvements. Further objectives are to develop and promote short-term and long-term strategies to enable and encourage local government officials to reduce costs, improve service delivery and to account for and protect their governments' assets.

The reports issued by this Office are an important component in accomplishing these objectives. These reports are expected to be a resource and are designed to identify current and emerging fiscally related problems and provide recommendations for improvement. The following is our report on the Roslyn Union Free School District-Independent Audit Services.

This audit was conducted pursuant to the State Comptroller's authority as set forth in Article V, §1 of the State Constitution and Article 3 of the General Municipal Law. The report contains opportunities for improvement for consideration by the Board of Education.

If we can be of assistance to you or if you have any questions concerning this report, please feel free to contact the local regional office for your county listed at the back of this report.

Respectfully submitted,

Office of the State Comptroller
Division of Local Government Services
and Economic Development

EXECUTIVE SUMMARY

The fiscal operations of the Roslyn Union Free School District (District) are currently being audited by the Office of the State Comptroller. The results of that audit will be discussed in a separate report. This report addresses one phase of that audit, the procurement of quality audit services.

The District is required to have an annual financial statement audit and has contracted with the same certified public accounting (CPA) firm, Miller, Lilly & Pearce, LLP, to perform this service since the 1992-1993 school year. In October 2002, after receiving information from a citizen, the CPA firm worked with the District and identified $223,000 of fraudulent payments made by the assistant superintendent for business. This resulted in the removal of the assistant superintendent for business, and the subsequent restitution of $250,000, which included auditing and legal fees, by the assistant superintendent.

In January 2003, the District's Board of Education approved additional services to be provided by the CPA firm. According to the CPA partner, the firm was to check monthly bank reconciliations, test claims, consult with the interim assistant superintendent for business on policies and procedures, and have a physical presence at the District. The firm continued to provide its audit services to the District until May 2004, when additional problems with disbursements came to light.

Scope and Objectives

We reviewed the audit service procurement procedures of the District and the work of the CPA firm retained by the District to audit its general purpose financial statements for the fiscal years ended June 30, 2002 and June 30, 2003. The objectives of our audit were to determine the adequacy of existing practices for the procurement of audit services and the effectiveness of such audit services as a means for the timely detection of errors and irregularities. Our audit addressed the following questions:

- Did the District follow appropriate policies and procedures when procuring audit services?
- Did the audit work of the CPA firm meet the purposes, terms and conditions of the contract of engagement and provide effective oversight for District fiscal operations?

Audit Results

The District did not effectively procure its annual audit services. The District did not comply with its own policies to obtain requests for proposals (RFPs) for professional audit services. Instead, the District contracted with the same CPA firm each year, for a dozen years, without seeking competitive offers from other firms.

We found that the annual audit of the District did not meet 9 of 22 required professional standards for such an audit. The audit was significantly deficient in planning and execution. In addition, we believe that the CPA firm that performed the audit was not independent. As a result of the numerous deficiencies we identified, a multi-million dollar fraud by District personnel was not identified, *even when the CPA firm was aware that a fraud had occurred*. We will refer this report to the State Board for Public Accountancy for further investigation and possible disciplinary action. In addition, we are going to refer this report to the Nassau County District Attorney.

One of the fundamental principles upon which the auditing profession is based is that auditing firms must be independent of the organizations they audit, both in fact and in appearance. Any impairment of independence calls into question the validity of the work done. In violation of this professional standard, two (of the three) partners of the CPA firm were not personally independent of the District during the audits. For the period of our review, these two partners each had an ownership interest in a software company that provided financial accounting software to the District. In fact, the audit partner for the District's annual audits had a 45 percent interest in the software company. In essence, the CPA firm was auditing its own financial system, a situation that is specifically prohibited by professional standards.

We also found that two of the partners in the CPA firm were involved in an arrangement that brought another administrative software program to the District. Contrary to professional auditing standards, these partners received a commission for their role in this arrangement.

We found numerous instances where the CPA firm did not meet professional standards when planning the audits. For example, the audit planning did not assess the possibility of fraud or illegal acts and plan audit tests accordingly, *even when the CPA firm was aware that a fraud had occurred in October 2002*. Also, there is no evidence that the audit planning considered the existence of related party transactions (there were numerous such transactions in the District). As a final example, there is no indication that the CPA firm considered the District's use of a computerized accounting system when planning audit tests. There are various application controls within the system that permit and restrict access to various functions. These controls were not assessed and not tested by the CPA firm to see if they were operating. In fact, during our audit, we found that the application controls had not been activated, thereby allowing a wide range of employees to manipulate the District's financial system. Consideration of such information is called for by professional auditing standards and would affect the nature, timing and extent of planned audit procedures.

The CPA firm's testing was also significantly deficient. For example, although the CPA firm's audit program calls for a test of budgetary controls, no findings were documented. However, the District routinely exceeded budgeted amounts in appropriation accounts and had to execute dozens of material year-end adjustments to expenditure accounts. This activity was primarily due to the theft occurring in the District, but was never identified by the CPA firm.

The most fundamental deficiency in the CPA firm's fieldwork was in its testing of disbursements. The CPA firm did not review any cancelled checks. In addition, while the CPA firm's workpapers show that they identified all sorts of problems, such as lack of proper authorization, missing invoices, no receiving signature, no purchase order, purchase order dated later than invoice, no quotes, no bids, payments of sales tax, and questionable purchases, none of these findings led them to do further audit work. The fraud in the District was so pervasive that a review of cancelled checks would have revealed instances where the actual payee on the checks was different than the payee recorded on the CPA firm's workpaper. For example, we reviewed 16 of the 240 disbursements that the CPA firm purportedly tested in 2002-2003. Five of these 16 payments were paid to vendors different than those listed on the CPA firm's workpaper, a fact instantly identified if the CPA firm had reviewed the cancelled checks.

In addition, the CPA firm's workpapers presented to us contained vendor names that were not recorded in the District's records at the time of the audit. For example, the auditor's workpapers, for the 2002-2003 audit, documenting the test of disbursements, purportedly prepared in July 2003 shows the following information for four specific checks while the District's records at the time show different names.

Check #	**Vendor Name in Audit Workpaper**	**Vendor name in District Records**
161262	Sargent Welch	American Express
161265	Nassau County BOCES	Citibank
161560	Kinderprint	Key.
161784	National Comp Sys	Nations

In fact, these disbursements are fraudulent and the vendor names recorded on the District's records as of October 17, 2002, are the actual vendors that checks were made out to. They were for the personal expenses of District personnel. It was not until late February or early March 2004 that someone with access to the District's computerized records changed the vendor names on the records in an apparent attempt to cover up the fraudulent activity. We questioned how a workpaper supposedly prepared in January 2003 could have included vendor names that were not placed into the District's records until February/March 2004. This raises serious questions as to the validity of the audit work done. In addition, we question the adequacy of the CPA firm's audit work when their audit sample included fraudulent payments and their audit work did not identify them as such.

Although the CPA firm claims that invoices were available to support the fictitious payments, and that they reviewed them, we found no evidence of such invoices. In our review of a sample of 24 disbursements that the CPA firm purportedly tested in both years, we could not find documentation (invoices, etc.) for 14 of these transactions, although the CPA firm claims to have reviewed such documentation. And, if the CPA firm had reviewed the final payment documents, the cancelled checks, a review that is standard for any test of a disbursement transaction, they would have identified the questionable nature of these transactions.

The CPA firm's audit program called for a review of expenditures over $25,000. The audit manager informed us, for both audit years, no bills were selected and reviewed. Rather, the listing, once compiled, was just "eye-balled" for reasonableness of expenditure payments. It would seem that even this cursory review would have identified transactions for further review.

Our review of the workpapers developed to support the 2001-2002 and 2002-2003 financial statement audits of the District disclosed recurrent problems with documentation. Virtually every segment of our review identified problems with the lack of evidence to support purported audit work. We also noted several instances where audit steps were not clearly explained, and audit conclusions and/or evaluations were not documented.

We found that certain conditions regarding the internal controls of the District were not reported as required by standards. It would appear that the events of October 2002 would provide the CPA firm with much of the evidence of reportable conditions, cited by professional standards. Also, our own audit work at the District has revealed additional reportable conditions in the internal controls over purchasing, budgeting and fixed assets.

Comments of Local Officials

We met with District officials to discuss the findings and recommendations contained in this report. District officials agree with the recommendations and indicated that they either have or plan to implement them.

Introduction

Background

The fiscal operations of the Roslyn Union Free School District (District) are currently being audited by the Office of the State Comptroller. The results of that audit will be discussed in a separate report. This report addresses one phase of that audit, the procurement of quality audit services.

In early 2004, information surfaced regarding possible wrongdoings at the District. This information indicated that a substantial misappropriation of funds had occurred in the District over a period of several years. The circumstances surrounding this alleged embezzlement are currently being investigated by our office and various law enforcement agencies. It was also learned that a fraud had been uncovered in the District months earlier. In October of 2002, certified public accountants had identified $223,000 in misused funds which resulted in the removal of the assistant superintendent for business. Subsequently, the District received restitution from the assistant superintendent. At the time, the District's Board of Education (Board) decided not to disclose the details of the fraud to the public.[1]

The Board is responsible for establishing a structure of internal controls designed to prevent or detect errors and irregularities. It is the Board's duty to make certain that established controls are appropriately designed and operating effectively. Such controls provide the Board with reasonable assurance that District assets are adequately safeguarded. The Board ensures the quality of its established controls through timely oversight of the District's fiscal operations.

One aspect of an effective system of internal controls is an annual audit performed by an independent public accountant.[2] Such an audit can be an effective oversight tool for school district managers by providing for the timely detection of errors or irregularities. The effectiveness of the annual independent audit as a control is dependent on the scope and quality of such audit and the resultant communications to management. Audit scope and quality is governed largely by generally accepted government auditing standards[3] (GAGAS). Such standards speak to the qualifications and responsibilities of the professionals conducting the audit, the quality of the audit work to be performed and the required communications to management. The audit scope, applicable professional standards and engagement expectations are documented in the public accountant's engagement letter[4] to the governing board.

