



SUMMARY REPORT
HAZLETON AREA SCHOOL DISTRICT'S
PAYMENTS TO NETWORKED EDUCATION
TECHNOLOGIES, INC.

December 2002

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INTRODUCTION

The Department of the Auditor General (the Department) conducts audits of school districts in the Commonwealth pursuant to its authority and jurisdiction under the Fiscal Code.¹ In April 2001, the Auditor General received a letter from a member of the Pennsylvania House of Representatives requesting that the Department conduct an audit or investigation “into all aspects of any dealings” between the Hazleton Area School District (HASD) and Networked Education Technologies, Inc. (NET). According to the letter, NET filed for bankruptcy on April 3, 2001, and may have owed HASD an estimated \$700,000 for work that was never completed. The letter contained a copy of a unanimous Resolution of the HASD school board dated April 9, 2001, which stated:

Since Pennsylvania State Funds were involved, the Board of Directors of the Hazleton Area School District hereby moves and requests that the Pennsylvania Auditor General, at the earliest possible time, conduct an audit and investigation into all aspects of any dealings between the Hazleton Area School District and Networked Education Technologies, Inc. of Dickson City, Pa. This audit or investigation should include, but not be limited to, how the School District “paid in full” for work which was never performed or provided, how the contracts were solicited, the procedures used for bidding this work, how the contracts were awarded, how contract performance was verified, a review of the payment authorization process, project management and the role of independent contractors or consultants who oversaw aspects of those contracts.

It is the further request of this board that the Pennsylvania Auditor General report back to this board any findings and recommendations at the earliest possible time.

An investigation was conducted by the Department’s Office of Special Investigations (OSI). The investigation included interviews with current and former school district and NET employees, examination and analysis of school district financial records and contracts, NET financial records and records of the bankruptcy court, and interviews of HASD consultants. In March 2002, the HASD board asked the Department to expand its inquiry to include the school district’s purchase of computer software from NET in November 1997.

The report’s draft findings, conclusions and recommendations were made available to HASD representatives on October 7, 2002. A response on behalf of HASD was submitted on November 8, 2002, and is presented on pp. 32-33, followed by the Department’s comments. The response was directed to the report as a whole and not to specific findings or recommendations. We also received a communication from the former business manger that raised various specific points related to statements in the findings. The former business manager’s responses are presented after the appropriate finding, followed by the Department’s comments.

¹ 72 P.S. § 403.

EXECUTIVE SUMMARY

Response to the questions presented in the HASD Board of Directors April 9, 2001, Resolution

Question No. 1: How did HASD pay “in full” for work that was never performed or provided?

Answer: The current HASD business manager issued checks which included a total of \$725,554, as final payment to NET, before work was completed on five contracts. The payments were in violation of the Public School Code and HASD’s policies and procedures (see Finding No. 1). The estimated cost of equipment and services, including training, that were not provided by NET in connection with the five contracts is approximately \$433,841 (see Finding No. 2). HASD’s staff also failed to ensure that much of NET’s work on the contracts, particularly training, was provided and did not monitor NET’s fulfillment of contract training requirements prior to 1999. The current business manager is the school district’s fiscal officer and, therefore, he was primarily responsible for making the payment to NET before work on the contracts was completed and the resulting misuse of school district funds. However, for the reasons described in the Findings, the school board, staff and consultants all share some responsibility for what occurred.

Question No. 2: How were the contracts solicited?

Answer: Contracts with NET were entered into as a result of the decision by the school district’s former business manager to obtain IBM computer hardware and software and to continue to obtain IBM equipment and related services from NET after IBM withdrew from the business of providing educational technology and services directly. This is discussed in detail in Finding No. 3.

Question No. 3: What procedures were used for bidding the work?

Answer: No bidding procedures were used in connection with the school district’s contracting for purchases of equipment and services from NET (see Finding No. 3).

Question No. 4: How were the contracts awarded?

Answer: Initially, the contracts were awarded to NET at the direction of the former business manager with school board approval. NET contracts prepared in 1997 and 1998 were signed on behalf of HASD by the former business manager and approved by the HASD school board. In 2000, contracts with NET were signed on behalf of HASD by the current business manager and approved by the school board (see Finding No. 1).

Question No. 5: How was contract performance verified?

Answer: The contracts contained no specific provisions for verification of contract performance. According to HASD policies and procedures, the business manager is responsible for verification that goods are received and services rendered. HASD failed to fully or adequately verify contract performance by NET (see Finding Nos. 1 and 2).

The Resolution also requested the Department to review the HASD payment authorization process, project management and the role of independent contractors or consultants. We found that the payment authorization process was deficient, project management was weak and the role of independent contractors/consultants contributed substantially to those deficiencies and weaknesses (see Finding Nos. 1, 2 and 3).

Finally, HASD's purchase of IBM software is discussed briefly in Finding No. 3. The information provided to us suggests that HASD management did not adequately evaluate the proposal to purchase IBM software before going forward with it.

Summary of Findings

The current HASD business manager failed to follow the Public School Code and the school district's policies and procedures when he made final contract payments to NET, totaling approximately \$725,554. He failed to take reasonable and appropriate steps to ensure that the work had been completed and made the payments without school board approval.

As a result of mismanagement and lack of effective internal controls in connection with the NET contracts, HASD paid NET approximately \$433,841 for equipment and services, including training, that the school district did not receive.

HASD failed to use appropriate contracting procedures in its dealings with NET. Specifically, the school district failed to take reasonable steps to protect itself in the event of the vendor's failure to perform the contracts.

During the investigation, we observed that there were questionable expenditures of NET funds during a period of approximately seven months preceding the bankruptcy that warrant further review by the Bankruptcy Court and law enforcement agencies.

RECOMMENDATIONS

1. HASD should take appropriate action to ensure that persons responsible for the business and financial management of the school district are qualified to carry out their duties properly and are familiar with legal requirements and school district policies and procedures concerning payments to contractors, as well as basic procedures for determining contract compliance.
2. HASD should consider whether the recovery of costs incurred as a result of the business manager's failure to perform his duty can be obtained through the business manager's bond.
3. HASD should establish clearly defined responsibilities and reporting requirements for the purchase and installation of computer-related technology and designate a specific office or individual with responsibility for ensuring that staff and teacher training related to computer technology is provided.
4. HASD should require as a condition of its agreements with consultants that, during the time period of such agreements, consultants not perform services for contractors or other vendors doing business with HASD. Consultants should also be required to disclose all of their financial or personal interests in such contractors or vendors as part of their consulting agreements with HASD.
5. HASD should establish policies and procedures to require performance bonds from vendors of computer equipment and services.
6. HASD should submit proposed projects and contracts for computer equipment and services related to school building renovation work to the Pennsylvania Department of Education (PDE) for review and approval under the Public School Code for the purpose of ensuring eligibility for state reimbursement when it is authorized and to obtain technical assistance when it is available.
7. HASD should inform IBM of NET's failure to complete work on the HASD contracts and request IBM to provide assistance to the school district to correct the deficiencies caused by the failure of NET, IBM's exclusive sales agent and partner, to comply with the terms of NET's contracts with HASD.

BACKGROUND

HASD purchased technology equipment and services totaling approximately \$4.2 million from NET from 1996 to 2001. The payments were made from the school district's General, Capital Reserve, Special Project, and Bond Issue Funds. There were approximately 20 separate written agreements with NET, plus numerous NET invoices and HASD purchase orders for specific items such as computer hardware and software, wiring, installation services, staff support, training and other related activities involving schools and administrative facilities. The contracts with NET were approved by the HASD school board. The contracts were not awarded through competitive bidding procedures.²

HASD paid approximately \$1,450,928 in connection with five of the NET contracts in late 2000 and early 2001. The contracts were for design and installation of computer and video equipment and related services, including training, at four schools. The contracts contained requirements calling for initial payments of 40 to 50 percent of the total contract amounts, due upon signing of the contracts or change orders. Three of the contracts stated that the remaining amount due would be billed as the work is completed. Two contracts stated that additional payments would be made on a monthly basis until the work was completed.

