

CITY OF SALEM, MASSACHUSETTS

REPORTS ON FEDERAL AWARD PROGRAMS

FISCAL YEAR ENDED JUNE 30, 2007

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REPORTS ON FEDERAL AWARD PROGRAMS
FISCAL YEAR ENDED JUNE 30, 2007

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

To the Honorable Mayor
and Members of the City Council
City of Salem, Massachusetts

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Salem, Massachusetts, as of and for the fiscal year ended June 30, 2007, which collectively comprise the City of Salem, Massachusetts' basic financial statements and have issued our report thereon dated January 29, 2008. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the City of Salem, Massachusetts' internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the basic financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City of Salem, Massachusetts' internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the City of Salem, Massachusetts' internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the City of Salem, Massachusetts' ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the City of Salem, Massachusetts' financial statement that is more than inconsequential will not be prevented or detected by the City of Salem, Massachusetts' internal control. We consider the deficiencies described in the accompanying schedule of findings and questioned costs as finding 2007-1 to be significant deficiencies in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the City of Salem, Massachusetts' internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses, as defined above. However, we do consider the significant deficiencies described above to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the City of Salem, Massachusetts' basic financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of basic financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying schedule of findings and questioned costs as finding 2007-2.

We also noted certain other matters that we reported to management of the City of Salem, Massachusetts in a separate letter dated January 29, 2008.

This report is intended solely for the information and use of management of the City of Salem, Massachusetts, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

A handwritten signature in cursive script that reads "Bowers + Sullivan".

January 29, 2008



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**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE WITH REQUIREMENTS
APPLICABLE TO EACH MAJOR PROGRAM AND INTERNAL CONTROL OVER
COMPLIANCE IN ACCORDANCE WITH OMB CIRCULAR A-133**

To the Honorable Mayor
and Members of the City Council
City of Salem, Massachusetts

Compliance

We have audited the compliance of the City of Salem, Massachusetts, with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement that are applicable to each of its major federal programs for the fiscal year ended June 30, 2007. The City of Salem's major federal programs are identified in the summary of auditors' results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts and grants applicable to each of its major federal programs is the responsibility of the City of Salem's management. Our responsibility is to express an opinion on the City of Salem's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the City of Salem's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on the City of Salem's compliance with those requirements.

As described in item 2007-3 and 2007-4 in the accompanying schedule of findings and questioned costs, the City of Salem, Massachusetts did not comply with the requirements regarding cash management and allowable costs that are applicable to its Fund for the Improvement of Education federal program. Compliance with such requirements is necessary, in our opinion, for the City of Salem, Massachusetts to comply with the requirements applicable to that program.

In our opinion, except for the noncompliance described in the preceding paragraph, the City of Salem, Massachusetts, complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the fiscal year ended June 30, 2007.

Internal Control Over Compliance

The management of the City of Salem, Massachusetts, is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts and grants applicable to federal programs. In planning and performing our audit, we considered the City of Salem's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the City of Salem's internal control over compliance.

A *control deficiency* is an entity's internal control over the compliance exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect noncompliance with a type of compliance requirement of a federal program on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies in internal control over compliance described in the accompanying schedule of findings and questioned costs as items 2007-3 and 2007-4 to be significant deficiencies.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected by the entity's internal control. We do consider the significant deficiencies in internal control over compliance described in the accompanying schedule of findings and questioned costs to be material weaknesses.

Our consideration of the internal control over compliance was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses.

This report is intended solely for the information and use of management of the City of Salem, Massachusetts, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

A handwritten signature in black ink, appearing to read "Bowers + Sullivan".

January 29, 2008



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INDEPENDENT AUDITORS' REPORT ON SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

To the Honorable Mayor
and Members of the City Council
City of Salem, Massachusetts

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Salem, Massachusetts, as of and for the fiscal year ended June 30, 2007, and have issued our report thereon dated January 29, 2008. Our audit was performed for the purpose of forming opinions on the financial statements that collectively comprise the City of Salem, Massachusetts' basic financial statements. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

This report is intended solely for the information and use of management of the City of Salem, Massachusetts, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

