

SPECIAL AUDIT OF:

TUITION RATES CHARGED TO

PENNSYLVANIA SCHOOL DISTRICTS BY

THE NORTHWESTERN ACADEMY

August 2004

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August 20, 2004

The Honorable Edward G. Rendell
Governor
Commonwealth of Pennsylvania
Room 225 Main Capitol
Harrisburg, Pennsylvania 17120

Dear Governor Rendell:

Enclosed is the final report of the special audit entitled *Tuition Rates Charged To Pennsylvania School Districts by The Northwestern Academy*, conducted by our Department's Office of Special Investigations.

The Northwestern Academy is a residential complex for delinquent youth located near Shamokin, Northumberland County. The Academy provides educational services to its residents and charges tuition to the Pennsylvania school districts where the parents of the adjudicated minors reside. The Academy is located within the Shamokin Area School District (SASD). The Academy and the school district have a contract for the educational services provided to Academy students from the resident counties.

Conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States, the special audit was performed to provide an independent assessment of the special education rate billed to the school districts and to ascertain the amount of lease rental payments inappropriately charged to school districts by Northwestern Human Services, Inc. (NHS), a private non-profit corporation which operates The Northwestern Academy. The scope of the audit was later expanded to include an issue relating to the improper recording of NHS-related costs by SASD. The period under review was July 1, 1998, through June 30, 2002, unless otherwise noted.

During the six years that the Academy has been in operation, the amount charged by NHS to resident school districts for special educational services has never been reconciled to the actual cost of the program. NHS is just now developing a procedure to do so. Rather than reflecting the true cost of the program, the special education rate has corresponded to inflated budget numbers and expenses unrelated to special education.

While the true special education rate cannot be determined at this time due to the nature and extent of the problems identified in the report, the *approximate* amount of the overcharges for special educational services was \$17.38 per day during 2001-2002, \$56.58 per day during 2000-2001, and \$70.68 per day during 1999–2000. Our report also identified 113 school districts which have been overcharged a total of approximately \$49,434 as a result of a mathematical error in the calculation of the 2001-2002 rate. The overcharge for the mathematical error is included in the \$17.38 identified above.

In addition to paying an inflated special education rate, school districts have also paid \$1.5 million in lease rental payments to NHS. In April 2003, the Pennsylvania Department of Education (PDE) concluded that the lease rental fee charged by NHS violated the Public School Code. While we do not agree with PDE’s legal conclusion, the fact that PDE has made this determination creates a question as to whether NHS is authorized to charge school districts a lease rental fee. At this time, in spite of this determination, NHS continues to charge school districts a lease rental fee, because, according to NHS representatives, it has not been instructed by PDE to discontinue the practice.

It is disturbing that these and other problems identified in this special audit could have been avoided or corrected if PDE had developed guidelines and/or regulations to cover the situation where a private entity and a school district have entered into a contract for the educational services at the “children’s institutions” to be provided by the private entity. PDE’s lack of guidance is becoming more significant as additional juvenile detention centers are built within the Commonwealth.

The lack of oversight by PDE and its ramifications are discussed more fully in a companion audit of SASD conducted by the Department’s Bureau of School Audits. That audit has been released under separate cover.

In its response to our audit of the Academy, NHS stated its willingness and ongoing effort to work with PDE to develop the methodology by which the special education rate is to be calculated. I encourage you to instruct PDE to work with NHS so that a methodology that meets the requirements of the Public School Code is developed quickly. Without such action, school districts may not receive refunds due to them as a result of the improper calculation of the special education rate.

I also encourage you to direct PDE to develop guidelines and/or regulations that address, not only the problems identified in this report, but also those described in the audit conducted by the Department’s Bureau of School Audits. Effective and timely oversight by PDE is needed to ensure that the students residing at juvenile detention centers and other “children’s institutions” are receiving an education in accordance with

the same regulations and requirements applicable to public school districts. School districts and private organizations that operate institutions for juveniles, as well as the public, need to know that state requirements are being met to ensure that the taxpayers' dollars are being used appropriately for educational purposes.

Sincerely,

Robert P. Casey, Jr.
Auditor General

INTRODUCTION AND BACKGROUND

Pursuant to the authority and responsibility of the Department of the Auditor General (the Department) under the Fiscal Code, audits are conducted of the affairs of Commonwealth departments and agencies as well as those of organizations that receive state funds.¹

Northwestern Human Services, Inc. (NHS), a Pennsylvania nonprofit corporation, is a “provider of community based behavioral health, mental retardation, juvenile justice and other human services” throughout Pennsylvania, Virginia and Washington, D.C. In 1998, NHS opened the Northwestern Academy (the Academy), “a comprehensive 242-bed residential complex for delinquent youth” located near Shamokin [Northumberland County], Pennsylvania. Adjudicated minors are placed at the Academy through the juvenile courts and county agencies that contract with NHS for its services. The Academy includes a boot camp, an intermediate secure facility, an intensive secure facility, a secure detention center and educational facilities for elementary and secondary students.

The educational component of the Academy is provided by NHS through an agreement (the Agreement) between NHS and the Shamokin Area School District (SASD), the public school district in which the Academy is located. Northwestern Human Services of Pa., Inc.² is licensed by the State Board of Private Academic Schools, part of the Pennsylvania Department of Education (PDE), to provide elementary and secondary education along with special education programs for students in the elementary and secondary grades who are “Socially Emotionally Disturbed” or “Learning Disabled.”³ As a licensed private academic school, NHS is subject to the legal requirements set forth in the Private Academic School Act⁴ and the regulations promulgated thereunder. The educational services are provided by the teaching staff of NHS, not SASD.

Per the Agreement, payment for the educational services provided by NHS is primarily based upon sections 1306, 1308, 1309 and 2561 of the Public School Code.⁵ Pursuant to these sections, SASD, as the host school district, bills the Pennsylvania school districts where the student’s parents reside (resident school districts). In most

¹ 72 P.S. §§ 402, 403.

² Northwestern Human Services of Pa., Inc., a nonprofit Pennsylvania corporation, is a subsidiary of NHS and had operational responsibility for the Academy from its inception to approximately July 2002, when operations were taken over by NHS Youth Services, Inc., another subsidiary of NHS. For purposes of clarity, NHS, as used in this report, will refer to the Northwestern Human Services, Inc. and all of its subsidiaries with oversight responsibilities of the Northwestern Academy.

³ NHS was initially licensed as a secondary school. In February 2001, its license was expanded to include elementary students.

⁴ 24 P.S. §§ 6701-6721.

⁵ 24 P.S. §§ 13-1306, 13-1308, 13-1309, 25-2561.

cases, the resident school districts are billed SASD's tuition charge as determined annually by the Commonwealth according to a statutory formula defined in section 2561 of the Public School Code.

In addition to the standard tuition charge, section 1309 of the Public School Code permits host school districts to also charge resident school districts for:

- A proportionate cost of the operating expenses, rental and interest on any investment required to be made in providing a separate school or in erecting additional school buildings for the accommodation of non-resident school children living in institutions.
- Special education programs for such school children.

The Agreement between NHS and SASD defines the responsibilities of each organization. Summaries of the Agreement provisions that relate to this report are as follows:

NHS's Responsibilities:

- Provide all residential students placed at the Academy with educational services that meet or exceed the curriculum requirements, standards, and obligations of PDE that are applicable to SASD.
- Provide SASD with all information necessary to establish the students' resident school districts.
- Calculate any special education charge and justify any conclusion that a student requires special education.
- Calculate lease rental payments billed to the resident school districts.

SASD's Responsibilities:

- Promptly process all information received in order to obtain reimbursements from the resident school districts.
- Make monthly payments to NHS and include a full accounting of reimbursement billings.
- Pay NHS net funds received by the districts less an administrative fee of seven percent of the educational charges.