[1] Refer to Appendix C

[2] Education Law and Regulations of the Commissioner of Education require that an external audit be conducted by a certified public accountant in accordance with generally accepted government auditing standards (GAGAS). Although the audit is required by statute, the school district exercises its discretion in choosing a qualified independent auditor. The independent auditor issues an opinion on the school district's annual financial statements and its compliance with certain laws and regulations and issues a report on its internal controls. The auditor may also issue reports related to federal award programs that the school district administers. The report on the school district's financial statements must be filed with the NYS Education Department by October 1 each year.

[3] Refer to Appendix A

[4] Refer to Appendix B

It is the Board's responsibility, through its established policies and procedures, to ensure that quality audit services are procured. This responsibility is further defined in statute. General Municipal Law §104-b requires political subdivisions, including school districts, to adopt procurement policies and procedures. The statute requires that goods and services which are not required by law to be procured pursuant to competitive bidding must be procured in a manner so as to assure the prudent and economical use of public moneys in the best interest of the taxpayers. The stated purpose of the statute is to facilitate the acquisition of goods and services of maximum quality at the lowest possible cost under the circumstances, and to guard against favoritism, improvidence, extravagance, fraud and corruption.

Objectives

The objectives of our audit were to determine the adequacy of existing practices for the procurement of audit services and the effectiveness of such audit services as a means for the timely detection of errors and irregularities. Our review addressed the following questions:

- Did the District follow appropriate policies and procedures when procuring audit services?
- Did the audit work of the CPA firm meet the purposes, terms and conditions of the contract of engagement and provide effective oversight for District fiscal operations?

Scope and Methodology

We examined the independent audit services of the District for the 2001-2002 and 2002-2003 fiscal years.

We conducted our audit in accordance with generally accepted government auditing standards. More information on such standards and the methodology used in performing this audit are included in Appendix D of this report.

Comments of Local Officials and Corrective Action

We met with District officials to discuss the findings and recommendations contained in this report. District officials agree with the recommendations and indicated that they either have or plan to implement them.

The District Board of Education has the responsibility to initiate corrective action. Pursuant to Section 35 of the General Municipal Law, the District Board of Education should prepare a plan of action that addresses the recommendations in this report and forward the plan to our office within ninety days. For guidance in preparing your plan of action, you may refer to applicable sections in the publication issued by the Office of the State Comptroller entitled *Local Government Management Guide*. We encourage the District Board of Education to make this plan available for public review in the District clerk's office.

Procurement of Audit Services

We assessed the District's procurement of audit services by determining if related policies and procedures were adequate. We reviewed the District's Purchasing Policy and Regulations, interviewed District office personnel and evaluated the process with which the District procured audit services for the 2001-2002 and 2002-2003 school years.

Our review disclosed that the District's written policies and procedures for the procurement of audit services were generally adequate. However, our audit found that officials did not comply with established policies and procedures and, as a result, did not procure audit services in an effective manner.

According to the District's Purchasing Regulations, when procuring professional services the District will contact a number of professionals (e.g., architects, engineers, accountants, lawyers, underwriters, fiscal consultants, etc.) and request that they submit written proposals. The requests for proposals (RFPs) may include negotiations on a fair and equal basis. The RFPs and evaluation of such proposals will consider price plus other factors such as:

- The special knowledge or expertise of the professional or consultant services
- The quality of the service to be provided
- The staffing of the service
- The suitability for the District's needs.

The District will first locate prospective qualified firms by:

- Advertising in trade journals
- Checking listing of professionals or
- Making inquiries of other districts or other appropriate sources.

The District will then prepare a well-planned RFP which will contain critical details of the engagement, including the methods which it will use in selecting the service provider.

The assistant superintendent for business of the District is delegated the responsibility, as purchasing agent, to ensure compliance with the District's purchasing policies.

Our review disclosed that District officials did not solicit RFPs for auditing services for the District's fiscal years 2001-2002 and 2002-2003. The associated fees paid by the District for the two years' services amounted to $17,700 and $40,000 respectively. The CPA firm retained to provide the foregoing audit services had been performing these same services for the District since 1993. The former assistant superintendent for business was responsible for ensuring that RFPs were solicited.

We expanded our review to determine how the District procured its professional services contract for the audit of its general purpose financial statements for the fiscal year 2003-2004. We found that the District, via acceptance of the terms and provisions of an engagement letter on November 20, 2003, contracted for audit services with the foregoing CPA firm, for a fee of $42,000. We found no evidence that the District had solicited RFPs for this professional service. In May 2004, prior to the annual audit services being rendered, the Board terminated its contract with the CPA firm.

In June 2004, the District's present assistant superintendent for business solicited proposals for the following services: 1) audit of general purpose financial statements for the fiscal year ending June 30, 2004, including the audit of the District's federal financial assistance programs; and 2) internal auditor. We found that the District had not prepared a written RFP for these services. District officials told us that "time was of the essence" to get a new audit firm on board as quickly as possible to ensure the conduct of timely audit services.

District personnel located prospective qualified firms by obtaining and contacting audit firms included on the SCOPE listing (a listing of Nassau County board members, attorneys, auditors, etc.). According to our discussions with District business officials, the District contacted by telephone all the auditors included on the listing. Most of the audit firms declined for various reasons, such as already having their audit resources fully committed for other engagements. In response, the District's forensic audit committee recommended the assistant superintendent for business re-canvass for audit proposals, and suggested that requests for proposals be extended to large audit firms as well. Ultimately, the District received three proposals for the general purpose financial statement audit, and two proposals for internal audit services. Not all proposals submitted to the District were done so in a documented manner, and/or the written proposal was not readily available for our review. The Board awarded the following service contracts: (1) annual financial statement audit for the fiscal year ended June 30, 2004 on August 16, 2004; (2) internal auditor for the 2004-2005 school year on July 6, 2004; and (3) consulting services for development of a five-year fiscal plan on July 6, 2004.

Recommendations

1. District officials should prepare a well-planned, written request for proposal for all subsequent audit services, in accordance with the District's Purchasing Regulations.

2. Written proposals should be obtained and retained on file at District offices.

3. District officials should consider changing audit firms or personnel, where appropriate, when contracts expire or at least every five years.

Effectiveness of Audit Services

The District contracted with the CPA firm Miller, Lilly & Pearce, LLP[5], to conduct an independent audit of its financial statements for the two fiscal years addressed by our audit. As a result of their audit work, the CPA firm issued an unqualified opinion to the District for both fiscal years.

We assessed the effectiveness of the District's engagement of an independent audit as an oversight tool for District managers by determining whether contractual audit services provided to the District met the terms and provisions of the engagement contract, including professional auditing standards.[6] Our review considered requirements under the standards concerning independence, planning the audit, obtaining evidence, and reporting on matters found during the audit, and covered the financial statement audits for the District's 2001-2002 and 2002-2003 fiscal years.

Generally accepted government auditing standards, as promulgated by the Government Accountability Office of the United States, consist of a series of measures intended to ensure quality audit work. These criteria are structured around four general standards, nine fieldwork standards and nine reporting standards. Non-compliance with one of these standards would be cause for concern and could result in a referral to the State Board of Accountancy. Our audit of the CPA's work for the District for the 2001-2002 and 2002-2003 fiscal years revealed compliance problems with 9 of those 22 standards.

Specifically we found problems with the quality of audit work for the following standards.

- In all matters relating to the audit work, the audit organization and the individual auditors, whether government or public, should be free from personal and external impairments to independence, should be organizationally independent, and should maintain an independent attitude and appearance.

- Due professional care should be used in conducting the audit and in preparing related reports.

- Each audit organization conducting audits in accordance with these standards should have an appropriate internal quality control system in place and undergo an external quality control review.

- Auditors should design the audit to provide reasonable assurance of detecting irregularities that are material to the financial statements.

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[5] This firm, located in East Setauket, NY, reports having a client base that consists of 50-60 school districts covering Long Island and the lower Hudson Valley.
[6] Refer to Appendices A and B.

- Auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from direct and material illegal acts.

- Auditors should obtain a sufficient understanding of the internal controls to plan the audit and determine the nature, timing, and extent of tests to be performed.

- A record of the auditors' work should be retained in the form of working papers.

- Working papers should contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditors' significant conclusions and judgments.

- The report on the financial statements should either (a) describe the scope of the auditors' testing of compliance with laws and regulations and internal controls and present the results of those tests or (b) refer to separate reports containing the information. In presenting the results of those tests, auditors should report irregularities, illegal acts, other material noncompliance, and reportable conditions in internal controls. In some circumstances, auditors should report irregularities and illegal acts directly to parties external to the audited entity.

Based on our review, we conclude that the work performed on the audits was significantly flawed and did not meet professional requirements. As a result, the CPA firm did not identify the multi-million dollar fraud carried out by District personnel. The audit work performed was so deficient we will refer our report to the State Board for Public Accountancy. In addition, we are going to refer this report to the Nassau County District Attorney.

