



**HAMBURG AREA SCHOOL DISTRICT
BERKS COUNTY, PENNSYLVANIA
PERFORMANCE AUDIT REPORT**

JUNE 2014

COMMONWEALTH OF PENNSYLVANIA

EUGENE A. DEPASQUALE - AUDITOR GENERAL

DEPARTMENT OF THE AUDITOR GENERAL





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EUGENE A. DePASQUALE
AUDITOR GENERAL

The Honorable Tom Corbett
Governor
Commonwealth of Pennsylvania
Harrisburg, Pennsylvania 17120

Mr. Brooke Adams, Board President
Hamburg Area School District
701 Windsor Street
Hamburg, Pennsylvania 19526

Dear Governor Corbett and Mr. Adams:

We conducted a performance audit of the Hamburg Area School District (District) to determine its compliance with certain relevant state laws, regulations, contracts, grant requirements, and administrative procedures (relevant requirements). Our audit covered the period May 17, 2011 through November 4, 2013, except as otherwise indicated in the report. Additionally, compliance specific to state subsidies and reimbursements was determined for the school years ended June 30, 2011 and June 30, 2012. Our audit was conducted pursuant to Section 403 of The Fiscal Code, 72 P.S. § 403, and in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States.

Our audit found that the District complied, in all significant respects, with relevant requirements, except as detailed in one (1) finding noted in this report. In addition, we identified one (1) matter unrelated to compliance that is reported as an observation. A summary of the results is presented in the Executive Summary section of the audit report.

Our audit finding, observation, and recommendations have been discussed with the District's management, and their responses are included in the audit report. We believe the implementation of our recommendations will improve the District's operations and facilitate compliance with legal and administrative requirements. We appreciate the District's cooperation during the conduct of the audit.

Sincerely,

A handwritten signature in black ink, appearing to read "Eugene A. DePasquale".

EUGENE A. DEPASQUALE
Auditor General

June 24, 2014

cc: **HAMBURG AREA SCHOOL DISTRICT** Board of School Directors

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Executive Summary

Audit Work

The Pennsylvania Department of the Auditor General conducted a performance audit of the Hamburg Area School District (District) in Berks County. Our audit sought to answer certain questions regarding the District's compliance with certain relevant state laws, regulations, contracts, grant requirements, and administrative procedures.

Our audit scope covered the period May 17, 2011 through November 4, 2013, except as otherwise indicated in the audit scope, objectives, and methodology section of the report. Compliance specific to state subsidies and reimbursements was determined for the 2010-11 and 2011-12 school years.

District Background

The District encompasses approximately 103 square miles. According to 2010 federal census data, it serves a resident population of 17,611. According to District officials, the District provided basic educational services to 2,375 pupils through the employment of 186 teachers, 136 full-time and part-time support personnel, and sixteen (16) administrators during the 2011-12 school year. The District received \$11,730,762 in state funding in the 2011-12 school year.

Audit Conclusion and Results

Our audit found that the District complied, in all significant respects, with certain relevant state laws, regulations, contracts, grant requirements, and administrative procedures, except for one (1) compliance related matter reported as a finding. In addition, we identified one (1) matter unrelated to compliance that is reported as an observation.

Finding: Possible Inaccurate Reporting of Retirement Wages. Our audit of the Hamburg Area School District (District) found that the District erroneously reported the payout of unused vacation and personal leave as retirement wages to the Public School Employees' Retirement System (PSERS). The information regarding these wages, totaling \$17,356, has been submitted to PSERS for review (see page 5).

Observation: The District Financed Some of Its Debt with Interest Rate Management ("Swap") Agreements, Which Resulted in a Net Loss of \$2.05 Million, Plus a Termination Fee of \$2.3 Million. On May 15, 2004, the Hamburg Area School District (District) entered into a swap agreement related to its issuance of \$25,000,000 of general obligation bonds. This yielded a net loss over the period of the swap agreement of \$2,054,689. The District terminated the swap agreement effective March 30, 2011. However, this termination resulted in an additional fee of \$2,386,000 (see page 8).

Status of Prior Audit Findings and Observations. There were no findings or observations in our prior audit report.

Audit Scope, Objectives, and Methodology

Scope

What is a school performance audit?

School performance audits allow the Pennsylvania Department of the Auditor General to determine whether state funds, including school subsidies, are being used according to the purposes and guidelines that govern the use of those funds. Additionally, our audits examine the appropriateness of certain administrative and operational practices at each local education agency (LEA). The results of these audits are shared with LEA management, the Governor, the Pennsylvania Department of Education, and other concerned entities.

Our audit, conducted under authority of Section 403 of The Fiscal Code, 72 P.S. § 403, is not a substitute for the local annual audit required by the Public School Code of 1949, as amended. We conducted our audit in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States.

Our audit covered the period May 17, 2011 through November 4, 2013, except for the verification of professional employee certification, which was performed for the period July 1, 2013 through September 9, 2013.

Regarding state subsidies and reimbursements, our audit covered the 2010-11 and 2011-12 school years.

