

November 17, 1998

The Honorable Bernard Siebenaler
School Board Chair
Independent School District No. 858, St. Charles
RR 2 Box 179
St. Charles, Minnesota 55972

Mr. Thomas Ames
Superintendent
Independent School District No. 858, St. Charles
600 East Sixth Street
St. Charles, Minnesota 55972

Dear Chair Siebenaler and Mr. Ames:

The Special Investigations Division of the Office of the State Auditor (hereinafter "OSA") was requested to investigate the possible misappropriation of funds by individuals involved in the School Age Child Care program (hereinafter "SACC") of Independent School District No. 858, St. Charles (hereinafter "School District").

The mission of the OSA's Special Investigations Division is to review allegations regarding malfeasance, misfeasance, and nonfeasance by local government employees or officers. Since the Division is a fact-finding entity and has no prosecutorial powers, its role is to evaluate allegations brought to the OSA's attention and, when appropriate, to provide specialized auditing techniques, initiate an independent investigation, or refer the matter to appropriate oversight authorities.

The OSA's findings are contained in an Investigative Report dated August 20, 1998, which has been submitted to the Winona County Attorney for review of possible criminal violations. A copy of the Investigative Report is enclosed.

In addition to the Investigative Report, the OSA discovered specific weaknesses in the internal controls of SACC. While the OSA's review did not necessarily disclose all internal control weaknesses, the purpose of this letter is to report those weaknesses discovered and to make recommendations to improve internal controls so as to better protect the School District's assets. The School District is responsible for establishing and maintaining internal controls for all of its programs, including SACC.

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I. BACKGROUND

In July of 1989, the School District adopted guidelines for a program to provide child care for school age children, which became known as SACC.¹ On August 8, 1989, the School District approved the hiring of a program coordinator and SACC opened a checking account and savings account at what is now Merchants National Bank (hereinafter "Bank"). These accounts were opened using the federal tax identification number of the School District.

SACC became part of the School District's Community Education Program, but maintained its own parent advisory board, bank accounts, and control over the hiring of personnel. SACC employs a Coordinator and part-time employees. Although there has never been a formal contract between SACC and the School District, SACC has always been allowed to use School District facilities free of charge. In addition, the School District paid the SACC Coordinator directly and was reimbursed by SACC for the cost of the Coordinator's wages and benefits.

Prior to April of 1998, the SACC Coordinator was generally responsible for the following: (1) billing parents and Winona County for child care costs; (2) receiving and recording payments from parents and Winona County; (3) preparing and making deposits; (4) purchasing supplies for the program; and (5) providing child care. The SACC Treasurer was generally responsible for signing checks, receiving bank statements and, at least in the early years of SACC, making some deposits at the Bank.

In March of 1998, the SACC Treasurer admitted to taking an undetermined amount of money from the SACC checking account by writing checks to herself and to cash. Based on this discovery, School District personnel initiated a review of SACC records, including records provided both by SACC and by the Bank. Subsequently, the OSA was notified of the misappropriation of funds, conducted an investigation, and produced an Investigative Report dated August 20, 1998.

II. STRUCTURE OF SACC

Minnesota law differentiates between school age child care programs based upon whether they are operated by a school or privately operated.² School age child care programs operated by a school

¹ Initially, the idea for this program was developed independently of the School District. Subsequently, the individuals involved in developing the program approached the School District and requested that the program become part of the School District.

² See Minn. Stat. § 245A.03, Subd. 2(12) (1998) (providing that school-operated school age child care programs are excluded from licensure requirements). See also Minn. R. 9503 (1997) (providing licensure requirements for child care

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are excluded from the licensure requirements of Minnesota law, while privately operated programs must meet these licensure requirements.³

In order to fully analyze the issues presented, the OSA was required to identify whether SACC is a school-operated program or a privately operated program within the framework of Minnesota law. Minnesota law provides that, when a school board offers an extended day program, such as a school age child care program, it must have the following characteristics:

- (1) be part of a community education program;
- (2) be available to children from kindergarten through grade 6;
- (3) offer adult supervised programs while school is not in session;
- (4) have parental involvement in program design and direction;
- (5) form partnerships with the K-12 system and other entities;
- (6) allow opportunities for trained secondary school pupils to work with younger children in a supervised setting;
- (7) have the ability to charge a sliding fee based upon family income and may receive money from other public or private sources; and
- (8) maintain a separate account within the community services fund for all funds related to such a program.⁴

The information reviewed by the OSA suggests that SACC is a school-operated program, because it exhibits all the characteristics of a school-operated extended day program, except that SACC funds are not maintained in a separate account within the School District's community services fund.⁵

providers).

