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February 25, 2008

Mayor Kimberley Driscoll
City of Salem
93 Washington Street
Salem, MA 01970

Dr. William Cameron, Superintendent
Salem Public Schools
29 Highland Ave
Salem, MA 01970

Dear Mayor Driscoll and Dr. Cameron:

We have completed our fiscal year 2007 audit of the City's financial statements and based on information that came to our attention we expanded our testing of certain school related activities. The expanded audit procedures related to a pattern of behavior that resulted in significant errors in reporting of the school's operations. Over the past 3 months we have worked with the City Finance Director and new School Business Manager to unravel these errors. We have agreed with the Finance Director and new School Business Manager on how they will correct the errors. Because all parties have the details related to these transactions and due to the large number of transactions, we will not list them in this report. This letter will summarize our findings on the school revenues and expenditures for fiscal years 2006, 2007 and 2008.

Summary of Findings

Based on the results of our audit, 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.

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. In our experience with him, he demonstrated proficiency in governmental accounting, budgeting and Massachusetts municipal finance rules and regulations. We firmly believe that he either knew or should have known that most of the fraudulent activity was in conflict with generally accepted accounting principles and the Uniform Municipal Accounting System of accounting required by the Massachusetts Department of Revenue. Furthermore, he knew or should have known the negative financial impact on the School and ultimately the City.

Based on our experience with clients that make errors based on a lack of knowledge, these errors normally do not show a pattern of behavior. In the case of Salem schools, substantially all of the errors we found had the effect of reducing general fund school expenditures where there was a legal limit on spending. We were all aware that the City and School had been experiencing financial problems that required controlling the level of expenditures. We found that the activity to push off expenditures from one year to the next occurred between fiscal years 2006 and 2007, and again on a much larger scale between fiscal years 2007 and 2008. We are also aware that the interim financial reports prepared for the School Committee and Superintendent did not accurately reflect the financial activity of the school as it was recorded in the City's general ledger. We are also aware that the former School Business Manager was scheduled for reappointment in the fall of 2007.

From an auditor's perspective, if someone is engaged in a pattern of misreporting financial activity it would be in their best interest that this activity not be disclosed prior to their scheduled reappointment. We found that the opportunity for this situation to occur existed because the individual had intimate knowledge of the City and School's financial systems which allowed activity to be processed without a critical review by other personnel. He also supervised the school business office staff who informed us that they were aware of these activities and reported their concerns to the former Superintendent but no actions were taken to stop the activities or to report it to either the Mayor or School Committee members.

The deliberate actions of the former School Business Manager along with the inaction of other school staff that had knowledge of the actions have resulted in several million dollars of fiscal year 2007 school expenditures being processed in fiscal year 2008; created a deficit in the health insurance trust that was previously thought to be in a surplus position; charged several hundred thousand dollars of expenditures to grants that were not allowed and may be considered illegal by the granting agencies; created significant risk that the granting agency may require grant funds to be returned; placed future grants in jeopardy; and created a fiscal year 2008 budget that was several million dollars lower than the anticipated level of expenditures.

The following section lists specific activities, as described to us, that permitted this situation to occur, and the financial results of this activity.

Again, we have not listed all of the related accounting details. We have gone over this information in detail with the City Finance Director and the current School Business Manager and would be willing to provide additional detail as necessary.

City and School Staff Statements

We interviewed City and School staff, who managed or processed the activity posted to School accounts, and were informed of the following actions regarding the inaccurate financial reporting:

- The former School Business Manager instructed various school finance staff to delay the processing of invoices related to fiscal year 2006 until fiscal year 2007 and repeated the same instruction for fiscal year 2007, delaying payments until fiscal year 2008.
- The former School Business Manager rejected the staff's protests that the invoices should not be delayed.
- The former School Business Manager explained that it was okay and that future funds would be received to resolve the issue.
- The staff brought their concerns up to the former Superintendent.
- The former School Business Manager initiated a significant number of journal entries to move expenditures between general fund line items and other school controlled funds without support.
- The former School Business Manager closed out special revenue funds to the benefit of the general fund at the end of fiscal year 2007.
- The former School Business Manager replenished accounts in special revenue funds in fiscal year 2008, in response to protests by the Grants Manager, and to the detriment of the general fund.
- The former School Business Manager initiated a significant number of these journal entries during the closing process of fiscal year 2007, in late July, August and September.
- The former School Business Manager altered the calculation made by school payroll staff and underreported the teacher's summer payroll liability to the City.
- The former School Business Manager rejected the payroll staff's concerns that the liability was understated.
- The former School Business Manager gave an accounts payable clerk his log-in and password to the MUNIS system and instructed the clerk to override the system control that prevents an expenditure from being processed if the budget would be exceeded.
- The former School Business Manager altered a significant number of budget amounts in the annual budget book that did not tie to prior reports or actual MUNIS amounts.

