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# STATE OF INDIANA

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**DISTRESSED UNIT APPEAL BOARD**



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PHONE (317) 234-2273**

**TO: Distressed Unit Appeal Board Members**

**FROM: Courtney L. Schaafsma, Executive Director**

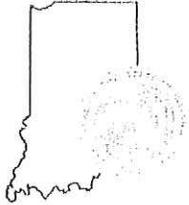
**DATE: August 17, 2018**

**RE: Gary Schools Recovery, LLC Internal Controls Performance Incentive**

On December 29, 2017, Gary Schools Recovery, LLC (“GSR”) submitted the Internal Controls of Major Financial Systems Report (“Report”) to the Distressed Unit Appeal Board (“DUAB”). The Report was submitted in accordance with the contract with GSR for emergency management services for Gary Community School Corporation (“GCSC”). The contract language requires the following for the Report:

The Emergency Manager will develop and adopt internal controls of the major financial systems of the School Corporation by December 31, 2017. The Emergency Manager shall provide DUAB with a letter documenting the policies and procedures for internal controls of the School Corporation’s major financial systems. DUAB, in consultation with the SBOA, shall review the policies and procedures for internal controls for sufficiency and compliance with requirements of SBOA. The achievement date for this performance incentive shall be the date on which the Emergency Manager submits the letter required herein. The performance incentive cannot be claimed until DUAB has reviewed and accepted the letter and policies and procedures provided as sufficient proof of the implementation of appropriate internal controls of the School Corporation’s major financial systems. Upon DUAB’s review and acceptance of the letter and policies and procedures, the Emergency Manager shall receive a \$100,000 performance incentive.

The State Board of Accounts (“SBOA”) reviewed the originally submitted version of the Report and provided feedback to GSR during a meeting March 2018. GSR submitted an updated version of the Report on May 2, 2018. On August 2, 2018, SBOA provided the attached letter to document its findings in regard to the Report’s compliance with minimum internal control standards and key principles of internal controls.



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August 2, 2018

File: Gary Community School Corporation

Distressed Unit Appeals Board  
Indiana Department of Local Government Finance  
100 N. Senate, N-1058B  
Indianapolis, Indiana 46204

Board Members:

On January 31, 2018, we received the following documents for review in consultation with the Distressed Unit Appeals Board (DUAB).

1. Cover Letter dated December 29, 2017
2. Resolution No: 002 – Gary Community School Corporation Emergency Manager Resolution to Adopt Internal Controls
3. *Internal Controls of Major Financial Systems* (Dated December 31, 2017)
4. Appendix A: *Gary Community School Corporation Business Office Procedures and Internal Controls* (Dated December 31, 2017)

The revised documents listed below that were prepared after the contract deadline were also reviewed for the purpose of consulting with DUAB.

1. Resolution No: 002 – Gary Community School Corporation Emergency Manager Resolution to Adopt Internal Controls (Adopted March 29, 2018)
2. Internal Controls Cover Letter dated May 2, 2018
3. Internal Control Revisions for v2.0
4. *Internal Controls of Major Financial Systems v2.0* with Appendices (dated April 24, 2018)

This letter represents the State Board of Accounts (SBOA) response to DUAB based on our review of the documents presented for sufficiency and compliance with the *Uniform Internal Control Standards for Indiana Political Subdivisions*, herein after, also referred to as the minimum internal control standards.

Our consideration of internal control was limited to review of the above listed documents. We reviewed these documents for the elements of internal control required to meet the minimum standards presented in the *Uniform Internal Control Standards for Indiana Political Subdivisions*, not for the purpose of expressing an opinion on the effectiveness of the School Corporation's internal control. Accordingly, we do not express an opinion on the effectiveness of the School Corporation's internal control.

This limited review was not designed to identify deficiencies in the design and implementation of internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that are not identified. However, we identified certain elements required by the minimum standards that were not sufficiently documented within the materials presented on January 31, 2018, that are noted below. After review of the revisions in *Internal Controls of Major Financial Systems v2.0 (Version 2.0)*, these elements have been given additional consideration by the School Corporation's Emergency Manager, Board, and management, sufficient to satisfy the minimum documentation required for compliance with the *Uniform Internal Control Standards for Indiana Political Subdivisions*.