³ *Id.*

⁴ Minn. Stat. § 124D.19, Subds. 11 (1998).

⁵ The OSA noted that SACC has maintained a degree of autonomy from the School District, as demonstrated by the following: (1) SACC has its own bank accounts;

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Additionally, the following factors further suggest that SACC is school-operated:

- (1) the SACC bank accounts were opened and maintained using the federal tax identification number of the School District;
- (2) Prior to August of 1996, some former SACC employees were paid by the School District and, currently, the salary of the SACC Coordinator continues to be paid by the School District;
- (3) the current SACC coordinator position qualifies for membership in the Public Employees Retirement Association (hereinafter "PERA"); and
- (4) SACC is not licensed, as is required for privately operated programs.

Therefore, the OSA has conducted its analysis based on the assessment that SACC is a school-operated program.

III. FINDINGS AND RECOMMENDATIONS

Based upon the OSA's identification of SACC as part of the School District, there were numerous weaknesses involving the internal control structure of SACC. The OSA's findings and recommendations regarding these weaknesses are contained in the following sections:

A. POLICIES AND PROCEDURES

1. Accounting Policies and Procedures

Prior to April of 1998, SACC operated without formalized written policies and procedures for processing financial transactions. Written policies and procedures provide guidance to employees on how to process and record financial activities. Without written policies and procedures, there is no assurance that accounting records and files will be maintained as intended.

Recently, the School District assumed responsibility for processing financial transactions for SACC.

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- (2) SACC was not included in the School District's annual budget; (3) SACC hired and paid employees outside of the School District's payroll system; and
 - (4) SACC's advisory board has exercised decision making authority without consistent School Board representation.

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The School District has various written policies and procedures for processing and recording financial activities, including: budgeting, borrowing, purchasing, records retention and expense reimbursement. However, the OSA noted the School District lacks written policies and procedures in numerous areas, including receipts, disbursements and payroll.

The OSA recommends that the School District review existing policies to determine whether it should implement additional procedures regarding receipts, disbursements and payroll. The policies and procedures implemented by the School District should be approved by the School Board and communicated to all School District employees.

2. Purchasing Policies and Procedures

SACC did not have written purchasing policies and procedures. Purchases were initiated on verbal authorizations and no purchase requisitions or purchase orders were prepared or approved. Additionally, the same employee who initiated purchases also generally received the purchased items and prepared claims for the payment of those purchases. Based upon a review of the School District's purchasing policies and procedures, purchase orders are required.

The OSA recommends that the School District review its current purchasing policies and procedures to include a requirement that goods received be reconciled with related purchase orders. All bills should be approved prior to payment.

3. Annual Audit

SACC was not included in the annual audit of the School District.

The OSA recommends that the financial records of SACC should be audited annually as part of the School District's audit.

4. School District Budget

SACC does not prepare an annual operating budget and, as such, is not included in the School District's budget.

The OSA recommends that SACC prepare a formal budget that is integrated into the School District's budget and approved by the School Board.

B. BANK ACCOUNT TRANSACTIONS

5. Segregation of Duties

Prior to April of 1998, the SACC Treasurer was generally responsible for preparing checks for payment and had possession of the bank statements, while the SACC Coordinator received mail, collected payments, and generally prepared and made deposits. As previously noted, the School District has recently assumed responsibility for processing financial transactions; however, a small number of individuals continue to have the primary responsibility for most of the accounting and financial duties of SACC.⁶

The School District's auditors have found a lack of segregation of duties within the School District during each of the past three years. The School District has indicated that it does not consider it to be economically feasible to hire additional people for the purpose of segregating duties.

The OSA recommends that the School District consider whether it is possible to adjust current staff responsibilities to better segregate duties. Further, the OSA recommends that the School Board be aware of the lack of segregation of duties and, if possible, develop oversight procedures to ensure that the internal control policies and procedures are implemented by staff.

6. Separate Bank Accounts

The SACC savings and checking accounts are maintained separately from the School District's accounts. Prior to April of 1998, the bank statements for the SACC accounts were not reconciled to the check register.⁷

The OSA recommends that SACC funds be maintained in a School District bank account and that the SACC savings and checking accounts be closed. If SACC continues to operate as a school-operated extended day program, the School District should maintain all SACC funds in separate general ledger accounts within the School District's community services fund. If the School District

⁶ Additionally, during the period of its review, the OSA noted that SACC checks were signed only by the SACC Treasurer, even though two signatures were required on checks in the early years of SACC. Minnesota law requires that checks paid by a School District contain at least two signatures. *See* Minn. Stat. § 123B.14, Subds. 2, 7 (1998) (requiring the clerk to draw and sign all orders upon the treasurer and the school board chair to countersign all such orders).