Table No. 1 shows the individual contract numbers for the five contracts, dates, schools/projects and payment totals.

² This is discussed in more detail in Finding No. 3.

Table No. 1 – HASD Payments to NET on Five Contracts, 2000-2001

Contract Number and Date	School/Project³	Initial (8/29/00) Payment Amount	Second Payment Amount	Total Payments
SA9765 11/30/97	Valley K-8 School WAN	\$152,556	\$152,556	\$305,112
SA9779 7/1/98	Drums K-8 School WAN	\$167,357	\$167,537	\$334,894
SA9926 7/26/00	Heights Elementary Renovation Data and Video Network	\$125,806	\$125,806	\$251,612
SA9929 7/26/00	Arthur Street Elementary LAN and Video Network	\$210,086	\$210,086	\$420,172
SA9942 7/26/00	Arthur Street Elementary WAN	\$69,569	\$69,569	\$139,138
Total		\$725,374	\$725,554⁴	\$1,450,928

Invoices for the initial payments were submitted by NET, signed off on by the HASD instructional technology coordinator, approved by the school board on August 24, 2000, and paid on the date designated in the contracts.⁵ The second, or final, payment on the contracts is discussed in detail in Finding No. 1.

The positions, duties and responsibilities of the principal individuals involved in the school district's contracting with NET were as follows:

The current business manager

The individual has been employed by the school district since May 1994 and served as assistant business manager from May 1997 until he became the business manager on September 1, 1999. According to his employment agreement, he is charged with the administration of the school district's business affairs under the direction of the school board and the superintendent,

³ The work included design and installation of a Wide Area Network (WAN) and/or Local Area Network (LAN) plus additional items as described below.

⁴ The final checks issued by the district total \$726,340. The checks include a \$786 payment to NET for work performed at the HASD Career Center as part of another NET contract.

⁵ Due to revisions in the total amounts of several contracts and an adjustment to the agreed-upon percentage of the initial payment in one contract, the total of the initial payments was not exactly 50 percent of the total amount of the contracts.

and serves as the school district's fiscal officer. He is also the secretary of the school board. As stated in the Public School Code, the board secretary is responsible for "general supervision of all of the business affairs of the school district, subject to the instructions and direction" of the school board⁶ and is required to be bonded.⁷

The director of Instructional Technology (IT director)

In September 1999, HASD hired an individual to serve as the IT director. According to the job description for the position, the IT director's duties include working with a technology team to establish goals, coordinating technology planning, implementation and evaluation, identifying hardware and software budgets, serving as liaison with vendors and providers, and ordering hardware and software. The IT director reports to the superintendent.

The former business manager

The individual served HASD in that capacity from 1993 to 1999. As discussed in Finding No. 3 of this report, in his capacity as business manager, he played a leading role in the school district's computer contracts, first with IBM, and later with NET. After he left his position as business manager, the school district retained his services as an independent contractor, "for the purpose of rendering advice and consultation on matters relating to school construction, technology and school finance." According to the contract, HASD was to retain the former business manager for two years (September 1, 1999 to August 31, 2001) at a rate of \$400 per day, not to exceed \$48,000 per year. He was to perform services including, "serving as principal liaison between the administration of the school district and the school construction team for the completion of the school district construction program and resolution of all Department of Education reimbursement issues." The individual's specific duties, according to the contract, included direction of "the installation of computer hardware and software pertaining to Project 2000 and District Administration."⁸ In October 2000, the HASD school board voted to terminate the professional services agreement as of December 2000. In this report, the individual is referred to as "the former business manager."

The former technology coordinator

The school district's former technology coordinator was hired by HASD as a consultant in August 1999. According to his agreement with HASD, he was to perform duties relating to Project 2000, including serving as liaison between the school district and contractors, assisting in the installation of new computer hardware and software, attending meetings with contractors, evaluating new hardware and software and reporting findings to the business manager. The contract was for two years (September 1, 1999, to August 31, 2001). The individual was to receive \$375 per day for his services. In October 2000, the school board decided to terminate the agreement, effectively in December 2000. In this report, the individual is referred to as the "former technology coordinator."

⁶ 24 P.S. § 4-333(5).

⁷ 24 P.S. § 4-431.

⁸ Project 2000 was an HASD construction program financed through the issuance of bonds.

The consulting agreements that the former business manager and former technology coordinator had with HASD contain no requirements that limited or prohibited the consultants from performing services for other public or private organizations during the period of their consulting agreements with HASD.

In 2000, the HASD Technology Department, and the IT director in particular, became more involved in monitoring NET's activities in the school district, which had previously been under the supervision of the former business manager. By mid-2000, the IT director was questioning the work done by NET, as well as the suitability of the IBM hardware and software for the school district's needs. Despite those concerns, in July and August 2000, HASD went forward with the five NET contracts listed in Table No. 1, i.e., two contracts that were signed previously (one in 1997 and the other in 1998) and three new contracts.

FINDINGS

Finding No. 1 – The school district’s current business manager failed to follow the Public School Code and the school district’s policies and procedures when he made final contract payments to NET, totaling approximately \$725,554, without taking reasonable and appropriate steps to ensure that the work had been completed and without school board approval of the payments.

On December 22, 2000, and February 8, 2001, HASD checks were issued payable to NET, for \$600,534 and \$125,806, respectively. The two checks, taken together, constituted the final payment for work by NET on the five contracts listed in Table No. 1.⁹ The payments were made despite the fact that work on the contracts had not been completed, without notice to the school board and without the board’s approval. A substantial portion of the work was never completed by NET, resulting in a financial loss to HASD, which is discussed in detail in Finding No. 3. This Finding addresses the failures related to the process through which the final payments were made.

The documentation concerning the payments disclosed the following:

- HASD’s records provided to OSI contained five invoices from NET, all dated October 27, 2000, for the contracts listed in Table No. 1. The invoices state that they are for the final payment on the contract to which they relate and all of them contain the statement “work completed.” The invoices are date-stamped as having been received by HASD on November 8, 2000.
- There is a punch list for the projects dated December 7, 2000. It contains the signature of the IT director, dated December 19, 2000, as verification of receipt of certain items/services by the school district. The punch list contained approximately 15 categories of items marked as “items not completed.” The items included installation of about 295 personal computers, security systems, servers and cabling.
- HASD issued a check dated December 22, 2000, drawn on the school district’s Capital Project Fund and made payable to NET in the amount of \$600,534. The check contains the stamped signatures of the current business manager, the HASD school board president, and the treasurer as the payors. The check was deposited into an NET account on December 26, 2000.
- There is a second punch list dated February 8, 2001, entitled “Hazleton Area School District Installation Completion Status and Work to be Completed.” The list describes the locations and items, accompanied by the words “COMPLETE” or “NOT COMPLETE,” with brief statements of reasons why work was listed as “NOT COMPLETE.” According to the punch list, the “work remaining” consisted of

⁹ As noted in Table No. 1, the December 22, 2000, check also included \$786 for work done pursuant to another contract.

approximately eight categories of items at the Arthur Street and Drums Elementary Schools. The punch list contained a section entitled “Work Remaining.” The items listed in that section were software, installation of hardware, servers, printers and other equipment at the Arthur Street and Drums Elementary Schools. The section stated that installation would continue as soon as certain software items arrived which was expected to be by no later than February 15, 2001. The punch list also contained a statement that NET and HASD agreed that the “installation status and work to be completed” included in the punch list were correct as of February 8, 2001. The signature lines under the wording of the Agreement are blank. The punch list contained no notations that the completion of the items or entries had been verified.