General Standards - Independence

The Independence Standard[7] requires, that in all matters relating to the audit work, the audit organization and the individual auditors, whether government or public, be free, both in fact and appearance, from personal, external, and organizational impairments to independence. Furthermore, the standards call for an audit organization to have an internal quality control system to help determine whether auditors have any personal impairments to independence that could affect their impartiality or the appearance of impartiality. Personal impairments of staff members result from relationships and beliefs that might cause auditors to limit the extent of the inquiry, limit disclosure, or weaken or slant audit findings in any way. [GAGAS §3.03, §3.07] Examples of personal impairment of an individual auditor under both the old and new Independence Standard follow:

[7] Our review included consideration of independence under both the old GAGAS Independence Standard (audits conducted before January 1, 2003) and the new GAGAS Independence Standard (audits beginning after January 1, 2003)

- For audits conducted before January 1, 2003: A personal impairment is present if the audit organization has a financial interest that is direct, or is substantial though indirect, in the audited entity or program. [GAGAS §3.16]

- For audits beginning after January 1, 2003: Similar to the old standard, a personal impairment is present if the audit organization has a financial interest that is direct, or is significant/material though indirect, in the audited entity or program. This newer Standard further states "audit organizations that provide other professional services (nonaudit services) should consider whether providing these services creates a personal impairment, either in fact or appearance, that adversely affects their independence for conducting audits." [GAGAS §3.07, §3.10]

Finance Manager

Two of the three partners of the CPA firm with which the District contracted for its annual financial statement audits were principal officers of the company from which the District procured its financial accounting software package, and with whom the District has maintained an ongoing relationship for service support for this software. From August 1992 to June 2004, a period of 12 years, the District paid a total of $129,000 for the software and support.

The Finance Manager software company (Company) was started by the CPA firm executive partner in 1991. According to the executive partner, he held the title of president of the Finance Manager software company until May 21, 2004, at which time the company vice-president assumed that role. Similarly, the CPA firm's administrative partner held the title of company secretary/treasurer until May 21, 2004. The CPA firm's executive and administrative partners hold 45 percent and 10 percent ownership of the Company, respectively. A third party, unrelated to the CPA firm, holds the remaining 45 percent interest. Approximately 250 school districts statewide use the Finance Manager financial accounting software. Based on our review of the relationship between Finance Manager and the CPA firm's executive and administrative partners, we concluded an impairment of independence was present due to the direct financial interest of the partners of the CPA firm garnered through their ownership interest of the Finance Manager software company.

Our conclusion as to the presence of an independence impairment is further supported by guidance issued by the Government Accountability Office (GAO) titled Government Auditing Standards: Answers to Independence Standard Questions.[8] This guidance addresses the issue in question:

[8] GAO-02-870G issued July 2002

> "If an audit organization develops or designs accounting or other financial systems software, can the audit organization sell the software to audit clients without impairing the audit organization's independence to audit the client's financial statements? What if the audit organization significantly modifies computer software that the audit client has purchased from another firm or off the shelf?
>
> In both cases, the answer would be no. Since the financial systems described in these questions are significant/material to the subject matter of the audit, an audit organization would not be independent to perform the financial statement audit because it would violate the principle of auditing its own work."

To remedy the aforementioned impairment, the executive partner conveyed to us that blind trust agreements were in the process of being drawn up, to be effective May 22, 2004, in which the executive and administrative partners of the CPA firm would place their financial interests in the Finance Manager software company in a blind trust administered by a third-party trustee. To support the executive partner's claim, we were provided a copy of a letter, dated May 27, 2004, sent to the CPA firm's clients, explaining that the principals of the CPA firm had determined that under the new Independence Standard, auditor independence could be jeopardized by the partners' relationship with Finance Manager, and as such, the two principals had resigned their positions as president and treasurer of the Finance Manager software company. This letter further explained to the CPA firm's clients that all of the principals' rights and privileges relative to management decisions and other areas of control of Finance Manager would be placed in a trust to be administered by an unrelated third-party trustee.

However, as of October 28, 2004, the trust agreements were not yet fully executed even though the documents explicitly state "trust agreement is made and entered as of the 22nd of May 2004." We were informed this date was purposely chosen as the effective date to sever ties with Finance Manager so as to not impair the CPA firm's ability to conduct audits for the fiscal years ended May 31, 2004 and beyond.

Further, we question whether a blind trust would, in fact, remedy an independence impairment. Information obtained from the American Institute of Certified Public Accountants' (AICPA's) website on Ethics Rulings on Independence, Integrity, and Objectivity appears to indicate that a blind trust would not remedy an independence impairment, as follows:

> "Would independence be considered to be impaired if a member transferred a direct financial interest in a client into a blind trust?

> Independence would be considered impaired if a covered member had a direct financial interest in a client, whether or not the interest was placed in a blind trust. Further, the covered member should ensure that any blind trust for which he or she is a beneficiary does not hold a direct or material indirect financial interest in any clients with respect to which he or she is a covered member." [ET §191.68 Blind Trust, Q.136 and A.137]

Student Manager

We also reviewed the relationship between the CPA firm and Student Manager. For approximately two and one-half years, the District utilized the SchoolMAX Student Information System (Student Manager) obtained through "an arrangement" with Finance Manager. According to District records, expenditures totaling in excess of $230,000 were paid for Student Manager between the period April 2001 and July 2003.

We found that two of the partners in the CPA firm were involved in the arrangement that brought the administrative software program to the District. Contrary to professional standards, these partners received a commission for their role in the arrangement.

During our review, we were informed that the executive partner of the CPA firm, acting in a "sales-agent" capacity, brokered the deal for Student Manager with the District. The executive partner informed us that Finance Manager simply received a commission for aiding in the marketing and sale of the software. To accommodate business transacted for sales of the SchoolMAX software, a company known as Municipal Technology Consultants, Ltd. was used. This company was activated in 1998, with the CPA firm's executive partner as principal officer, and dissolved in 2003.

In a subsequent meeting with the executive and administrative partners, it was explained to us that the Student Manager deal had been brokered by a sales representative from a third-party consulting company,[9] and that Finance Manager's involvement was merely that of the use of Finance Manager's established name to broker the deal, and to serve as the billing and fee distribution conduit for the transaction. Based on our understanding, Student Manager via Finance Manager would bill the District for products, services and support. We believe over the course of the two and one-half years the system was in place, Finance Manager's only service provided was sending bills to the District. District payments were made payable to Student Manager

[9] Information obtained from the New York State Department of State indicated this third-party sales representative is/was employed by MML Software Ltd. d/b/a Finance Manager holding the title of Sales and Information.

and generally deposited into a bank account under the name of Municipal Technology Consultants, Ltd. Upon receipt of payment, cash distributions were made to the company that actually supplied the software, to the sales representative of the consulting company for selling the software, to another individual who brokered the agreement that allowed for the use of Finance Manager's name to market the SchoolMAX software, and to Finance Manager for repayment of a startup loan to Municipal Technology Consultants, Ltd.

The above transaction appears to be a commission or referral fee, and would be prohibited under the AICPA rules on Commission and Referral Fees [ET §503.01]. According to those rules, a member in public practice can not receive a commission to recommend or refer to a client any product or service, or recommend or refer any product or service to be supplied by a client, when the member or the member's firm also audits the client's financial statement. Although the commissions in question were paid to Finance Manager, the CPA firm executive and administrative partners collectively held a majority interest in the Finance Manager software company; thereby garnering them financial benefit from this arrangement.

Internal Quality Control

The GAGAS standards call for an audit organization to have an internal quality control system to help determine whether auditors have any personal impairments to independence that could affect their impartiality or the appearance of impartiality. Personal impairments of staff members result from relationships and beliefs that might cause auditors to limit the extent of the inquiry, limit disclosure, or weaken or slant audit findings in any way. [GAGAS §3.03, §3.07]

The CPA firm's internal quality control system includes a Quality Control Standards document[10] which requires all personnel to review and complete an Independence Checklist for Employees on a semi-annual basis. The CPA firm was unable to initially provide us the Independence Checklist for Employees for the executive and administrative partners for the years 2001-2003. A week after our initial request, on November 3, 2004, we received the requested checklists accompanied by correspondence indicating "we have only performed the independence review on an annual basis for the past five years so we will update our Quality Control documentation."

[10] According to this document "all personnel are required to adhere to the independence rules, regulations, interpretations, and rulings of the AICPA, New York State CPA Society, New York State Board of Accountancy, and State statutes. Compliance with policies and procedures relating to independence is monitored. Semiannually, at staff meetings, provision is made for all personnel to review and complete the Independence Checklist for Employees. The purpose of the checklist is to indicate that they are familiar with the firm's independence policies and procedures, they are not now nor have been holding prohibited investments, and that are not now nor have been involved in relationships or transactions that are prohibited."

On each of the six forms provided to us, the partners represent that they "have not entered into any prohibited transactions, nor am aware of having any prohibited relationships; and, any situations where I am either not independent or do not know whether I am independent is listed and explained." The forms provided to us were dated December 2001, 2002 and 2003. However, in August 2002, the CPA firm was advised by the Professional Ethics Committee of the New York State Society of Certified Public Accountants to contact the General Accounting Office to obtain a ruling concerning the potential independence impairment caused by the relationship of two of the CPA firm's partners with the Finance Manager software company. Therefore, information concerning possible independence issues should have been disclosed on the respective Independence Checklist for Employees executed by the partners for both the 2002 and 2003 years.

Field Work Standards-Planning the Audit

Our review of the CPA's workpapers documenting audit planning for the 2001-2002 and 2002-2003 fiscal years revealed several instances where generally accepted government auditing standards were not met.

The planning phase of the audit is critical to the success (and quality) of the resultant fieldwork and communications to management. The information gathered during the planning phase will help the auditor determine the nature, timing and extent of audit tests needed to accomplish the audit objectives (and adhere to professional standards).

Internal Control in a Financial Statement Audit

The CPA firm's documented understanding of the District's internal control structure did not substantially comply with auditing standards. Auditing standards require that a sufficient understanding of internal controls be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

The AICPA Statement on Auditing Standards (SAS) (AU 319) states that in all audits, the auditor should perform procedures in order to obtain an understanding of the design of controls relevant to the audit, and whether the controls are actually operating. Internal control consists of five interrelated components which are:

- Control Environment
- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring

The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the following:

- Integrity and ethical values
- Commitment to competence
- Board of directors or audit committee participation
- Management's philosophy and operating style
- Organizational structure
- Assignment of authority and responsibility
- Human resource policies and practices

For the 2001-2002 and 2002-2003 fiscal years, several internal control components contained in AU 319 were not addressed by the audit. The CPA's form used to document the auditor's understanding of the District's internal controls did not address the District's:

- Control Environment for integrity and ethical values
- Control Environment for commitment to competence
- Risk Assessment
- Information and Communications
- Monitoring

In addition, these audits contained no conclusions or evaluations of the components that were considered. (We noted that a control risk assessment of "maximum"[11] was documented for each financial statement balance item on the auditors' Overall Audit Approach workpaper. Such an assessment allows the auditor to do less audit work involving internal controls.)

