PERFORMANCE AUDIT

Scranton School District

Lackawanna County, Pennsylvania

October 2017

Commonwealth of Pennsylvania
Department of the Auditor General

Eugene A. DePasquale • Auditor General

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EUGENE A. DEPASQUALE
AUDITOR GENERAL

Dr. Alexis Kirijan, Superintendent
Scranton School District
425 North Washington Avenue
Scranton, Pennsylvania 18503

Mr. Bob Sheridan, Board President
Scranton School District
425 North Washington Avenue
Scranton, Pennsylvania 18503

Dear Dr. Kirijan and Mr. Sheridan:

Our performance audit of the Scranton School District (District) evaluated the application of best practices in the areas of finance, safety, and contracts. In addition, this audit determined the District's compliance with certain relevant state laws, regulations, contracts, and administrative procedures (relevant requirements). This audit covered the period July 1, 2012, through June 30, 2016, except as otherwise indicated in the audit scope, objective, and methodology section of the report. The audit was conducted pursuant to Sections 402 and 403 of The Fiscal Code (72 P.S. §§ 402 and 403), and in accordance with the Government Auditing Standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

During our audit, we found significant instances of failing to apply best practices and noncompliance with relevant requirements, as detailed in our nine findings. A summary of the results is presented in the Executive Summary section of the audit report. These findings include recommendations for the District.

Our audit findings 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 course of the audit.

Sincerely,

Eugene A. DePasquale
Auditor General

October 24, 2017

cc: **SCRANTON 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 District. Our audit sought to answer certain questions regarding the District's application of best practices and compliance with certain relevant state laws, regulations, contracts, and administrative procedures and to determine the status of corrective action taken by the District in response to our prior audit recommendations.

Our audit scope covered the period July 1, 2012, through June 30, 2016, except as otherwise indicated in the audit scope, objectives, and methodology section of the report (see Appendix). Compliance specific to state subsidies and reimbursements was determined for the 2012-13 through 2015-16 school years.

Audit Conclusion and Results

Our audit found significant instances of failing to apply best practices and noncompliance with certain relevant state laws, regulations, contracts, and administrative procedures, as detailed in the nine findings within this report.

Finding No. 1: Chronic Operating Deficits and a Negative General Fund Balance Have Led the District to Incur Unsustainable Amounts of Debt. The District experienced a significant financial decline during our audit period that resulted in a substantial negative General Fund balance which could place the District's future sustainability in jeopardy. We found that the District's General Fund balance decreased by more than $25 million and that the District had to borrow from other District restricted funds and also had to obtain General Obligations Bonds in order to sustain current operations (see page 13).

Finding No. 2: District Officials and the Board Failed to Perform Their Fiduciary Responsibilities Regarding a $26 Million Transportation Contract That Included over $4 Million in Questionable Fuel Surcharges over a 10-Year Period. The District continues to use the same primary transportation contractor (Contractor) since the 1990s. In the ten school years from 2007 through 2016, the District paid the Contractor $26.1 million. Most striking, however, was the trend of increasing payments during much of that period. The District did not effectively monitor the daily rate or analyze a compounding 4 percent fuel surcharge levied in a 2006 addendum (see page 29).

Finding No. 3: The District's Transportation Expenditures Significantly Exceeded PDE's Final Formula Allowance. The District's transportation expenditures exceeded the Pennsylvania Department of Education's (PDE) "final formula allowance" by more than $11 million during the 2012-13 through 2015-16 fiscal years. We found that the payment structure outlined in the District's transportation agreements were based on a per-vehicle daily rate, which did not align with the mileage calculations that PDE uses to reimburse school districts for transportation expenditures. As a result, the District had to use over $12 million in revenue, in addition to transportation reimbursement from PDE, to pay for transportation expenditures (see page 46).

<u>Finding No. 4: The District Incorrectly Reported the Number of Charter School and Nonpublic Students Transported Resulting in an Overpayment of $128,590</u>. The District was overpaid a total of $128,590 in transportation reimbursement from PDE. This overpayment was due to the District misreporting to PDE the number of charter school and nonpublic students that it transported (see page 54).

<u>Finding No. 5: For Over Twelve Years, the District Circumvented Payment Procedures, Improperly Provided Health Benefits, and Failed to Issue any of the Required Tax Documents to the IRS for a Mechanic Performing Services as a Non-Employee of the District</u>. For years, the District improperly paid a mechanic's business for services without an appropriate board-approved agreement and without issuing the annual Internal Revenue Service (IRS) Form 1099 or obtaining a completed IRS W-9 Form. Also, the mechanic was not an employee of the District; however, he received District provided health insurance since January 2006. The District provided medical and dental benefits to the mechanic and his spouse, a benefit that was both improper and *not* board-approved (see page 57).

<u>Finding No. 6: The District Offered Two Enhanced Retirement Incentives, One with Flawed Language, Both Without a Cost Analysis, Resulting in Increasing General Fund Liabilities</u>. Twice in three years, while the District was clearly in a declining financial position, it offered enhanced retirement incentives without a commitment to specific offsetting costs and without a prior cost-benefit analysis. As a result, the District added more than a million dollars to its ongoing General Fund liabilities, for the 2015 calendar year, without first demonstrating specific, projected cost savings or desired results (see page 68).

<u>Finding No. 7: The District Continued to Provide Health Insurance to Former Employees After the Employees Failed to Pay Their Premiums</u>. We found that the District failed to timely request and obtain overdue health insurance payments due from three former employees. Further, the District did not cancel health insurance coverage when payment was not received; therefore, the District was exposed to additional costs for former employees that should have been dropped from the insurance plan. Finally, our review of payment records for the three former employees disclosed that one of these prior employees still has an outstanding balance of $17,896 that the District failed to collect (see page 76).