January 29, 2008

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

FOR THE FISCAL YEAR ENDED JUNE 30, 2007

<u>Federal Grantor/Program Title</u>	<u>Federal CFDA Number</u>	<u>Expenditures</u>
U.S. DEPARTMENT OF AGRICULTURE:		
<u>Passed through State Department of Education:</u>		
Food Donation	10.550	\$ 90,131
School Breakfast Program	10.553	181,767
National School Lunch Program	10.555	<u>718,183</u>
TOTAL AGRICULTURE		<u>990,081</u>
U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT:		
<u>Direct Program:</u>		
Community Development Block Grant/Entitlement Grants	14.218	1,532,507
Community Development Block Grants/Browning Economic Development Initiative	14.246	6,008
<u>Passed through North Shore Home Consortium:</u>		
HOME Investment Partnerships Program	14.239	<u>118,568</u>
TOTAL HOUSING		<u>1,657,083</u>
U.S. DEPARTMENT OF JUSTICE:		
<u>Direct Program:</u>		
Grants to Encourage Arrest Policies and Enforcement of Protection Orders	16.590	77,622
Local Law Enforcement Trust Funds Program	16.592	2,000
<u>Passed through Executive Office of Public Safety:</u>		
Public Safety Partnership and Community Policing Grants	16.710	<u>83,031</u>
TOTAL JUSTICE		<u>162,653</u>
U.S. DEPARTMENT OF LABOR:		
<u>Passed through State Commonwealth Corporation:</u>		
Unemployment Insurance	17.225	9,185
WIA Incentive Grants Section 503 Grants to States	17.267	260
<u>Passed through State Division of Career Services:</u>		
Employment Service	17.207	46,544
Workforce Investment Act - Adult Program	17.258	767,796
Workforce Investment Act - Youth Activities	17.259	778,176
Workforce Investment Act - Dislocated Worker	17.260	826,511
Work Incentive Grant	17.266	53,891
<u>Passed through Community Transportation Association of America:</u>		
Employment and Training Administration Pilots, Demonstrations, and Research Projects	17.261	16,657
<u>Passed through Division of Career Services - Workforce Development</u>		
Disabled Veterans' Outreach Program (DVOP)	17.801	<u>6,710</u>
TOTAL LABOR		<u>2,505,730</u>
U.S. ENVIRONMENTAL PROTECTION AGENCY:		
<u>Direct Program:</u>		
Environmental Justice Collaborative Problem-Solving Cooperative Agreement Program	66.306	<u>15,995</u>

(continued)

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

FOR THE FISCAL YEAR ENDED JUNE 30, 2007

<u>Federal Grantor/Program Title</u>	<u>Federal CFDA Number</u>	<u>Expenditures</u>
U.S. DEPARTMENT OF EDUCATION:		
<u>Direct Program:</u>		
Fund For the Improvement of Education	84.215	247,493
<u>Passed through State Department of Education:</u>		
Adult Education State Grant Program	84.002	8,559
Title I Grants to Local Educational Agencies	84.010	938,030
Special Education Grants to States	84.027	1,029,841
Vocational Education Basic Grants to States	84.048	21,541
Safe and Drug Free Schools and Communities State Grants	84.186	42,736
State School Improvement Grants	84.218	46
Eisenhower Professional Development State Grants	84.281	18
Twenty-First Century Community Learning Centers	84.287	187,068
State Grants for Innovative Programs	84.298	8,724
Education Technology State Grants	84.318	24,985
Reading First State Grants	84.357	185,584
English Language Acquisition Grants	84.365	79,989
Improving Teacher Quality State Grants	84.367	235,513
<u>Passed through State Department of Early Education and Care:</u>		
Special Education Preschool Grants	84.173	30,939
TOTAL EDUCATION		3,041,066
U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES:		
<u>Passed through North Shore Elder Services, Inc.:</u>		
Special Programs for the Aging Title III, Part B Grants for		
Supportive Services and Senior Centers	93.044	14,948
Special Programs for the Aging Title III, Part C Nutrition Services	93.045	62,804
<u>Passed through Department of Transitional Assistance:</u>		
Temporary Assistance for Needy Families	93.558	168,816
TOTAL HEALTH & HUMAN SERVICES		246,568
CORPORATION FOR NATIONAL AND COMMUNITY SERVICE:		
<u>Passed through State Department</u>		
<u>of Education:</u>		
Learn and Serve America School and Community Based Programs	94.004	7,441
U.S. DEPARTMENT OF HOMELAND SECURITY:		
<u>Direct Program:</u>		
Assistance to Firefighters	97.044	119,980
TOTAL		\$ 8,746,597

(concluded)

See notes to schedule of expenditures of federal awards.

NOTE 1 – Definition of Reporting Entity

The accompanying Schedule of Expenditures of Federal Awards presents the activity of all federal financial assistance programs of the City of Salem, Massachusetts. All federal financial assistance received directly from federal agencies as well as federal financial assistance passed through other governmental agencies is included on the schedule.

NOTE 2 – Significant Accounting Policies

The accounting and reporting policies of the City of Salem, Massachusetts are set forth below:

- (a) Basis of Presentation - The accompanying Schedule of Expenditures of Federal Awards is presented on the modified accrual basis of accounting.
- (b) School Lunch Program - Program expenditures represent federal reimbursement for meals provided during the year.