For the 2002-2003 annual financial statement audit, the omitted components take on added significance. The audit partner (and others of the firm) had been involved in the documentation of a misappropriation of funds discovered at the District in October 2002.[12] This event gave the auditors first-hand knowledge of the District's control environment, particularly management's integrity and ethical values. We found no evidence that this information was included in the 2002-2003 planning workpapers.

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[11] Auditing standards state that after obtaining the understanding of internal control, the auditor may assess control risk at the maximum level for some or all of the assertions because he or she believes controls are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient. Assessing control risk below the maximum level involves: (a) identifying specific controls relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions and (b) performing tests of controls to evaluate the effectiveness of such controls.

[12] Refer to Appendix C

The Auditor's Responsibility to Detect and Report Errors and Irregularities

The CPA firm's documentation of Potential Errors and Irregularities consisted of a standardized form with identical information for 2001-2002 and 2002-2003. Risk factors used on the form were consistent with guidance contained in AU 316A.10[13], except that one risk factor was omitted. While SAS guidance only suggests the risk factors that the auditor may consider, there seems to be no rationale for the ones used and omitted by the auditors. The form did not assess the following:

- Management operating and financing decisions are dominated by a single person.

Many sources have indicated that the District and the Board relied heavily on, and implicitly trusted, the superintendent. Had the CPA firm considered this one additional factor, the risk assessment could not have been "low" (as all the others were). Conversely, the audit form included a risk assessment factor for "going concern" which is a negligible risk for New York State school districts. This risk was assessed as low, instead of not applicable. It would seem that the risk of decisions dominated by a single person would be a much more pertinent risk to assess for New York State school districts.

Other risk factors used on the form are consistent with guidance contained in AU 316A.15, except that several factors were omitted. The CPA form did not assess the following:

- Effect of risk factors identified at the financial statement or engagement level on the particular account balance or transaction class
- Frequency or significance of difficult-to-audit transactions affecting balance or class
- Extent of judgment involved in determining the total balance or class
- Size and volume of individual items constituting the balance or class
- Complexity of calculations affecting the balance or class.

All risk factors considered on the CPA form were assessed as low for the 2001-2002 and 2002-2003 audits. The CPA form carried a standard conclusion that "The risk of potential error and irregularities is acceptable. Our overall audit program includes sufficient procedures to offset any risk and irregularities. Exceptions may be noted." This particular form was signed and dated by the CPA firm partner in 2001-2002 and 2002-2003.

[13] This guidance was superseded by Statement on Auditing Standards No. 82; effective for audits of financial statements for periods ending on or after December 15, 1997.

As with other sections of the 2002-2003 audit planning workpapers, it is reasonable to expect that the District events of October 2002[14] should have impacted the CPA firm's consideration of certain risks. Since documented irregularities had occurred in the District, that fact should have been included in the CPA's assessment of risk for errors and irregularities and, therefore, the risk would have been assessed at a higher level and would have required increased testing.

Consideration of Fraud

We found no evidence that fraud was considered as part of the audit planning for the 2001-2002 fiscal year. In the 2002-2003 audit workpapers there was a checklist, Planning the Engagement, that contained a step requiring the auditor to "complete Consideration of Fraud planning documents." (This same checklist used in the 2001-2002 audit did not contain such a step.) According to the 2002-2003 checklist, this step was performed on January 9, 2003. However, there was no cross-reference to any fraud planning documents and such documents were not found during our review of the planning section.

Auditing standards (AU 316) state that the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.[15]

Per these auditing standards, the auditor should specifically assess the risk of material misstatements of the financial statements due to fraud and should consider that assessment in designing the audit procedures to be performed. In making this assessment, the auditor should consider fraud risk factors that relate to both misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets in each of the related categories presented in paragraphs .16 and .18. Paragraph .16 states that the risk factors that relate to misstatements arising from fraudulent financial reporting may be grouped in the following three categories:

- Management's characteristics and influence over the control environment
- Industry conditions
- Operating characteristics and financial stability.

[14] Refer to Appendix C.
[15] The Statement on Auditing Standards No. 82, Consideration of Fraud in a Financial Statement Audit, is effective for audits of financial statements for periods ending on or after December 15, 1997.

More pertinent to a school district's operations, paragraph .18 states that the risk factors relating to misstatements arising from misappropriation of assets may be grouped in the two categories below. The extent of the auditor's consideration of risk factors in category *b* is influenced by the degree to which risk factors in category *a* are present.

a) Susceptibility of assets to misappropriation
b) Controls

We note that the CPA firm, in their Overall Audit Approach, assessed control risk at maximum for each financial statement balance in the 2001-2002 and 2002-2003 workpapers. Such an assessment of control risk does not reduce their responsibilities to evaluate the risk of fraud. The auditor should assess the risk of material misstatement due to fraud regardless of whether the auditor otherwise plans to assess inherent risk or control risk at the maximum.

If the CPA firm had properly assessed the risk of fraud using the guidance contained in the applicable auditing standard, they may have considered the following specific indicators, all of which were present in the District:

- Domination of management by a single person or small group without compensating controls such as effective oversight by the board of directors (Board of Education) or audit committee
- Inadequate monitoring of significant controls
- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm
- Significant, unusual, or highly complex transactions, especially those close to year end, that pose difficult "substance over form" questions
- Susceptible inventories or fixed assets consisting of small size, high marketability or lack of ownership identification
- Lack of appropriate segregation of duties or independent checks
- Lack of appropriate system of authorization and approval of transactions (for example, in purchasing).

Given the known events of October 2002[16] regarding the misappropriation of District assets, the lack of documented planning work in this area for the 2002-2003 financial statement audit is particularly troubling.

Illegal Acts by Clients

Although the planning workpapers for the 2001-2002 and 2002-2003 fiscal years demonstrate some compliance with auditing standards regarding illegal acts by clients (AU 317), our review disclosed certain deficiencies.

[16] Refer to Appendix C.

The audit program for Year End Considerations addressed the issue of illegal acts. In the 2001-2002 and the 2002-2003 workpapers, the CPA firm partner signed this program which required the auditor to: "Inquire of management concerning client's compliance with laws and regulations." Based on this inquiry, the auditor was then required to "list formal policies relative to the prevention of illegal acts and note (and discuss) directives issued by management, if any." [17] These audit steps would signify minimum compliance with the standards.

This audit form also contained the following standardized conclusion: "Our overall procedures indicate no indications of possible illegal acts and that there is no need to follow-up in accordance with professional standards." In 2002-2003, "N/A" was entered for each section of the form. There were no cross-references to workpapers documenting inquiries of management or lists of policies and/or directives.

The standards suggest that in applying audit procedures and evaluating the results of those procedures, the auditor may encounter specific information that may raise a question concerning possible illegal acts, such as the following:

- Unauthorized transactions, improperly recorded transactions, or transactions not recorded in a complete or timely manner in order to maintain accountability for assets
- Large payments for unspecified services to consultants, affiliates, or employees
- Unexplained payments made to government officials or employees.

Our audit work at the District has identified that wide-ranging illegal acts were occurring at the District for a number of years, including 2001-2002 and 2002-2003. Many of these illegal acts could have been evidenced by one or more of the items contained in the above guidance.

The audit partner and others from the CPA firm were aware of at least one of these items, (the theft and restitution of $250,000 by the assistant superintendent for business in October 2002)[18] and yet this information was not documented in the 2002-2003 audit plan. In fact, that section of the plan was designated N/A.

Related Party Transactions

The extent of work for related party transactions evidenced in the audit planning workpapers for the 2001-2002 and the 2002-2003 fiscal years was below standard.

[17] In the absence of evidence concerning possible illegal acts, the standards (AU 317.08) require the auditor to inquire of management concerning the client's compliance with laws and regulations. Where applicable, the auditor should also inquire of management concerning policies relative to the prevention of illegal acts and directives issued by the client.

[18] Refer to Appendix C.

The planning workpapers for Year End Considerations addressed the issue of related party transactions. In 2001-2002 and 2002-2003, the audit partner signed the workpaper which required the auditor to determine existence of related parties. (In 2001-2002, a check mark was used for this procedure. In the 2002-2003 workpapers, "None" was entered for this procedure.) No cross-references were provided in either year, and we found no workpapers documenting any work done to determine the existence of related parties.

Auditing standards define related parties as, among other things, management of the organization. This concept would be applied to the elected members of the Board and appointed officials of the District.

For determining the existence of related parties, the auditor should place emphasis on testing material transactions with parties they know are related to the reporting entity. Determining the existence of related party transactions requires the application of specific audit procedures. Auditing standards (AU 334.09) state that the following procedures (and others) are intended to provide guidance for identifying material transactions with parties known to be related and for identifying material transactions that may be indicative of the existence of previously undetermined relationships:

- Review conflict-of-interests statements obtained from management
- Review the extent and nature of business transacted with major customers, suppliers, borrowers, and lenders for indications of previously undisclosed relationships
- Review accounting records for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period.

Many of the questionable transactions revealed during our audit of the District were to employees and managers of the District. Also, it appears that payments were made to companies created by District officers. Further, fraudulent payments were credited to major suppliers, service providers and lending institutions. We found also, that for the 2001-2002 fiscal year, there were large, unusual and nonrecurring adjustments to recorded expenditures made near fiscal year-end. These adjusting transactions involved many of the expenditures presently under investigation.

Analytical Review Procedures

The extent of work for analytical review procedures evidenced in the audit planning workpapers for the 2001-2002 and the 2002-2003 fiscal years was below standard.