When, in July 2002, the Department's Office of Special Investigations (OSI) received a referral from the Pennsylvania Office of the Attorney General regarding NHS and SASD, the Department's Bureau of School Audits was already reviewing similar complaints as part of its audit of SASD. During that audit, the auditors from the Bureau of School Audits learned that NHS's special education rate had never been substantiated and that PDE has determined that the lease rental payments violate the Public School Code. The audit also found that the contractual arrangement between SASD and NHS is not authorized under the Public School Code.⁶

OSI conducted this special audit of NHS to provide an independent assessment of the special education rate charged by NHS and to expand upon the work completed by the Bureau of School Audits regarding lease rental payments. While conducting this audit, we became aware of an issue relating to SASD. The scope of our audit was expanded to include this item, and the results are included in the Observation section of our report.

To accomplish these objectives, we

- Interviewed officials and staff from NHS, SASD, PDE, the Labor, Education and Community Services (LECS) Comptroller's Office and SASD's independent auditing firm.
- Examined statutes and regulations relating to non-resident inmates of children's institutions, the contracts between SASD and NHS, documents maintained by PDE relating to NHS's licensure as a licensed private academic school and the lease agreement between NHS and the company from which it rents the Academy.
- Obtained from NHS all documents relating to its calculation of the special education rates and analyzed the data for mathematical accuracy, reasonableness of the assumptions used in the calculations, and the appropriateness of the expenditures included in the calculations; examined cost allocations ratios utilized to distribute the expenditures between regular and special education; compared actual expenses to the budget figures used to calculate the rate; and compared NHS's method of calculating its special education rate to the Public School Code and the method used by a similar organization.

⁶ For additional information, see the Department's report of the audit of Shamokin Area School District for the years ended June 30, 2000 and 1999 conducted by the Department's Bureau of School Audits.

- Assessed the reasonableness of the method by which NHS calculated lease rental payments; verified the mathematical accuracy of the calculations; verified that the correct rates were added to the tuition charges billed to the resident school districts; and confirmed that funding from SASD was not used to construct any part of the Academy or the areas used for education.
- Determined how SASD recorded revenues and expenditures related to NHS; ascertained the reasoning behind the classification; compared the classification to the *Manual of Accounting and Financial Reporting for Pennsylvania Public Schools*, issued by the LECS Comptroller's Office; and determined what effect, if any, the classification had on the SASD annual tuition rates.

The special audit did not review NHS's method used to conclude that a student requires special education services, nor did it verify such designations made by NHS or evaluate whether NHS's special education programs met legal and regulatory requirements. Accordingly, we do not express an opinion on NHS's special education program as a whole.

We conducted this audit in accordance with *Government Auditing Standards* as issued by the Comptroller General of the United States. Unless otherwise indicated in the body of this report, our audit covered the period of July 1, 1998, through June 30, 2002.

Notwithstanding the previously noted finding in the audit of SASD that the contractual agreement between SASD and NHS is not authorized by the Public School Code, some recommendations in this report are prospective in nature. These recommendations are included in the event that PDE concludes, contrary to our finding, that the contractual agreement is legally permissible and may continue.

Copies of the draft audit report were given to NHS and SASD on April 24, 2004, to provide the opportunity to respond. We received a response from NHS. The contents of the response have been incorporated into the appropriate parts of the report. In addition, the response has been incorporated in full in a separate section of the report. SASD declined to respond.

In its response, NHS requested that the Department not finalize or distribute the audit until the matters addressed in the report concerning the special education rate and lease rental payments are resolved between NHS and PDE. Unfortunately, while efforts have been made by the parties to reach a resolution, no such agreement has been reached. We have determined that the release of the report at this time is in the public interest and will, hopefully, help to advance the resolution of those matters.

EXECUTIVE SUMMARY

NHS miscalculated the 2001-2002 special education tuition rate resulting in an overcharge to resident school districts of \$49,434.

NHS's special education rate does not reflect the actual costs of its special education program; rather, it is based upon inflated budget numbers, expenses unrelated to special education, and an unsupported cost allocation ratio. Moreover, a rate based on actual expenses cannot be determined due to differences in categories used by NHS when preparing the budget and recording the actual expenses.

NHS received approximately \$1.5 Million in lease rental payments which, per the legal interpretation of PDE, were not authorized under the Public School Code.

SASD improperly recorded all costs related to NHS as special education expenses even though a portion of those expenditures related to regular education and lease rental payments.

RECOMMENDATIONS

Recommendations also appear at the end of each finding and observation to which they relate.

1. NHS should determine the number of special education days billed to each of the 113 resident school districts during the 2001-2002 fiscal year and credit the school districts \$2.49 for each special education school day billed. SASD should review its own records to determine the same information. The results should be compared and any discrepancies between the lists should be resolved. (Finding No. 1.)
2. NHS should analyze the computer spreadsheet used to calculate the tuition rate and correct any errors. NHS should also ensure that its staff is aware of the correct manner in which to enter data into the spreadsheet. (Finding No. 1.)
3. Each year, when NHS provides SASD with the annual special education rate, SASD should manually recalculate the rate using the supporting documentation provided by NHS. Any discrepancy should be corrected prior to issuance of bills at the new rate. (Finding No. 1.)
4. NHS should recalculate the special education rates it has charged since the Academy's inception using the actual expenses and a valid, documented cost allocation method. The results should be forwarded to SASD and PDE for

verification. Arrangements should be made between NHS, SASD and the resident school districts for repayment of any funds. (Finding No. 2.)

5. NHS should recalculate the special education rate after the close of the fiscal year, starting with the 2003-2004 fiscal year. The results should be sent to SASD to bill resident school districts accordingly. (Finding No. 2.)
6. Unless and until PDE modifies its legal position, SASD should discontinue billing resident school districts for lease rental payments. Lease rental payments collected by SASD and currently held in escrow or otherwise should be refunded to the respective resident school districts. For each year since its inception, NHS should determine the amount that each school district with students attending the Academy paid NHS in lease rental payments. The results should be forwarded to SASD, PDE and the individual resident school districts. Arrangements should be made between NHS, SASD and the resident school districts for repayment of these funds. (Finding No. 3.)
7. PDE should provide guidance regarding the account codes to which SASD is to record expenditures and revenues related to NHS. This information should be transmitted to the LECS Comptroller's office. SASD should review this issue with its independent auditor and the LECS Comptroller's office to determine the consequences, if any, of the overstatement of special education expenses. (Observation)

FINDING NO. 1 - NHS MISCALCULATED THE 2001-2002 SPECIAL EDUCATION TUITION RATE RESULTING IN AN OVERCHARGE TO RESIDENT SCHOOL DISTRICTS OF \$49,434.

Prior to the start of each school year, NHS informs SASD of the rate to be billed to resident school districts for special education and lease rental payments. As justification of the special education rate, NHS provides SASD with a copy of the budget used by NHS to calculate the special education rate.

To verify the mathematical accuracy of the special education rates, we recomputed the rates using the supporting documentation that NHS provided to SASD. *The computation revealed that for the 2001-2002 fiscal year the special education rate was misstated by \$2.49 (\$68.29 v. \$70.78) due to a mathematical error.*

NHS's Director of Finance reviewed the matter and later told OSI that the correct rate was \$68.29 and not the \$70.78 charged to resident school districts. She stated that she believed the miscalculation was due to a data input error or a calculation error on NHS's spreadsheet used to determine the rate.

As a result of the miscalculation, 113 resident school districts were overcharged an aggregate of \$49,434 during the fiscal year. The school districts that overpaid NHS for special education services are listed in Appendix A.

