

Washington State Auditor's Office
Financial Statements Audit Report

Orcas Island School District No. 137
San Juan County

Audit Period
September 1, 2003 through August 31, 2006

Report No. 73422

Issue Date
October 8, 2007



Washington _____
State Auditor

Brian Sonntag



**Washington State Auditor
Brian Sonntag**

October 8, 2007

Board of Directors
Orcas Island School District No. 137
Eastsound, Washington

Report on Financial Statements

Please find attached our report on Orcas Island School District No. 137's financial statements.

We are issuing this report in order to provide information on the District's financial condition.

In addition to this work, we look at other areas of our audit client's operations for compliance with state laws and regulations. The results of that audit will be included in a separately issued accountability report.

Sincerely,

BRIAN SONNTAG, CGFM
STATE AUDITOR

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San Juan County
September 1, 2003 through August 31, 2006

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Schedule of Audit Findings and Responses

Orcas Island School District No. 137 San Juan County September 1, 2003 through August 31, 2006

- 1. Orcas Island School District No. 137 did not have adequate internal controls and monitoring over financial transactions, reporting and financial condition.**

Background

Historically, audits of the District's financial statements have not identified weaknesses with internal controls over financial reporting. However, during the audit period the District experienced significant turnover in key positions, including Superintendent and Business Manager. As a result, we were unable to identify internal controls over financial transactions, reporting, and financial condition for the current audit period.

Description of Condition

The District's internal controls over accounting transactions and reporting were not sufficient to provide reasonable assurance that financial reports are accurate. We identified the following conditions:

- Entries to accounting records were not made consistently and accurately.
- Accounting records were not always reconciled to Office of the Superintendent of Public Instruction apportionment statements.
- The District's financial statements contained a number of errors.
- The District had a bank account which was not included in the District's general ledger or reflected in its financial statements.
- The District did not have reliable financial information available for decision-making and the District's fund balance has declined to a level of significant concern.

Cause of Condition

The District experienced staff turnover in the positions of Business Manager and Superintendent during the three year audit period. Most notably, the District has been without a full-time permanent Business Manager since May 2005.

The full-time Business Manager position was originally vacated May 2005 and was replaced by a part-time Business Manager. That position was vacated in August 2005 and again in May 2006. It was not filled until August 2006.

Due to the turnover in key positions, monitoring of business activities and supervision, training and monitoring of staff were inadequate.

Effect of Condition

The District's ability to provide pertinent and accurate information to its citizens, Board of Directors, school administrators and bond holders is at risk due to lack of internal controls over

the recording of transactions. In addition, the District's fund balance is extremely low and the District may not be able to continue operations without significant improvement.

Recommendation

We recommend the District establish and maintain financial reporting procedures to ensure its financial statements are accurate and complete. We also strongly recommend the District take steps to improve its financial condition.

District's Response

The District recognizes that materially significant improvement in the area of examining day-to-day accounting activity, month-to-month financial analysis, and month-to-month and annualized reporting must be in place to ensure that school district funds are; 1) utilized for proper purposes, 2) are accounted for in a manner that can be adequately, reasonably, and efficiently traced, and 3) are sufficient on a daily, monthly, and annual basis to ensure financially prudent and solvent operations.

In recognition of this fact, two major steps occurred; 1) the District specifically searched, recruited, and hired a Superintendent with knowledge, experience, and commitment to financial management, and 2) beginning in September 2006 the District entered into a contractual agreement with Northwest Educational Service District 189 for Fiscal Management Services. The contractual agreement provides the District with school business and management capability to provide accounting, oversight, reporting, and managerial level services. Each area is designed to provide information that is relevant, timely, and essential to the decision-making process.

In the year 2006-07, the District adopted a budget plan that recognizes historical trends in the areas of employee contractual and non-contractual costs, employee benefit costs, program-to-program revenues versus expenditures, and non-employee related costs (NERC's) at levels of average or above.

The budgetary approach for the 2007-08 Fiscal Year was conservative in the areas of; 1) enrollment, 2) staff mix, and 3) contingency capacity (unallocated resource program/sub-program specifically identified in the budget).

In addition, in the operations of the 2006-07 Fiscal Year, the Board of Directors was informed of concerns tied to the 2006-07 adopted budget and measures were put in place to focus on a positive ending fund balance as of August 31, 2007. At present, this appears highly likely.