NOTE 3 – Program Clusters

In accordance with Subpart A §_.105 of OMB Circular No. A-133, *Audits of States, Local Governments and Non Profit Organizations*, certain programs have been clustered in determining major programs. The following represents the clustered programs:

<u>Name of Cluster/Program</u>	<u>CFDA Number</u>
Child Nutrition Cluster	
School Breakfast Program	10.553
National School Lunch Program	10.555
Summer Food Serve Program for Children	10.559
WIA Cluster	
WIA Adult Program	17.258
WIA Youth Activities	17.259
WIA Dislocated Workers	17.260
Special Education Cluster	
Special Education Grants to States	84.027
Special Education Preschool Grants	84.173

A. Summary of Auditors' Results

1. The auditors' report expresses an unqualified opinion on the basic financial statements of the City of Salem, Massachusetts.
2. Significant deficiencies relating to the audit of the financial statements are reported in the Report on Compliance and on Internal Control over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*.
3. Instances of noncompliance material to the financial statements of the City of Salem, Massachusetts, were disclosed during the audit.
4. Significant deficiencies relating to the audit of the major federal award programs is reported in the Report on Compliance with Requirements Applicable to Each Major Program and Internal Control Over Compliance in Accordance with OMB Circular A-133.
5. The auditors' report on compliance for the major federal award programs for the City of Salem, Massachusetts, expresses a qualified opinion.
6. There were two audit findings related to federal award programs.
7. The programs tested as major grants include:

<u>Program Title</u>	<u>CFDA Number</u>
Workforce Investment Act – Adult Program	17.258
Workforce Investment Act – Youth Activities	17.259
Workforce Investment Act – Dislocated Worker	17.260
Fund for the Improvement of Education	84.215

8. The threshold for distinguishing Types A and B programs was \$300,000.
9. The City of Salem, Massachusetts, was determined to be a low-risk auditee.

B. Findings-Financial Statements Audit**Finding 2007-1 Material Weaknesses in Internal Control Over Financial Reporting****Overview**

The City and School have been experiencing financial pressures in recent years that have required budget reductions. The budgets controlled by the City have been managed to make changes in operations that resulted in the approved budget exceeding actual expenditures. The School did not manage their approved budget in the same manner as the City but instead engaged in series of deceptive practices to hide a \$2.9 million dollar budget deficit in FY2007.

We found a deliberate pattern of fraudulent financial reporting of the operations of the school for fiscal years 2006, 2007 and 2008. These actions included intentional misrepresentations, questionable accounting policies and mistakes that appear to be human errors due to a lack of detective internal controls. The common thread for all of these activities is that the former School Business Manager initiated the transactions.

The FY2007 financial statements were adjusted to properly reflect the correct activity, however, FY2006 and FY2007 reports filed with the Commonwealth and granting agencies did not properly reflect the adjustments and should be amended during FY2008.

These practices we consider to be fraudulent financial reporting practices that result in a series of material weaknesses in internal controls. We have summarized below the activities that occurred.

School Department Bills Paid in the Subsequent Fiscal Year

The School Department intentionally withheld the payment \$647,000 of invoices for services provided the school during FY2006 until FY2007. At the end of FY2007 the School Department intentionally withheld the payment of \$1.4 million of invoices for services provided the school during FY2007 until FY2008.

A significant number of these invoices related to special education tuition and transportation and the dates of the services provided by the vendor were for the months of February through June of each year. Most of these invoices were received and approved for payment within the School well before June 30th but were not forwarded to the City Auditor for payment. At the end of each fiscal year each department of the City is required to forward to the City Auditor a complete list of unpaid invoices for goods or services received for that fiscal year. The City Auditor uses this list to record the expenditure and accounts payable in the current fiscal year. The School Business Manager submitted an incomplete list of unpaid invoices that only included a limited number of invoices that were mostly individual student tuition bills for June. In most cases the unpaid tuition bills for the months of April through May were not included in the list provided to the City Auditor but instead were processed in several accounts payable batches early in the next fiscal year.

The posting of a significant amount of special education costs to the new fiscal year budget during the months of July and August, when the schools are closed, are unusual transactions which should raise red flags at the school. We believe these red flags were ignored since those responsible were aware of the activity.

Based on the audit evidence we obtained which includes discussions with the school staff responsible for the payment of bills, it is apparent that the School intentionally withheld the payment or accrual of bills at the end of FY2006 and FY2007 in order to process them early in the subsequent fiscal year. The shifting of expenditures to the subsequent fiscal year is fraudulent financial reporting in order to cover budget deficits. The staff informed us that the former School Business Manager was the person who withheld the bills over their objections. It is apparent to us that the School Business Manager was fully aware of this activity since he prepared the incomplete year end accrual list of unpaid invoices; approved the accounts payable batches posted during the months of July

and August; is the direct supervisor of the clerical staff; and is in charge of budgetary and financial reporting.