The calculation error would have been identified and corrected prior to any billing for the 2001-2002 school year if SASD reviewed NHS's supporting documentation and verified its mathematical accuracy prior to implementing the new special education rate. According to the responsible SASD employee, she uses the special education rate communicated to her via letter from NHS. When the documentation supporting the special education rate is received, she files the document without examining its contents.

Recommendations

NHS should determine the number of special education days billed to each of the 113 resident school districts during the 2001-2002 fiscal year and credit the school districts \$2.49 for each special education school day billed. SASD should review its own records to determine the same information. The results should be compared and any discrepancies between the lists should be resolved.

NHS should analyze the computer spreadsheet used to calculate the tuition rate and correct any errors. NHS should also ensure that its staff is aware of the correct manner in which to enter data into the spreadsheet.

Each year, when NHS provides SASD with the annual special education rate, SASD should manually recalculate the rate using the supporting documentation provided by NHS. Any discrepancy should be corrected prior to issuance of any bills at the new rate.

NHS's RESPONSE TO FINDING NO. 1

NHS's response confirms that a mathematical error occurred in the special education rate used for 2001-2002. NHS proposes to correct the error in the context of "the larger activities," i.e., the calculation of the appropriate special education rate, that will take place in relation to Finding No. 2. If those activities result in additional changes relating to 2001-2002, NHS will ensure that they also correct for the \$2.49 mathematical error. If no other changes are made for 2001-2002, NHS will take steps to ensure that districts receive a credit or refund on account of the mathematical error.

THE DEPARTMENT OF THE AUDITOR GENERAL'S COMMENTS

The Department disagrees with NHS's proposal to correct the mathematical mistake it made in the calculation of the special education rate for the 2001-2002 school year as part of any "larger activities." As noted in its response, NHS has had difficulty scheduling a meeting with PDE to discuss the special education rate, and the time frame for the development of a special education rate calculation is unknown. Overpayments by the resident school districts as a result of the error should be refunded as soon as possible.

FINDING NO. 2 - NHS'S SPECIAL EDUCATION RATE DOES NOT REFLECT THE ACTUAL COSTS OF ITS SPECIAL EDUCATION PROGRAM; RATHER, IT IS BASED UPON INFLATED BUDGET NUMBERS, EXPENSES UNRELATED TO SPECIAL EDUCATION, AND AN UNSUPPORTED COST ALLOCATION RATIO. MOREOVER, A RATE BASED ON ACTUAL EXPENSES CANNOT BE DETERMINED DUE TO DIFFERENCES IN CATEGORIES USED BY NHS WHEN PREPARING THE BUDGET AND RECORDING THE ACTUAL EXPENSES.

According to the Public School Code, a resident school district is required to “pay a special education charge *in addition to* the applicable tuition charge” when special education services are provided to its students residing at a “children’s institution,” provided that “[s]uch special education charge when combined with the applicable tuition charge shall not exceed the total net cost of the special education program provided.”⁷

Rather than assess a standard tuition rate to all students and an additional charge for the special education component, NHS bills resident school districts either a regular education rate **or** a special education rate. The special education rate includes costs related to providing regular education in addition to those costs strictly relating to the special education program.

NHS’s procedures for calculating and applying the education rates are as follows:

- The total annual budget for the Academy is determined from the previous year’s expenditures and/or management’s estimates.
- The cost associated with each category listed in the budget is distributed between regular and special education using varying cost allocation ratios.
- After the costs are allocated between regular and special education, the total cost for special education is reduced by the amount of expenses to be paid through other funding sources.
- The total net budgeted costs for special education are divided by the anticipated number of special education student days. The resulting number is the special education rate charged by NHS.
- The regular education rate charged by NHS is the tuition rate for SASD calculated by the LECS Comptroller’s Office.

⁷ 24 P.S. § 13-1309(a)(2) (emphasis added).

There are several problems associated with NHS's method of calculating the special education rate:

- A. The special education rate is based on inflated budget figures.*
 - B. The special education rate includes expenses unrelated to special education.*
 - C. The cost allocation method used to distribute costs between regular and special education is unsupported.*
 - D. The special education rate is never adjusted to reflect the actual expenses incurred.*
 - E. The difference in cost categories used in the budget and actual financial records prevents a budget-to-actual comparison.*
- A. NHS calculates its special education rate based upon inflated budget figures.**

NHS calculates two budgets for the Academy -- the budget used to determine the special education rate (special education budget) and the budget for NHS's financial system (corporate budget) used to track the financial progress of the Academy. Both budgets reflect the entire educational program and cover the same time period.

A comparison of the two budgets disclosed that the total expenses in the special education budget were greater than the expenses in the corporate budget even though the amounts should be identical. (Table No. 1, p. 14.) Specifically, the expenses in the 2000-2001 special education budget are overstated by \$133,023, and the expenses in the 2001-2002 special education budget are overstated by \$370,745. NHS could not locate the corporate budgets for fiscal years 1998-1999 and 1999-2000.

Since a portion of all expenses (except lease rental payments) are included in the special education rate, any artificial increase in expenses also artificially increases the special education rate. The potential exists for NHS to receive more money from resident school districts than the actual costs of NHS's special education program. NHS's profits would be increased, thus minimizing any potential financial losses that may result from the operation of the Academy. The probability of NHS receiving more money than it is entitled to is increased by NHS' failure to reconcile the budget figures used to calculate the special education rate to the actual expenditures.⁸

⁸ See pp. 18-20.

Table No. 1 - Comparison Of Expenses Used To Calculate The Special Education Rate To The Budget Figures Reported In NHS Financial Records.

	Expenses per “special education” budget	Expenses per “corporate” budget	Difference
2001-2002			
Salaries and benefits	\$ 1,768,344	\$ 1,699,331	\$ 69,013
Operating expenses	<u>\$ 964,869</u>	<u>\$ 663,137</u>	<u>\$ 301,732</u>
Total for 2001-2002	<u>\$2,733,213</u>	<u>\$2,362,468</u>	<u>\$370,745</u>
2000 – 2001			
Salaries and benefits	\$ 1,609,994	\$ 1,568,424	\$ 41,570
Operating expenses	<u>\$ 975,877</u>	<u>\$ 884,424</u>	<u>\$ 91,453</u>
Total for 2000-2001	<u>\$2,585,871</u>	<u>\$2,452,848</u>	<u>\$133,023</u>

B. The special education rate includes expenses not related to special education.

According to PDE’s Bureau of Special Education, only those instructional and non-instructional costs directly attributable to providing special education or services should be included in the special education rate. Costs that would be incurred if the student received regular education instead of special education should not be included.

While the categories of special education costs vary between school districts due to the needs of individual students, a recent study conducted by PDE concluded that the areas listed in Table No. 2 (p. 15) represent the non-instructional categories of expenditures that are most common for school districts to incur for the support and operation of their special education program. According to PDE, this is the result of “nearly two years of research and effort by districts from across the Commonwealth.”⁹

⁹ “Your Schools, Your Money” Guidelines, Revised July 22, 2002, page 7.

Table No. 2 - Non-Instructional Expenditures Most Commonly Incurred By School Districts For The Support And Operation Of Their Special Education Program.

<ul style="list-style-type: none"> • Pupil personnel (supervise special education) • Appraisal Service (assessing students) • Placement Services • Psychological Services • Psychological Testing Services • Speech Pathology & Audio Services • Supervision Speech Pathology & Audio Services • Social Work Services • Computer Assisted Instruction Services 	<ul style="list-style-type: none"> • Instruction & Curriculum Development Services • Instruction Staff Development Services • Legal Services • Office of Principal Services • Medical Services • Nursing Services • Transportation Services (only for specialized transportation) • Staff Development Services (non-instructional, certified) • Staff Development Services (non-instructional, non-certified).
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The categories of special education non-instructional expenditures determined from PDE’s study are in sharp contrast to the expenditures that NHS classifies as special education costs. NHS’s expenses are listed below in Table No. 3. The total dollar amount charged to the special education program during our four-year review is included in parenthesis after each category. In aggregate, these non-instructional expenses represent approximately 22 percent of the total amount used to calculate NHS’s annual special education rate.