- The former School Business Manager intentionally under-budgeted certain line items even though the staff informed him that the amounts were significantly in error – examples include:
 - Fiscal year 2008 SPED Evaluations line item was budgeted at \$85,000 even though \$166,000 of fiscal year 2007 invoices were pushed off until fiscal year 2008. Therefore, before the year began, this line item would have been \$81,000 in deficit.
 - Fiscal year 2008 SPED Transportation was only budgeted at \$450,000 even though the expense is significantly higher and \$149,000 of fiscal year 2007 expenses were pushed off until fiscal year 2008.
- The former School Business Manager prepared the year-end “Accrued Expenses” reported to the City without including all of the invoices being held for payment in fiscal year 2008.
- The former School Business Manager reported a receivable and revenue for amounts that the staff believes were questionable.
- The former School Business Manager engaged in similar behavior at the end of fiscal year 2006 and moved at least \$650,000 in invoices to fiscal year 2007.

Fiscal Year 2006 Expenses Paid in Fiscal Year 2007

In fiscal year 2006, the School held off paying \$647,578 of invoices and paid them in fiscal year 2007. In addition, we have recalculated the fiscal year 2006 school payroll accrual and found that the amount posted to the ledger was \$451,570 lower than the correct amount. Therefore \$1,099,148 of fiscal year 2006 expenditures were improperly recorded in fiscal year 2007.

Fiscal Year 2007 Expenses Paid in Fiscal Year 2008

In fiscal year 2007, the School held off paying \$1,444,307 of invoices and paid them in fiscal year 2008. In addition, we have recalculated the fiscal year 2007 school payroll accrual and found that the amount posted to the ledger was \$455,374 lower than the correct amount. The staff’s initial estimate of this under accrual was \$361,000; therefore the actual deficit is \$94,374 higher than previously reported. The total deficit at June 30, 2007, before the journal entries listed below, totals \$1,899,681.

Fiscal Year 2007 Year End Journal Entries

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 and we discussed the issue with City and School staff. When the extent of the other fraudulent transactions were discovered, we decided that it was necessary to audit every journal entry that moved expenditures between funds and every journal entry that recorded a receivable in both fiscal years 2007 and 2008. The following is a summary of the journal entries initiated by the former School Business Manager that were not adequately supported:

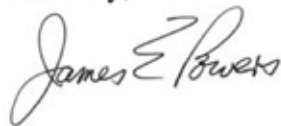
- In fiscal year 2007, revenue was overstated in the school special revenue funds by \$310,209, due to journal entries recording unsupported accounts receivable. These accruals had to be reversed in fiscal year 2008.
- In fiscal year 2007, expenditures were understated in the general fund by \$655,332 due to journal entries that moved expenditures to special revenue funds. These charges have been reversed in fiscal year 2008.
- The School was required to refund excess interest earnings on a federal grant and the refund was incorrectly posted to the School Administrator's special revenue fund. As a result, the general fund interest earnings were overstated by \$27,500 in fiscal year 2007. This error has been corrected in fiscal year 2008.
- Various grants were charged for health insurance costs that were either not allowed or exceeded the eligible costs by a total of \$341,187. The majority of the deficit relates to one federal grant being charged \$250,000 which created a deficit in the grant. Neither the City nor the School investigated this fund deficit during the fiscal year 2007 closing process and they did not review the grant contract which would have highlighted the fact that health insurance costs were not included in the grant budget. The correction of these charges eliminated the grant deficit but created a deficit in the City's health insurance fund.

Combined Dollar Effect on Fiscal Year 2007 General and Health Insurance Fund

The City closed its fiscal year 2007 ledgers, before audit, with the general fund and health insurance trust fund overstated by a combined total of \$2,896,200. This amount is over one million dollars higher than the initial estimate made by the City. We are aware that the initial deficit estimate was raised during the fiscal year 2008 budget process. However, the City will need to work with the Department of Revenue to account for the additional one million dollar deficit during the fiscal year 2009 budget process.

We are available to assist the City and School in understanding the implications of the deficit and to provide guidance on how to properly account for the numerous fiscal year 2008 ledger adjustments that will be required. If you have any questions please do not hesitate to contact me.

Sincerely,



James E. Powers CPA
Partner