In addition to the School Business Manager several other school personnel were aware of the situation and did not take adequate steps to report it. This is an indication that the control environment at the school department did not adequately discourage this type of behavior, increasing the susceptibility to fraud.

The City's internal controls to detect or correct this type of fraud during the normal course operations were circumvented by the actions of the School Business Manager. Prior to being appointed the School Business Manager, this individual was the City's Finance Director for several years. This experience gave him specific knowledge of the financial operations of both the City and School. A further breakdown in the operations of internal controls that is place to detect potential errors or fraud is that the City's finance offices did not provide for an independent review and approval school expenditures. The City's financial offices are responsible for reviewing all expenditures to ensure they are reported in the proper budgetary period. The lack of control consciousness with the school department and the City's lack of controls to detect a material misstatement in their financial statements resulted in a material weakness in the system of internal control.

School Summer Payroll Accrual Misstatement

The 10 month school year runs from September through June and the teacher's contract pays them for those 10 months of service. The contract gives teachers the option to spread out their pay for a 12 month period so they can receive funds in July and August for work performed though June 30. This is a common practice in Massachusetts and throughout the country.

In order to properly report the expenditures for the fiscal year, the School reports to the City Auditor the "Teacher's Summer Payroll" who records the expenditures and related liability. The calculation of this accrual is been completed by the school's payroll staff and is forwarded to the School Business Manager for review and submission to the City Auditor. In both FY2006 and FY2007 the accrual submitted by the School Business Manager did not include all liabilities calculated by the school payroll staff. In each year the accrual was understated by approximately \$450,000.

Various school department staff was aware of the inadequate year-end payroll accruals and did not take the proper steps to report the situation. Again the City's internal controls to detect or correct this type of fraud during the normal course operations were circumvented by the actions of the School Business Manager.

The City's financial offices are responsible for ensuring that all material liabilities are recorded in the City's financial statements. We are aware the City's finance staff questioned the School Business Manager on the accrual and he verbally explained the calculation. This procedure is part of a sound internal control process but should have been supplemented by requiring detailed supporting documentation from the school before the accrual was approved. The lack of control consciousness with the school department and the City's lack of controls to detect a material misstatement in their financial statements resulted in a material weakness in the system of internal control.

Journal Entry Deficiencies

Journal entries are normally used to record year-end accruals, correct mistakes and record non-cash transactions. During our audit we questioned the validity of several journal entries initiated by the former School Business Manager and found a significant number of entries lacked any supporting documentation. Upon further investigation we found a pattern of entries that had the net effect of decreasing the general fund expenditures and increasing the expenditures in another fund. Most of these entries were not made throughout the fiscal year but

instead were made as part of the year end closing entries. The risk of fraudulent journal entries is increased significantly when made at the end of the year and when there is no supporting documentation.

The pattern of the entries was to record expenditures equal to the remaining fund balance in grant and revolving special revenue funds and to make corresponding decreases in general fund school expenditures. The questionable entries were created by the School Business Manager and forwarded to the City Auditor's Office for approval and processing. These entries were not adequately reviewed by the City before processing and the City did not require any explanation or supporting documentation for the journal entry. The initial creation of fraudulent journal entries is the fundamental reason the accounting ledgers are misstated but the lack of a process by the City to require supporting documentation and complete a review before posting is considered a material weakness in internal control.

The effect on these entries was that school expenditures in the general fund were understated by \$655,000 and special revenue expenses were overstated by the same amount; the health insurance internal service fund revenues were overstated by \$341,000 and the special revenue expenditures were overstated by the same amount; special revenue revenues were overstated by \$310,000; and general fund interest income was overstated by \$27,500 and special revenue expenditures were overstated by the same amount.

The City and School need to post correcting entries in FY2008 to reverse the effect of these fraudulent entries. However simply reversing the entry may correct the fund balance in each fund it does not properly report the FY2008 actual revenues and expenses. As these entries are made the City and School must also determine how to amend the various reports submitted to state, federal and private agencies. We noted that other school employees not aware of the initial year end entries found errors in certain special revenue funds opening balances in FY2008.

The City's financial statements, and other financial reports, could have been materially misstated, and the City's internal controls were not designed to prevent or detect the misstatement. Prior to the issuance of the City's fiscal year 2007 financial statements, any significant unsupported journal entries have been corrected.