<u>Finding No. 8: The District Entered Into Two Separatation Agreements With Former Employees That Resulted In Questionable Use of Taxpayer Funds and Possible Inadequate Reporting of Retirement Wages</u>. The Board voted to enter into separation agreements with its former Superintendent and former Solicitor, with each agreement containing provisions for transitional services and compensation. However, the District could not provide evidence of any work performed to justify the compensation. In addition, the District may have improperly reported ineligible retirement wages and service time to the Public School Employees' Retirement System (PSERS) for the period from July 1, 2014, to October 1, 2014 (see page 83).

<u>Finding No. 9: The District Had Weak Controls over IT Inventory</u>. The District's IT Department was responsible for purchasing and receiving IT equipment, controlling its distribution and disposal, and maintaining inventory records. However, the Business Office, the Superintendent, and the Board did not provide sufficient oversight of IT equipment inventory processes (see page 90).

<u>Status of Prior Audit Findings and Observations</u>.

With regard to the status of our prior audit recommendations to the District of an audit released on October 30, 2013, we found that the District had taken appropriate corrective action in implementing our recommendations pertaining to the membership reporting errors (see page 96), transportation reporting errors (see page 97), continued errors in health service data (see page 98), and financing debt with interest-rate management (Swap) agreements (see page 99).

However, we found the District had not taken appropriate corrective action in implementing our recommendations relating to transportation contractors being paid significantly more than the state's final formula allowance (see page 99).

Background Information

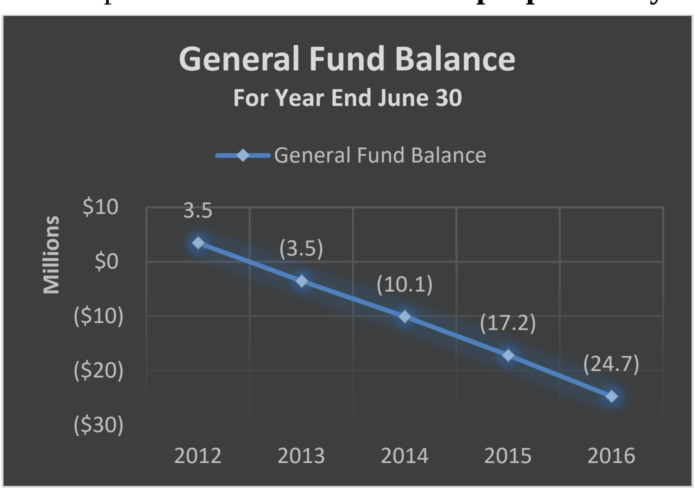
School Characteristics 2015-16 School Year[A]	
County	Lackawanna
Total Square Miles	25.3
Resident Population[B]	76,065
Number of School Buildings	18
Total Teachers	767
Total Full or Part-Time Support Staff	356
Total Administrators	45
Total Enrollment for Most Recent School Year	10,062
Intermediate Unit Number	IU 19
District Vo-Tech School	Career Technology Center of Lackawanna County

A - Source: Information provided by the District administration and is unaudited.
B - Source: United States Census http://www.census.gov/2010census

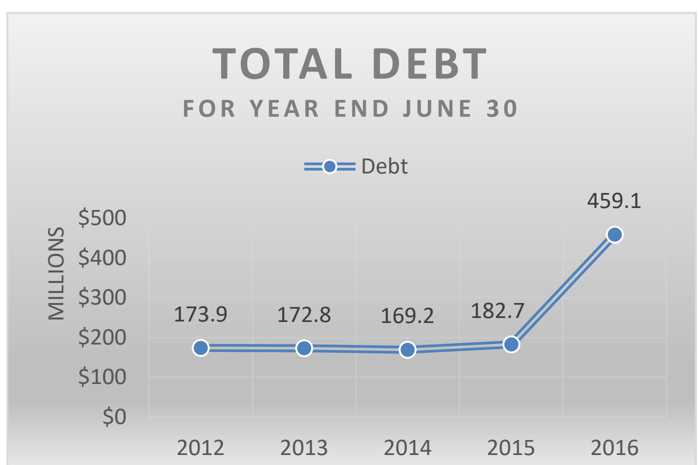
Mission Statement[A]
According to the District, it's mission is …
To educate, inspire, and empower students.

Financial Information

The following pages contain financial information about the District obtained from annual financial data reported to PDE and available on PDE's public website. This information was not audited and is presented for **informational purposes only**.