Auditing standards (AU 329.06) state that the purpose of applying analytical procedures in planning the audit is to assist in planning the nature, timing and extent of auditing procedures that will be used to obtain evidential matter for specific account balances or classes of transactions. To accomplish this, the analytical procedures used in planning the audit should focus on (a) enhancing the auditor's understanding of the client's business and the transactions and events that have occurred since the last audit date, and (b) identifying areas that may represent specific risks relevant to the audit. Thus, the objective of the procedures is to identify such things as the existence of unusual transactions and events, and amounts, ratios and trends that might indicate matters that have financial statement and audit planning implications.

The CPA firm's General planning workpaper provided a checklist of nine steps to perform. For 2001-2002 and 2002-2003, Step 5 required the auditor to perform analytical procedures during the planning stage. Step 5a called for the auditor to "Obtain sufficient understanding of clients business, transactions and events since the last audit date." Step 5b directed the auditor to "Identify specific risk on Overall Audit Approach, if any. If none, no comment necessary on Overall Audit Approach." (No specific risks were noted on the 2001-2002 or the 2002-2003 Overall Audit Approach).

No cross-referenced documentation was noted, or found, in the CPA firm's workpapers for these procedures. However, there is a reasonable expectation that such procedures would document the events of October 2002 for the 2002-2003 financial statement audit and the material journal entries made to reclassify expenditures at fiscal year-end for the 2001-2002 audit.

Client Representations

For the 2001-2002 financial statement audit, a representation letter from management was not obtained as required by auditing standards.[19]

Management makes many representations to the auditor, both written and oral, in response to specific inquiries or through the financial statements. Such representations from management are part of the evidential matter the independent auditor obtains.

[19] Section AU 333.11 states that management's refusal to furnish a written representation letter constitutes a scope limitation and precludes an unqualified opinion. We note that the CPA firm issued an unqualified opinion for the District's 2001- 2002 financial statements.

Auditing standards require that the auditor obtain written representations from management to complement other auditing procedures. The specific written representations obtained by the auditor will depend on the circumstances of the engagement and the nature and basis of presentation in the financial statements. Some matters ordinarily included in a representation letter, if applicable, are:

- Availability of all financial records and data
- Absence of errors in the financial statements and unrecorded transactions
- Information concerning related party transactions
- Noncompliance with aspects of contractual agreements
- Irregularities involving management or employees
- Violations or possible violations of laws or regulations.

The CPA firm's General planning workpaper provides a checklist of nine steps to perform. (Note: In 2001-2002, six of the nine steps did not indicate who performed the step and the date performed.) For the 2001-2002 audit, this form does not indicate that a representation letter was obtained from management (Step 2). There is no explanation given in the workpapers for the absence of this representation letter.

We note that the management representation letter obtained by the CPA firm for 2002-2003 audit addressed each of the previously identified matters except for the one concerning related parties. This letter, dated July 29, 2003, was signed by the District's interim assistant superintendent for business. Among other things, his signature confirmed that, to the best of his knowledge and belief, "There have been no irregularities involving management or employees who have significant roles in the internal control structure." Given the events of October 2002 and the fact that he was appointed to replace the assistant superintendent for business who was implicated in the misappropriation of funds, we question the reliability of this letter. We found no evidence that the CPA firm did the same.

Information Technology/Computer Applications

Our review of the planning workpapers for the financial statement audits for the 2001-2002 and 2002-2003 fiscal years disclosed no indication that the CPA firm had considered the District's use of information technology (IT) in planning the audit. Furthermore, we found no consideration of the specific risks associated with using IT in the workpapers.

According to the standards, during the planning phase of a financial statement audit, the auditor is required to consider the methods the auditee uses to process accounting information because such methods influence the design of the internal controls. The extent to which computer processing is used in significant accounting applications, as well as the complexity of that processing, may also influence the nature, timing and extent of audit procedures. Accordingly, the auditor should consider: (1) the extent to which the computer is used in each significant accounting application; (2) the complexity of the entity's computer operations; (3) the organizational structure of the computer processing activities; and (4) the availability of data. While an entity's use of IT may be extensive, the auditor is primarily interested in the entity's use of IT to initiate, record, process, and report transactions and other financial information.

Furthermore, the standards caution that information technology poses specific risks to an entity's internal control including: (1) reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both; (2) unauthorized access to data; (3) unauthorized changes to data in master files; (4) unauthorized changes to systems or programs; (5) failure to make necessary changes to systems or programs; (6) inappropriate manual intervention; and (7) potential loss of data. Therefore, as part of obtaining an understanding of internal control, it is incumbent upon the auditor to document his/her consideration of how an entity's use of IT may affect controls relevant to the audit.

We were informed by the executive partner that assessments of the District's computer systems were done in connection with Single Audit engagements. However, our review of the workpapers for the 2002 and 2003 single audits of the District found no evidence of consideration or assessment of the District's computer systems for the 2002 Single Audit, and it was determined that the auditor's assessment for the 2003 Single Audit was limited to systems in the Special Education Department.

A review of the documentary evidence of the foregoing assessment (a workpaper titled Assessment of Reliability of Computer Generated Output) provided the following information:

- The <u>objective</u> contained on the workpaper stated "to assess the reliability of computer generated output of the FM 2000 Accounting Software reports utilized at various points throughout this audit."

- The <u>work performed</u> statement on this workpaper stated, in part, "to test reliability of the computer generated output, we inputted a dummy receipt, disbursement, and journal entry into the system.

We then printed the Revenue Status Reports and the Appropriation Status Reports for the accounts the entries were book [sic] into and found the entry to be properly posted. Once satisfied, we had these entries voided from the system."

- The <u>conclusion</u> contained on this workpaper stated "based upon work performed as described above and our experience with the FM 2000 Software program, it appears that the computer generated output is reliable."

We found no additional documentation to support the foregoing test of data (e.g. copy of report, journal entry). Consequently, we sought to verify the voided entries in the Finance Manager software program. We found no voided entries in the stated accounts for the test entries claimed to be made by the CPA firm. Pursuant to our discussion with the executive partner on October 28, 2004, these entries were never made on the District's system, but rather were posted to a "demo software package" at the CPA firm's place of business.

Furthermore, we note that the CPA firm also formed its conclusion based on its "experience with the FM 2000 Software program" (or, viewed in another way, the audit partner's experience with the design and development of the FM software program). This further supports our claim that an impairment to independence was, in fact, present due to a professional and financial relationship that caused the CPA firm to limit the extent of its inquiry concerning the reliability of computer generated output. To demonstrate, consider some of the aforementioned risks that IT poses to an entity's internal control (e.g., unauthorized access to data, or inappropriate manual intervention). The CPA firm should have considered these risks in its assessment.

The Finance Manager program was designed with application controls built into the software to restrict and/or set off a warning when information does not appear reasonable (e.g., restricting access to certain software functions, or prohibiting the posting of an entry to an account with insufficient funds). We found no evidence in the workpapers that the CPA firm had considered the specific risks posed by IT and/or the controls the District had put into place to mitigate those risks. In fact, during our audit of the District, we found that the application controls built into the Finance Manager software had not been activated. Pursuant to our discussion with the executive partner on October 28, 2004, the CPA firm did not inquire about the activation of the Finance Manager application controls during the conduct of the audits of the District.

Based on the foregoing, we believe the CPA firm did not meet the professional audit standards, insofar as documenting a sufficient understanding, as well as in performing an adequate assessment, of the computer systems at the District.

Fieldwork Standards - Evidential Matter

Our review of the workpapers developed to support the 2001-2002 and 2002-2003 financial statement audits of the District disclosed recurrent, pervasive problems with the documentation. Virtually every comment in this report section cites problems with the lack of cross-references and lack of evidence to support supposed audit work. We noted numerous instances where initials and dates were missing when required, audit steps were not clearly explained, and audit conclusions and/or evaluations were not documented.

Generally accepted government auditing standards state that:

- A record of the auditors' work should be retained in the form of working papers.
- Working papers should contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditors' significant conclusions and judgments.
- The workpapers should contain the objective(s), scope and methodology, including any sampling criteria used.
- Workpapers should contain documentation of the work performed to support significant conclusions and judgments, including descriptions of transactions and records examined that would enable an experienced auditor to examine the same transactions and records.

The CPA's planning workpapers address a range of subjects including: Planning the Engagement, General, audit programs, Other Items of Importance, Confirmations, Commitments and Contingencies, and Year-end Considerations. Our review of these audit planning documents for the 2001-2002 fiscal year revealed 128 instances where either workpapers required additional explanation, cross-references to supporting workpapers were not provided, or the person performing (and the timing of) the audit procedure was not noted. Our review of these same workpapers for the 2002-2003 fiscal year identified 77 similar deficiencies.

When planning documents do not contain sufficient explanations there is increased risk that required procedures may not be completed correctly. If supporting documents are not developed and properly referenced, then the auditor's judgments and conclusions can not be verified. The person performing the audit procedure should be identified in the workpapers, as should the date that the tests are performed. This information establishes credibility (and accountability) to the work performed and allows for proper supervision of audit staff as required by professional standards.

Furthermore, our re-performance of certain procedures contained in the CPA's audit programs for the 2001-2002 and 2002-2003 fiscal years revealed several instances (outlined below) where our results differed from those documented in the audit workpapers.

Auditor Testing of Cash Disbursements

To assess the adequacy of audit evidence to support the CPA firm's conclusions and judgments, we reviewed the work done by the CPA firm in the cash disbursements cycle. The CPA firm's audit program for the cash disbursements cycle was comprised of the same five steps for both years reviewed. Our review of the workpapers provided by the CPA firm disclosed concerns with the application of audit tests, adequacy of documentation, and auditor judgments and conclusions for four of the five audit steps, as outlined below.

Audit Step #1
Determine that current purchasing policy is in accordance with State guidelines.