Table No. 3 - Non-Instructional Expenditures NHS Charged To Its Special Education Program.

<ul style="list-style-type: none"> • Administrative Fee Paid to SASD (\$275,802) • Communications (\$12,620) • Corporate/Regional Allocation [costs incurred by NHS’s parent companies] (\$404,255) • Contracted Professionals (\$6,720) • Depreciation (\$9,600) • Equipment (\$2,750) • Executive Administrative (\$84,603) • Facility Insurance (\$19,029) 	<ul style="list-style-type: none"> • Food (\$12,702) • Maintenance Service (\$31,478) • Office Supplies (\$9,100) • Professional Liability Insurance (\$13,000) • Security Service (\$19,881) • Staff Training (\$24,000) • Staff Travel (\$4,400) • Student Books and Supplies Cost (\$53,500)
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Clearly, many of the costs pertain to NHS’s overall operations of the Academy. For example, the seven (7) percent administrative fee paid to SASD is not contingent upon the student’s educational requirements, nor are the costs of the Academy’s parent companies.

For the costs in Table No. 3 to be eligible special education expenses, NHS would have to support the costs with either educational plans or time analyses indicating how the expense directly relates to the education of a special needs child. This is not occurring. As discussed in the next section, NHS allocates costs using an unsupported methodology.

C. The cost allocation method used to distribute costs between regular and special education is unsupported.

After NHS determines its annual budget to operate the Academy, it distributes those costs between regular and special education. The costs charged to special education become a component of the special education rate paid by resident school districts.

Standard business practices require the development of an allocation methodology when distributing costs between appropriate service centers. While the exact methodology is at the discretion of the organization, it should result in costs being distributed in a fair and equitable manner and logically apportioned. For example, in PDE's *Spending Analysis and Management Project*, special education costs are to be allocated based on the "actual or estimated time worked . . . on special needs and programs."¹⁰ "Costs not associated with someone's time should be allocated based on the number of [special education] students."¹¹

The percentages most frequently used by NHS to allocate costs within each cost category are noted in Table No. 4 (p. 18). Also included in the table are the percentages of estimated special education students for each year. Only once in the twelve times that costs were distributed on an unknown basis was the distribution of expenses made in agreement with the percentage of special education students to the total student body. *For the remaining eleven instances, costs were distributed to the special education program in a greater percentage than that of the population of special education students. In fact, salary expenses for the 1999–2000 through the 2001–2002 school years were distributed in an inverse proportion to the student body. For example, in 2001 – 2002, 70 percent of the costs were allocated to the special education program even though only 30 percent of the students were enrolled in special education programs.*

¹⁰ "Your Schools, Your Money" Guidelines, Revised July 22, 2002, page 7.

¹¹ "Your Schools, Your Money" Guidelines, Revised July 22, 2002, page 8.

Table No. 4 - Percentages, By Cost Category, Most Frequently Used By NHS To Distribute Expenses To Special Education.

	<u>1998-1999</u> ¹²	<u>1999-2000</u>	<u>2000-2001</u>	<u>2001-2002</u>
Enrollment	55% special ed.	40% special ed.	40% special ed.	30% special ed.
Salaries ¹³	60 %	60 %	60 %	70 %
Benefits	60 %	60 %	60 %	% of salary costs
Operating expenses	60 %	60 %	40 %	50 %
Indirect costs	% of operating costs	% of operating costs	% of operating costs	60 %

Source: NHS annual budgets used to calculate special education expenses.

The basis for the allocation ratios is unknown. When asked to describe the allocation methodology, NHS representatives, including the Director of Finance, were unable to do so. The Director of Finance stated that the Executive Director believed that salaries were charged at the inverse ratio of the student population because the teachers spend additional time with the special education children. However, no analysis of the teachers' time has been conducted to support this claim or the allocation ratio.

The risk of using unsupported allocation methods is that the expenses charged to service centers (special education) are greater than the benefit received. For NHS, it means that resident school districts would be responsible for paying costs unrelated to the special education their students receive at the Academy.

D. The special education rate is never adjusted to reflect the actual expenses incurred. Moreover, a rate based on actual expenses cannot be determined due to differences in categories used by NHS when preparing the budget and recording the actual expenses.

Prior to the start of the school year, NHS informs SASD of the special education rate and the date that it should be implemented. SASD bills resident school districts this rate throughout the year. For regular education, SASD bills resident school districts at SASD's previous year's tuition rate until the updated tuition rate is released in April or May of the year. When the new rate is received, SASD sends each school district an invoice documenting the impact of the new rate. If the new rate is lower, SASD credits the school districts' accounts and future bills are reduced by the amount that the school

¹² Initial year of operation.

¹³ Salary expenses charged exclusively to the special education program are not included.

districts overpaid. If the new rate is higher, resident school districts are billed for the difference.

As previously stated, the Public School Code limits the reimbursement that NHS can receive for special education services to the total net cost of the special education program.¹⁴ In other words, NHS cannot receive reimbursement in amounts greater than its actual expenses. While the regular tuition rate is adjusted to reflect actual expenditures, the special education rate is not. *No one - not NHS, SASD, or PDE - has ever recalculated a special education rate using NHS's actual expenses.* Without recalculating the special education rate using actual expenses, it is not possible to determine if the school districts paid NHS more than its actual costs.

According to the NHS Director of Finance, NHS was never directed, verbally or in writing, to recalculate the special education rate based upon actual figures. Another NHS representative stated that the special education rate could not be more than the actual rate because, as seen in the financial statements, the Academy incurs a financial loss every year. However, this is not an accurate inference. The financial loss could be due to the expense to provide regular education and not special education.

We attempted to calculate the special education rate using the actual expenses, but were unable to accurately replicate the formula due to differences between cost categories used by NHS to establish the special education budget and the cost categories in which the expenses are recorded.¹⁵ While the exact rate could not be determined, it was possible to *approximate* the actual special education rate based upon the proportion of special education costs, per cost category, to the total expense of that category.

The approximate special education rates, based upon the aforementioned cost allocation method and NHS's total net costs are:

- \$53.40 for 2001-2002.
- \$0 for 2000-2001.
- \$0 for 1999-2000.

The special education rates of zero for the 1999-2000 and 2000-2001 school year resulted from NHS distributing certain operating costs related to the education program to the four programs offered at the Academy; e.g., boot camp, an intermediate facility, an intensive secure facility, and a secure detention center. The distributed educational costs were paid by the funding sources for the four program areas. As a result, there were no remaining expenses to be charged to the resident school districts.

¹⁴ 24 P.S. § 13-1309(a)(2).

¹⁵ See p. 13 for additional information.

Comparing these rates to those charged by NHS, *resident school districts were overcharged for each day of special education billed during the period July 1999 through June 2002*. Specifically, resident school districts were overcharged:

- \$17.38 per day during 2001-2002.
- \$56.58 per day during 2000-2001.
- \$70.68 per day during 1999-2000.

These overcharges do not take into account those costs identified in Table No. 3 as unrelated to special education or any amount that may be charged for regular education services.

Recommendations

NHS should recalculate the special education rates it has charged since the Academy's inception using the actual expenses and a valid, documented cost allocation method. The results should be forwarded to SASD and PDE for verification. Arrangements should be made between NHS, SASD and the resident school districts for repayment of any funds.

Starting with the 2003-2004 fiscal year, NHS should recalculate the special education rate after the close of the fiscal year. The results should be sent to SASD to bill resident school districts accordingly.