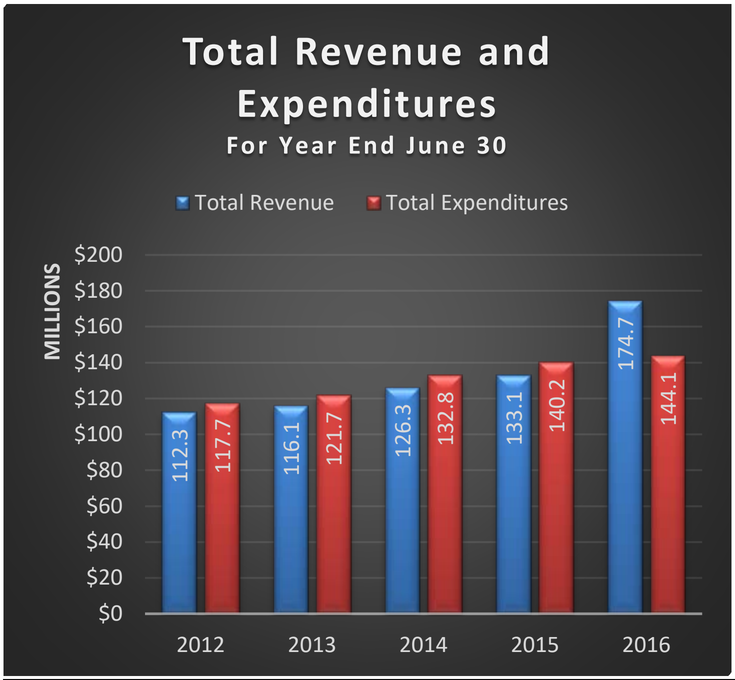


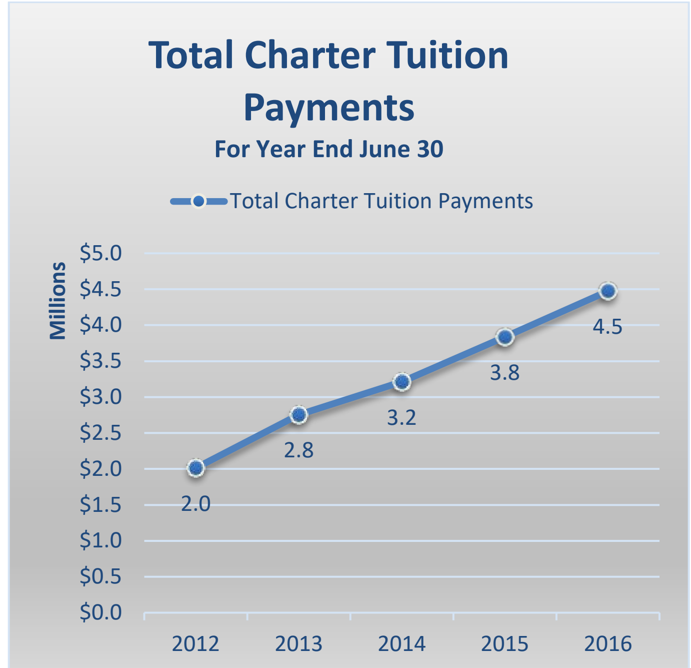
Note: General Fund Balance is comprised of the District's Committed, Assigned and Unassigned Fund Balances.

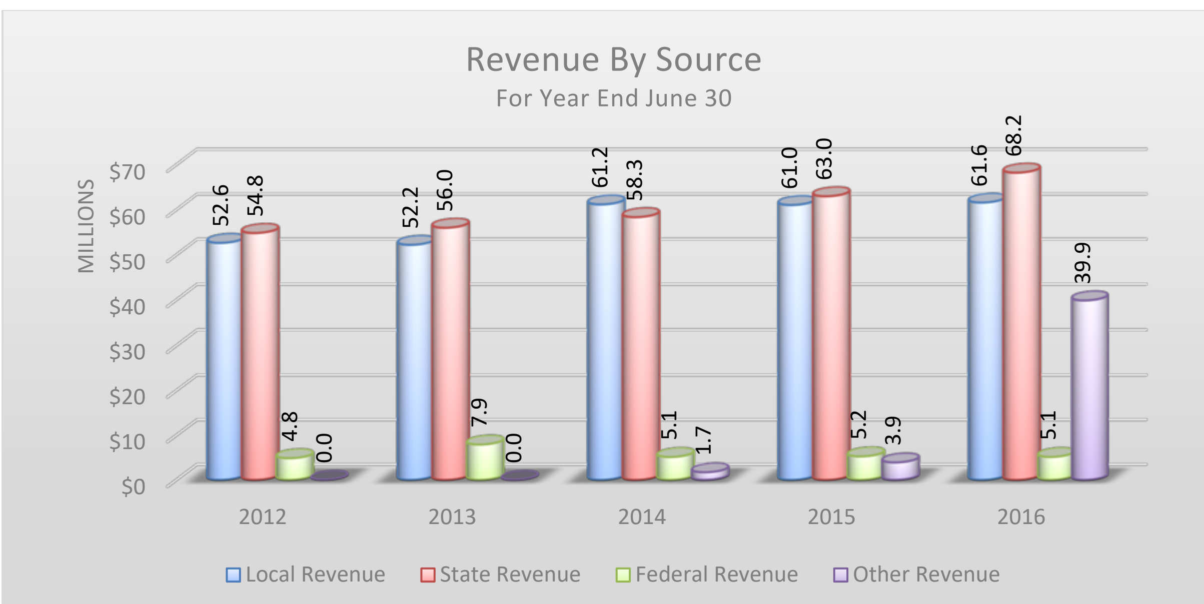


Note: Total Debt is comprised of Short-Term Borrowing, General Obligation Bonds, Authority Building Obligations, Other Long-Term Debt, Other Post-Employment Benefits and Compensated Absences.

Financial Information Continued







Academic Information

The graphs on the following pages present School Performance Profile (SPP) scores, Pennsylvania System of School Assessment (PSSA), Keystone Exam results, and 4-Year Cohort Graduation Rates for the District obtained from PDE's data files for the 2014-15 and 2015-16 school years.[1] These scores are provided in the District's audit report for **informational purposes only**, and they were not audited by our Department. Please note that if one of the District's schools did not receive a score in a particular category and year presented below, the school will not be listed in the corresponding chart.[2] Finally, benchmarks noted in the following graphs represent the statewide average of all public school buildings in the Commonwealth that received a score in the category and year noted.[3]

What is a SPP score?

A SPP score serves as a benchmark for schools to reflect on successes, achievements, and yearly growth. PDE issues a SPP score using a 0-100 scale for all school buildings in the Commonwealth annually, which is calculated based on standardized testing (i.e. PSSA and Keystone exams), student improvement, advance course offerings, and attendance and graduation rates. Generally speaking, a SPP score of 70 or above is considered to be a passing rate.

PDE started issuing a SPP score for all public school buildings beginning with the 2012-13 school year. For the 2014-15 school year, PDE only issued SPP scores for high schools taking the Keystone Exams as scores for elementary and middle scores were put on hold due to changes with PSSA testing.[4] PDE resumed issuing a SPP score for all schools for the 2015-16 school year.

What is the PSSA?

The PSSA is an annual, standardized test given across the Commonwealth to students in grades 3 through 8 in core subject areas, including English and Math. The PSSAs help Pennsylvania meet federal and state requirements and inform instructional practices, as well as provide educators, stakeholders, and policymakers with important information about the state's students and schools.

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[1] PDE is the sole source of academic data presented in this report. All academic data was obtained from PDE's publically available website.

[2] PDE's data does not provide any further information regarding the reason a score was not published for a specific school. However, readers can refer to PDE's website for general information regarding the issuance of academic scores.