⁷ In addition, the bank statements were mailed to the home of the SACC Treasurer. The OSA noted that the bank statements are currently being mailed directly to the School District.

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chooses to maintain separate SACC savings and checking accounts, the bank statements should be reconciled to the check register promptly upon receipt and the reconciliations should be retained. Any differences should be resolved before the next statement is received. Those preparing the reconciliation should initial and date the statements. Finally, management should review all reconciliations.

7. Cash Withheld from Savings and Checking Account Deposits

The OSA noted that cash was withheld from the SACC savings and checking account deposits.

The OSA recommends that all collections be deposited intact. If collections are not deposited intact, internal controls are weakened, making it possible for the misuse or theft of funds to occur.

8. Cash Withdrawn from Savings Account

Cash was withdrawn on several instances from the SACC savings account. The OSA was unable to locate any documentation to explain these withdrawals.

The OSA recommends that the School District instruct the Bank not to allow cash withdrawals.

9. Retention of Canceled Checks

Numerous canceled checks were not retained by SACC. This resulted in the Bank having to provide copies from microfiche, when available.

The OSA recommends that all canceled checks be retained in accordance with the School District's records retention schedule and Minnesota law.⁸

⁸ Minn. Stat. §§ 138.17, 138.225 (1998).

C. RECEIPTS AND DISBURSEMENTS

10. Cash Receipts

The OSA noted that the receipts ledger maintained by SACC identified each payment received as being either cash or check, but that the composition of cash and check receipts did not match the composition of cash and checks noted on the corresponding deposit slip. Additionally, although the School District assumed responsibility for receiving child care payments in April of 1998, the OSA noted that a check dated April 23, 1998, was made payable to the SACC Coordinator and given to the SACC Coordinator by a parent paying for child care.

The OSA recommends that the receipts ledger include the date of deposit and that the composition of cash and check receipts be reconciled to the composition of cash and checks listed on the corresponding deposit slip. In addition, the OSA recommends that the individual preparing the deposit and the individual reconciling the composition of cash and checks included in the deposit both sign their initials on the deposit slip. Further, all payments for child care should be submitted directly to the School District in a manner consistent with Minnesota law.⁹

11. Payment of Invoices

The OSA reviewed invoices paid by SACC. Most of the invoices reviewed did not indicate whether payment had been made to the vendor for that invoice. If invoices are not marked as having been paid, a possibility exists that multiple payments or non-payment of such invoices may occur.

The OSA recommends that all supporting documentation relating to the payment of invoices be marked with the check number and date paid.

12. Billing of Daycare Costs to Winona County

During its review, the OSA discovered numerous instances in which SACC charged Winona County Human Services an amount that differed from the amount recorded on SACC's ledger.¹⁰ This resulted in what appear to be instances in which SACC either overbilled or underbilled Winona

⁹ See Minn. Stat. § 123B.14, Subds. 3, 6 (1998) (requiring any School District employee who receives money to pay it over to the Treasurer for deposit).

¹⁰ The OSA reviewed bills to Winona County for the months of April, September, October and November of 1997.

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County.

The OSA recommends that SACC bills to Winona County be reviewed to determine whether overbilling or underbilling did, in fact, occur in the past and to ensure that the correct amount is charged in the future.

13. Fund Raising Activities

SACC organized fundraisers for its program. The proceeds from the fundraisers were apparently deposited into the checking account without consistent records of the expenses or profits associated with the fundraisers. While the OSA was unable to locate any specific authority that allows a school district to engage in fundraising activities, such fundraisers are often organized by private, non-profit entities, such as a parent advisory board. Such entities may then donate the proceeds to a school district as provided by Minnesota law.¹¹

The OSA recommends that any future fundraising be performed only by those entities authorized by Minnesota law to engage in such activities and that SACC records include the expenses and profits associated with the fundraisers.

14. Interest-Free Loans

The OSA noted instances in which checks written to the SACC Coordinator and a SACC employee were characterized as loans. The OSA was unable to locate any authority that allows a School District to make loans. The School District is only permitted to issue checks to pay valid claims presented to the School Board for payment.¹² A loan or advance is not a valid claim that an employee has against the School District. Therefore, no order or check can be used to pay such an amount.

The OSA recommends that SACC funds not be loaned to employees or others.

15. Expense Reimbursement

The OSA reviewed expense reimbursements of SACC employees and found that most were paid without adequate supporting documentation and that all were paid without requiring that a claim form be completed. Minnesota law requires claims to be itemized in writing and signed by the claimant

¹¹ Minn. Stat. § 123B.02, Subd. 6 (1998).

¹² Minn. Stat. §§ 123B.02, Subds. 17, 18, 123B.14, Subds. 2, 7 (1998).