NHS's RESPONSE TO FINDING NO. 2

In its response, NHS states that it understands that its method of billing a single amount for special education students is different from how the Public School Code requires special education services to be billed. NHS proposes addressing this issue by providing SASD with information that will make it easy for SASD, in the future, to express the billing for special education students in two components.

Regarding the issue that billing for special education students has been based on start-of-year budgets, NHS agrees that it should develop a mechanism so that, ultimately, billing and payments are based on actual experience. NHS further responds that:

This can only be known toward or after the end of the year. NHS thinks of the desired process as one of "reconciliation payments." That is, billings and payments based on expected costs will later be reconciled with actual experience. NHS has not yet concluded whether this can be done toward the end of a year or must be done after the end of a year. NHS agrees, however, to provide the calculations for such reconciliation payments, and to work with PDE to devise the acceptable timing for doing so.

The remainder of this finding relates to the calculation of the billings for special education students. The draft Audit asserts a lack of time analyses or other demonstrated methodology for calculating the costs of educating special education students, and the draft Audit makes some comparisons with the special education accounting done by school districts. We do not agree with all of the inferences that might be drawn from some of your comparisons. However, we agree that, as PDE says in its Basic Education Circular on the subject, the host district may charge the district of residence an amount that does not exceed the total cost of the special education provided minus the amount received per child from the Commonwealth under Section 2509.1(b). NHS agrees that it should recalculate the amounts billed for special education students and make any adjustments that result.

Rather than come up with our own calculations or recalculations in isolation and then submit them to others, we have elected to work with PDE's Bureau of Budget and Fiscal Administration (including its Division of Subsidy Data and Administration) as we move forward. We have begun this process.... Although the exact methodology will no doubt evolve, we hope to arrive at a mutually acceptable set of figures for the most current year, and then to explore whether and how to apply this work to prior years. Also we anticipate that some techniques, such as time studies, may be

implemented in the future even if it is impossible to reach back in time for such techniques. Where the optimal technique is impossible, we will do our best to provide an express method or rationale.

THE DEPARTMENT OF THE AUDITOR GENERAL'S COMMENTS

The Department is pleased that NHS will recalculate the amounts billed for special education services based upon actual expenses and a formula developed in concert with PDE. However, we take exception to portions of NHS's responses.

1. NHS states in its response that it would provide SASD with information in such a manner as to allow SASD to bill special education services in two components. Simply breaking the special education costs currently being billed by NHS into two components will not address the problem of NHS not complying with the billing method established in the Public School Code. For the problem to be addressed correctly, resident school districts with special needs students will need to be billed the regular education rate for SASD as determined by the LECS Comptroller's Office and a special education rate based upon true and accurate costs incurred by NHS for providing special educational services.
2. While we have no objection at this time to NHS's decision to bill special education services on a reconciliation basis, we are concerned that NHS will continue to bill resident school districts based on inflated budget figures that do not correspond with the budget figures recorded in NHS's financial accounts. The Department acknowledges that the actual expenses may not be known until the close of the fiscal year. Accordingly, we encourage NHS to perform the reconciliation as timely as possible.
3. The portion of the Basic Education Circular referenced by NHS in its response does not apply to NHS.¹⁶ The statement referenced by NHS applies in situations where the special education services are being provided by intermediate units, which is not the case in this situation.

To limit the calculation of the "total net cost of the program" to only reimbursements received by intermediate units as implied in NHS's response is contrary to the phrase "total net costs" and disregards the reimbursements NHS receives from other sources. It would also allow NHS to retain the overpayments it received when it fails to account for the reimbursements from other sources in its calculation of the special education rate for these years. As noted on pages 18-20 of our report, the disbursement of educational costs to program areas during the 2000-2001 and 1999-2000 years resulted

¹⁶ Basic Education Circular, Non-Resident Students in Institutions, issued by PDE on July 1, 1999, pursuant to 24 P.S. § 13-1306.

in these costs being paid by sources other than resident school districts. When these disbursements are included in the calculation of the special education rate charged to the resident school districts, the rate for both years is zero. However, NHS billed resident school districts \$55.58 and \$70.68 per special education student per day for these two years.

FINDING NO. 3 - NHS RECEIVED APPROXIMATELY \$1.5 MILLION IN LEASE RENTAL PAYMENTS WHICH, PER THE INTERPRETATION OF PDE, WERE NOT AUTHORIZED UNDER THE PUBLIC SCHOOL CODE.

As stated in the Introduction and Background section of this report, NHS and SASD entered into contracts whereby NHS would provide educational service to all residential students placed at the Academy, and SASD would bill the resident school districts on NHS's behalf. One cost billed to the resident school districts was for lease rental payments.

During the four years under audit, NHS received approximately \$1.5 million in lease rental payments.¹⁷ The annual amounts received by NHS are documented in Table No. 5.

Table No. 5 – Lease Rental Payments Remitted to NHS

Fiscal Year	Amount
1998-1999	\$ 242,654
1999-2000	\$ 508,189
2000-2001	\$ 376,686
2001-2002	\$ 362,287
Total	\$ 1,489,816

Section 1309 of the Public School Code states:

Where, for the accommodation of such children, it shall be necessary to provide a separate school or to erect additional school buildings, the charge for tuition for such children may include a proportionate cost of the operating expenses, rental, and interest on any investment required to be made in erecting such new school buildings.¹⁸

In an April 30, 2003, letter, legal counsel from PDE informed SASD's attorney that:

[PDE] reads Section 1309(a)(1) [of the Public School Code] to mean that a school district must incur capital expenditures for erecting additional school buildings or creating a separate school before the district may charge a student's resident district 'a proportionate cost of the operating expenses, rental and interest on any investment required to be made in erecting such

¹⁷ The approximate value of the lease rental payments remitted to NHS was determined from the total amount of lease rental fees billed on NHS's behalf less the lease rental fees that two school districts refused to pay.

¹⁸ 24 P.S. §13-1309(a)(1).

new school buildings.’ Based on the information provided to [PDE], it is our understanding that [SASD] has not incurred any capital expenditure to erect additional school buildings or create a separate school for students placed at Northwest Academy. If that is, in fact, the case, [SASD] would have no basis for charging lease payments to students’ resident school districts on behalf of [NHS], at least under the interpretation of the statute [PDE] has uniformly and consistently applied.

PDE’s understanding that no school district funds were used to construct education facilities at the Academy appears to be correct. SASD’s business manager confirmed that no SASD money was used to construct the buildings.

Conclusions and Recommendations

PDE has concluded that a school district must incur capital expenditures for erecting additional school buildings in order for a host district to charge resident school districts the costs permitted under section 1309(a)(1). As explained more fully below, the Department does not agree with PDE’s interpretation of section 1309(a)(1) of the Public School Code. Specifically, it is the Department’s opinion that costs which may be included in tuition charges under section 1309(a)(1) are not limited only to those associated with buildings and facilities which school districts themselves have incurred capital expenditures to erect, but may also include costs associated with buildings erected and financed by other entities, which are used for the purpose of educating delinquent youths. However, notwithstanding this Department’s opinion, PDE is the arbiter of what costs may be included in tuition charges pursuant to section 1309(a)(1). Thus, unless and until PDE modifies its opinion or a court of competent jurisdiction holds that PDE’s position is erroneous, SASD should discontinue billing resident school districts for lease rental payments.

Moreover, absent a contrary judicial holding or a modification by PDE of its position, any lease rental payments collected by SASD and currently held in escrow or otherwise will have to be refunded to the respective resident school districts. NHS should work with PDE and SASD to develop a process for refunding lease rental payments it has collected to date from the resident school districts involved.