[3] Statewide averages were calculated by our Department based on individual school building scores for all public schools in the Commonwealth, including district schools, charters schools, and cyber charter schools.

[4] According to PDE, SPP scores for elementary and middle schools were put on hold for the 2014-15 school year due to the state's major overhaul of PSSA exams to align with state Common Core standards and an unprecedented drop in public schools' PSSA scores that year. Since PSSA scores are an important factor in the SPP calculation, the state decided not to use PSSA scores to calculate a SPP score for elementary and middle schools for the 2014-15 school year. Only high schools using the Keystone Exam as the standardized testing component received a SPP score.

The 2014-15 school year marked the first year that PSSA testing was aligned to the more rigorous PA Core Standards.[5] The state uses a grading system with scoring ranges that place an individual student's performance into one of four performance levels: Below Basic, Basic, Proficient, and Advanced. The state's goal is for students to score Proficient or Advanced on the exam in each subject area.

What is the Keystone Exam?

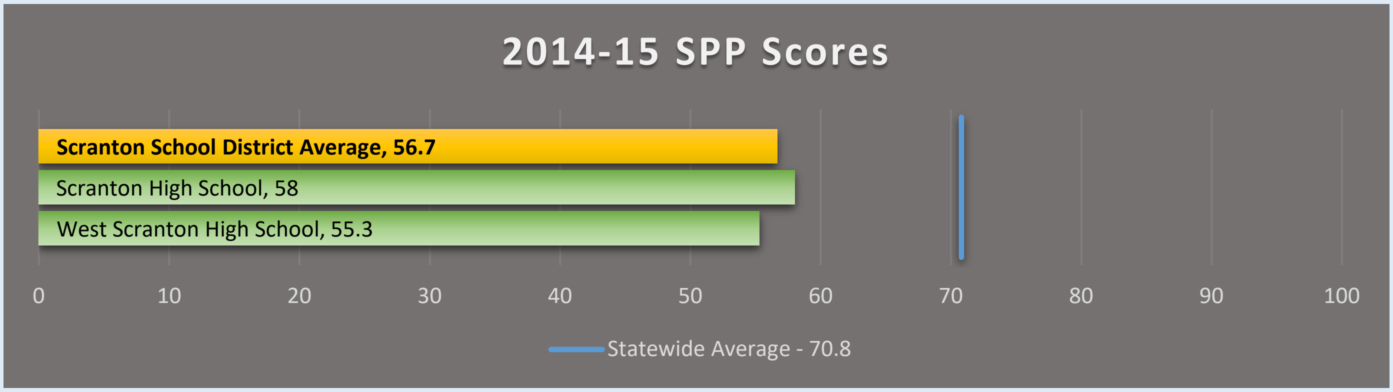
The Keystone Exam measures student proficiency at the end of specific courses, such as Algebra I, Literature, and Biology. The Keystone Exam was intended to be a graduation requirement starting with the class of 2017, but that requirement has been put on hold until at least 2020. In the meantime, the exam is still given as a standardized assessment and results are included in the calculation of SPP scores. The Keystone Exam is scored using the same four performance levels as the PSSAs, and the goal is to score Proficient or Advanced for each course requiring the test.

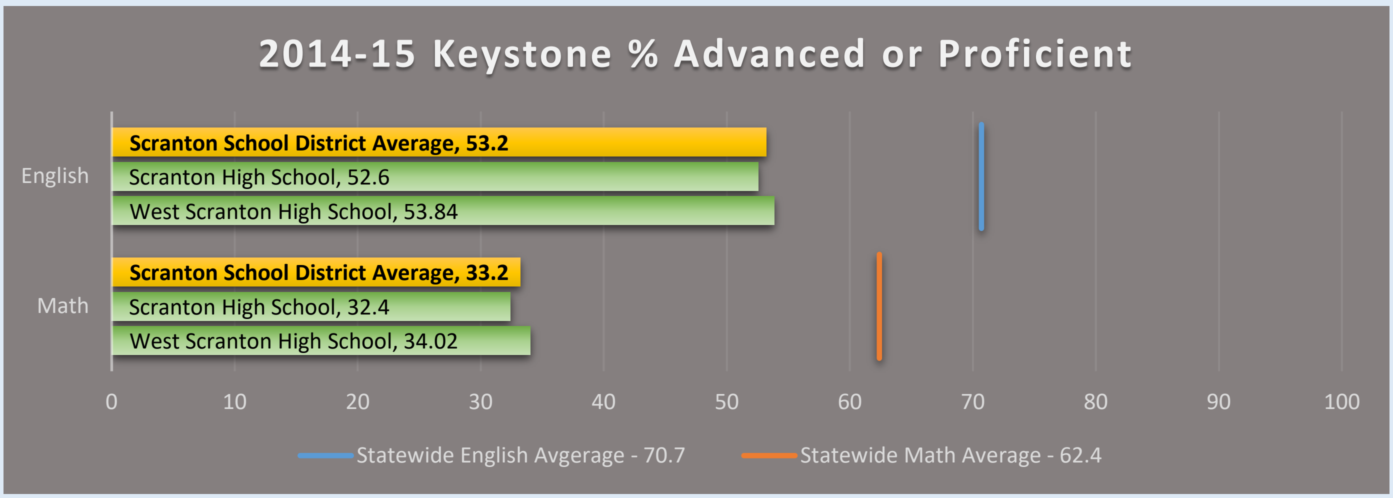
What is a 4-Year Cohort Graduation Rate?