- A HASD check dated February 8, 2001, was issued to NET in the amount of \$125,806. The check, which was computer generated, contained the stamped signatures of the school board president, secretary (i.e., the current business manager) and the treasurer as payors and was drawn on the HASD Capital Project Fund 2000 account. The “for” line contains the entry “Invoice 1384,” the invoice for final payment on the Heights Elementary School contract (Contract Number SA9926). The check was deposited into a NET account on February 12, 2001.
- There is no record or other evidence that the school board was informed of either the December 22, 2000, or the February 8, 2001, payments prior to issuance of the checks or at any other time prior to April 2001, that the school board authorized or approved the payments or that the school board was informed that NET had not completed the work before the payments were made.
- The school board was informed of the NET bankruptcy and the December 22, 2000, and February 8, 2001, payments to NET at its April 9, 2001, meeting, the same meeting at which the school board adopted the Resolution calling for an audit and investigation by the Department of the Auditor General.

The current business manager and IT director submitted separate written statements to the school board concerning their activities related to the December 22, 2000, and February 8, 2001, payments to NET. We interviewed both individuals as well as the former business manager, the former technology coordinator and others concerning the events related to the issuance of the checks to NET. The current business manager also gave us a written response to specific questions. There were contradictions and discrepancies in the statements. A summary of the relevant main points of the statements is set forth below.

The December 22, 2000 payment

According to the current business manager's April 9, 2001, memorandum to the school board and superintendent, he forwarded the invoices to the IT director and the former technology coordinator for review. According to the current business manager, the IT director informed the current business manager that he (the IT director) was unsure of the status of NET's work because the former business manager and the former technology coordinator, under contract to HASD as consultants, had been monitoring NET's progress on these contracts. In an interview with OSI, the current business manager told OSI that he forwarded the invoices to the IT director for approval and that the IT director told him that he did not feel comfortable signing the bills because the consultants (the former business manager and the former technology coordinator) oversaw the contracts. In another interview with OSI, the business manager told OSI that the IT director told him that the payments could not be made because work had not been completed on the contracts.

In an April 14, 2001, memorandum to the school board, the IT director stated that the final invoices for the projects at the four schools were never sent to the HASD Technology Department for final authorization. The IT director told OSI that he never saw the final invoices. He denied telling the current business manager that he (the IT director) felt uncomfortable about paying anything.

According to the current business manager's April 9, 2001, memorandum, he talked to the consultants (the former business manager and the former technology coordinator) regarding the invoices. The former business manager told OSI that the current business manager told him that the IT director would not sign off on the NET final invoices and that the IT director felt uncomfortable about doing so because he was not monitoring the contracts and knew that all of the work had not been completed. The former business manager told OSI that he then told the current business manager to schedule a meeting with the consultants, NET and the current business manager. According to the current business manager, the meeting took place in late November or early December 2000. At the meeting, it was decided that a punch list would be prepared by NET.

According to the current business manager and the IT director, the consultants, an HASD technology staff member and an NET representative conducted a tour of the school buildings to check the items on the punch list (the one dated December 7, 2000).

According to the IT director, after the completion of the punch list, he met with the consultants, the HASD technology staff member who had been on the building tour and an NET representative. The former business manager asked the IT director to sign the punch list and he did so, "since [he] felt confident that the items and services on the list were reported accurately." According to the IT director, it was clear to him, in reviewing the list, that many items were unchecked, indicating that the services were not provided and equipment not delivered. He also said that copies of the punch list were given to the former business manager and the NET representative. The former business manager told OSI that he did not receive a copy of the punch list.

The current business manager told OSI that he issued the December 22, 2000, check to NET because he was directed to do so by the former business manager. When we asked the current business manager to explain what the directive consisted of, he said that the former business manager told him to pay the invoices when the punch list was completed. The business manager told OSI that he followed the direction because it was his understanding that the former business manager was in charge of the NET contracts.

A former HASD board member, who served as board president during 2000, told OSI that he recalled saying at a school board meeting that the consultants were to be involved in and in charge of NET contracts. The superintendent told OSI that she said essentially the same thing on a different occasion. (There is no evidence that either official made the statement specifically in connection with the December 22, 2000, and February 8, 2001, payments to NET).

In a written response to OSI's questions, the current business manager said that the former business manager directed him to make the payment to NET in full for the final invoices when the punch list was signed by the IT director. The current business manager said that he (the business manager) responded by saying that he could not pay the invoices until a bond issue to provide funds for the project was finalized. Apparently, the funds were available on the date the check for \$600,534 was issued.

The former business manager told OSI that he never told the current business manager to pay for work that had not been completed; that by the words "completion of the punch list," he meant the completion of the work on the items on the list, not the completion of the list itself; that, as a consultant, he never considered himself to be the current business manager's "boss"; and that a business manager should never make payments knowing that all work has not been completed.

The decision to withhold a portion of the final payment.

The payment of \$600,534 was not payment in full of the total amount of the NET invoices for the work on the five contracts. In the current business manager's April 9, 2001, memorandum he stated:

[The former technology coordinator] met with me soon after the meeting [apparently, a meeting that took place after the punch list was prepared] and recommended that I make payment for the final invoices but retain approximately \$125,000 for a few weeks since employees of NET planned to work over the Christmas Holiday and be finished in early January 2001. A payment was given to NET in the amount of \$600,534 before the Christmas Holiday.

In a written answer to OSI's questions, the current business manager stated that the former technology coordinator came to the current business manager's office soon after the decision was made to pay NET and recommended that the current business manager not follow the former business manager's "directive to make full payment," but, instead:

hold an amount which would satisfy an amount equal to the goods/services the District did not receive to date which he [the former technology coordinator] felt was about \$100,000. Instead of prorating an amount for each contract, he picked the Heights-Terrace invoice in the amount of \$125,000. He told me to retain it for a few weeks since employees of NET planned to work over the Christmas Holiday and be finished early in January 2001. I handed him [the former technology coordinator] a check in the amount of \$600,534 to NET before the Christmas Holiday. [The former technology coordinator] was considered by everyone as an honorable person and always provided me good advice so I felt that the payment was reasonable at the time.

In an interview with OSI, the current business manager stated that the former technology coordinator came to the business manager's office a day or two after the "punch list meeting" to discuss the issue; they agreed to withhold about \$125,000 from NET to cover work that was not completed. According to the current business manager, the payment was considered as the second and final payment on the Heights Elementary contract (see Table No. 1), although the former technology coordinator did not specifically tell the current business manager to withhold that particular payment. The current business manager told us that it was the Wednesday before Christmas, the former technology coordinator told him NET would like to be paid before Christmas and the school district would be closed on Friday. According to the current business manager, they arranged to meet at a local restaurant on the next day (Thursday), at which time the current business manager gave the \$600,534 check to the former technology coordinator.

The former technology coordinator told OSI that he met with the current business manager a few days after the punch list meeting; both were concerned that some work was not finished and they agreed that about \$125,000 should be withheld.

The February 8, 2001 payment

According to the current business manager, in February 2001, the IT director scheduled a meeting with the current business manager and NET representatives to discuss training which was to have been provided by NET pursuant to several of NET's contracts with HASD. According to the current business manager, at, or in connection with, the meeting, the NET representatives gave the school district representatives another punch list (the punch list dated February 8, 2001) and the NET president asked when NET could expect final payment. The current business manager told the NET representatives that, at the earliest, they could expect to receive a check the following week.

The current business manager told OSI that, after the meeting, he spoke to the former technology coordinator, who, according to the business manager, “did not see a problem with releasing the final check to NET.”

According to the IT director’s account of the February 9 meeting in his memorandum to the school board, the president of NET presented a second punch list at the meeting; the items on the list did not include any of the items on the first list; the second punch list was not part of the meeting agenda; and there was no discussion of the issue of final payment to NET, or the \$125,806 check, in his (the IT director’s) presence. The IT director also told us that he did not schedule the February 9 meeting; the current business manager informed him of it. According to the IT director, the items on the punch list, including those listed as “COMPLETE,” as well as those listed as “NOT COMPLETE,” are not the same items as those on the December 2001 punch list.