> The audit program for the year ended June 30, 2002 indicated that this audit step had been completed merely by the placement of a checkmark on the "Done By and Date" sign-off line. Consequently, we were unable to determine who had conducted this audit step or when it had been conducted.

Audit Step #2
Inquire into the purchasing procedures. Prepare a system description including controls over credit cards, charge accounts, and quotation and bidding requirements. Evaluate internal controls. Determine District policy for issuing 1099s and W-9s.

To accomplish this step, the auditor prepares a Purchasing Write-up and Accounts Payable Write-up. These workpapers were prepared in January 2002, and then updated in April and May of 2003, and document only the processes related to purchasing and accounts payable; neither write-up included an evaluation of the associated internal controls.

We observed commentary contained in the write-ups that should have been considered in the auditors' internal control evaluation. For example, the auditor documented that central office staff had access to approximately 20 gas cards; the superintendent sometimes lent out his Corporate American Express card; blank checks were kept in an unlocked cabinet, the current box of checks was kept outside of the cabinet and opened; the superintendent's secretary signs the checks; and the Board does not review warrants.

A meeting with the CPA firm partners on October 28, 2004 disclosed errors in the write-ups that further contribute to our conclusion that the audit evidence reviewed for this audit step was insufficient. For example, the Accounts Payable Write-up, for both years reviewed, stated that "the Internal Auditor reviews and signs each PO…" However, per our discussion with the CPA firm partners, it was determined that the internal auditor does not review and sign each purchase order (PO), but rather reviews the bill packets and then signs off on the warrants.

Finally, no evidence was found to indicate the CPA firm had determined the District's policy for issuing 1099 Miscellaneous Income forms and W-9 Request for Taxpayer Identification Number and Certification forms.

Audit Step #3
Judgmentally select paid bills on a monthly basis from the warrants. The sample size and materiality limit will be determined by engagement partner. Special attention should be given to operations and maintenance, disbursements to individuals, travel and conference expenses for Board members and superintendent, and bidding requirements. Auditors should examine all bills for: (1) authorization; (2) arithmetic accuracy; (3) proper treatment of discounts; (4) exclusions from sales taxes; (5) documented receipt of goods and services; (6) accuracy of coding; (7) supporting invoices; (8) quotes needed per policy; and (9) bids where required. Expenditures not supported by invoices should be investigated.

To accomplish this audit step, the CPA firm selected approximately 240 "paid bill packets" (comprised of the Accounting and Receiving copies of the purchase order, vendor invoice, receiving slip, if any, and duplicate copy of the District's disbursement check) to review. Independent from the aforementioned sample, the CPA firm's audit program called for testing expenditures greater than $25,000. To accomplish this, the auditors were suppose to generate data from the Finance Manager accounting software system, sort it and glance at every amount paid. The auditors then were to judgmentally select bills to review from this sample (at a minimum, at least one bill for every vendor listed).

Our review of the testing and documentation for this audit step disclosed the following deficiencies:

- Auditor review of supporting documentation was limited to viewing paid bill packet only. For example, where bids were required, the auditor simply looked for "reference" to bid number(s) on the bill packet documentation, and did not review the physical bid documentation.

- Auditors did not inspect checks for any of the disbursements tested. Physical inspection of checks can provide assurance that the payee on the check corresponds with the name recorded in the district's disbursement records and any supporting documents.

- We found no evidence that the absence of invoices for four disbursements for the 2001-2002 school year, and eight disbursements for the 2002-2003 school year, were investigated.

- The audit manager informed us, for both audit years, no expenditures identified for the test of expenditures greater than $25,000 were selected for a detailed review. Rather, the listing, once compiled, was just "eye-balled" for reasonableness of expenditure payments.

Audit Step #4
Summarize results of voucher testing. Paragraph or numerical summary. Render an opinion on overall compliance with purchasing policy.

- We found no documented evidence in the workpapers to indicate test "exceptions" were discussed with District management for the 2001-2002 audit. Exceptions ran the gamut, and included absence of authorization, absence of invoice, no receiving signature, no purchase order, purchase order dated later than invoice, no quotes, and no bids.

- We found no evidence that four of the disbursements sampled for the 2002-2003 audit were actually tested.

- A note on the findings summary workpaper for the 2002-2003 audit indicated that someone had discussed the findings related to purchase orders being dated after the invoice dates with the interim superintendent for business (upon inquiry, we were informed that the executive partner had held this discussion with the interim superintendent for business). However, we found no other documented evidence in the workpapers to indicate that all other test "exceptions" were discussed with District management. Exceptions ran the gamut, and included absence of authorization, absence of invoice, no receiving signature, no purchase order, purchase order dated later than invoice, no quotes, no bids, payments of sales tax, purchases of gifts/flowers and lunches.

- While the audit program for each of the two years reviewed indicated the test of expenditures greater than $25,000 had been completed, a summary workpaper of the results of this test was not prepared, nor was a conclusion to this testing found.

Given the deficiencies in the CPA firm's disbursements testing as described above, we retested some of the same transactions to review the supporting documentation available for them and to determine whether any of the tested transactions were part of the fraudulent activity occurring at the District. We retested 24 transactions for the two years and found that documentation for 14 of the transactions (58 percent) was not available, and that 5 of the transactions (21 percent) were paid to vendors different than those listed on the CPA firm's workpaper.

We reviewed the results of our "re-test" with the executive and administrative partners. With regard to the missing supporting documentation, the executive partner told us that, at the time his auditors conducted the audits, supporting documentation for the exceptions noted above was on file and reviewed by the auditors.

Concerning the five payments that were made to vendors other than those listed on the CPA firm's workpaper, we found that had the auditors inspected the physical checks associated with their test items, they would have been alerted to possible irregularities and illegal acts.

In addition to the foregoing, we reviewed the four disbursements from the sample above that had not been tested by the auditors during the conduct of the 2002-2003 audit. We found that, other than one open purchase order, documentation to support these disbursements could not be found at the District. Interestingly, had the auditors viewed the one open purchase order, they may have been alerted to seek out additional information involving the related disbursement. This purchase order contained conflicting information. For example, it was issued to M&T (a known financial institution); however, it was charged to Maintenance Building Supplies, which was the account much of the fraudulent activity was originally charged to.

In addition, we found one workpaper where three vendor names differed from those recorded on the District's records. The workpaper documenting the test of disbursements for 2001-2002, which was purportedly prepared on or about August 1, 2002, shows the following information for three specific checks:

Check #	Vendor Name
155785	Champion Products
159945	Protech Comp Systems
160386	Sargent - Welch

However, our review of the District's computerized records as of October 17, 2002 (the earliest computer backup data available) shows that the vendor names recorded in the District's records were different than the names recorded on the CPA firm's workpapers, as follows:

Check #	Vendor Name On October 17, 2002
155785	American Express
159945	Providian
160386	American Express

In fact, these three disbursements are fraudulent and the vendor names recorded as of October 17, 2002, are the actual vendors that checks were made out to. They were for the personal expenses of District personnel.

It was not until late February or early March 2004 that someone with access to the District's computerized records changed the vendor names on the records in an apparent attempt to cover up the fraudulent activity.

We questioned how a CPA workpaper supposedly prepared in August 2002 could have included vendor names that were not placed into the District's records until February/March 2004. In response to our inquiry, the audit partner claimed that he received this vendor information directly from the assistant superintendent for business. The implication was that the assistant superintendent for business had changed the vendor names on the information she gave to the auditors in order to cover up her fraudulent activity. There is no evidence that the names were changed in the system at that time.

In addition, we found the same discrepancies in the 2002-2003 audit workpapers which were produced after the assistant superintendent for business had been dismissed in October 2002. For example, the auditor's workpapers documenting the test of disbursements, purportedly prepared in July 2003, shows the following information for four specific checks:

Check #	Vendor Name
161262	Sargent Welch
161265	Nassau County BOCES
161560	Kinderprint
161784	National Comp Sys

However, our review of the District's computerized backups[20] of their accounting records shows different vendor names as follows:

Check #	Vendor Name on October 17, 2002 and March 19, 2003
161262	American Express
161265	Citibank
161560	Key.
161784	Nations

The vendors names from the District's backup data are the actual vendor names on the checks. The names recorded in the auditor's workpapers are incorrect, and again, were not available in the District's system until sometime in February/March 2004.

Therefore, for two consecutive years, the CPA firm's workpapers contain vendor names that were not recorded in the District's records at the time of the audit. This raises serious questions as to the validity of the audit work done and the CPA firm's explanation for the discrepancy. In addition, we question the adequacy of the CPA firm's audit work when their audit sample included fraudulent payments and their audit work did not identify them as

[20] We reviewed the backup data from October 17, 2002 and March 19, 2003, the two closest backup dates before and after the purported workpaper date.

such. Although the CPA firm claims that invoices were available to support the fictitious payments, and that they reviewed them, we found no evidence of such invoices. And, if the CPA firm had reviewed the final payment documents, the cancelled checks, a review that is standard for any test of a disbursement transaction, they would have identified the questionable nature of these transactions.

Budgetary Controls

The CPA firm's audit program entitled Other Items of Importance required the auditor to "Prepare analysis of budgetary changes. Verify to Board Meeting Minutes." There was no cross-reference for this audit procedure in the 2001-2002 or 2002-2003 workpapers. Our review of District appropriation records for 2001-2002, revealed significant year-end budgetary adjustments and frequent over-expenditures that reflect a lack of budgetary control.

Our analysis of budgetary changes for certain 2001-2002 general fund appropriation accounts revealed the existence of dozens of material year-end expenditure reclassifications/transfers. These unusual entries ranged in amounts from \$4,500 to \$600,000, with more than a dozen of adjustments exceeding \$50,000. For these general fund accounts, we found that budgeted amounts were exceeded routinely and that purchase orders were issued when no appropriations were available. (The Finance Manager software allows the user to override budgetary controls.) These findings would constitute material weaknesses in budgetary (and purchasing) controls, which were undocumented and unreported by the CPA firm. Also, had the CPA firm done this work, they could have been alerted to the fraudulent transactions since many of the inappropriate transactions were reclassified in these year-end adjustments.