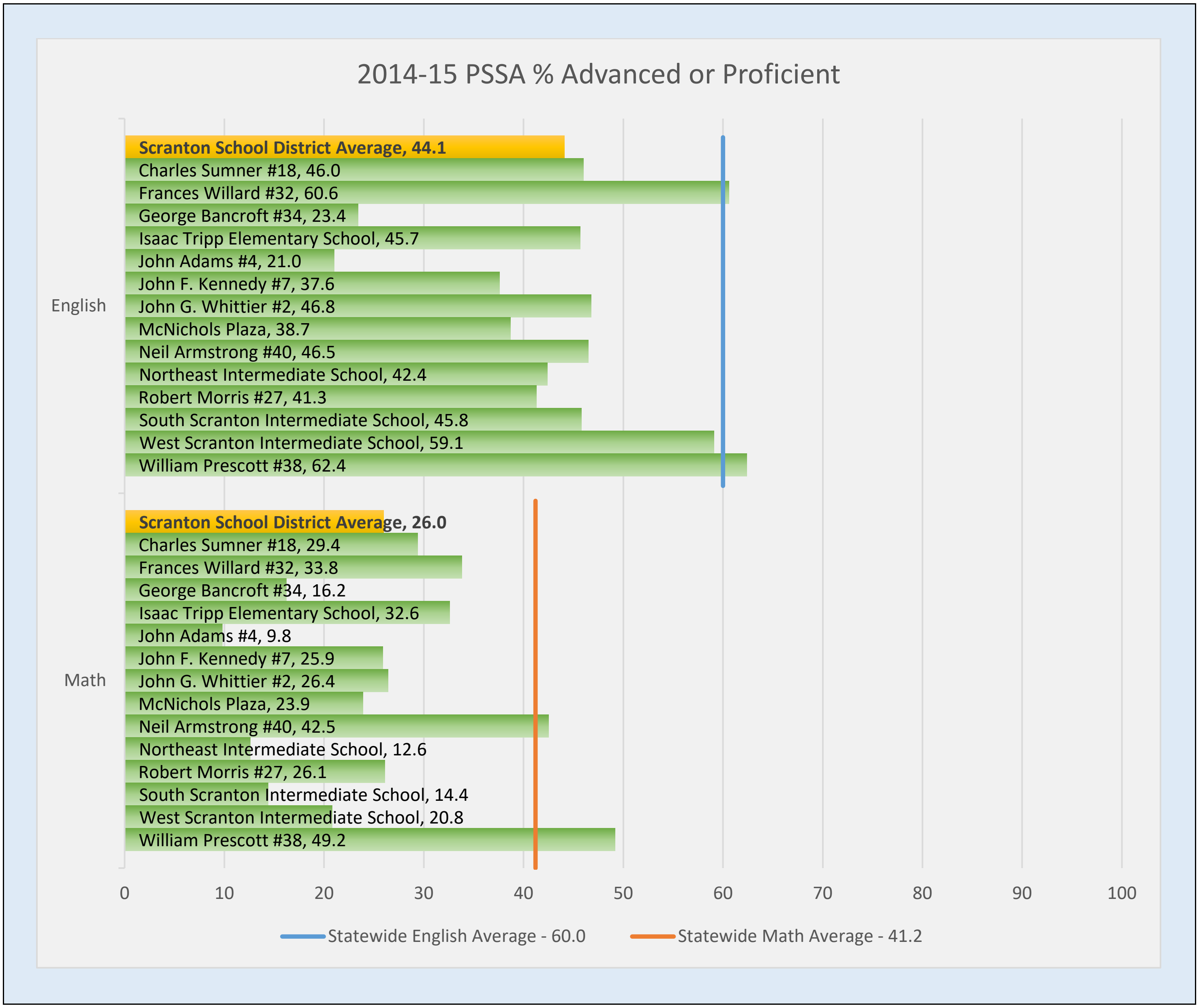
PDE collects enrollment and graduate data for all Pennsylvania public schools, which is used to calculate graduation rates. Cohort graduation rates are a calculation of the percentage of students who have graduated with a regular high school diploma within a designated number of years since the student first entered high school. The rate is determined for a cohort of students who have all entered high school for the first time during the same school year. Data specific to the 4-year cohort graduation rate is presented in the graph.[6]

[5] PDE has determined that PSSA scores issued beginning with the 2014-15 school year and after are not comparable to prior years due to restructuring of the exam. (Also, see footnote 4).
[6] PDE also calculates 5-year and 6-year cohort graduation rates. Please visit PDE's website for additional information: http://www.education.pa.gov/Data-and-Statistics/Pages/Cohort-Graduation-Rate-.aspx.

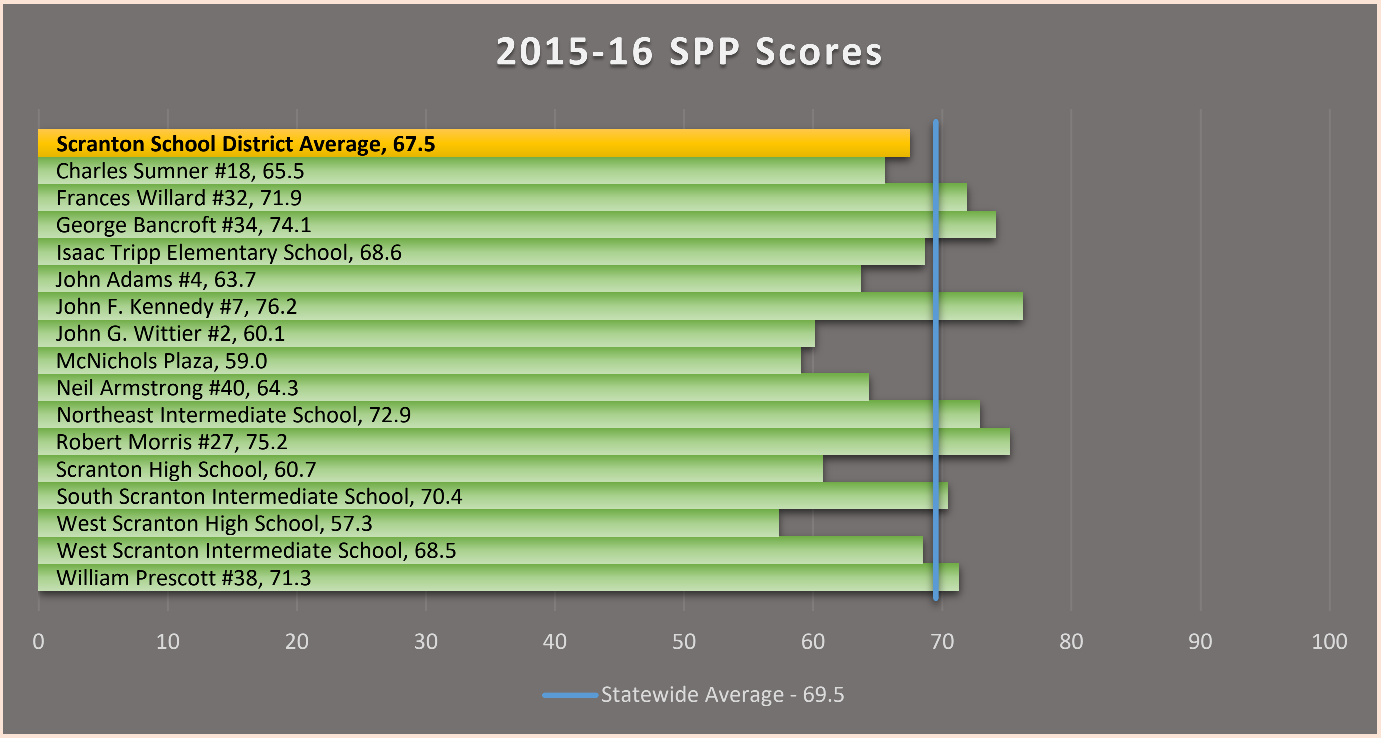
2014-15 Academic Data
School Scores Compared to Statewide Averages