Further changes are being explored to provide the District with a solid foundation to systemically assure this issue is systemically addressed on an ongoing basis.

Auditor's Remarks

We thank District staff and officials for their cooperation and assistance during the audit. We will review the status of the condition during the next audit.

Applicable Laws and Regulations

Chapter 3, Section 1 of the *Accounting Manual for Public School Districts*, issued by the Superintendent of Public Instruction and the State Auditor's Office states, in part:

Basic Internal Control Requirements

Each school board is responsible for establishing and maintaining an effective system of internal control throughout the school district. An internal control system should provide *reasonable assurance* that a school district will

accomplish its educational objectives. The concept of reasonable assurance recognizes that the cost of an internal control activity should not exceed the benefit derived from it. Reasonable assurance equates to a satisfactory level of confidence given considerations of costs, benefits, and risks.

School district management should identify and analyze the risks in achieving educational objectives and determine how to most effectively and efficiently manage those risks.

Management defines the level of risk that the school district is willing to accept and strives to maintain risks within those levels.

Each school district should adopt methods to assess risk and review control activities. The methods developed should address each school district's specific needs.

Components of Internal Controls

The five components of good internal controls within a management control system are: 1. **Control environment**—The control environment sets the tone of a school district. Providing discipline and structure, it is the foundation for all other components of internal control. Control environment factors include the integrity, ethical values, and competence of the school district's staff; management's philosophy and operating style; the way management assigns authority and responsibility; the way management organizes and develops its staff; and the attention and direction provided by the board.

2. **Risk Assessment**—Every school district faces a variety of risks from external and internal sources, all of which must be assessed. A precondition to risk assessment is establishment of objectives, linked at different levels and internally consistent. Risk assessment is the identification and analysis of obstacles to achieving the objectives and forms a basis for determining how risks should be managed.

3. **Control Activities**—Control activities are the internal policies and procedures that help ensure management directives are carried out. They help ensure necessary actions are taken to address risks to achieving the school district's objectives. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, review of operating performance, security of assets and segregation of duties.

4. **Information and Communication**—Pertinent information must be identified, captured, and communicated in a form and time frame that enables people to carry out their responsibilities. Information systems produce reports containing operational, financial, and compliance related information, making it possible to efficiently manage the school district.

5. **Monitoring**—Management systems and internal activities need to be monitored to assess the quality of their performance over time. Assessment is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two. Deficiencies should be reported upstream, with serious matters reported to top management.

RCW 43.09.200 Local government accounting--Uniform system of accounting.

The state auditor shall formulate, prescribe, and install a system of accounting and reporting for all local governments, which shall be uniform for every public institution, and every public office, and every public account of the same class.

The system shall exhibit true accounts and detailed statements of funds collected, received, and expended for account of the public for any purpose whatever, and by all public officers, employees, or other persons.

The accounts shall show the receipt, use, and disposition of all public property, and the income, if any, derived there from; all sources of public income, and the amounts due and received from each source; all receipts, vouchers, and other documents kept, or required to be kept, necessary to isolate and prove the validity of every transaction; all statements and reports made or required to be made, for the internal administration of the office to which they pertain; and all reports published or required to be published, for the information of the people regarding any and all details of the financial administration of public affairs.

RCW 28A.400.030(3) states in part:

The Superintendent shall . . . keep accurate and detailed accounts of all receipts and expenditures of school money.

Schedule of Audit Findings and Responses

Orcas Island School District No. 137 San Juan County September 1, 2003 through August 31, 2006

- 2. Orcas Island School District No. 137 does not have adequate internal controls in place to ensure documentation existed to support staff placement of the Legislative Evaluation and Accountability Program (LEAP) schedule.**

Background

Washington state school districts are funded in part based on the education and number of years experience of their Certificated Instructional staff. The District's calculation of these instructors' is used, in part, to determine the District's apportionment allocation from the Office of Superintendent of Public Instruction (OSPI). For fiscal years 2006, 2005 and 2004, the District received approximately \$2.7 million, \$2.5 million and \$2.4 million in combined state enrollment and staff mix funding, respectively.

Description of Condition

Internal Controls over staff mix reporting are insufficient to assure accurate reporting.