While all districts have the same school years, some have different fiscal years. Therefore, for the purposes of our audit work and to be consistent with Pennsylvania Department of Education (PDE) reporting guidelines, we use the term *school year* rather than fiscal year throughout this report. A school year covers the period July 1 to June 30.

Objectives

What is the difference between a finding and an observation?

Our performance audits may contain findings and/or observations related to our audit objectives. Findings describe noncompliance with a statute, regulation, policy, contract, grant requirement, or administrative procedure. Observations are reported when we believe corrective action should be taken to remedy a potential problem not rising to the level of noncompliance with specific criteria.

Performance audits draw conclusions based on an evaluation of sufficient, appropriate evidence. Evidence is measured against criteria, such as laws and defined business practices. Our audit focused on assessing the District's compliance with certain relevant state laws, regulations, contracts, grant requirements, and administrative procedures. However, as we conducted our audit procedures, we sought to determine answers to the following questions, which serve as our audit objectives:

- ✓ Were professional employees certified for the positions they held?
- ✓ In areas where the District received state subsidies and reimbursements based on pupil membership (e.g., basic education, special education, and vocational education), did it follow applicable laws and procedures?

- ✓ In areas where the District received state subsidies and reimbursements based on payroll (e.g. Social Security and retirement), did it follow applicable laws and procedures?
- ✓ Did the District, and any contracted vendors, ensure that current bus drivers were properly qualified, and did they have written policies and procedures governing the hiring of new bus drivers?
- ✓ Did the District pursue a contract buy-out with an administrator and if so, what was the total cost of the buy-out, what were the reasons for the termination/settlement, and did the current employment contract(s) contain adequate termination provisions?
- ✓ Were votes made by the District's Board of School Directors free from apparent conflicts of interest?
- ✓ Did the District have sufficient internal controls to ensure that the membership data it reported to PDE through the Pennsylvania Information Management System was complete, accurate, valid, and reliable?
- ✓ Were there any declining fund balances that may pose a risk to the District's fiscal viability?
- ✓ Did the District take appropriate steps to ensure school safety?
- ✓ Did the District have a properly executed and updated Memorandum of Understanding with local law enforcement?
- ✓ Were there any other areas of concern reported by independent auditors, citizens, or other interested parties?

Methodology

Government Auditing Standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our results and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our results and conclusions based on our audit objectives.

What are internal controls?

Internal controls are processes designed by management to provide reasonable assurance of achieving objectives in areas such as:

- Effectiveness and efficiency of operations.
- Relevance and reliability of operational and financial information.
- Compliance with certain relevant state laws, regulations, contracts, grant requirements, and administrative procedures.

The District's management is responsible for establishing and maintaining effective internal controls to provide reasonable assurance that the District is in compliance with certain relevant state laws, regulations, contracts, grant requirements, and administrative procedures (relevant requirements). In conducting our audit, we obtained an understanding of the District's internal controls, including any information technology controls, as they relate to the District's compliance with relevant requirements that we consider to be significant within the context of our audit objectives. We assessed whether those controls were properly designed and implemented. Any deficiencies in internal controls that were identified during the conduct of our audit and determined to be significant within the context of our audit objectives are included in this report.

In order to properly plan our audit and to guide us in possible audit areas, we performed analytical procedures in the areas of state subsidies and reimbursements, pupil transportation, pupil membership, and comparative financial information.

Our audit examined the following:

- Records pertaining to pupil transportation, pupil membership, bus driver qualifications, professional employee certification, state ethics compliance, financial stability, reimbursement applications, tuition receipts, and deposited state funds.
- Items such as board meeting minutes and policies and procedures.

Additionally, we interviewed select administrators and support personnel associated with the District's operations.

Findings and Observations

Finding

Criteria relevant to the finding:

The Public School Employees' Retirement System (PSERS) allows only qualified salary and wages to be included for retirement purposes. According to Pennsylvania School Employees' Retirement Board Regulations, 24 Pa C.S. § 8102, reported compensation should exclude payments for unused sick leave or vacation leave.

Furthermore, PSERS' Employer's Reference Manual, Chapter 8, reiterates that reported compensation excludes, among other payments, those for "unused vacation and sick leave."

Possible Inaccurate Reporting of Retirement Wages

Our audit of the Hamburg Area School District (District) administrator's employment contracts, payroll, and retirement records found that retirement wages might have been overstated in reports submitted to the Public School Employees' Retirement System (PSERS) for the 2012-13 school year.

Three (3) administrative employees received payments for unused vacation and personal days at the end of their employment with the District. These payments were erroneously reported to PSERS for inclusion in retirement wages. Ineligible payments reported to PSERS for the three (3) administrators during the 2012-13 school year totaled \$17,356.

The District's Board of School Directors (Board) accepted resignations from three (3) former administrators with no clear effective date of resignation. District personnel included payments for unused vacation and personal days in retirement wages because they believed the official date of resignation was after all leave was used. However, our review of PSERS membership records found the three (3) former administrators immediately began employment with other education agencies that enrolled them in full-time membership with PSERS. Therefore, termination of employment was the last day worked at the District, and payments for the balance of vacation and personal days remaining at that time were ineligible for retirement wages.