The former technology coordinator told us that, sometime in January 2001, the business manager approached him and asked if “the work” was completed. He said he told the business manager that the project that he, the former technology coordinator, was involved in was “up and operational” and that the business manager should “see” the IT director about final payment to NET. This conversation appears to have taken place after the former technology coordinator’s consulting agreement with HASD had been terminated.

The current business manager stated in his April 9, 2001, memorandum that he made the \$125,806 payment to NET because, “a month and a half [had] passed which was longer than the two or three weeks [he] was told NET needed to finish the projects;” he had met with the IT director; payments had been made to NET in the past prior to NET’s completing projects; and due to “the amount of work they [NET] performed for the district over the years.” The current business manager told OSI that he “did not think it would be a problem.”

In March 2001, an NET employee told the IT director that NET was filing for bankruptcy. The IT director informed the current business manager.

HASD payment procedures

According to the current business manager, HASD has procedures for the payment of bills or invoices. Invoices paid out of the school district’s general fund are handled through a computer system. A requisition is entered by the individual seeking the item or service; the requisition goes to the business manager for his approval; the requisition then becomes a purchase order which is signed by the business manager and sent to the vendor. After the work is done, or supplies delivered, the invoice is sent to the school district. The individual who submitted the original requisition is responsible for checking to determine that the work was done and/or the supplies delivered and for entering his/her initials into the computer system. The computer system then generates a check.

According to the current business manager, payments for work on projects financed through the Capital Projects Fund and other special funds are made in accordance with HASD’s

procedure for contracts previously approved by the school board. According to the procedure, bills or invoices concerning such projects do not require school board approval prior to payments. According to the current business manager, the payments to NET were made in accordance with that procedure.

OSI was given a copy of an HASD policy statement entitled "Payment of Claims," containing a date of adoption of November 20, 1980, and "Revised" date of July 21, 1994. According to the Policy Statement, "It is the purpose of the Board to effect the prompt payment of bills, but at the same time to ensure that due care has been taken in the review of such bills." The Statement provides that certain specified items may be paid prior to approval by the school board. These items include bills related to contracts or agreements previously awarded by the school board.

The Policy Statement also provides that bills "for supplies and equipment not awarded by bid are among the items that must be approved by the School Board prior to payment." The following appears in the Policy Statement:

It shall be the responsibility of the Business Manager upon receipt of an invoice to verify that the purchase invoice is in order, the goods were received in acceptable condition or services were satisfactorily rendered, funds are available to cover the payment, the item is one for which the Board budgeted, and the invoice is for the amount contracted.

The Policy Statement also contains the following:

Payment of contracts. The Hazleton Area School District Board of School Directors recognize that a contract is a legally binding agreement between two parties.

It is implicit in this agreement that payment is to be made by the district upon the completion of such services and that in such instances the board has acted in good faith authorizing and agreeing to said contractual agreements.

It is implicit that such agreement authorizes payment for such services upon successful and satisfactory completion.

The Administration is authorized and directed to make incremental and final payment to contractors subject to satisfactory performance of the contract, and that the satisfactory completion of said contract may be determined by the Board or by properly qualified school personnel and/or consultants when so directed. That official responsible for the program must sign off that the payment is appropriate at this time.

The Business Manager is authorized and directed to cause funds to be expended in accordance with this policy and notify the Board of the satisfactory completion.

Conclusions and Recommendations

The Public School Code provides that the board of school directors may employ a person serving in the function of business administrator of the school district to perform the duties of the school board secretary related to business responsibilities, including general supervision of all business affairs of the school district, subject to the direction of the school board, and ordering payments of amounts owing under contracts previously approved by the school board.¹⁰

The current business manager is the person responsible for the fiscal management of the school district. He did not follow HASD's policies and procedures in connection with the payment of the December 22, 2000, and February 8, 2001, checks to NET. There was no verification that the goods were received and services rendered pursuant to the contracts. There was no determination that there was "successful and satisfactory completion" of the work. In fact, there was substantial evidence that the work was not completed. The current business manager's explanations do not provide a reasonable basis to conclude that the work was complete or satisfactory, or that his actions were properly justified. It appears that the primary reason for issuance of the checks was to accommodate the vendor rather than to serve the school district and manage its funds properly.

Even after the checks were issued, the school board was not informed about the payments until after HASD officials heard that NET was in bankruptcy. This was despite, (1) the school district policy requirement that board approval be obtained for payment of bills for work not awarded by bid and, (2) the fact that previous payments to NET in connection with the same group of contracts were approved by the school board.

The current business manager's statements contain inconsistencies and are contradictory to the statements of others, particularly the IT director and the former business manager. The current business manager's statement that he made the \$600,534 payment to NET because the former business manager directed him to pay NET when the punch list was completed is not credible. If the current business manager did not understand the difference between the completion, i.e., preparation, of a punch list and the completion, i.e., delivery and/or installation of the items of the work, his qualifications for the position are subject to question. It was unreasonable for him to rely on the advice of the former technology coordinator in connection with the decision to make the payments. At the time of the first payment, the consultant was virtually at the end of his period of service to HASD. At the time of the second payment, the former technology coordinator was no longer serving as a consultant to HASD.

¹⁰ 24 P.S. §§ 10-1089 and 4-433. Section 10-1089(b) provides that a person serving as business administrator may also serve as secretary or treasurer of the school board. Section 10-1089(c) of the Public School Code provides for removal of the business administrator by the school board for neglect of duty or violation of school laws of the Commonwealth, after due notice and a hearing.

The information obtained during the investigation warrants the conclusion that the current business manager failed to carry out his duties and responsibilities under the Public School Code and failed to follow the school district's policies and procedures, resulting in a substantial and unjustified expenditure of school district funds.

It is recommended that HASD take appropriate action to ensure that persons responsible for the business and financial management of the school district are qualified to carry out their duties properly and are familiar with legal requirements and school district policies and procedures concerning payments to contractors, as well as basic procedures for determining contract compliance.

As school board secretary, the current business manager was required to furnish a bond for the faithful performance of his duties.¹¹ It is, therefore, also recommended that HASD consider whether recovery of costs incurred as the result of the current business manager's failure to perform his duties can be obtained through the bond.

Responses

HASD's response is presented in its entirety on pp. 32-33. The former business manager's response contained the following related to Finding No. 1. (The names of individuals have been omitted):

NET did not prepare the punch list. A punch list by definition is a listing of unfinished or unsatisfactory work or missing equipment. NET created an equipment list from the respective contracts and the punch lists were produced by the former business manager, the former technology coordinator, NET representatives and an HASD staff member. The IT director was asked to participate in the building inspections but sent the HASD staff member in his place. The punch lists were created after three days of inspection of each building.

The former business manager did not ask the IT director to sign the punch lists. The lists were signed on December 13 and 19. The former business manager was on a plane going to Rome on the 13th and was in Pittsburgh on the 19th.

The check was given to a representative of NET not to the former technology coordinator. Those two individuals were having lunch in a local restaurant when the check was delivered by the business manager.

¹¹ 24 P.S. § 4-431. According to HASD records, Public Official's Bond, No. 3575231, issued on behalf of the current business manager and in favor of HASD, was in effect for the period from September 1, 1999, to September 1, 2002.

The Department of the Auditor General's Comments

HASD staff referred to the documents as a punch list and we retained that description. According to statements of the IT director and the former business manager, NET was a major participant in the preparation of the list and the inspections.

According to the IT director, the former business manager asked him to sign the punch list. We have no information concerning the date on which the request was (reportedly) made.

The former business manager's statement concerning the delivery of the December 22 check is inconsistent with the statements of the current business manager as presented in the report (see p. 13). However, either or both versions support a conclusion that the transaction was a highly unusual and questionable way to conduct school district business.