#### Adoption of Internal Control Policy

The *Uniform Internal Control Standards for Indiana Political Subdivisions* manual, page 4, requires "At a minimum, the legislative body shall stipulate in a policy that they have adopted the internal control standards as defined by SBOA under IC 5-11-1-27(e)." The documents received January 31, 2018, did not contain this stipulation, but Resolution No. 002, dated March 29, 2018, later satisfied this requirement.

#### Objectives

The *Internal Controls of Major Financial Systems Report*, page 1, contains broad categories of internal control objectives adopted by the Committee of Sponsoring Organizations of the Treadway Commission (COSO); some of these are also incorporated into the *Uniform Internal Control Standards for Indiana Political Subdivisions* manual, page 5. However, the specific objectives of the Gary Community School Corporation are not categorized into these areas so our ability to provide constructive guidance on the sufficiency of the design of the control activities and other components of the internal control structure in achieving operations, reporting, and compliance objectives is limited.

The specific objectives enumerated within the *Internal Controls of Major Financial Systems Report* are found within Part 3.0, Detail for Each Major Financial System. Control objectives are not labeled as such within each area. Some general controls listed within each area are objectives. Other objectives are described in the detail for the section. This arrangement does not lend itself to providing clear guidance or efficient training to the officials and employees that will be responsible for implementation, monitoring, and maintenance of the system of internal controls. Additionally, some of the objectives are not supported within the documents reviewed by all five components of internal control required to meet the minimum internal control standards.

*Internal Controls of Major Financial Systems v2.0* still does not clearly label objectives, as such, for each major financial system which would clarify this guidance for the responsible officials and employees, it does identify objectives for each of the major financial systems as required by the minimum internal control standards.

#### Control Environment

According to the *Uniform Internal Control Standards for Indiana Political Subdivisions* manual, the following principles must be present and functioning to support the control environment component:

- Principle 1. The oversight body and management demonstrate a commitment to integrity and ethical values;
- Principle 2. The oversight body oversees the entity's internal control system;
- Principle 3. Management establishes an organizational structure, assigning responsibility, and delegates authority to achieve the political subdivision's objectives;

- Principle 4. Management demonstrates a commitment to attract, develop and retain competent individuals; and
- Principle 5. Management evaluates performance and holds individuals accountable for their internal control responsibilities.

The Guiding Internal Controls Standards in section 1.E. of the *Internal Controls of Major Financial Systems Report* document the proper tone and could be effective communication of the governing body's commitment to integrity and ethical values required by Principle 1. We recommended the word "should" used throughout this section be replaced by the word "must" or "shall" to demonstrate a stronger commitment by management and those charged with governance and to give clearer guidance to officials and employees. In Version 2.0 revisions, management incorporated this recommendation which clearly meets the minimum requirements of Principle 1.

The oversight body has the authority to oversee the entity's internal control system by Indiana Code and within the body of these documents. Although the responsibility for oversight and the objective of Principle 2 are incorporated into these documents, no specific guidance, policy, or procedure for overseeing the internal control system is included in the documentation presented. An example of this is on page 2 of the *Business Office Procedures and Internal Controls* under section 1.C. It states: "Monitoring internal controls allows for assessing the effectiveness of the internal control system. Those charged with governance should take necessary steps to keep the internal controls system." Although the example language is still in place within the *Business Office Procedures and Internal Controls* document, Version 2.0, Part I.F., Internal Control Oversight has been added to satisfy Principle 2.

Within the documents reviewed, management does not discuss the methodology for establishing the organizational structure or provide a comprehensive organizational structure for review, but it is evident that effort has been made to assign responsibilities for incompatible duties to different individuals. Segregation of incompatible duties is evidence of management's desire to establish an internal control system to achieve the objectives of the school corporation and is sufficient documentation to meet the minimum standard in Principle 3 when properly implemented. Version 2.0 contains additional information on the organizational structure and improves documentation in support of Principle 3. However, there are objectives and control activities contained in the documents reviewed for which responsibility is not specifically assigned to an individual position. It is unclear from this review if the established organizational structure and assignment of responsibilities at the school corporation is sufficient to support the achievement of all stated objectives.

The *Internal Controls of Major Financial Systems Report*, page 4, General Controls Related to Payroll and section 3.A.2.1.1 incorporate the minimum standards in Principle 4.

Our review of the documents presented in January 2018, found no specific policies and procedures to state how management is to evaluate performance and hold individuals accountable for their internal control responsibilities required for compliance with Principle 5. Subsequently, Part I.H. Performance and Accountability was added to Version 2.0 to meet the requirements of Principle 5.