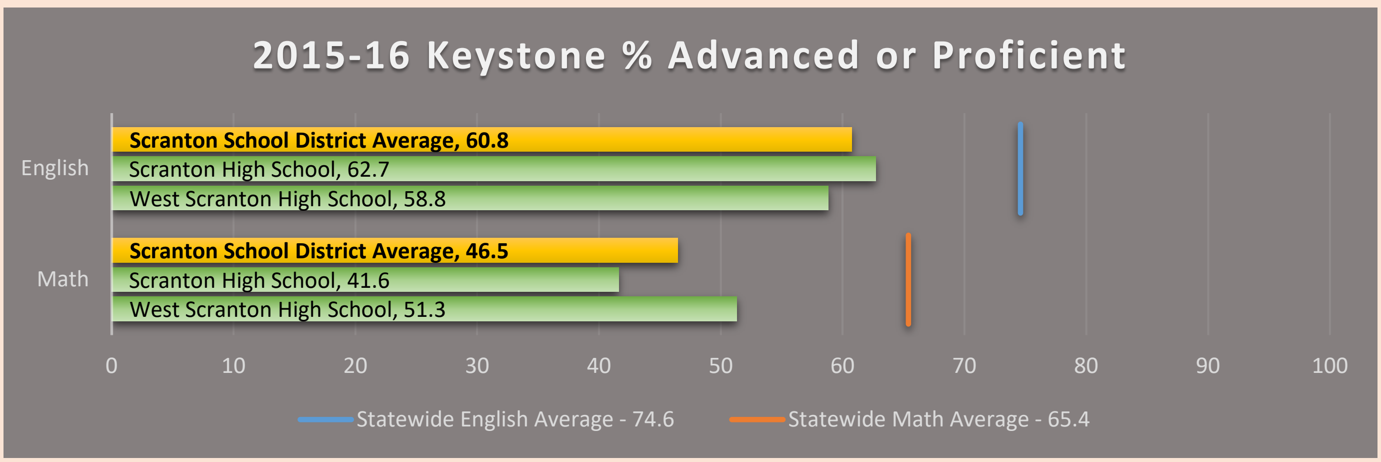


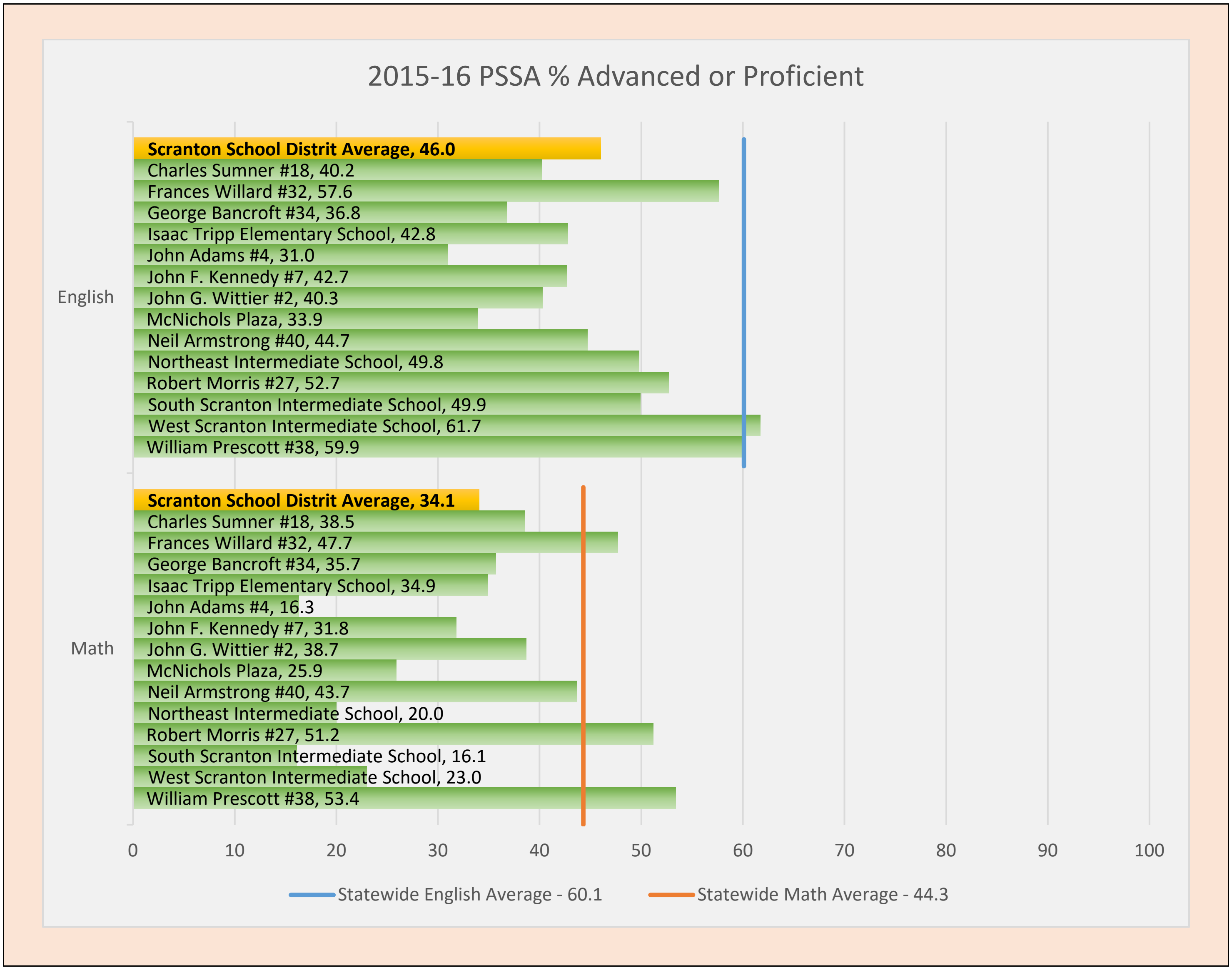



2014-15 PSSA % Advanced or Proficient
English
Scranton School District Average, 44.1
Charles Sumner #18, 46.0
Frances Willard #32, 60.6
George Bancroft #34, 23.4
Isaac Tripp Elementary School, 45.7
John Adams #4, 21.0
John F. Kennedy #7, 37.6
John G. Whittier #2, 46.8
McNichols Plaza, 38.7
Neil Armstrong #40, 46.5
Northeast Intermediate School, 42.4
Robert Morris #27, 41.3
South Scranton Intermediate School, 45.8
West Scranton Intermediate School, 59.1
William Prescott #38, 62.4
Math
Scranton School District Average, 26.0
Charles Sumner #18, 29.4
Frances Willard #32, 33.8
George Bancroft #34, 16.2
Isaac Tripp Elementary School, 32.6
John Adams #4, 9.8
John F. Kennedy #7, 25.9
John G. Whittier #2, 26.4
McNichols Plaza, 23.9
Neil Armstrong #40, 42.5
Northeast Intermediate School, 12.6
Robert Morris #27, 26.1
South Scranton Intermediate School, 14.4
West Scranton Intermediate School, 20.8
William Prescott #38, 49.2
0
10
20
30
40
50
60
70
80
90
100
Statewide English Average - 60.0
Statewide Math Average - 41.2

2015-16 Academic Data
School Scores Compared to Statewide Averages

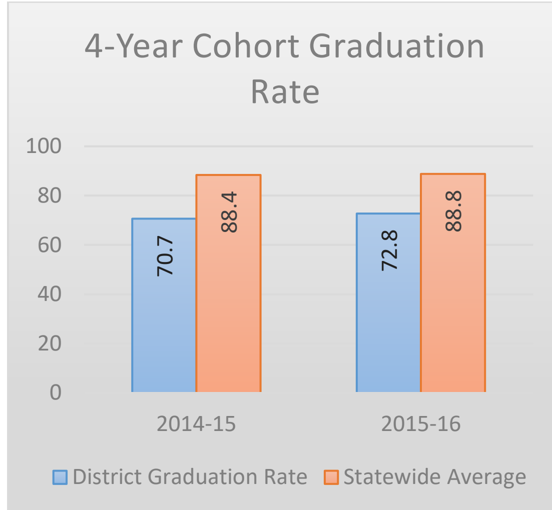





2015-16 PSSA % Advanced or Proficient
English
Scranton School Distrit Average, 46.0
Charles Sumner #18, 40.2
Frances Willard #32, 57.6
George Bancroft #34, 36.8
Isaac Tripp Elementary School, 42.8