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with a declaration that the claim is just and correct and that no part has been paid.¹³ If claims for reimbursement are not properly itemized and accompanied by supporting documentation, it is difficult to determine whether the reimbursement is for a legitimate expense. Further, Internal Revenue Service regulations require unsubstantiated reimbursed expenses to be included as income to the recipient on the IRS Form W-2 or Form 1099.

The OSA recommends that the School District comply with IRS regulations and Minnesota law referred to above by implementing a policy that requires itemization of all claims before payment is made. In addition, supporting documentation should be required.

D. EMPLOYEES

16. Reporting of Income

Except for the SACC Coordinator, SACC employees have not been included in the School District's payroll since August of 1996. Rather, they have been paid with checks written from the SACC checking account. These employees are paid an hourly rate. During its review, the OSA found that SACC did not deduct income taxes, social security taxes or Medicare taxes from the wages of its employees. An employer must generally withhold income taxes, withhold and pay social security taxes and Medicare taxes and pay unemployment taxes on wages paid to an employee. Penalties can be assessed against the employer for failure to withhold these taxes. The OSA was informed that the wages paid to these employees were not reported to the IRS, nor did the employees receive IRS Form 1099 or Form W-2 to be filed with their individual income tax returns. Further, the OSA received no evidence that the employer's portion of social security tax, Medicare tax, unemployment tax or worker's compensation insurance premiums were paid on behalf of these employees.

The OSA recommends that SACC employees be included on the School District's payroll, so as to adhere to IRS requirements for wage reporting and income tax withholding. The OSA further recommends that the School District contact the IRS for guidance as to how to come into compliance with applicable IRS rules and regulations.

Additionally, the OSA reviewed canceled checks used to pay wages to employees and noted one instance where two employees, apparently from the same family, were paid with the same check. Paying employees in this manner makes it difficult to properly report an individual's income.

The OSA recommends that each employee be paid with a check payable to that individual.

¹³ Minn. Stat. § 471.38, Subd. 1 (1998).

17. Time Reporting by Employees

During its review, the OSA found that timesheets for SACC employees, other than the SACC Coordinator, were not maintained after August of 1996.

The OSA recommends that SACC employees be made part of the School District's payroll system and that hours worked and leave taken be reported each pay period using the School District's uniform timesheet for all employees.

18. Employee Files

It does not appear as if SACC maintained personnel files on part-time and seasonal employees. Hence, the OSA was unable to ascertain whether any information was retained on such employees, including their names, addresses, birthdates, and social security numbers.

The OSA recommends that personnel data be maintained on all employees of SACC as required by the Minnesota government data practices act and in accordance with the School District's records retention schedule and Minnesota law.¹⁴

19. Employee Bonuses

During its review, the OSA noted that SACC employees received bonuses in addition to their base compensation. These bonuses were generally in the form of cash or "in-kind" benefits such as gift certificates.

Governmental units may provide benefits to employees only if otherwise authorized by statute or charter.¹⁵ Additionally, "in-kind" benefits to officers and employees must be expressly authorized by statute.¹⁶ Providing a bonus to an employee is not valid compensation unless expressly agreed to in advance as a term or condition of employment. The OSA is unaware of any statutory authority allowing school districts to provide bonuses to employees in this manner.

The OSA recommends that the School District not provide bonuses to employees, unless authorized by law or expressly agreed to in advance as a term or condition of employment. Additionally, the

¹⁴ Minn. Stat. §§ 138.17, 138.225 (1998).

¹⁵ Op. Att'y Gen. 359b, October 24, 1989.

¹⁶ *Id.*

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OSA recommends that the School District not provide "in-kind" benefits to employees, unless authorized by law.

IV. CONCLUSION

The OSA encourages the School District to implement the recommendations included in this letter. Please provide written notification upon implementation of any of these recommendations. Copies of the Minnesota statutes referenced in this letter are enclosed for your convenience.

The OSA would like to thank the School District staff for their assistance during this review. The OSA believes that the investigation and review was a positive example of cooperation among government agencies.

If you have any questions or concerns regarding the findings and recommendations contained in this letter, please contact Darcy Roddy at (651) 282-2387 or me at (651) 297-7107.

Sincerely,

Lea D. Speeter, Esq.
Director, Special Investigations

Enclosures

cc: The Honorable Bernadine Stevens, School Board Member
The Honorable Keith Persons, School Board Member
The Honorable Mary Abbott, School Board Member
The Honorable Lynn Schwieder, School Board Member
The Honorable Rory Ellsworth, School Board Member
The Honorable Randy Dick, School Board Member
The Honorable Charles MacLean, Winona County Attorney
Ms. Beth Rasmussen, School District Business Manager