Our audit of ten of the District's 54 certificated instructional staff identified errors in eight of the files tested. Four of the errors were significant enough to result in misreporting of the LEAP factors as noted below:

- Credits were over-reported for one instructor for all three years of the audit. This error was also identified in the fiscal year 2000 audit of staff mix, but had not been corrected.
- Two instructors' years of experience were over-reported for all three years of the audit.
- One instructor's years of experience were under-reported for all three years of the audit.
- Required Credit approval forms were not in place for nine out of ten staff files under audit.

Cause of Condition

The District did not have controls in place to assure credits and experience were calculated properly or fully supported and approved as required by regulations.

Effect of Condition

The District incorrectly reported staff mix data including LEAP factors for state funding. The LEAP errors identified above resulted in combined over funding of \$23,849.81 for the three years under audit.

Recommendation

We recommend the District:

- Report staff mix data for each certificated staff member based on the regulations published by OSPI.

- Use prior audit results as a starting point when calculating subsequent year's credits and years of experience for staff members still employed with the District.
- Evaluate whether additional training in staff mix reporting should be made available to staff.
- Establish and follow internal controls over the monitoring and reporting of staff mix.

District's Response

Immediately upon the State Auditor's Office (SAO) presentation of this deficit, the District contracted for a third-party audit/analysis of its personnel records during the 2006/07 year (specifically certificated instructional and administrative staff). An examination began in early June 2007 that examined each certificated personnel file.

The personnel records audit/analysis resulted in identification of items requiring corrective action in staff files and that process has been ongoing from the inception of the examination until present. In addition, the District fully disclosed the results of the audit/analysis to the SAO. The full and complete financial impact is as of yet unknown; however, the District will report the progress to the SAO upon its examination of the District's 2006-07 financial records.

The District is fully committed to attaining staff training and has begun to do so during the summer of 2007 and this will be on-going. In addition, the District has realized significant under-staffing at the District Office Level contributed to the deficiencies identified in the maintenance of personnel files and is committed to addressing Administrative Support in the operations of its 2007-08 operations and beyond.

The District will work with OSPI regarding payback of any S-275 impact that has been identified by the SAO audit as well as the personnel audit/analysis.

Auditor's Remarks

We thank District staff and officials for their cooperation and assistance during the audit. We will review the status of the condition during the next audit.

Applicable Laws and Regulations

Washington Administrative Code (WAC) 392-117-050 provides the definition of documentation requirements:

School districts and educational service districts shall provide upon request . . . for audit purposes, documentation to support all data reported . . .

WAC 392-121-262 provides the definition for additional criteria for all credits states in part:

Credits earned after September 1, 1995, must satisfy . . . criteria in addition to those found in WAC 392-121-255, 392-121-257, and 392-121-259:

WAC 392-121-264 provides the requirements for reporting years of experience states in part:

(1) Professional education employment shall be limited to the following: (a) Employment in public or private . . . schools . . . in positions which require certification . . .

WAC 392-121-280 Placement on LEAP salary allocation documents – Documentation required states in part:

School districts shall have documentation on file and available for review which substantiates each certificated instructional employee's placement on LEAP salary allocation documents. The minimum requirements are as follows:

(2) Districts shall document academic credits by having on file a transcript from the registrar of the regionally accredited institution of higher education granting the credits

(3) Districts shall document in-service credits; (a) By having on file a document meeting standards established in WAC 180-85-107; and (b) . . . credits earned after September 1, 1995, districts shall document that the course content meets . . . WAC 392-121-262(1). At a minimum, such documentation must include a dated signature of the immediate principal, supervisor, or other authorized school district representative and must be available to the employee's future employers . . .

(5) Districts shall document certificated years of experience

Schedule of Audit Findings and Responses

Orcas Island School District No. 137 San Juan County September 1, 2003 through August 31, 2006

3. Orcas Island School District No. 137 lacked adequate controls over enrollment reporting.

Background

The Office of Superintendent of Public Instruction (OSPI) establishes the rules and provides instructions on how school districts should report enrollment for state funding. These rules require that only students who participate in school one of the first four days of September or who have not been absent for 20 consecutive days in October through May on count dates, are eligible to be counted for funding purposes.