NHS's RESPONSE TO FINDING NO. 3

In its response, NHS states that the draft audit relies on an April 30, 2003, letter from the Office of Chief Counsel (OCC) of the Pennsylvania Department of Education (PDE). NHS characterizes the contents of the letter as expressing the opinion that 24 P.S. § 1309(a)(1) means that a school district must incur capital expenses before the district can charge for a proportionate share under that statute. Earlier this year, NHS states that it was informed by OCC/PDE that PDE was reconsidering its interpretation of section 1309(a)(1). NHS believes that OCC/PDE's legal interpretation is wrong, and that it would be wrong for the Department of the Auditor General's audit to rely on or incorporate that interpretation.

In its response, NHS includes five observations mainly of a legal nature "[t]o assist the Departments of Education and Auditor General in reconsidering the content of OCC/PDE's 2003 letter." The specific observations are noted in NHS's complete response located on pp. 32-33 of this report.

NHS also states that Finding No. 3 should be substantively reversed in, or deleted from, the final audit. To the extent that the subject matter of the draft's Finding No. 3 is addressed in the final audit, NHS believes that the final audit should include a disavowal of the previous position of OCC/PDE, and should conclude that the charges for rent are proper under section 1309(a)(1) without regard to whether the property being rented was erected with school district funds.

THE DEPARTMENT OF THE AUDITOR GENERAL'S COMMENTS

The Department acknowledges the various legal arguments made by NHS in challenging PDE's legal interpretation of section 1309(a)(1). As set forth above, we are not in agreement with PDE's various interpretations of section 1309(a)(1) limiting the circumstances in which a school district is authorized to charge a lease rental payment. Nevertheless, since PDE is ultimately responsible for determining allowable costs under the section, absent a change in its position or a contrary judicial interpretation, our conclusion stands.

OBSERVATION RELATING TO SASD

SASD IMPROPERLY RECORDS ALL COSTS RELATED TO NHS AS SPECIAL EDUCATION EXPENSES EVEN THOUGH A PORTION OF THOSE EXPENDITURES RELATE TO REGULAR EDUCATION AND LEASE RENTAL PAYMENTS.

The Agreement between SASD and NHS requires SASD to deposit the proceeds from all transactions relating to NHS into a separate bank account, independent of SASD's other bank accounts. The disbursements from this account consist of the seven percent administrative fee that SASD receives pursuant to its agreement with NHS and the transfer of the remaining collected funds to NHS.

The transactions of this account are incorporated into SASD's financial records as part of the annual independent audit of SASD. According to SASD's Independent Auditor, in accordance with the *Manual of Accounting and Financial Reporting for Pennsylvania Public Schools* (Manual) issued by the LECS Comptroller's Office, revenues are reported as *Tuition from Patrons* and expenditures are recorded as *Special Programs*.

The Chart of Accounts section of the Manual defines *Special Programs* as those "[a]ctivities designed primarily for students having special needs." According to the LECS Comptroller's Office, only those costs associated with special education should be recorded in the *Special Programs* accounts.

SASD records NHS expenditures entirely to *Special Programs* even though approximately 47 percent of costs relate to regular education and lease rental payments and not to the special education program. According to the Manual, these expenses should be classified as *regular programs*.¹⁹

As a consequence of misrecording NHS's costs pertaining to regular education and lease rental payments, SASD has overstated the cost of its special education program. This overstatement does not affect SASD's tuition rate as calculated by the LECS Comptroller's office because the costs would have been included in the tuition rate calculation if properly recorded. It is not known what, if any, effect the overstatement has on other financial calculations based on special education costs.

¹⁹ The Manual defines regular programs to be "[a]ctivities designed to provide grades K-12 students with learning experiences to prepare them for activities as citizens, family members, and non-vocational workers as contrasted with programs designed to improve or overcome physical, mental, social and/or emotional handicaps."

Conclusions and Recommendations

SASD's independent accountant should not have to determine how costs related to NHS are to be recorded. This information should be determined by PDE and transmitted to all public school districts that have an agreement with a private school to provide educational services to students residing in a "children's institution." The lack of specific oversight of the NHS/SASD contract by PDE allows this error to occur and creates the possibility that SASD and other school districts will record such costs improperly.

It is recommended that PDE provide guidance regarding the account codes to which SASD should record expenditures and revenues relating to NHS. This information should be transmitted to the LECS Comptroller's Office.

SASD should review this issue with its independent auditor and the LECS Comptroller's Office to determine the consequences, if any, of the overstatement of special education expenses.

SASD'S RESPONSE TO THE OBSERVATION

SASD declined to respond to the audit report.

NHS's RESPONSE

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S**

Youth Services

Peter J. Smith
Deputy Auditor General for Performance Audits/
Director, Office of Special Investigations
Department of the Auditor General
Room 327, Finance Building
Harrisburg, PA 17120

Re: Draft Special Audit of Tuition Rates Charged to Pennsylvania School Districts
by the Northwestern Academy

Dear Mr. Smith:

I am writing on behalf of Northwest Human Services of Pennsylvania, Inc. and NHS-Youth Services, Inc., in response to your letter to Alan Tezak dated April 23, 2004.¹ We appreciate the opportunity to review the draft Audit, and the extension of time that your office has given us to do so. We agree in principle with some parts of the draft Audit and disagree with others.

The title of the draft Audit refers to tuition rates charged by the Northwestern Academy, and page 3 of the draft Audit refers to "this special audit of NHS." We believe that that this technically misstates who charges the tuition, and we do not agree that an audit of NHS is encompassed by the authority given to the Department of Auditor General in 72 P.S. §§ 402 & 403. However, we acknowledge that we may be closest to the some of the relevant facts in this area and that we have a strong interest in the subject. Therefore, we respond below to the content of the draft Audit. However, this is not to be construed as a waiver of our position on this issue.

The Northwestern Academy serves a particularly challenging population, and does so comprehensively in a way that is recognized for its high value. The Northwestern Academy School provides part of that coordinated program. Each young person who is served by the Academy and the Academy School is placed at the Academy by a Juvenile Court Judge. They are commonly placed at Northwestern after experiencing multiple other placements, and they sometimes have been in those placements for two or three years. They bring with them a most challenging array of therapeutic, drug-related, and educational needs. Under the School Code, the Shamokin Area School District (SASD) has the responsibility for providing their education. Unable to fulfill that responsibility with its own pre-existing resources,

¹ *As in footnote 2 of the draft Audit, we see no problem referring to the operations of the Northwestern Academy collectively as "NHS," since each entity has owned and operated the Academy at relevant periods of time.*

SASD has contracted with NHS to augment those resources. The quality and extraordinarily high value of what we provide has been recognized this year, as the Pennsylvania Juvenile Court Judges

Commission selected one of the Academy's units as the Residential Program of the Year. This is, we believe, a deserved reflection of what we contribute to the Commonwealth's youth. Our program is intensive and well-coordinated. For example, our therapeutic staff and our education staff are cross-trained. Through such activities, we have avoided the coordination problems that plague other programs (including some of NHS') where therapeutic and education staffs are separately operated and operate in separate cultures, and where the programs are thus more wasteful and less effective in providing educational and other interventions.

We understand, of course, that the auditing of the education program that is provided by SASD and NHS affects several school districts. Because of the confusion that now exists, for example in the area of lease payments, there have been interruptions and other problems in terms of districts paying their bills. This adds yet another challenge to NHS' ability to operate an education program on SASD's behalf. NHS does not seek to operate the Academy School at a profit; nor are we seeking to operate the School so as to provide financial support to the Northwestern Academy site as a whole or to other NHS operations. It is, however, not tenable to operate the School -- which, after all, is a voluntary activity undertaken to assist SASD and to provide a superior package of interventions -- at a loss over the course of years. Our goal is to operate the Academy School in a way that is revenue-neutral to the operation of the larger Northwestern Academy effort. Consistent with this, what NHS seeks from the Commonwealth (including both the Department of Auditor General and the Department of Education) is a process that comes to a prompt resolution while causing a minimum of friction among the many entities involved. Therefore, NHS requests that the Audit not be finalized or distributed until the matters addressed below are resolved between NHS and the Department of Education.