John Adams #4, 31.0
John F. Kennedy #7, 42.7
John G. Wittier #2, 40.3
McNichols Plaza, 33.9
Neil Armstrong #40, 44.7
Northeast Intermediate School, 49.8
Robert Morris #27, 52.7
South Scranton Intermediate School, 49.9
West Scranton Intermediate School, 61.7
William Prescott #38, 59.9
Math
Scranton School Distrit Average, 34.1
Charles Sumner #18, 38.5
Frances Willard #32, 47.7
George Bancroft #34, 35.7
Isaac Tripp Elementary School, 34.9
John Adams #4, 16.3
John F. Kennedy #7, 31.8
John G. Wittier #2, 38.7
McNichols Plaza, 25.9
Neil Armstrong #40, 43.7
Northeast Intermediate School, 20.0
Robert Morris #27, 51.2
South Scranton Intermediate School, 16.1
West Scranton Intermediate School, 23.0
William Prescott #38, 53.4
0
10
20
30
40
50
60
70
80
90
100
Statewide English Average - 60.1
Statewide Math Average - 44.3

4-Year Cohort Graduation Rates

The cohort graduation rates are a calculation of the percentage of students who have graduated with a regular high school diploma within a designated number of years since the student first entered high school. The rate is determined for a cohort of students who have all entered high school for the first time during the same school year.[7]



[7] PDE also calculates 5-year and 6-year cohort graduation rates. Please visit PDE's website for additional information: http://www.education.pa.gov/Data-and-Statistics/Pages/Cohort-Graduation-Rate-.aspx.