In the 2006, 2005 and 2004 school years, the District reported 506, 482 and 493 students and received approximately \$2.7 million, \$2.5 million and \$2.4 million in combined state enrollment and staff mix funding, respectively.

Description of Condition

Internal Controls over enrollment reporting are insufficient to assure accurate enrollment reporting.

Our audit of the District identified the following deficiencies.

- The District did not correctly calculate full-time equivalent (FTE) based on actual class and pass times, but used an average per period.
- Students' schedules were not retained, but thrown away at the end of the semester. Without student schedules, we can not verify the number of classes students attended nor how many should be counted for funding.
- Attendance was not consistently taken by all instructors at the high school.
- Attendance was not tracked during the first four school days in September. Attendance should be tracked to assure all students reported actually attended.
- An FTE warnings report detailing partial students FTE was not generated.
- The District allows students to enroll in "independent study" courses. These classes must follow alternative learning experience guidelines. Files examined lacked documentation to support an evaluation or monitoring process was in place. There were no student plans in place.
- The District incorrectly allowed an "excused absence" to break the chain of absences when determining if students have been absent 20 consecutive days at count dates. This is not an allowable practice.
- The District lacked oversight of reporting accuracy of the P223.
- District lacked proper oversight of monitoring students in juvenile detention facilities. Students who are in a juvenile detention center on the count date could possibly be included in the District's totals.

Cause of Condition

The District did not have procedures in place to ensure only eligible students were reported as enrolled or that proper schedules were used in the calculation of student hours.

Effect of Condition

The District may have received an inappropriate amount of funding. We were unable to calculate accurate enrollment numbers.

Recommendation

We recommend the District establish and follow controls to ensure:

- Students counts are based on the number of hours of enrollment for each student reported;
- All required documentation necessary to support enrollment information reported to OSPI is generated and retained for the required three years or until audited.

District's Response

The District recognizes a need for enhanced day-to-day and month-to-month management, analysis, and oversight of its enrollment reporting. The results of the audit provide detailed items that will be addressed at the outset of the 2007-08 School Year (2006-07 was well into session at the time of the audit by the SAO).

The District, similar to measures taken in finding number two (2), will require its front-line staff to attend training provided by the Office of the Superintendent of Public Instruction (OSPI) to further enhance their ability to work toward enrollment management, analysis, oversight, and reporting.

In addition, the District will attain additional tools/processes from other districts with successful and appropriate controls in the monthly verification process performed at the building level. This will ensure reasonable, adequate, and timely reporting occurs in the area of enrollment reporting.

Auditor's Remarks

We thank District staff and officials for their cooperation and assistance during the audit. We will review the status of the condition during the next audit.

Applicable Laws and Regulations

Washington Administrative Code (WAC) 392-121-106 provides the definition of an enrolled student and identifies the requirement for attending one of the first 4 days of September:

(4) Actually participated on a school day during the first four school days of the current school term, or on a school day during the current school term on or prior to the date being counted

WAC 392-121-122 provides the definition of a full time equivalent student and minimum hours necessary to be counted as a full time student:

. . . hours . . . inclusive of class periods and normal class change passing time, but exclusive of noon intermissions:

(1) The minimum hours for each grade . . . (e) Secondary (grades 7 through 12): 25 hours each week . . .

(2) A student enrolled for less than the minimum hours . . . shall be counted as a partial full-time equivalent student equal to the student's hours of enrollment divided by the minimum hours for the student's grade level

Washington Administrative Code (WAC) 392-117-050 provides the definition of documentation requirements:

School districts and educational service districts shall provide upon request . . . for audit purposes, documentation to support all data reported.

WAC 392-121-182, Alternative learning experience requirements states in part:

Alternative learning experience may be counted as a course of study . . . if the following requirements are met:

(9) Documentation . . . a school district . . . shall maintain the following . . . (d) written student learning plans (e) Student progress reviews, evaluations and assessments . . . (f) student enrollment detail substantiating full-time equivalent enrollment reported to the state, including estimated total hours of participation in educational activities, and any actual documentation of hours of learning for those students failing to make satisfactory progress

Secretary of State Disposition Authority Number GS51-02-03 provides the retention period for enrollment data:

. . . enrollment reports that generate apportionment funding are 3 years of until completion of audit.

Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters in Accordance with *Government Auditing Standards*

Orcas Island School District No. 137
San Juan County
September 1, 2003 through August 31, 2006

Board of Directors
Orcas Island School District No. 137
Eastsound, Washington

We were engaged to audit the financial statements of Orcas Island School District No. 137, San Juan County, Washington, as of and for the years ended August 31, 2006, 2005 and 2004. We were not able to obtain financial statements supporting the financial activities of the District for the years ended August 31, 2006, 2005 and 2004, nor were we able to satisfy ourselves as to those financial activities by other auditing procedures. Accordingly, we do not express an opinion on the financial activities for 2006, 2005 and 2004.

INTERNAL CONTROL OVER FINANCIAL REPORTING

In planning and performing our audit, we considered the District's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting.

However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the District's ability to initiate, record, process and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying Schedule of Audit Findings and Responses as Finding 1.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud 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. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider Finding 1 to be a material weakness.

COMPLIANCE AND OTHER MATTERS

As part of obtaining reasonable assurance about whether the District's financial statements are free of material misstatement, we performed tests of the District's compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion.

The results of our tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and are described in the Schedule of Audit Findings and Responses as Findings 2 and 3. The matters identified in these findings are considered to have a significant and negative impact on the financial condition of the District.

This report is intended for the information and use of management and the Board of Directors. However, this report is a matter of public record and its distribution is not limited. It also serves to disseminate information to the public as a reporting tool to help citizens assess government operations.

A handwritten signature in black ink, appearing to read "Brian Sonntag", is positioned above the printed name and title.

BRIAN SONNTAG, CGFM
STATE AUDITOR

July 30, 2007

Independent Auditor's Report on Financial Statements

Orcas Island School District No. 137 San Juan County September 1, 2003 through August 31, 2006

Board of Directors
Orcas Island School District No. 137
Eastsound, Washington

We were engaged to audit the financial statements of Orcas Island School District No. 137, San Juan County, Washington, as of and for the years ended August 31, 2006, 2005 and 2004. These financial statements are the responsibility of the District's management.

The District did not provide accurate financial statements for the periods ended August 31, 2006, 2005 and 2004. We identified unexplained differences between amounts shown in the financial statements and those recorded in the financial records of the county treasurer. Further, the District did not retain sufficient documentation in support of transactions made in the accounting system to allow us to evaluate the fair statement of revenues, expenditures, and fund balance for the periods ending August 31, 2006, 2005 and 2004. Finally, we also identified a significant liability that was not recorded in the District's financial records.

Since the District was unable to provide explanations for discrepancies in its financial records, did not retain sufficient documentation in support of transactions made in the accounting system, and since we were not able to apply other auditing procedures to satisfy ourselves as to the fair statement of revenues, expenditures, and fund balances, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statements. The statements are not included in our report.

In accordance with *Government Auditing Standards*, we have also issued our report on our consideration of the District's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.



BRIAN SONNTAG, CGFM
STATE AUDITOR

July 30, 2007



ABOUT THE STATE AUDITOR'S OFFICE

The State Auditor's Office is established in the state's Constitution and is part of the executive branch of state government. The State Auditor is elected by the citizens of Washington and serves four-year terms.

Our mission is to work in cooperation with our audit clients and citizens as an advocate for government accountability. As an elected agency, the State Auditor's Office has the independence necessary to objectively perform audits and investigations. Our audits are designed to comply with professional standards as well as to satisfy the requirements of federal, state, and local laws.

The State Auditor's Office has 300 employees who are located around the state to deliver our services effectively and efficiently. Approximately 65 percent of our staff are certified public accountants or hold other certifications and advanced degrees.

Our regular audits look at financial information and compliance with state, federal and local laws on the part of all local governments, including schools, and all state agencies, including institutions of higher education. We also perform fraud and whistleblower investigations. In addition, we have the authority to conduct performance audits of state agencies and local governments.

The results of our audits are widely distributed through a variety of reports, which are available on our Web site. We continue to refine our reporting efforts to ensure the results of our audits are useful and understandable.

We take our role as partners in accountability seriously. We provide training and technical assistance to governments and have an extensive program to coordinate audit efficiency and to ensure high-quality audits.

**State Auditor
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