Purchasing Controls

Although much of the District's purchasing policy matches State guidance verbatim, it appears only parts of it were tested by the CPA firm. There are other aspects of the policy that raise audit concerns. For example, the director of finance is appointed to serve as the purchasing agent. This puts one person in a position to initiate and record purchasing transactions (a significant internal control weakness).

For the 2001-2002 and 2002-2003 financial audits, Step 1 of the audit program for Cash Disbursements required the auditor to "determine that the current purchasing policy is in accordance with State guidelines." A copy of the District's policy was kept in the CPA firm's permanent file.

A review of the CPA firm's copy of the District's purchasing policy disclosed the following relevant statements:

- The purchasing agent has sole authority for the District to contract for necessary supplies, equipment and services.

- The director of finance is appointed by the Board to serve as the purchasing agent. The purchasing agent shall be responsible for developing and administering the program of the District.

- No Board member, officer or employee of the District shall have an interest in any contract entered into by the Board or the District, as provided in Article 18 of the General Municipal Law.

- Goods and services … must be procured in a manner so as to assure the prudent and economical use of public moneys in the best interest of the taxpayers of the political subdivision or District, to facilitate the acquisition of goods and services of maximum quality at the lowest possible cost under the circumstances, and to guard against favoritism, improvidence, extravagance, fraud and corruption.

Step 2 of the audit program required the auditor to:

- Inquire into the purchasing procedures
- Prepare a system description including controls over credit cards, charge accounts, and quotations and bidding requirements
- Evaluate internal controls
- Determine District policy for issuing 1099s, W-9s.

The audit program did not indicate why these particular areas (see 2nd and 4th bullets above) of purchasing were emphasized and others were not. The program for Cash Disbursements testing procedures stated that "We reviewed the supporting documentation of the selected disbursements for overall compliance with the District's purchasing policy (located in the permanent file)..."

We found no evidence that tests were performed to determine whether contracts prohibited by General Municipal Law, Article 18 (Conflicts of Interest of Municipal Officers and Employees) were in effect in the District. We found no evidence that tests were performed to determine that goods and services were procured in a manner so as to assure the prudent and economical use of public moneys (or that gifts of public funds were made in violation of the State Constitution, Article VIII, § 1). We found no evidence that the CPA firm had determined the District's policy for issuing 1099s or W-9s.

All of these particular audit program tests of purchasing become even more relevant given the events of October 2002, known to the audit partner and others at the CPA firm.

Inventories

Our forensic audit work revealed that from November 1997 to July 2001, at least 49 computers totaling $110,000, purchased with District moneys, were not recorded on the inventory list prepared by an outside firm. Such inventory items would normally be verified because of the high risk associated with them.

The audit program for Fixed Assets (Capital Assets in 2002-2003) included several steps for the auditor to address controls over these assets. The audit program required the auditor to "Do System Description to determine controls over assets. Include addition and deletion controls. Determine how inventory records are maintained. Determine whether assets are tagged or otherwise identified as property of the District."

A review of the audit workpapers for capital assets for the 2002-2003 audit did not disclose any evidence that these procedures were performed to determine the controls over fixed assets. The 2002-2003 audit program did contain a note that a meeting was held "to discuss F/A controls and how it deals w/ GASB 34." We found no workpaper reference and no evidence of this discussion.

Further, there was no evidence in the workpapers that the (assertion) existence of recorded capital assets were verified. The CPA firm's workpapers for fixed assets (capital assets) do not indicate that the existence (and completeness) of any of these assets was confirmed through audit tests, such as the observation of inventories. (The Fixed Assets Write-Up for 2001-2002 mentions that the District contracted with an outside firm to conduct the initial inventory (1998) and update the accounting records each year based on District purchase orders.)

Other Audit Tests

Step 3 of the audit program for Cash Disbursements stated that "Special attention should be given to operations and maintenance, disbursements to individuals, travel and conference expenses for Board members and superintendent, and bidding requirements."

Our work at the District has revealed that many of the questionable activities from 1998 to 2003 occurred in the very areas that were to be reviewed per this audit program step. Further, one 2001-2002 appropriation account where many of the questionable transactions were recorded (and then adjusted at year-end) was, in fact, a maintenance account.

The audit program for Commitments and Contingencies required the auditor to "Review major contracts, lease agreements, and government regulations affecting the company." The program indicated that these items were discussed with the assistant superintendent for business for the 2001-2002 audit and the interim assistant superintendent for business for the 2002-2003 audit. The workpapers indicated that no note disclosures were required. The program does not identify the items reviewed nor does it provide a workpaper cross-reference.

Although this audit work is primarily intended to determine the need for note disclosures for the readers of the audited financial statements, had these items been more thoroughly reviewed rather than just discussed, perhaps some questions would have been raised. Our audit work has revealed questionable payments that could be considered major contracts (BOCES), lease agreements (Wells Fargo) and violations of government regulations (gifts of public funds).

Reporting Standards - Reporting on Internal Controls

Government audit standards state "the report on the financial statements should either (1) describe the scope of the auditors' testing of compliance with laws and regulations and internal controls and present the results of those tests or (2) refer to separate reports containing that information. In presenting the results of those tests, auditors should report irregularities, illegal acts, other material noncompliance, and reportable conditions in internal controls. In some circumstances, auditors should report irregularities and illegal acts directly to parties external to the audited entity." [GAGAS §5.15]

Communication of Internal Control Related Matters

Certain conditions regarding the internal controls of the District were not reported as required by standards.

The audit program for Year End Considerations addresses the issue of reportable conditions. In 2001-2002 and 2002-2003, the audit partner signed the workpaper which stated that "We noted no conditions that we considered reportable conditions under professional standards that should be reported to the Board of Directors or an appropriate level of management."

Auditing standards provide guidance for identifying and reporting conditions that relate to an entity's internal control observed during an audit of financial statements. These standards (AU 325.21) provide examples of conditions that may be reportable. Some pertinent examples include:

- Evidence of failure to safeguard assets from loss, damage or misappropriation
- Evidence of intentional override of internal control by those in authority to the detriment of the overall objectives of the system
- Evidence of willful wrongdoing by employees or management
- Evidence of manipulation, falsification, or alteration of accounting records or supporting documents
- Absence of a sufficient level of control consciousness within the organization
- Evidence of significant or extensive undisclosed related party transactions.

It would appear that the events of October 2002 would provide the CPA firm with much of the evidence of reportable conditions, cited by AU 325.21. Also, our audit work at the District has revealed additional reportable conditions in the internal controls over purchasing, budgeting and fixed assets.

Recommendations

4. The District should improve the quality of its acquired audit services. As part of its procurement policies and procedures for audit services, the engagement letter should adequately address:

   - The audit scope, including specific requirements of the District
   - The qualifications, independence, and experience of the firms selected and
   - The rotation of personnel where appropriate.

5. The Board should work with its recently established Citizens' Advisory Audit Committee to ensure that audit work and resultant findings receive adequate oversight. At a minimum, the Audit Committee should report directly to the Board and the Board should ensure that its Audit Committee has sufficient financial expertise necessary for reviewing the audit report and underlying audit work.

6. The responsibilities of the Audit Committee should include:

   - Providing timely oversight of external (and any internal) audit work
   - Involvement in the selection process of external (and internal) auditors

- Reviewing the District's financial statements before presentation to the Board and
- Monitoring any District corrective action plans.

7. The Board should ensure that the CPA firm reports directly to them and the Audit Committee.

8. The Board should communicate directly with its CPA firm to ensure that all reportable conditions are disclosed. Also, the Board should prepare a formal response to those disclosures, including a corrective action plan for any identified conditions.

9. The Board should increase (and maintain) its knowledge and awareness of its fiscal oversight, accountability and fiduciary responsibilities through continued education and other means available.

10. District officials and Board members should educate themselves on the scope and limitations of the annual independent audit. If audit services that are not covered by the annual audit are periodically needed, officials should consider expanding the scope of the audit or contracting for separate audits or reviews.

APPENDIX A

GENERALLY ACCEPTED GOVERNMENT AUDITING STANDARDS

Education Law and Regulations of the Commissioner of Education require an external audit be conducted by a certified public accountant in accordance with generally accepted government auditing standards (GAGAS).

Generally accepted government auditing standards are promulgated by the Government Accountability Office of the United States. The "Yellow Book", issued by the Comptroller General, contains guidelines for the conduct of financial statement audits that pertain to auditors' professional qualifications, the quality of audit effort, and the characteristics of professional and meaningful audit reports. The Yellow Book incorporates the standards of the American Institute of Certified Public Accountants (AICPA) and adds additional requirements for government audits. The Yellow Book standards are outlined below.

<u>Government Auditing Standards – 1994 Revision (Yellow Book)</u>
(Effective for financial audits of periods ending on or after January 1, 1995)

This document contains standards for audits of government organizations, programs, activities and functions, and of government assistance received by contractors, nonprofit organizations, and other non-government organizations. These standards, often referred to as generally accepted government auditing standards (GAGAS) are to be followed by the auditors and audit organizations when required by law, regulation, agreement, contract, or policy. The standards pertain to auditors' professional qualifications (general), the quality of audit effort (field work), and the characteristics of professional and meaningful reports (reporting).

The comprehensive nature of auditing done in accordance with these standards places on the audit organization the responsibility for insuring that:

1. The audit is conducted by personnel who collectively have the necessary skills

2. Independence is maintained

3. Applicable standards are followed in planning and conducting audits and reporting the results

4. The organization has an appropriate internal quality control system in place and

5. The organization undergoes an external quality control review.

<u>General Standards</u>

These general standards apply to all audit organizations, both government and non-government (for example, public accounting firms and consulting firms), conducting audits of government organizations, programs, activities and functions, and of government assistance received by non-government organizations.