Recording Unsupported Accounts Receivable

At year end the School Business Manager prepared a series of journal entries that recorded \$310,000 in unsupported and non-deferred receivables at June 30, 2007 in various special revenue grant and revolving funds. This is in violation of budgetary accounting standards. These entries were made to grant and revolving special revenue funds at the close of the fiscal year. The consistent pattern of journal entries made by the School Business Manager followed the following steps; 1) expenditures were increased in the special revenue fund equal to the remaining budgetary fund balance; 2) the budgetary fund balance in the special revenue fund was now zero; 3) he then made a fraudulent receivable journal entry to increase the fund balance in that fund; 4) he then made another expenditure entry equal to the receivable entry to again eliminate the special revenue fund balance. The ultimate purpose of these entries was to decrease expenditures in the general fund.

The initial creation of fraudulent journal entries is the fundamental reason the accounting ledgers are misstated but the lack of a process by the City to require supporting documentation and complete a review before posting is considered a material weakness in internal control.

Health Insurance Charges

The City maintains an internal service fund that accounts for the activities of its health insurance activities. In prior years the general fund and its enterprise funds were charged for their share of the cost of providing this benefit. Special revenue grants and other funds were not charged for their share and the general fund absorbed the cost. In FY2007 the City began the process to charge these special revenue funds their estimated share of the costs.

The City is allowed to charge grants and other funds their direct cost of health insurance benefits only if the grant contract provides for this type of expenditure. The amount of the charges to the grant must be the lesser of the actual cost or budgeted amount. We found that the City and School did not verify the allowable amounts that could be charged and did not adjust the estimated amount to the actual cost at year-end. As noted in an earlier comment, the lack of internal controls over health insurance allocations resulted in material errors in several grants being overcharged and a \$341,000 overstatement in the health insurance internal service fund. The lack of controls is considered a material weakness.

Allocation of the Grant Administration Costs

The School established a special revenue fund to account for the costs of a Grants Administrator with the intention to allocate 100% of the costs to the grants he administrates. Neither the School Business Manager nor the Grants administrator established a cost allocation plan that would allocate his cost based on cost allocation principles. These principles only allow the allocation of costs equal to each grants proportional share. This would require that all grants under the control of the grants administrator would share in this cost.

Similar to the health insurance comment, administration costs can only be charged if the grant contract provides for this type of expenditure. The amount of the charges to the grant must be the lesser of the actual cost or budgeted amount. We found that the charges to grants for administration costs were not based on a cost allocation plan but instead were based solely on whether there were available funds left in the grant. No consideration was made as to whether there was a grant budget for administration. Approximately 50% of the cost was allocated to one grant because there was a significant amount of unspent grant funds that would have to be returned to the granting agency.

We also became aware that one of the grants staff time charges is being allocated to one grant and although is a budgeted grant position the staff person is also responsible for other grants. Again this is in violation of cost allocation principles.

We also found expenditures unrelated to grant administration was charged to this fund. After our proposed audit adjustments were accepted by the City and School this fund was left in a permanent deficit. The School will still need to amend the grant reports for these and other errors mentioned in the other comments. School management needs to understand that it is rare that 100% of a grant administrators cost position will be allocated to grants and that some of the costs will have to be funded through the general fund budget.

Adherence to cost allocation principles is a requirement that the City and School needs to be in compliance with in order to correctly account for grants. The lack of internal controls over cost allocations is considered a material weakness in internal control.

Grants Management and Monitoring Account Balances Throughout the Year

The School Department carried inaccurate grant balances throughout the year and reclassified expenditures to the grants through numerous journal entries at the end of the fiscal year in what was asserted to be the correction of the account balances. Some of these entries were supported by the school staff with documentation and the other entries discussed above were not supported. This system of managing grant balances and the schools operating budget is haphazard and does not provide the City's management the ability to monitor the financial

position of the City and to make sound financial decisions throughout the year as necessary. The lack of controls places an extra burden on the school to support charges to grants and puts at risk the continuation of the grant funding.

As an example, we found an instance that a federal grant was in a deficit position of over \$270,000 at year end. Although both the City and School officials provided us with internal reports that showed that there was a deficit we are not aware of any procedures that investigated or corrected the deficit. The accounting for this grant was only corrected after we proposed audit adjustments.

Because the school department relied on a significant number of year end adjustments to grant balances, management was not able to monitor balances throughout the year. Even after the year end adjustments were recorded, several significant and unexplained deficits existed in grant balances which the City's system of controls was not designed to detect or prevent. This is considered a material weakness in internal control.

Norman H. Read Private Grant

We are listing this grant in its own comment due to the material nature of the unsupported journal entries, charges made in excess of the grant agreement and charges for health insurance benefits not allowed.

Each year the School has submitted a grant proposal to the Norman H. Read 1985 Trust for funds to support the science and technology programs. The FY2007 \$317,000 grant proposal listed individual budget line items for salaries and activities that were expected to be spent during the school year. During FY 2007 the School received a grant for \$317,000.