#### Risk Assessment

As stated in the *Uniform Internal Control Standards for Indiana Political Subdivisions* manual, risk assessment is the process used to identify and assess internal and external risks to the achievement of the objectives, and then establish risk tolerances. Each identified risk is evaluated in terms of its impact and likelihood of occurrence. Overall, risk assessment is the basis for determining how risk will be managed. The following principles are to be present and functioning for this component:

- Principle 6. Management defines objectives clearly to enable the identification of risks and defines risk tolerances;
- Principle 7. Management identifies, analyzes, and responds to risk related to achieving the defined objectives;
- Principle 8. Management considers the potential for fraud when identifying, analyzing, and responding to risks; and
- Principle 9. Management identifies, analyzes, and responds to significant changes that could impact the internal control system.

Principles 6 through 9 are recognized within the *Internal Controls of Major Financial Systems Report* by identification of objectives and Section 1.B.4 of the *Business Office Procedures and Internal Controls*, page 2, recognizes the risk assessment process as forming the basis for determining the risks, which needs to be monitored and that managing risks allows for the prevention, identification, and correction of misstatements. The documents submitted for review in January 2018 do not provide guidance to management in the areas of identification of risks or the performance of risk assessment. We found no discussion of risk tolerances, consideration of fraud in risk analysis, or risk response within these submissions. Part I.I., Risk, was subsequently incorporated within Version 2.0 to meet the requirements of Principles 6 through 9.

#### Control Activities

The control activities are the actions established through policies and procedures to detect, prevent, or reduce the identified risks that could interfere with achievement of objectives. The following principles apply to control activities and are required by the minimum internal control standards for this component:

- Principle 10. Management designs control activities to achieve the objectives and respond to risks;
- Principle 11. Management designs the political subdivision's information system and related control activities to achieve objectives and respond to risks; and
- Principle 12. Management implements control activities through policies.

The documents submitted in January 2018 contain control activities to support the achievement of objectives stated within the *Internal Controls of Major Financial Systems Report*. We could not locate any identified risks or clearly see where management had designed specific control activities to respond to risks to the achievement of stated objectives. Version 2.0 added identification of risks and risk analysis by major financial area. Although the documentation of the design of control activities still does not draw clear lines between the control activities designed to ensure achievement of objectives and those designed as risk responses, we consider Version 2.0 adequate to meet minimum documentation requirements of Principle 10.

We found no documentation on the design of the information system or information on how such a system is in place to achieve management's objectives and respond to risks even though the *Business Office Procedures and Internal Controls* refers to the information system in general terms. The additions made in Version 2.0 to the checklists and Part I.J., Monitoring and Remedy of a Deficiency, are sufficient to support compliance with Principle 11.

The *Internal Controls of Major Financial Systems Report* calls for the establishment of several policies in effort to ensure achievement of stated objectives, but does not actually incorporate the policies into documents presented for this review. Management policies documenting the details of the internal controls are required to determine if the design of the controls are sufficient to achieve the stated objectives.

These policies should also describe proper implementation for achievement of management's objectives and address related risks. From this review, we cannot determine the degree to which the internal control system is properly designed and implemented. The documentation is sufficient to determine there is compliance with the minimum documentation requirements of Principle 12. We recommend that management's specific policies be incorporated by reference into the *Internal Controls of Major Financial Systems Report* as they are developed and installed.

#### Information and Communication

Relevant information is needed from internal and external sources to support the other components of the internal control system. The following are the principles that apply to this component to meet the minimum internal control standards:

- Principle 13. Management uses quality information to achieve the political subdivision's objectives;
- Principle 14. Management internally communicates the necessary quality information to achieve the political subdivision's objectives; and
- Principle 15. Management externally communicates the necessary quality information to achieve the entity's objectives.

Principle 13 requires management to define the types of information needed and the acceptable sources of information. Then the information is processed and evaluated for relevancy by management. The Internal Control Procedures listed in section 2.0 of the *Business Office Procedures and Internal Controls* specifies information needed; the appropriate sources; and management processes that document management's inclusion of this principle.

Principle 14 requires information to be communicated using established reporting lines considering the audience, nature of the information, availability, cost and any legal or regulatory requirements. The documents reviewed show management's consideration of sensitive information and necessary safeguards over that information. The Internal Control Procedure information referenced above in section 2.0 shows established lines of communication internally.