It would, no doubt, be easier for NHS to simply relinquish this educational and financial challenge. That way, NHS would fulfill its commitment to the Juvenile Court system, and SASD would fulfill its responsibility under the Public School Code in some other way. This is certainly a possibility, but we think it is an undesirable option for the Commonwealth and for the school districts and the children whose lives we are working hard to improve.

Draft Audit Finding and Recommendations No. 1

Your draft Audit detected a mathematical error of \$2.49 in a rate used for 2001-2002, and your draft Audit reported that NHS staff confirmed the error. We again confirm it here. We propose to correct this in the context of the larger activities that will take place in relation to Audit Finding No. 2. If those activities result in larger changes relating to 2001-2002, NHS will ensure that they also correct for the \$2.49 error. If no other changes are made for 2001-2002, NHS will take steps to ensure that districts receive a credit or refund on account of the mathematical error.²

Draft Audit Finding and Recommendations No. 2

One of the issues raised in draft Audit Finding No. 2 is that, for special education students, home districts are billed a single amount, rather than being billed a standard tuition amount and another amount on account of the student being a special education student.³ We understand that this is different

² *A refund, rather than a credit, would be appropriate with regard to a district that was a "home district" for students in 2001-2002 but not for the year in which the correction is executed.*

³ *This issue is symbolized by the fact that you have bolded the words "in addition to" on page 8 of the draft Audit.*

than how the billing is expressed in 24 P.S. §13-1309(a)(2). NHS will provide SASD with information that will make it easy for SASD, in the future, to express the billing for special education students in two components, as indicated in the text of 24 P.S. §13-1309(a)(2).

Another of the issues raised in draft Audit Finding No. 2 is that billing for special education students has been based on start-of-year budgets (which the draft Audit characterizes as based on previous year's expenditures and/or management estimates).⁴ NHS agrees that it should develop a mechanism so that, ultimately, billings and payments are based on actual experience. This can only be known toward or after the end of the year. NHS thinks of the desired process as one of "reconciliation payments." That is, billings and payments based on expected costs will later be reconciled with actual experience. NHS has not yet concluded whether this can be done toward the end of a year or must be done after the end of a year. NHS agrees, however, to provide the calculations for such reconciliation payments, and to work with PDE to devise the acceptable timing for doing so.

The remainder of this Finding relates to the calculation of the billings for special education students. The draft Audit asserts a lack of time analyses or other demonstrated methodology for calculating the costs of educating special education students, and the draft Audit makes some comparisons with the special education accounting done by school districts. We do not agree with all of the inferences that might be drawn from some of your comparisons. However, we agree that, as PDE says in its Basic Education Circular on the subject, the host district may charge the district of residence an amount that does not exceed the total cost of the special education program provided minus the amount received per child from the Commonwealth under Section 2509.1(b). NHS agrees that it should recalculate the amounts billed for special education students and make any adjustments that result. This will, of course, be easier for the recently completed year and harder for earlier years.

Rather than come up with our own calculations or recalculations in isolation and then submit them to others, we have elected to work with PDE's Bureau of Budget and Fiscal Administration (including its Division of Subsidy Data and Administration) as we move forward. We have begun this process. Unfortunately, relevant PDE staff have not been very available to us in recent weeks, because of the current budget season. Although this has been frustrating, it is understandable. We hope that, with the budget crunch about to be over, we will be able (in concert with SASD whenever useful) to continue our work with PDE. Although the exact methodology will no doubt evolve, we hope to arrive at a mutually acceptable set of figures for the most current year, and then to explore whether and how to apply this work to prior years. Also, we anticipate that some techniques, such as time studies, may be implemented in the future even if it is impossible to reach back in time for such techniques. Where the optimal technique is impossible, we will do our best to provide an express method or rationale.

Draft Audit Finding and Recommendations No. 3

The draft Audit relies on a letter from a then-member of the Office of Chief Counsel (OCC) of the Pennsylvania Department of Education (PDE). That letter expressed the opinion that 24 P.S. § 1309(a)(1) means that a school district must incur capital expenses before that district can charge for a proportionate share under that statute.⁵ In a generally congenial but inconclusive meeting earlier this year, NHS was informed by Amy Foerster of OCC/PDE that her office was reconsidering its earlier letter. We are not privy to the progress or results of that reconsideration. Nor are we aware of whether

⁴ As we read the draft Audit, this issue is discussed most directly on pages 9 and 14.

⁵ Letter from Christine E. Waring (OCC/PDE) to Frank E. Garrigan dated April 30, 2003.

the Department of Auditor General (DAG) has formed its own judgment on the question. We would assume that, since DAG is aware that OCC/PDE has committed itself to reconsidering its position, DAG would not issue the final Audit until DAG has spoken with OCC/PDE about its legal interpretation.

NHS's response can be simply stated: NHS believes that OCC/PDE's legal interpretation is wrong, and that it would be wrong for the Department of Auditor General's Audit to rely on or incorporate that interpretation.

Naturally, we would prefer to resolve this issue without litigation. To assist the Departments of Education and Auditor General in reconsidering the content of OCC/PDE's 2003 letter, we make the following observations:

1. The position ascribed to PDE is not the product of a regulation or an adjudication. Rather, it is a letter from a staff member. Therefore, it cannot be used to establish what is referred to (pursuant to the Commonwealth Attorneys Act, the Commonwealth Documents Law, and the Regulatory Review Act) as a binding norm.
2. Section 1309 is quoted accurately on page 16 of the draft Audit. The first portion of the statute refers to situations in which certain actions are taken "for the accommodation of such children [described in § 1306]." Neither PDE nor the draft Audit has suggested that the actions in question were not taken legitimately for this statutory purpose. The actions in question were in fact taken legitimately for this purpose.
3. The next clause in § 1309 describes the action in question. That action is "to provide a separate school or to erect additional school buildings." This language does not support a conclusion that the only actions that "count" are actions that are funded with school district capital (or other) funds.
 - a. The statute does not limit itself to actions that were funded in any particular way.
 - b. The conjunction between providing a separate school or erecting additional school buildings is an "or." Thus, even if the statute was limited to school districts as the actors, the legitimate actions under the statute include both erecting and providing. Regardless of who is seen as erecting the building, the school district in question in fact provided an additional school building for the § 1306 students at issue.
 - c. The remainder of § 1309 states that, under actions that satisfy the preceding language, the inter-district charge can include a proportionate charge for:
 - (i) cost of operating expenses;
 - (ii) rental; and
 - (iii) interest on any investment required to be made in erecting such new school buildings.
 - d. In § 1309, the phrase "on any investment required . . ." cannot logically be attached to "the cost of operating expenses" or "rent." Therefore, the cost of operating expenses and rent stand, verbally in the statute, on their own as the subjects of "proportionate charge."
 - e. One does not pay "rent . . . on any investment." Therefore, again, the statutory inclusion of "rent" stands on its own.

- f. The plain language of § 1309 provides for proportionate charges for the rental necessary to provide a separate school for § 1306 students.
4. There is no rational relationship between the source of the capital expenditure and the purpose of §§ 1306-1309 that would support the distinction, between district-funded and privately-funded construction, made in the PDE staff letter. Thus, even if the statutory language were construed to be ambiguous, there is no reason to believe that the General Assembly intended to make this distinction.
5. Nor is there a rational policy basis for the Executive Branch to make this distinction. The host school district, *i.e.*, Shamokin Area School District (SASD) must educate the students regardless of whose money paid for the construction of the building as SASD fulfilled its educational responsibilities under § 1306. If the construction of the building had not been privately financed, it would have had to be publicly financed. In all likelihood, this would have entailed a direct Commonwealth contribution (and this Commonwealth contribution was saved through private development). Either way, the result is the same and there is no rational basis under § 1306 for favoring the publicly-funded erecting of buildings over the private funding of the same activity.