Finding No. 2 – As a result of mismanagement and lack of effective internal controls in connection with the NET contracts, HASD paid NET approximately \$433,841 for equipment and services, including training, that the school district did not receive.

HASD did not receive a substantial portion of the equipment and services that NET was supposed to provide pursuant to the contracts listed in Table No. 1. As discussed in Finding No. 1, HASD made final payments to NET in connection with five contracts before contract work was completed. Some additional work was done in the period between December 2000 and March 2001. However, equipment, installation services and training with a total estimated value of \$433,841 was never provided.

Equipment and Installation Services

The IT director submitted a report to the HASD school board in which he listed the estimated monetary value of the equipment and services that NET had not provided. The report was based on cost information provided by NET for use in preparing applications for federal grants, the December 7, 2000,¹² punch list and estimates of the value of work that was not performed. With the exception of specific items discussed below, we confirmed the conclusions of the IT director concerning equipment that was not provided. We also found that his methodology for estimating the value of the services that were not provided was reasonable, based on the value of the items.

The IT director’s report included an additional \$5,040 estimate for equipment and services that NET failed to provide as part of a contract relating to another HASD facility. Our review agreed with that estimate. However, we have not included this amount because it relates to equipment and services that were part of an NET contract other than the five involved in Finding No. 1. The IT director’s estimate also included \$9,672 for equipment originally listed as a requirement of the Drums K-8 School contract that NET failed to provide. However, we determined that the equipment was delivered by NET.

Table No. 2 – Estimated Cost of Equipment and Services (Other than Training) Not Provided by NET

School	Equipment	Services
Valley K-8 School	N/A	\$15,750
Drums K-8 School	\$20,000	\$83,870
Arthur Street Elementary	\$50,799	\$70,785
Heights Elementary	\$93,237	\$24,400
Total	\$164,036	\$194,805
Total of Equipment and Services:	\$358,841	

¹² See Finding No. 1.

Training

Three of the contracts listed in Table No. 1 required NET to provide teacher and staff training.¹³ According to the terms of the contracts, NET was to provide training on the use of all hardware and software, in-service instruction to introduce new technology to faculty and staff, and mentoring to enhance the use of the technology. The contracts assigned no dollar value for the training NET was required to perform. However, a dollar value can be estimated based on the following:

An NET employee supplied cost documentation to HASD that indicated a training allocation of \$75,000 for the Arthur Street School contract. The current business manager and the IT director were told by the NET president that NET allocated \$75,000 for training at each school for which it had contracted to provide training. Additionally, OSI contacted the accounting firm that performed NET's annual audit for the year ended September 30, 2001. The audit included payments made under the contracts listed in Table No. 1. Employees of the accounting firm told OSI that, based on information provided to them by NET's staff, NET allocated \$75,000 for training per school, based upon statements by NET's president that each school was allocated 60 days of training at \$1,250 per day, a total of \$75,000. Thus, there is a reasonable basis to conclude that the value of the training that was paid for, but not provided, was at least \$75,000, and may have been as much as \$225,000 (\$75,000 times three schools).

Training services are not mentioned on the December 7, 2000, punch list. The IT director and the current business manager were aware that NET was paid for training never provided pursuant to the 2000 contracts for three of the schools. Both said that, in early 2001, shortly before NET's bankruptcy, they were in the process of negotiating with NET to obtain other services in lieu of training paid for but not provided under the contracts. We found no evidence that the school board was informed or aware that the training had not been provided prior to, or at the time of the December 22, 2000, or February 8, 2001, payments to NET. We found no documentation or other evidence that HASD staff members were authorized to negotiate with NET for "other services" to be provided in lieu of the training.

We also reviewed the contracts for three other HASD schools at which training was to be provided pursuant to other contracts with NET.¹⁴ According to a report prepared by the IT director, not all of the training was not provided. OSI obtained an internal NET report for the 1999-2000 school year which contained data showing that NET owed the school district \$45,495 worth of training under these contracts. We attempted to verify the accuracy of this report through HASD training logs and other documentation. However, there was no internal training documentation within the school district for the period prior to the hiring of the IT director in

¹³ The contracts listed in Table No. 1 which included training as a service to be provided by NET were Nos. SA9765 (Valley K-8 School WAN), SA9779 (Drums K-8 School WAN) and SA9929 (Arthur Street Elementary School LAN and Video Network).

¹⁴ The contracts were for McAdoo K-8, No. SA9766; West Hazleton K-8, No. SA9769; and Freeland K-8, No. SA9771. All three contracts were dated November 20, 1997, and contained the signature of the HASD former business manager (who, at that time, was the HASD business manager) as the person authorized to sign the agreement on behalf of HASD.

September 1999. Therefore, we could not verify training actually conducted by NET prior to that time. It is possible, therefore, that the school district paid for training in connection with those contracts that was never provided. We asked both the former and current business managers why the school district failed to maintain records of the training provided by NET. Both said that they felt that it was not their responsibility to keep track of training. Neither individual attempted to verify whether the training was provided.

The former business manager told OSI that he was aware that there were training provisions in HASD contracts with NET. He could not state the value of the training and said that no one at HASD monitored the training until the IT director was appointed to his position in 1999. The former business manager did not know if NET provided the training listed in the contracts discussed in Finding No. 1. He stated that the school district should not pay for training that was not provided pursuant to the contracts. However, he questioned the figures used by the IT director concerning the amount of training provided by NET pursuant to other HASD contracts.

The former NET vice-president for sales told us that there were problems affecting the providing of training at HASD: According to her, much of the equipment was not yet in place and HASD wanted the training to take place during school hours so that it would not have to pay overtime.

The estimated total cost of equipment, services and training that were not provided by NET pursuant to the contracts in Table No. 1 is set out below in Table No. 3:

Table No. 3 – Total of Equipment, Services, and Training Paid For But Not Received

Description	Amount
Equipment	\$164,036
Services	\$194,805
Training	\$ 75,000
Total	<u>\$433,841¹⁵</u>

Conclusions and Recommendations

HASD did not receive a substantial portion of equipment and services, including training, that NET contracted to provide. To a great extent, this was the result of the school district’s failure to monitor contract compliance prior to the hiring of the IT director, poorly defined responsibilities in the area of contract management and poor coordination between HASD staff and the consultants. The school board failed to establish clear areas of responsibility for and between the current business manager, the IT director and the consultants and also failed to exercise effective control over the consultants and the work being done as part of the NET contracts. NET’s failure to provide equipment and services, coupled with the lack of training,

¹⁵ If the cost of the training to be provided at three schools was, in fact, \$75,000 for each school (\$225,000), the total cost could be as high as \$564,497.

impeded the ability of teachers, staff and students to use the equipment, thereby undermining the purpose for the school district's expenditures on IBM computer hardware and software.

It is recommended that HASD establish clearly defined responsibilities and reporting requirements for purchases and installation of computer related technology and designate a specific office or individual with responsibility for ensuring that staff and teacher training related to computer technology is provided.

This Finding, and, to some extent, Finding No. 1 of this report, show that HASD failed to ensure that the services of the consultants (the former business manager and the former technology coordinator) were used consistently and effectively in the best interests of the school district. We found no evidence that HASD's consultants had any personal or financial interest in NET. As discussed in the Observation (see p. 29), NET attempted to engage the consultants to perform services for NET and the former business manager actually did engage in one limited activity on behalf of NET. We recommend that HASD should require as a condition of its agreements with consultants that, during the period of such agreements, consultants not perform services for contractors or other vendors doing business with HASD. Consultants should also be required to disclose their financial or personal interests in such contractors or other vendors as part of their consulting agreements with the school district.