Pennsylvania School Employees' Retirement Board Regulations, as well as language in the PSERS Employer's Reference Manual, prohibits the inclusion of cash payments for unused vacation and personal leave into the salary reported for retirement purposes. Although the Board has the authority to craft the terms of a contract to allow for a cash payment for unused vacation and personal leave, the Board may not supersede the PSERS benefit structure.

We have provided PSERS with a copy of our audit report and a report detailing the discrepancies for use in adjusting the individual's retirement wages.

Recommendations

The *Hamburg Area School District* should:

1. Contingent upon PSERS final determination, report to PSERS only those wages allowable for retirement purposes, as stated in Pennsylvania School Employees' Retirement Board Regulations and PSERS Employer's Reference Manual.
2. Implement procedures for reviewing all salary and contribution reports, in order to ensure that only eligible wages are being reported to PSERS for retirement contributions.
3. Ensure the Board only approves resignation requests with clear resignation dates that are consistent with any subsequent employment.

The *Public School Employees' Retirement System* should:

4. Review the propriety of the wages for the above employees and make any necessary adjustments.

Management Response

Management stated the following:

“For certain employees who resigned from the District, the payment of earned vacation and personal days was included as wages when reported to PSERS. Therefore, wages were possibly over-reported to PSERS for these employees.

The corrective action will be to document the correct reporting method in our payroll practices and for the business manager and superintendent to thoroughly review all payments made for vacation and personal day payments.”

Auditor Conclusion

We are encouraged that the District is taking action to address this deficiency. We will follow up on the status of our recommendations in our next cyclical audit of the District.

Observation



The District Financed Some of Its Debt with Interest Rate Management (“Swap”) Agreements, Which Resulted in a Net Loss of \$2.05 Million, Plus a Termination Fee of \$2.3 Million

Criteria relevant to the observation:

The Local Government Unit Debt Act, Act 177 of 1997, as amended by Act 23 of 2003 (53 Pa. C.S. § 8001 *et seq.*) authorizes local government units, including school district, to include qualified interest rate agreements in connection with the issuance of bonds and notes.

On May 15, 2005, the Hamburg Area School District (District) entered into a swap agreement related to its issuance of \$25,000,000 of general obligation bonds. The swap yielded a net loss of \$2,054,689. The District terminated the swap effective March 30, 2011, incurring an additional fee of \$2,386,000.

Current state law permits school districts and other local government units to enter into qualified interest-rate management agreements, known more commonly as “swaps.” Swaps are financial instruments that form a contract between a school district and an investment bank, speculating on the direction interest rates will move, as well as on other unpredictable factors. Specifically, the party to the contract that guesses correctly about whether interest rates will go up or down gets paid by the party to the contract that guesses incorrectly. This is called a swap interest payment. The amount of money changing hands is determined by several factors, including the amount of the debt associated with the swap and the overall fluctuation of interest rates.

Swaps allow school districts to enter into variable-rate debt financing, and thereby take advantage of low interest rates, while at the same time mitigating the possibility of those same interest rates rising. However, swaps are complicated, financial instruments that can cost money if the district judges incorrectly on which way interest rates will move. Likewise, districts can end up paying financial advisors, legal fees, and underwriting fees, especially if these services are not competitively bid and evaluated for independence. Additionally, swaps can cause districts to pay large termination fees to the investment banks.

For example, and as mentioned above, the District’s swap agreement yielded a net loss over the period of the agreement of \$2,054,689. The District terminated the swap agreement effective March 30, 2011. However, this termination resulted in an additional fee of \$2,386,000. Whenever the District terminates a swap, it should weigh

the cost of the fees against the potential long-term costs of maintaining the investment.

Recommendations

The *Hamburg Area School District* should:

Consider all the risks, including potential termination fees, when entering into any new swap agreements in the future.

Management Response

Management stated the following:

“The interest rate swap with the [bank] . . . was implemented to fix the interest rate being paid on a bond issue. The interest rate on the bond was variable, which meant the interest amount paid by the District each year was also variable and difficult to budget. The interest rate swap was entered into to fix the interest amount paid and eliminate the variability from interest payment to interest payment. Since the District agreed to pay the fixed rate, the District knew what the interest rate and payment would be for the life of the swap. There was no risk that the District would have to pay more interest than was agreed on, and so taxpayer funds could not have been jeopardized.”

Auditor Conclusion

While we certainly appreciate the District’s desire to budget more accurately with the fixed interest rate payments provided by the swap agreement, we reiterate our recommendation to consider all risks, including termination fees, when entering into future swap agreements.

Status of Prior Audit Findings and Observations

Our prior audit of the Hamburg Area School District resulted in no findings or observations.

Distribution List

This report was initially distributed to the Superintendent of the District, the Board of School Directors, our website at www.auditorgen.state.pa.us, and the following stakeholders:

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This report is a matter of public record and is available online at www.auditorgen.state.pa.us. Media questions about the report can be directed to the Pennsylvania Department of the Auditor General, Office of Communications, 231 Finance Building, Harrisburg, PA 17120; via email to: news@auditorgen.state.pa.us.