Principle 15 requires management to identify external parties and appropriate communication methods giving the same consideration to the audience, nature of the information, availability, cost and any legal or regulatory requirements. Once again, the documents reviewed show management's consideration of sensitive information and necessary safeguards over that information. The Internal Control Procedure information referenced above in section 2.0 identifies external parties and appropriate communication methods for external communications.

#### Monitoring Activities

Ongoing or periodic evaluations are to be used to determine whether each of the five components of internal control is present and functioning. These evaluations are to be developed by the oversight body, governing board and management. The following principles are required to meet the minimum internal control standards for this component:

- Principle 16. Management establishes and operates monitoring activities to monitor the internal control system and evaluate the results; and
- Principle 17. Management remediates identified internal control deficiencies on a timely basis.

Management incorporated several periodic monitoring activities within the documents submitted for review in January 2018. These activities listed in the *Internal Controls of Major Financial Systems Report* are assigned in the Internal Control Procedures listed in section 2.0 of the *Business Office Procedures and Internal Controls*. However, these documents do not indicate how and to whom the results of the activity are to be communicated and who will evaluate the documented results and when. Evaluating the results is a critical function to comply with Principle 16. The necessary information for evaluation of results and decision making thereon was subsequently incorporated into the Version 2.0 checklists for each major financial system and in Part I.J., Monitoring and Remedy of a Deficiency.

Although the documentation presented for review indicates on page 2 of the *Business Office Procedures and Internal Controls* under 1.C ". . . Those charged with governance should take necessary steps to keep the internal controls system" we did not find documentation establishing a mechanism for personnel to report internal control issues identified while performing their responsibilities. Documentation of the appropriate process; timing for documenting and evaluating issues; and specific responsibility for remediation of issues was also not located within the documents reviewed to meet the requirements of Principle 17. This information was subsequently added in the Version 2.0 checklists for each major financial system and in Part I.J., Monitoring and Remedy of a Deficiency.

Proper internal control systems are designed and implemented to operate as an integrated whole. The interrelated components and principles have been analyzed individually for purposes of this discussion. The attached schedule is presented as a quick review of the individual elements required by the *Uniform Internal Control Standards for Indiana Political Subdivisions* noted within the documents presented for review. This letter and the attached schedule are not sufficient on their own to assess the effectiveness of the internal control system's overall design, implementation or operation.

Sincerely,



Tammy R. White, CPA  
Deputy State Examiner

TRW:

MINIMUM STANDARDS	ORIGINAL SUBMISSION	VERSION 2.0
Adoption of Internal Control Policy by the legislative body		✓
Defined Objectives of the Internal Control System	✓	✓
<u>Components and Principles</u>		
<u>Control Environment</u>		
Principle 1. Oversight body and management demonstrate a commitment to integrity and ethical values.	✓	✓
Principle 2. The oversight body oversees the entity's internal control system.	✓	✓
Principle 3. Management establishes an organizational structure, assigning responsibility, and delegates authority to achieve the objectives.	✓	✓
Principle 4. Management demonstrates a commitment to attract, develop and retain competent individuals.	✓	✓
Principle 5. Management evaluates performance and holds individuals accountable for their internal control responsibilities.		✓
<u>Risk Assessment</u>		
Principle 6. Management defines objectives clearly to enable the identification of risks and defines risk tolerances.		✓
Principle 7. Management identifies, analyzes, and responds to risk related to achieving the defined objectives.		✓
Principle 8. Management considers the potential for fraud when identifying, analyzing, and responding to risks.		✓
Principle 9. Management identifies, analyzes, and responds to significant changes that could impact the internal control system.		✓
<u>Control Activities</u>		
Principle 10. Management designs control activities to achieve the objectives and respond to risks.	✓	✓
Principle 11. Management designs the political subdivision's information system and related control activities to achieve objectives and respond to risks.	✓	✓
Principle 12. Management implements control activities through policies.	✓	✓
<u>Information and Communication</u>		
Principle 13. Management uses quality information to achieve objectives.	✓	✓
Principle 14. Management internally communicates the necessary quality information to achieve the objectives.	✓	✓
Principle 15. Management externally communicates the necessary quality information to achieve the entity's objectives.	✓	✓
<u>Monitoring Activities</u>		
Principle 16. Management establishes and operates monitoring activities to monitor the internal control system and evaluate the results.		✓
Principle 17. Management remediates identified internal control deficiencies on a timely basis.		✓