When we reviewed the ledger activity and compared it to the grant budget we noted the following:

- Unspent grant funds from the prior year was \$224,000, however no mention of the unspent funds was made in the grant proposal.
- The actual payroll and expenses processed throughout the year appear to be allowable expenditures in accordance with the grant agreement.
- A journal entry was made in February 2007 charged the grant \$24,969 for health insurance benefits however there was no provision in the grant agreement that allowed this charge.
- The School Business Manager made three journal entries that increased payroll expenses by \$140,961 as the last activity posted to the ledger in FY2007. A corresponding entry was made to reduce school payroll in the general fund. We were not provided any support for these entries.
- Prior to the entries mentioned above the grant's payroll budget for five teachers was exactly \$200,000 and the payroll expenditures posted to the ledger was \$199,666. Before the School Business Manager's year end entry the payroll charges were in line with the grant agreement.
- Per discussion with school staff, the Assistant Superintendent did not realize these payroll entries were made during the closing period of FY2007 and discovered the funds were missing from the grant when she reviewed the FY2008 ledger. Before our year end audit work started, she had the School Business Manager replenish the account in FY2008.
- The replenishment entry was made in August 2008 by the School Business Manager which on its face demonstrated he knew the original entry was wrong. As the former Finance Director, current School Business Manager and a college Accounting Professor he knew that the proper way to correct an error would be to reverse the error in the same fiscal year the error was made. The FY2007 ledgers were still open in August of 2007 but he chose to post the correction to the FY2008 ledger. This again demonstrates the intentional pattern of concealing the FY2007 deficit.
- We would not expect that the Assistant Superintendent would know how posting the correction to the next fiscal year would conceal a prior year deficit in another fund.
- Per our review of the FY2008 ledger we did not see an adjustment for the \$24,969 of health insurance charges.

- The FY2007 activity in this fund, after adjustment, show grant funds received of \$317,000 and allowable grant expenditures of (\$261,000) which results in unspent grant funds of \$56,000.
- At the end of FY2007 the fund had a cumulative balance of unspent grant funds of \$280,000.

Our findings related to this fund demonstrate some positive controls but also identifies material weaknesses in internal controls. Our first finding is that the school had some detective controls that required a correction of the unsupported payroll entries within 2 months of the original posting which is a positive. We found that except for the February journal entry for health insurance charges, all other expenditures appear to be consistent with the grant agreement.

The material weaknesses in internal control have been discussed in the preceding comments. The health insurance charges occurred in February 2007 and were not corrected until we proposed our audit adjustments. The school did not follow up with the Read Trust to determine if unspent grant funds would be expendable subsequent to the grant year. The journal entries created by the School Business Manager at year end were in direct violation of the grant agreement and the City did not properly require supporting documentation before posting both the original and correcting entries in the 2 fiscal years. All of these findings are considered material weaknesses in internal controls.

Budgeting and Interim Reporting

The School Business Manager was responsible for completing the budget document and interim financial reports to the Superintendent and School Committee throughout the fiscal year. Although he did not approve the final budget, he played a significant role in its formulation. As we assisted the current City and School management unravel all of these accounting irregularities, we became aware that many of the budget documents and interim reports prepared by the School Business Manager did not reflect the actual activities. We found numerous instances where the budget and actual expenditures presented to the Superintendent and the School Committee was significantly different than the actual expenditures reported on the ledgers.

This consistent pattern of providing inaccurate reports to those in charge of school operations is considered a material weakness in internal control.

Summary

In summary, the objectives of an internal control structure are to safeguard the assets of the City and provide reasonable assurance that transactions are executed in accordance with management's authorization and recorded properly in the City's ledgers. The omission of one or more elements of internal control can compromise the City's ability to obtain these objectives. We have concluded that the deficiencies noted above, individually and collectively, represent material weaknesses in the City's system of internal control under standards established by the American Institute of Certified Public Accountants.

These deficiencies constitute being classified as material weaknesses because they represent significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the City's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Furthermore, we believe that the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

We recommend that the City implement procedures to strengthen controls provide reasonable assurance that expenditures and revenues are properly reported in the City's financial records in the proper periods.

Finding 2007- 2 Noncompliance with Certain Provisions of Laws, Regulations, Contracts, and Grant Agreements

We extended our audit procedures due to the fraudulent activity related to journal entries made by the School which we found a pattern of increasing expenses of special revenue funds and decreases the expenses of the general fund school function. During the course of these procedures we found a series of questioned costs within these funds. We have listed below the questioned costs found for nonmajor school related federal grants. We did not treat these grants as major grants and only are reporting our findings from non single audit procedures.