For these any other reasons, Finding #3 should be substantively reversed in, or deleted from, the final Audit. To the extent that the subject matter of the draft's Finding #3 is addressed in the final Audit, the final Audit should include a disavowal of the previous position of OCC/PDE, and should conclude that charges for rent are proper under § 1309(a)(1) without regard to whether the property being rented was erected with school district funds.

NHS requests that, in its final Audit, DAG explicitly state whether DAG: (a) continues to rely on the same interpretation of § 1306 as was written by PDE staff, (b) if so, whether it has adopted PDE's legal interpretation of § 1306 as DAG's own (or whether, instead, DAG is simply relying on PDE's interpretation as a matter of agnostic deference to a sister Department). NHS also requests that, in its final Audit, DAG explicitly state the appropriate avenue for seeking administrative or judicial review of the interpretation.

Summary

Notwithstanding the issue of DAG's authority under 72 P.S. §§ 402 & 403, NHS acknowledges the mathematical error referred to in draft Finding #1, will work with PDE's Bureau of Budget and Fiscal Administration toward finding a mutually agreeable method of supporting future calculations (and recalculations) of the cost of educating special education students, will devise a system of reconciliation accounting for the end of 2003-2004 and each future year, and asserts that the 2003 interpretation of 24 P.S. § 1309(a)(1) with regard to lease payments is wrong.

Thank you for this opportunity to respond to the draft Audit. If you have any questions or concerns, please do not hesitate to contact me.

Sincerely,



Michael J. Breslin
Senior Vice President

THE DEPARTMENT OF THE AUDITOR GENERAL'S ADDITIONAL COMMENTS

Comments concerning specific aspects of NHS's responses to individual findings are presented immediately after each finding and the related NHS response. In addition to those comments, we note our disagreement with any suggestion in NHS's response that the Department of the Auditor General does not have authority to audit NHS (see p. 29).

While nominally the tuition rate that provides the basis for payments to NHS is charged by SASD, in reality, the rates are calculated by NHS with SASD serving essentially as a vehicle through which the funds pass. The funds themselves are school district funds, the expenditure of which is subject to reimbursement by the Commonwealth and audit by the Department of the Auditor General.²⁰ NHS cannot reasonably take the position that the Academy provides essential educational program services to SASD and other school districts in accordance with requirements of the Public School Code and, at the same time, suggest that the funds it obtains for those services are not subject to audit by the agency authorized to exercise oversight over expenditure of those funds.

Finally, we decline to opine on the appropriate avenue for seeking administrative or judicial review of PDE's position in regard to the lease rental payments.

²⁰ 72 P.S. § 403 and opinions of the Attorney General relating to 24 P.S. § 25-2553.

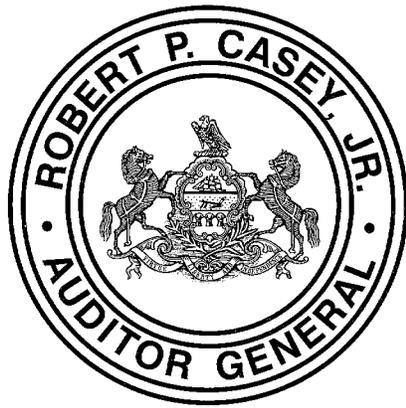
APPENDIX A

**School Districts That Paid NHS for Special
Education Services Provided During the 2001-2002 Fiscal Year**

SCHOOL DISTRICT	COUNTY	SCHOOL DISTRICT	COUNTY
Abington	Montgomery	Donegal	Lancaster
Allentown City	Lehigh	DuBois Area	Clearfield
Ambridge	Beaver	East Lycoming	Lycoming
Athens Area	Bradford	East Stroudsburg Area	Monroe
Bald Eagle Area	Centre	Eastern Lebanon County	Lebanon
Bellefonte Area	Centre	Elizabethtown Area	Lancaster
Bethlehem Area	Northampton	Gettysburg Area	Adams
Big Beaver Falls Area	Beaver	Greater Nanticoke Area	Luzerne
Big Spring	Cumberland	Hanover Area	Luzerne
Blackhawk	Beaver	Harrisburg City	Dauphin
Blue Mountain	Schuylkill	Hatboro-Horsham	Montgomery
Bristol Township	Bucks	Hazleton Area	Luzerne
Carbondale Area	Lackawanna	Hopewell Area	Beaver
Centennial	Bucks	Huntingdon Area	Huntingdon
Central Bucks	Bucks	Jersey Shore Area	Lycoming
Central Columbia	Columbia	Juniata County	Juniata
Central Dauphin	Dauphin	Lake-Lehman	Luzerne
Central York	York	Lancaster	Lancaster
Chester-Upland	Delaware	Lebanon	Lebanon
Chichester	Delaware	Lewisburg Area	Union
Cocalico	Lancaster	Lower Dauphin	Dauphin
Columbia Borough	Lancaster	Manheim Central	Lancaster
Conestoga Valley	Lancaster	Mechanicsburg Area	Cumberland
Connellsville Area	Fayette	Mid Valley	Lackawanna
Cornwall-Lebanon	Lebanon	Middletown Area	Dauphin
Cumberland Valley	Cumberland	Midland Borough	Beaver
Danville Area	Montour	Minersville Area	Schuylkill
Delaware Valley	Pike	Mohawk Area	Lawrence

**School Districts That Paid NHS for Special
Education Services Provided During the 2001-2002 Fiscal Year**

SCHOOL DISTRICT	COUNTY	SCHOOL DISTRICT	COUNTY
Montgomery Area	Lycoming	Shikellamy	Northumberland
Montoursville Area	Lycoming	Somerset Area	Somerset
Mount Union Area	Huntingdon	Souderton Area	Montgomery
Neshaminy	Bucks	South Williamsport Area	Lycoming
New Castle Area	Lawrence	Southeast Delco	Delaware
Norristown Area	Montgomery	Southern Lehigh	Lehigh
North Penn	Montgomery	Southern York County	York
Northern Lebanon	Lebanon	Spring Cove	Blair
Northwest Area	Luzerne	Springfield	Delaware
Palisades	Bucks	Spring-Ford Area	Montgomery
Palmyra Area	Lebanon	St. Marys Area	Elk
Penn-Delco	Delaware	State College Area	Centre
Pennsbury	Bucks	Stroudsburg Area	Monroe
Philadelphia City	Philadelphia	Sullivan County	Sullivan
Phoenixville Area	Chester	Titusville Area	Venango
Pleasant Valley	Monroe	Tri-Valley	Schuylkill
Pocono Mountain	Monroe	Tyrone Area	Blair
Pottstown	Montgomery	Upper Darby	Delaware
Pottsville Area	Schuylkill	Upper Perkiomen	Montgomery
Quakertown Community	Bucks	Valley View	Lackawanna
Reading	Berks	Wayne Highlands	Wayne
Red Lion Area	York	West Perry	Perry
Ridgeway Area	Elk	Western Wayne	Wayne
Riverside Beaver County	Beaver	Whitehall-Coplay	Lehigh
Rochester Area	Beaver	Wilkes-Barre Area	Luzerne
Sayre Area	Bradford	William Penn	Delaware
Scranton City	Lackawanna	Williamsport Area	Lycoming
Shade Central City	Somerset	Wyoming Valley West	Luzerne
		York City	York



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This report was distributed initially to officials of and attorney for Northwestern Human Services, members of the school board, the superintendent and the solicitor for Shamokin Area School District and to the following:

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The Honorable Barbara Hafer
State Treasurer

The Honorable Gerald Zahorchak
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