1. The staff assigned to conduct the audit should collectively possess adequate professional proficiency for the tasks required.

2. In all matters relating to the audit work, the audit organization and the individual auditors, whether government or public, should be free from personal and external impairments to independence, should be organizationally independent, and should maintain an independent attitude and appearance.

3. Due professional care should be used in conducting the audit and in preparing related reports.

4. Each audit organization conducting audits in accordance with these standards should have an appropriate internal quality control system in place and undergo an external quality control review.

Field Work Standards

For financial statement audits, GAGAS incorporates the AICPA three generally accepted standards for field work. AICPA and GAGAS require the following:

1. The work is to be properly planned, and auditors should consider materiality, among other matters, in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures.

2. Auditors should follow up on known material findings and recommendations from previous audits.

3. Auditors should design the audit to provide reasonable assurance of detecting irregularities that are material to the financial statements.

4. Auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from direct and material illegal acts.

5. Auditors should be aware of the possibility that indirect illegal acts may have occurred. If specific information comes to the auditors' attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditors should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.

6. Auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from noncompliance with provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statement amounts. If specific information comes to the auditors' attention that provides evidence concerning the existence of possible noncompliance that could have a material indirect effect on the financial statements, auditors should apply audit procedures specifically directed to ascertaining whether that noncompliance has occurred.

7. Auditors should obtain a sufficient understanding of the internal controls to plan the audit and determine the nature, timing, and extent of tests to be performed.

8. A record of the auditors' work should be retained in the form of working papers.

9. Working papers should contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditors' significant conclusions and judgments.

<u>Reporting Standards</u>

For financial statement audits, GAGAS incorporates the AICPA four generally accepted standards for reporting. AICPA and GAGAS require the following:

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.

2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

5. Auditors should communicate certain information related to the conduct and reporting of the audit to the audit committee or the individuals with whom they have contracted for the audit.

6. Audit reports should state that the audit was made in accordance with generally accepted government auditing standards.

7. The report on the financial statements should either (a) describe the scope of the auditors' testing of compliance with laws and regulations and internal controls and present the results of those tests or (b) refer to separate reports containing the information. In presenting the results of those tests, auditors should report irregularities, illegal acts, other material noncompliance, and reportable conditions in internal controls. In some circumstances, auditors should report irregularities and illegal acts directly to parties external to the audited entity.

8. If certain information is prohibited from general disclosure, the audit report should state the nature of the information omitted and the requirement that makes the omission necessary.

9. Written audit reports are to be submitted by the audit organization to the appropriate officials of the auditee and to the appropriate officials of the organizations requiring or arranging for the audits, including external funding organizations, unless legal restrictions prevent it. Copies of the reports should also be sent to other officials who have legal oversight authority or who may be responsible for acting on audit findings and recommendations and to others authorized to receive such reports. Unless restricted by law or regulation, copies should be made available for public inspection.

APPENDIX B

ENGAGEMENT LETTER

Engagement History

The accounting firm that performed the annual audit of the Roslyn Union Free School District for fiscal years ending June 30, 2002 and June 30, 2003 had been performing this same service for the District since the 1992-1993 school year.

Scope

In an engagement letter to the Board, dated December 4, 2001, the CPA firm agreed to conduct an audit of the District's general purpose financial statements as of, and for the year ending June 30, 2002. The stated purpose of this engagement was to express an unqualified opinion that the financial statements are fairly presented, in all material respects, in conformity with accounting principles generally accepted in the United States of America and to report on the District's compliance with laws and regulations and its internal controls as required by the Single Audit Act of 1996.

Audit Standards

The letter states that these audits will be made in accordance with auditing standards generally accepted in the United States of America; the standards for financial audits contained in "Government Auditing Standards," issued by the Comptroller General of the United States; the Single Audit Act of 1996; the provisions of OMB Circular 133; and guidelines promulgated by the Department of Audit and Control of the State of New York, and will include tests of the accounting records and other procedures considered necessary.

Management's Responsibilities

The engagement letter also delineates the responsibilities of the District's managers. Among other things, it states that management is responsible for selecting sound accounting principles, maintaining an adequate internal control structure, and assisting audit staff with locating invoices, contracts, minutes and other documentation needed to complete audit tests. The CPAs will request written representations of the District's attorneys and management.

CPA's Responsibilities

The CPA firm's various responsibilities are also defined in the letter. The engagement letter states that, among other things, the CPAs are responsible for:

- Expressing an opinion on the financial statements.
- Designing the audit to detect errors and irregularities that would have a material effect on the financial statements. Informing the District of consequential irregularities that are discovered during the audit.

- Being aware of the possibility of illegal acts that have a direct and material effect on the financial statements. Informing the District of consequential violations of government laws and regulations that are discovered during the audit.

- Reporting on internal control deficiencies encountered while obtaining an understanding of the District's internal control structure. Such reportable conditions are defined as significant deficiencies in the design or operation of the internal control structure, which would adversely affect the District's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. Advising the District of any opportunities to improve the effectiveness or economy of operations that are observed during field work. Describing these (internal control) matters in a letter to management at the conclusion of the audit.

- Issuing the report no later than October 1, 2002.

<u>Disclaimer</u>

One disclaimer contained in the engagement letter addressed the CPA's responsibility for detecting fraud. It asserts that, since the auditors will not examine all the transactions that occurred during the preceding year, the audit cannot provide absolute assurance that such errors and irregularities, including fraud or defalcations, will be detected.

<u>2002-2003</u>

An engagement letter to the Board, dated December 16, 2002, from the same CPA firm, agreeing to conduct an audit of the District's general purpose financial statements as of, and for the year ending June 30, 2003, contained the exact same language with no significant exceptions.

APPENDIX C

THEFT IDENTIFIED IN OCTOBER 2002

In late September 2002, the CPA firm received information that the District was making unusual purchases at a Home Depot, purchases of items that would not normally be associated with a school district. The CPA firm contacted the Board audit committee chairman about the concerns and arrangements were made through the District's superintendent for the CPA firm to obtain access to the District's financial records.

We were informed by the partner of the CPA firm that very little documentation exists for this engagement. According to the CPA firm partner, all three partners from the firm and two staff members reviewed the District's records on October 16, 2002. During this time the assistant superintendent for business was contacted and evidence of inappropriate purchases was recovered from her personal files.

Although the CPA firm had very limited documentation of the work they performed, one workpaper summarized the results of their work on October 16, 2002. This document lists the names of 12 venders and the total amount of $192,970 in questioned payments to them. The CPA firm then added $30,166 for payments made to Home Depot per information provided by the assistant superintendent for business for a total of $223,136 in inappropriate payments.

On October 23, 2002, the Board accepted the CPA firm's determination and allowed the assistant superintendent to make restitution of $250,000 ($223,136 for the funds stolen and an additional $26,864 for fees for the auditing and legal services rendered to identify the theft) and retire, without pressing criminal charges or announcing the fraud publicly.

The CPA firm partner told us that he identified the questioned expenditures by downloading from the District's computerized financial records all of the disbursement transactions that had been personally entered by the assistant superintendent for business. He stated that, using this list, they viewed the supporting documentation for the listed vendors. Per the CPA, where documentation was lacking, that vendor would be flagged and the total amount paid to that vendor would be identified as questionable.

Using the criteria provided by the CPA firm, we duplicated this test on the stored back-up of the District's records dated October 17, 2002. Our list identified 85 vendors totaling $1.6 million in such transactions, not $223,000. Notwithstanding this difference, whether the CPA reviewed the total list of $1.6 million in expenditures and reduced it during the work on October 16, 2002, or arrived at the list of $223,000 by some other means, both lists raise serious questions that would need to be reviewed further, either at the time of the October 2002 work by the CPA firm or during the audit of the 2002-2003 financial statements. The list of $223,000 contains payments to several credit card companies such as Capital One and CitiBank that were not for the District's official credit cards, and payments to several other financial institutions such as M&T Bank and Washington Mutual. The expanded list of $1.6 million included numerous questionable vendors. For example there were numerous payments to financial institutions such as American Express ($226,840), Chase ($218,185), CitiBank ($167,987), MBNA ($177,429), Bank of America ($53,324) and Wells Fargo ($82,146), and payments to District managers and employees.

In addition, when we compared our list to the list supporting the CPA firm's $223,000 in questioned payments, we found several discrepancies. Vendors on the CPA firm's list did not appear on our list and dollar amounts did not match dollar amounts reported. These discrepancies raise questions about the work performed by the CPA firm to quantify the fraud and/or the criteria given to us.

We question how a professional auditor could review either listing and not have serious questions and concerns that would cause much more extensive work and testing. The theft identified in October 2002 is a troubling indicator of the adequacy of the work that was performed during the subsequent annual audit since it was not factored into the CPA firm's planning for the audit and did not lead them to extend their testing of transactions.

APPENDIX D

AUDIT METHODOLOGY AND STANDARDS

To address our first objective, we reviewed the District's Purchasing Policy and Regulations, interviewed District business office personnel, and evaluated the process with which the District procured audit services for the 2001-2002 through 2003-2004 school years. To address our second objective, we considered the requirements under generally accepted government auditing standards concerning independence, planning the audit, obtaining evidence, and reporting on matters found during the audit. The procedures used to carry out the latter part of our review included, but were not limited to, interviewing pertinent audit firm personnel, reviewing the audit firm's policies and procedures, reviewing the District-specific audit work papers and performing tests on certain District records.

We conducted our audit in accordance with Generally Accepted Government Auditing Standards. Such standards require that we plan and conduct our audit to adequately assess those municipal operations within our audit scope. Further, those standards require that we understand the municipality's management controls and those laws, rules and regulations that are relevant to the municipality's operations included in our scope. An audit includes examining, on a test basis, evidence supporting transactions recorded in accounting and operating records and applying such other auditing procedures, as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for the findings, conclusions and recommendations contained in this report.

APPENDIX E

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