Our findings for these nonmajor federal grants can be classified in a few different categories.

- We found a pattern of year end journal entries that increased the expenses of a grant and reduced the expenditures of the school general fund. The school was having a budget crisis that was being hidden by shifting expenses to grant funds at the end of the year without support. Many times the entry made was equal to the exact amount of unspent grant funds at fiscal year end.
- We found a pattern of charging grants an administration cost without having a cost allocation plan in place. Per discussion with the client and other audit evidence the charges made to grants were based on unspent funds or the administration budget approved in the grant.
- We found a pattern that charged grants for supplies the exact amount of the budget and no supporting documentation exists. The charge was made through journal entries that increase the grant expenditure and decreased the general fund expenditure.
- We found a pattern of charging health insurance costs based on the expected cost for the year. The School and City did not adjust the charge to the actual costs and many times charged grants that did not have an approved budget for these charges.

Special Education Grants to States – CFDA No. 84.027

Condition and Criteria: The City and School charged \$250,000 to the grant for estimated health insurance costs even though the grant agreement did not allow for this charge. This charge created a deficit in this fund however the ledger was not adjusted until we proposed audit adjustments. The client agreed to make the adjustment and the costs are not reported in the schedule of federal awards.

The School posted \$146,886 of charges to this grant instead of the general fund. These charges created a deficit in this fund however the ledger was not adjusted until we proposed audit adjustments. The client agreed to make the adjustment and the costs are not reported in the schedule of federal awards.

Effect: The lack of monitoring of this grant created deficits for excess charges over and above the grant amount. Charges above the grant amount is not considered a questioned cost since these charges had to be adjusted to the general fund and internal service fund. It does indicate a material weakness in internal controls over financial reporting and grants. It also understated the deficit in the other funds.

Cause: Lack of internal controls over the grant.

Questioned Costs - None

Title I Grants to Local Educational Agencies – CFDA No. 84.010

Condition and Criteria: The School charges 100 percent of the salary for a grant administrator to this grant. Although working on this grant is her primary responsibility it is apparent that her responsibilities extend beyond this grant. We were not able to determine nor were there records that the allocation of time between responsibilities.

Effect: The costs charged to the grant are not in accordance with a cost allocation plan and therefore charges in excess of actual costs charged to the grant.

Cause: There is no cost allocation plan in place to allocate administration costs.

Questioned Costs: Unknown

Reading First State Grants – CFDA No. 84.357

Condition and Criteria: The school charged this grant \$10,500 for administration costs however the grant budget was only \$7,000. The school agreed to adjust the administration charge to be equal to the budgeted amount and only the remaining \$7,000 is reported in the schedule of federal awards. However as mentioned before the school does not have a cost allocation plan and charges administration cost based on available funds. Therefore there is insufficient documentation to support the charge.

Effect: The costs charged to the grant are not in accordance with a cost allocation plan and therefore charges in excess of actual costs charged to the grant.

Cause: There is no cost allocation plan in place to allocate administration costs.

Questioned Costs: Unknown

C. Findings and Questioned Costs-Major Federal Award Programs Audit**Finding 2007-3**

Fund for the Improvement of Education – CFDA No. 84.215

- Teaching American History Grant – CFDA No. 84.215X
- Smaller Learning Communities Grant – CFDA No. 84.215L

Condition and Criteria: The City was not in compliance with Federal Regulations for Cash Management, which requires grantees to follow procedures to minimize the time elapsing between the transfer of funds from the U.S. Treasury and the disbursement of the funds. Additionally, the City was not in compliance with Federal Regulations requiring interest earned on advances by local government grantees to be submitted at least quarterly to the federal agency.

Effect: On the Teaching American History Grant, the City requested and received the entire grant of \$877,472 in the first year of a three year grant program. The cash was pooled with other City funds in interest-bearing bank accounts. Expenditures on the program totaled \$148,853 in year 1 (fiscal year 2004), \$196,701 in year 2 (fiscal year 2005), \$260,608 in year 3 (fiscal year 2006), and \$271,310 in year 4 (fiscal year 2007). The City has received an extension of time to spend the remaining grant

funds which expires on September 30, 2007 (fiscal year 2008). Consequently, the City accumulated approximately \$32,500 in interest revenue, of which \$7,100 has not been reported or remitted to the federal awarding agency as required.

On the Smaller Learning Communities Grant, the City requested and received \$85,000 in year 1 (fiscal year 2004), \$175,000 in year 2 (fiscal year 2005) and \$240,000 in year 3 (fiscal year 2006). The cash was pooled with other City funds in interest-bearing bank accounts. Expenditures on the program totaled \$44,233 in year 1, \$158,087 in year 2, \$240,711 in year 3, and \$56,970 in year 4 (fiscal year 2007). Consequently, the City accumulated approximately \$3,100 in interest revenue, of which, \$1,100 has not been reported or remitted to the federal awarding agency as required.