Responses

HASD's response is presented in its entirety on pp. 32-33. The former business manager's response contained the following related to Finding No. 2:

The early contracts with IBM did not contain an amount for training. It was not until the inception of the E-Rate was established. The UNIVERSAL SERVICE for SCHOOLS and LIBRARIES required staff development as a condition for funding and the IT director was in charge of the E-Rate applications and as such was aware of the training moneys in each proposal. He also prepared the completion reports for the business manager's signature. In this capacity, he should have tracked the training. Prior to his appointment, the IT director was part of the technology committee and was also responsible for scheduling training in concert with other central office personnel.

The Department of the Auditor General's Comments

The former business manager's statement does not provide a basis to change our conclusion in Finding No. 2 that clearly defined responsibilities and reporting requirements were not established. The continuing disagreements between various individuals only serve to further demonstrate the validity of the conclusion.

Finding No. 3 – HASD failed to use appropriate contracting procedures in its dealings with NET. Specifically, the school district failed to take reasonable steps to protect itself in the event of the vendor’s failure to perform the contracts.

NET was incorporated in March 1996. Its chief executive officer (one of NET’s two shareholders at the time of its bankruptcy) was a former employee of IBM. Other former IBM employees also worked for NET as employees or subcontractors. In HASD’s current business manager’s April 9, 2001, memorandum, he stated that, “when the District began putting technology in its buildings, it decided to go with IBM hardware and educational software Sometime in 1996, we were told that IBM would no longer directly provide the . . . items and services we were purchasing. Around that time . . . NET was formed as an IBM business partner and began doing business with the District.” According to the current business manager, NET was a “Certified IBM Business Partner” and IBM granted NET a protected territory so that, if a potential customer wanted to purchase IBM products, it had to be done through NET.

HASD’s records contained a letter, dated March 17, 1998, from an IBM official to the former business manager. According to the letter, NET was a partner of “IBM Global Education in supporting schools in Eastern and Central Pennsylvania” for the previous two years; was the only “K-12 Education Dealer in Eastern and Central Pennsylvania that met the strict requirements to become IBM/Education’s Exclusive Courseware Sales Agent [in that area] in 1997”; had received a “Business Partner Leadership Award” from IBM; and, for those reasons, IBM had “chosen to partner with NET in IBM K-12 Solution Opportunities in Eastern and Central Pennsylvania.”

According to the former business manager:

- HASD awarded its original computer contracts to IBM in 1993; he recommended awarding the contracts to IBM; other firms bid on the contracts but were more expensive and could not offer the range of services and products presented by IBM.
- NET became involved with HASD gradually as IBM began to get out of the educational technology business.
- The school district first awarded contracts to NET in 1997; the contracts were not advertised or put out for competitive bidding; and the decision to not use advertising or competitive bidding was based on two separate legal opinions.
- The school district did not obtain price quotes from other firms for the following reasons: (1) the legal opinions concerning competitive bidding; (2) HASD was happy with NET; and, (3) NET was familiar with IBM computer software used at HASD.
- HASD tried to deal with local firms regarding purchases of items such as computers and cabling, but those firms could not put together a complete system such as IBM’s.

- The payment of 50 percent of the contract price upon signing of the contracts that was a provision of the NET contracts was a high advance payment, but it allowed NET to purchase the equipment and was not unusual.
- The HASD board approved all NET proposals and contracts, and, after a demonstration by IBM, the board approved a plan to install computers and software in all of the district's schools and equip the schools with the same technology.
- If the school board wanted to use IBM, NET was the logical choice as the contractor.

According to the current business manager, the decision to put IBM computer equipment in HASD classrooms was made by the former business manager; NET's chief executive officer and other NET employees had done work at HASD for years as IBM employees and were "close" to the former business manager; and, after NET was formed, the school district "just started" doing business with NET without seeking bids or formal proposals.

HASD's records contained copies of the legal opinion letters referred to by the former business manager. The letters concluded that competitive bidding was not necessary. One was a letter from a private attorney to a NET employee. The letter stated that it was written at the request of the NET employee and the former business manager, who at that time was the HASD business manager. The former business manager told OSI that he did not request the legal opinion letter, but that he might have given the attorney's name to NET. The second legal opinion was from the HASD solicitor. It is dated December 22, 1997, three months after the signing of the first group of contracts with NET.

Decisions of the Pennsylvania courts support the view that personal service contracts that require a degree of personal skill and professional expertise are exempt from the competitive bidding requirements of the Public School Code.¹⁶ Therefore, there is a reasonable basis for a conclusion that HASD was not required to use competitive bidding to obtain the computer equipment and services. However, we found no documentation or other evidence that HASD officials took steps to protect the school district against non-performance of the contracts. There is no record that the school district sought alternative vendors for the non-service portions of the contract, i.e., the installation work. The investigation found no evidence that HASD made inquiries concerning alternatives to IBM equipment, despite the knowledge that IBM was phasing out of the business, or the availability of other vendors. There is no documentation or other evidence that HASD sought or obtained information concerning other options, conducted inquiries concerning the financial viability of NET or considered requiring the retainage of a percentage of the contract price in case NET was unable to complete the contracts.

¹⁶ Malloy v. Boyertown Area School Board, 657 A.2d 915 (Pa. 1995). In another case involving the competitive bidding requirements of the County Code, the Supreme Court ruled that advertising and competitive bidding were not required in connection with a complex service contract in which the hardware is inextricably linked to the system involving services and software. In Re Audit Report of Belcastro, 595 A.2d 15 (Pa. 1991).

The school district failed to consider requiring a performance bond or bonds.¹⁷ We questioned both the current and former HASD business managers regarding the school district's failure to obtain performance bonds. The former business manager stated that, as an afterthought, the school district should have required performance bonds; however, HASD was dealing with a company (IBM) that it had dealt with for years with no bad experiences and that, in his judgment, performance bonds were not necessary. He added that, since NET was associated with IBM, he felt there was little possibility of bankruptcy.

The current business manager said that the previous business manager never required performance bonds in contracts of this type and the decision not to require them in regard to NET was a continuation of existing procedures. According to the current business manager, upon his recommendation, the HASD school board now requires performance bonds in all contracts, including technology projects. He provided materials indicating that the vendors working on two technology projects in the 2001-02 school year were required to obtain performance bonds.

The school district's projects that were to be carried out through NET contracts were not submitted to the Pennsylvania Department of Education (PDE) for review and approval. The Public School Code contains a requirement that the review and approval of PDE is applicable to "all projects, plans and specifications for school building construction and reconstruction."¹⁸ Certain costs incurred by school districts in construction and reconstruction projects subject to review and approval by PDE are reimbursable by the Commonwealth.¹⁹

The former business manager told OSI that he did not submit information to PDE concerning the projects involved in the NET contracts because, according to him, the projects were not reimbursable. The current business manager told OSI that he did not submit information concerning the projects to PDE because HASD had not done so in the past. One of the five contracts included in Table No. 1 above, Contract No. SA9926, was part of a renovation project at the Heights Elementary School and, therefore, may have been subject to the PDE review and approval requirements of the Public School Code. According to the current business manager, in 2001, the school district filed plans with PDE for a project similar to the NET contracts.

¹⁷ The Public Works Contractor Bond Law, 8 P.S. § 191 *et seq.*, requires that contractors furnish contracting bodies (the term includes school districts) with performance bonds at 100 percent of the contract amount, conditioned on faithful performance of the contract. The statute states that such bonds should be solely for the protection of the contracting body. 8 P.S. § 193.1. The statute appears to be intended to be used in connection with building and road construction. However, nothing in the statute prohibits contracting bodies from requiring performance bonds in service and installation contracts.

¹⁸ 24 P.S. § 7-731. Pursuant to this requirement, PDE is also empowered to assist school districts in pre-planning of projects and to offer such architectural, engineering and financial advice as will enable projects to comply with the standards prescribed by the State Board of Education.

¹⁹ State Board of Education Regulations, 22 Pa. Code § 21.1 *et seq.* (2001).