During fiscal year 2007, the City returned \$27,500 of the interest earned on both programs through fiscal year 2005 to the Massachusetts Department of Education. In September, 2007, the City returned \$6,600 of interest earned on both programs through fiscal year 2006 to the Massachusetts Department of Education, and in February, 2007, placed all remaining unspent funds in a non interest bearing bank account. The total funds that the City has yet to return includes \$1,600 in interest earned in fiscal year 2007.

Cause: The City does not have procedures in place to minimize the time elapsing between the transfer of funds from the U.S. Treasury and disbursement of the funds. Specifically, when requesting a draw of funds from the U.S. Treasury, the City is required to certify that the funds will be expended within 3 days of receipt. This certification was required for the transfer to take place. The funds were then not expended within 3 days and were not returned to the grantor.

Questioned Costs: Approximately \$1,600

Auditor's Recommendation: We recommend the City return the unreported interest earnings to the awarding federal agencies. We also recommend the City adopt procedures to minimize the time elapsing between the transfer of funds from the U.S. Treasury and the use of the funds for program purposes.

Finding 2007-4

Fund for the Improvement of Education – CFDA No. 84.215

- Teaching American History Grant – CFDA No. 84.215X
- Smaller Learning Communities Grant – CFDA No. 84.215L

Condition and Criteria: We tested \$276,294 in total grant expenditures recorded on the City's general ledger for the Teaching American History and Smaller Learning Communities Grants and found the following:

- \$7,129 of invoices charges to these grants was found to be ineligible. These expenses have been reported as part of the schedule of federal awards.
- The last entry made to the ledger at the close of the Small Learning grant was a journal entry for \$30,159 that charged the grant for the exact amount of unspent funds and reduced general fund expenses. The new school business manager explained that the charge was for a portion of the salary of the housemaster of the freshman house. We were not satisfied that sufficient documentation was available to support this charge and we are questioning the charge. These expenses have been reported as part of the schedule of federal awards.

- In December 2006, a journal entry was made that charged both grants \$4,000 for administration costs for a total of \$8,000. In January 07, a journal entry was made that charged \$8,462 to the Smaller Learning Grant for administration. In March 2007, a journal entry was made that charged \$20,000 to the Teaching American History Grant for administration cost. The School did not have a cost allocation plan to determine the costs. Per discussion with the grants administrator he agreed that the charges were based on which grants had funds remaining and that he spent very little time on these 2 grants. The entire \$36,462, which is over ½ of his annual salary, is a questioned cost. The City and School agreed that these charges should not have been charged and the amounts have been removed from the schedule of federal awards. However the final reports for these grants have not been amended and unspent grant funds have not been returned to the granting agency at the time of this report.
- The last entry made on the ledger at the close of the Teaching American History Grant was a journal entry that charged this grant for \$44,325 which was the exact amount of unspent grant funds and reduced general fund expenses. There was no supporting documentation for this charge and we have determined that the entry is without merit. The City and School agreed that this entry was not proper and the amount has been removed from the schedule of federal awards.

Cause: As explained in the material weakness comment above most of the questioned costs were due to either lax controls or fraudulent financial reporting.

Effect: The City and School have a material weakness in internal control over financial reporting and compliance with major federal awards. A minimum of \$118,075 in ineligible costs have been recorded as grant expenditures and the lack of procedures to verify that all expenditures charged to the grant are for allowable purposes increases the risk that additional ineligible expenditures have been or will be recorded against the grant. Consequently, the City is not in compliance with the grant agreement.

Auditors' Recommendation: We recommend the City correct the identified questioned items charged against the Teaching American History and Smaller Learning Communities Grants and amend the final reports. Any questioned costs and unspent grant proceeds must be returned to the granting agency. The City and School must take immediate action to implement procedures to ensure that expenditures charged against the grant are for allowable purposes.

Questioned Costs:

As noted above our audit identified \$118,075 in questioned costs originally charged against the grants. The School agreed to adjust the ledgers for \$80,787 of these costs and these amounts are not reported in the schedule of federal awards. The remaining \$37,288 of questioned costs has not been adjusted on the ledgers and are reported as expenditures in the schedule of federal awards

D. Prior Year Audit Findings and Questioned Costs

Finding 2006-1

Teaching American History Grant – CFDA No. 84.215X
Smaller Learning Communities Grant – CFDA No. 84.215L

These findings are detailed in finding 2007-3.

Finding 2006-2

Title I Grants to Local Educational Agencies – CFDA No. 84.010

The City has implemented procedures to improve the timeliness of filing grant reports to insure compliance with grant requirements.