Software Purchases

HASD purchased IBM software at a total cost of approximately \$1.1 million through three annual payments made, respectively, in December of 1997, 1998 and 1999. Payments were made directly to IBM. According to the minutes of an HASD school board meeting, the proposal to obtain IBM software was presented to the school board as a lease of computer software with three annual payments and the school board voted unanimously to authorize the lease. A letter dated November 4, 1997, to IBM from the business manager at that time stated that HASD agreed to order the IBM software, accept shipment by December 19, 1997, and finance the purchase “interest free” through the IBM Credit Corporation by making three payments. According to the letter, this enabled HASD to “secure” the software at the price set in May 1997.

According to the IT director, the IBM software has been installed; HASD staff and teachers had very little input into the software purchases; a portion of the software does not match the curriculum or cannot be used in the school district’s computer systems; HASD did not compare the software prices with prices offered by other vendors; and, in his view, HASD should have purchased a limited amount of software initially as a pilot program, instead of purchasing all of the software at one time.

The former business manager said that he and the IT director had a difference of opinion regarding the software. The former business manager’s view was that, since the school board had approved the technology plan, the purchase and installation of the IBM software was appropriate and any necessary changes could be made later.

Conclusions and Recommendations

Competitive bidding may not have been legally required. However, HASD contracted with NET to obtain IBM computer equipment without taking reasonable steps to protect itself against any failure on the part of NET to fulfill contract requirements.

HASD’s acceptance of the terms of the contracts with NET that called for payment of 50 percent of the total contract price in advance appears highly questionable. At the very least, the advance payment provision should have alerted HASD officials to NET’s lack of other financial resources to purchase equipment and fund its operations. Furthermore, the advance payment requirement should have caused HASD officials to add contract requirements that would have protected the school district’s funds or explore the availability of other vendors. By making the advance payments on the contracts, HASD, in effect, made the equivalent of an interest-free loan to NET

It is recommended that HASD establish policies and procedures to require performance bonds from vendors of computer equipment and services. It is also recommended that HASD submit proposed projects and contracts for computer equipment and services related to school building renovation work to PDE for review and approval as a way of ensuring eligibility for state reimbursement when it is authorized and to obtain technical assistance when it is available.

It is recommended that HASD inform IBM of NET's failure to complete work on the HASD contracts, and request IBM to provide assistance to the school district to correct the failure of IBM's exclusive sales agent and partner to comply with the terms of NET's contracts with the school district.

Responses

HASD's response is presented in its entirety on pp. 32-33. The former business manager's response contained the following related to Finding No. 3:

The contracts with IBM did not require a performance bond due to the fact that no advanced payment was made and payment was made ONLY after work was completed. The advance payment began when the E-Rate was established. The initial advance was 40% and no work was to begin until the District received a notice to proceed from the Universal Service Fund. The balance was paid to the contractor by the service find, not the school district, when the work was completed. In the early contracts the business office was careful to see that NET was owed funds on other jobs which was sufficient to cover the advances. The technology committee held weekly meetings in order to monitor work and no moneys were paid (other than the advance) for work not completed. As an after thought a performance bond should have been required for the NET contracts that included an advance.

The first legal opinion concerning bidding was obtained from the Easton School District. Beginning with the bids for the Freeland School the Hazleton School Solicitor wrote an opinion at the request of PDE covering the non-bid status of division 17 contracts for project 2000. Each construction project after Freeland was accompanied by a similar opinion. These opinions predated the NET contracts and are similar to the two opinions given to the auditors.

All construction related items were submitted to PDE for approval. All data drops, electrical connections, video locations, cable trays and other related items were listed on the PDE approved plans and specifications. The district's technology plan showing all special equipment layouts and [a] listing [of] the equipment was submitted to PDE for approval. There plans by the direction of PDE were submitted to the office of technology and were in fact approved by PDE. A copy of the plan approval should be located in the district's file. This plan approval is a requirement for the E-Rate.

All of the contracts awarded to NET were in fact advertised. The request for proposals were advertised on a web site created by the Universal

Services Fund. The IT director was responsible for posting of the projects. All potential vendors in the U.S. had access to this site.

The current business manager stated that the former business manager was close to IBM-NET. The former business manager did not know any of the aforementioned persons any longer than the current business manager. If one were to check the tapes of the building and grounds committee prior to the awarding of the last three contracts, they would discover that the former business manager recommended bidding the contracts and the computers that were purchased by the district. An informal poll of all staff and board members was taken. They were asked if they were satisfied with the IBM computers and with NET. All staff responded that THEY WERE SATISFIED as well as all but two board members. It was decided that there was no reason to change.

The Department of the Auditor General's Comments

The report does not question the lack of a performance bond for the original agreement with IBM, but, rather, the lack of a bond or some other mechanism to protect the school district's financial interest in the contracts with NET.

The Finding addressed legal opinions submitted in connection with the NET contracts. Even if other legal opinions were also a factor in the decision to proceed to contract with NET without competitive bidding, it would not provide a basis to change the Finding.

According to the current business manager, the NET projects were not submitted to PDE for approval.

The advertising referred to by the former business manager does not comply with the notice requirement for competitive bidding. There is no evidence that the contracts with NET were bid competitively within any reasonable definition of that term.

We have no information to confirm or dispute the former business manager's description of events at the building and grounds committee meeting. From our perspective, the key deficiency was the failure to ensure that the work was completed. The decision, or series of decisions, to contract with NET without competitive bidding were only contributory factors.

Observation – There Were Questionable NET Expenditures in the Seven-Month Period Prior to the Bankruptcy

An emergency voluntary petition for bankruptcy under Title 7, Chapter 11 of the United States Code was filed on behalf of NET on April 3, 2001.²⁰ We reviewed NET financial records in the custody of the bankruptcy trustee and obtained information from former NET employees and the firm that performed accounting services for NET. Our limited review found no evidence that HASD officials or consultants involved in HASD's payments to NET received anything of financial value from NET.

According to the former NET vice-president for sales, she asked the former business manager and the former technology coordinator if they would be interested in consulting for NET after they left their positions as full-time employees of HASD. According to the NET vice-president, the former technology coordinator did not respond to the question and the only NET activity the former business manager engaged in was making a recommendation on behalf of NET in New York at her request. She said there was no discussion of compensation. The former business manager told us that he did not receive any compensation from NET. In the NET records that were available to us, we found no documentation concerning payments to the former business manager.

Our review noted that NET appeared to be in financial difficulty at the time the five contracts with HASD listed in Table No. 2 were approved by the HASD board. According to the Bankruptcy Court file, prior to the bankruptcy NET had a \$500,000 line of credit from Progress Bank (Progress), Blue Bell, PA. According to loan documents dated January 26, 2000, Progress had a first priority security interest and a lien on NET's assets, including inventory. By letter dated March 29, 2001, Progress notified NET that one or more "Events of Default," as defined in the loan agreement, existed and that the balance of the debt, \$402,293, was due and payable immediately in accordance with the loan agreements. According to a motion filed by Progress in the NET bankruptcy case, NET was in default as a result of "failing to comply with numerous financial covenants in the loan agreement and by failing to make payments due and owing thereunder" and also had "ceased operations as a going concern," prior to the date of the filing of the Bankruptcy Petition.

Bankruptcy Schedules and Statements were filed with the Bankruptcy Court on June 8, 2001. According to the filings, NET had property consisting of computer hardware and software, accounts receivable, a tax refund and other equipment, all with a total value of \$200,952. Progress was listed as the only secured creditor. Unsecured claims totaling approximately \$306,538 were listed. According to the Statement of Financial Affairs (the Statement) filed on behalf of NET, the firm's business income for the most recent three fiscal years was approximately \$6.9 million for FY 1998-1999; \$3.4 million for FY 1999-2000; and \$1.2 million for the period 10/1/00 to 4/3/01. The payments made by HASD on December 22, 2000, and February 8, 2001, comprised about 60 percent of NET's income during the six months prior to bankruptcy.

²⁰ In Re Networked Education Technologies, Inc., Bankruptcy No. 5-01-01416 (U.S. Bankruptcy Court, M.D. Pa.).

The Statement contains a list showing a total of \$268,947 paid to creditors between January 3 and April 3, 2002. The Statement also lists the names and titles of officers, directors and shareholders of NET. Two officers/directors are listed, the chief executive officer of NET and one other stockholder. Each is described as a 50 percent shareholder. The Statement included a list of payments made within one year immediately preceding the bankruptcy, "to or for the benefit of creditors who were or are insiders." According to the list, \$119,700 was paid to the two NET stockholders between June 2000 and April 2001. Approximately \$36,000 of that total (\$24,000 to the NET chief financial officer and \$12,000 to the other stockholder) was paid after the deposit of the December 22, 2000, HASD check for \$600,534.

Based on our review of NET records and the Bankruptcy Statement and Schedules, there were several pre-bankruptcy NET financial transactions that appear questionable:

The \$200,000 commission payment in September 2000

In approximately September 2000, the NET vice-president for sales received a check for \$200,000 from NET. The payment was in addition to her NET salary. According to her, the payment was for commissions; she received it after the contracts with HASD were signed in July 2000. (These are contracts listed in Table No. 1.) The former NET vice-president for sales told us that NET was in financial trouble before the contracts with NET were signed. She said that she used \$100,000 from the commission payment to pay off a home equity loan which was used to pay the same amount, \$100,000, to the chief executive officer of NET for his interest in a townhouse.

NET's former bookkeeper stated that the \$200,000 payment was made while she was on maternity leave; she did not learn of it until January 2001 and could not determine the basis for the payment. There is no reference to the \$200,000 or the subsequent \$100,000 payment to the NET chief executive officer in the Statement or Schedules filed in connection with the NET bankruptcy.

Check and cash transactions totaling approximately \$38,957 in March 2001

An NET check dated March 20, 2001, in the amount of \$26,304, and a second NET check, undated, in the amount of \$1,655 were issued to "cash." According to the former NET bookkeeper, the money (totaling \$27,959) was used to obtain cashier's checks to pay tax and utility bills. The checks to cash and the disposition of their proceeds do not appear to be included in the Bankruptcy Statement. The bank has not been able to provide us with further information concerning the cashier's checks.

Two other checks issued in March 2001, one for \$4,000 to the bookkeeper and another for \$6,962 to NET's chief executive officer, do not appear to be included in the Statement. According to the bookkeeper, the check to her was a payment for services related to the bankruptcy and the check to the NET chief executive officer was for two owner draws (payments to NET shareholders) totaling \$6,000 and a payment to American Express. The Bankruptcy

Statement lists a \$6,000 payment to the NET chief executive officer on March 1, 2001, the same date as the \$6,962 check. However, we cannot determine if the listing on the Statement is a reference to that check or to another payment to the same individual. We spoke to the former chief executive officer of NET by telephone earlier in the investigation, prior to learning about the above payments. He stated that he was responsible for all funds expended by NET and that nothing illegal or improper was done.

The information concerning the above expenditures will be turned over to the Bankruptcy Court and law enforcement agencies for further review.

Responses

HASD's response is presented in its entirety on pp. 32-33. The former business manager's response contained the following related to the Observation:

It was stated that the former business manager made a presentation on behalf of NET in New York. The presentation was made by the former business manager and the former technology coordinator and was essentially the same presentation made by the IT director and the former technology coordinator at the PSBA technology conference two years earlier. It was a presentation of the Hazleton Technology program and how technology can be financed. It was not a pitch for NET. The IT director was in the audience. No compensation was offered or received for the presentation.

The Department of the Auditor General's Comments

In the Observation (p. 29), the report states that we found no evidence that the former business manager received payments from NET.

HASD'S RESPONSE

HASD provided a written response by letter dated November 8, 2002, as set forth below. The letter was signed by the Board President, Finance Chairman, and Technology Chairman. Names of individuals have been omitted from the response.

We appreciate the report that was submitted regarding the bankruptcy of the Networked Education Technologies and their dealings with the Hazleton Area School District. As a result of this incident, we have taken the appropriate actions and have qualified personnel in place to see that this will not occur in the future.

The Current Secretary/Business Manager

Has improved the financial position of the District since taking the position in the 1999/2000 fiscal year. The unreserved fund balance increased from \$7.86 million in 1999/2000 to \$10.36 million in 2001/2002. He led the District in the decision and implementation of a self-funded health insurance program for its employees. In the first year, the District was able to save \$1.7 million on health insurance premiums. The \$1.7 million was used to establish a reserve fund for future increases and is not included in the \$10.36 million from above.

He led the District through the implementation of Act 50 Tax Reform. The Hazleton Area School District was one of three districts in Pennsylvania that elected to implement Act 50. Under the new tax structure, homeowners are given a homestead exclusion in an effort to provide tax relief.

This past year, the Commonwealth initiated the Your Schools Your Money program requiring school districts to account for expenditures by building, grade and subject matter. The Business Office of the HASD did such an exceptional job that the Secretary of Education personally came to Hazleton and announced the project to the public at the Hazle Elementary School using Hazleton's data that was submitted.

The current business manager totally upgraded the budget process this past year using a zero based approach. He went from a centralized to a decentralized process involving the administrators in all of the schools and allowed for their input. This also is related to the Your Schools Your Money project so that we can plan what is being spent in each building and for what grade/subject.

The Director of Instructional Technology

Established the Technology Department in the District and was successful in staffing the department with employees who are capable of maintaining and repairing the technology hardware and software in-house. He works with administrators and teachers closely in order to assist in purchasing and installing software that integrates with the curriculum and maximizes the resources that are allocated for technology.

He worked closely with the current business manager on two projects after the bankruptcy of NET. The Hazleton Area High School and McAdoo-Kelayres Elementary School technology projects took place in the summer of 2001. In these two projects, the District involved an architect in order to develop extensive specifications that provided the bidders a uniform document to submit a proposal. He held a pre-bid conference for all of the bidders. The District advertised the projects in accordance with the School Code and filed with the Department of Education form PDE 3074 for non-reimbursable projects. The Business Office required bid and performance bonds from the contractors.

The District made substantial progress with the structure of the HAHS and McAdoo contracts. The Business Office will continue to follow the philosophy that the District will benefit from competitive bidding knowing that the lowest reasonable price will win the bid.

For these reasons, we do feel these two district employees are very competent in what they do and have full support of the current Board of Directors in performing their respective duties as employees of the Hazleton Area School District.

It is interesting to note during the implementation of the NET contracts, everything was done at the direction of the consultants. The consultants commanded authority when they were under contract and their agreements gave them the authority when it came to the technology implementation.

The Department of the Auditor General's Comments

As noted in the report's Findings (see p. 25), as well as the school district's response, a number of encouraging positive actions have been taken by HASD since the NET bankruptcy to prevent similar incidents in the future. These steps include greater use of advertising and competitive bidding, performance bond requirements, filing of plans with PDE and development of greater in-house capability to install and manage new technology. It will be the school district's responsibility to ensure that these corrective steps are made part of its written policies and procedures and fully implemented in future contracting activities.

REPORT DISTRIBUTION LIST

This report is being initially distributed to members of the board of directors of the Hazleton Area School District, school district officials and the solicitor, and to the following:

The Honorable Charles B. Zogby
Secretary
Department of Education

The Honorable Barbara Hafer
State Treasurer
Department of Treasury

The Honorable Mike Fisher
Attorney General
Office of Attorney General

Thomas A. Marino
United States Attorney
U.S. Attorney's Office
Middle District of Pennsylvania

John J. Martin, Esquire
Trustee
United States Bankruptcy Court for
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Labor, Education and Community Services
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