Findings

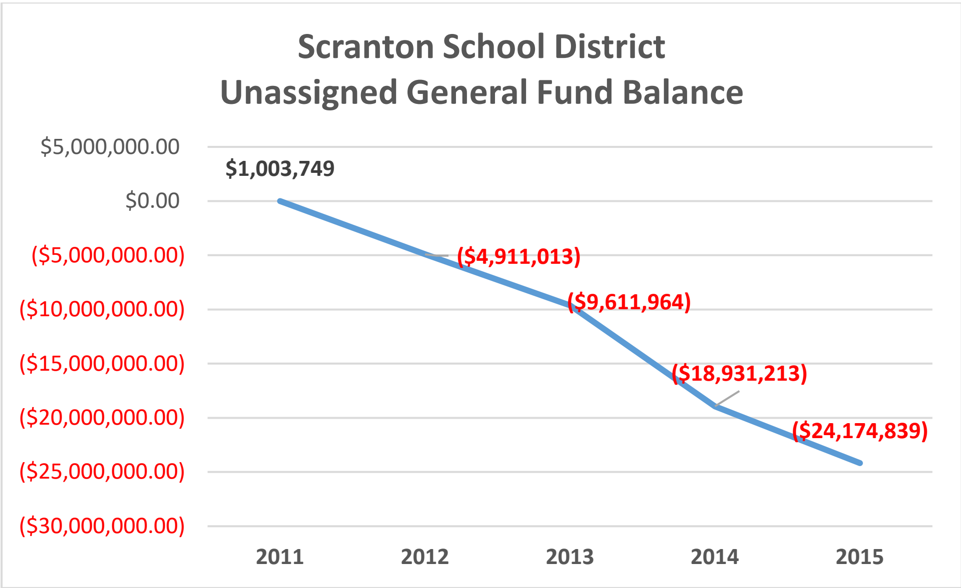
Finding No. 1	Chronic Operating Deficits and a Negative General Fund Balance Have Led the District to Incur Unsustainable Amounts of Debt

Criteria relevant to the finding:

Section (b) of Section 611-A (relating to Early warning system) the Public School Code (PSC) provides as follows: "(b) Duties.-- When a school district is identified through the early warning system for financial watch status, the department shall: (1) Notify the school district that the department has identified the school district for financial watch status. (2) Request from the school district all information necessary to enable the department to conduct a review of the school district's financial condition. A school district that receives a request for information under this paragraph shall provide the department with all information requested within 15 days. (3) Perform a thorough review of the school district's financial condition, which shall include a review of the information provided by the school district under paragraph (2) and which may include visits and correspondence with school district officers and employees. (4) Provide the school district with technical assistance appropriate to remedying the school district's financial difficulties, which may include, but shall not be limited to, contracting with financial consultants to assist the school district." *See* 24 P.S. § 6-611-A (b).

The District experienced a significant financial decline during our audit period that resulted in a substantial negative General Fund balance which could place the District's future sustainability in jeopardy. We found that the District's General Fund balance[8] decreased by more than $25 million as shown in Chart 1 below.[9]

Chart 1



The substantial decrease in the District's General Fund balance is the direct result of the District's cumulative operating deficit of over $25 million from January 1, 2012, through December 31, 2015. In other words, the District's General Fund balance was significantly depleted as rising expenditures outpaced revenues and created annual

[8] The District's entire General Fund balance was unassigned in the 2011 through 2014 calendar years. In 2015, the District had $38,241,255 restricted for debt service and health care that they secured through borrowings.
[9] Scranton School District is one of two districts in the Commonwealth that operate on a calendar year (1/1 to 12/31) budget as opposed to a fiscal year (7/1 to 6/30) budget.

Criteria relevant to the finding (continued):

The benchmarks used as criteria for this objective were based on best business practices established by several entities, including the Pennsylvania Association of School Business Officials, the Colorado State Auditor, and the National Forum on Education Statistics. The following are some of the benchmarks used in our evaluation:

1. Operating position is the difference between actual revenues and actual expenditures. Financial industry guidelines recommend that the district operating position always be positive (greater than zero).

2. A school district should maintain a trend of stable fund balances.

operating deficits. The District's negative $24.2 million unassigned General Fund balance as of December 31, 2015, highlights the need for the District to gain immediate control of its expenditures and generate sufficient revenue to not spend above the approved budget.

As detailed in the criteria box, it is considered best practice for school districts to maintain an unrestricted, or unassigned, fund balance of no less than 10 percent of General Fund operating revenues. With such a large negative General Fund balance, the District is far from operating in accordance with best practices.

Instead, we found that because the District did not have the fund balance to absorb the annual operating losses, the District had to borrow from other District restricted funds and also had to obtain General Obligations Bonds in order to sustain current operations. The additional borrowing will increase expenses by increasing interest expense on the bonds, thus exerting more financial pressure on the District.[10]

For example, with such a sizable negative General Fund balance, external borrowing will lead to higher borrowing costs as the District will be considered a high risk borrower. Increasing borrowing costs puts the District in a perpetual negative financial cycle, whereby the District may be unable to fund operations without continued borrowing and borrowing leads to additional future interest expenses.

The District's gross amount of debt currently outstanding and the projected yearly debt service payments call into question the District's continued ability to service such high debt obligations. The questions concerning the District's long term viability will continue unless the District is able to refinance current debt, fund expenditures with available revenue, and implement a strategic plan to control expenditures.

[10] The District's calendar year 2016 financial statements were not available for review during our audit. However, the preliminary financial statements show that the General Fund balance was expected to decrease to approximately negative $30 million.

Criteria relevant to the finding (continued):

The Government Finance Officers Association (GFOA) has developed Budgeting Best Practices for School Districts. Among the best practices are:

General Fund Reserve. School districts should establish a formal policy on the level of unrestricted fund balance that should be maintained in the general fund as a reserve to hedge against risk.

The GFOA recommends, at a minimum, that school districts maintain an unrestricted fund balance in their general fund of no less than 10 percent of regular general fund operating revenues or regular general operating expenditures and operating transfers out.

Budgeting and maintaining adequate fund balances allow school boards and superintendents to maintain their educational programs and services with level tax adjustments. They also provide financial stability in emergency situations so that it is certain that employees and vendors are paid on time. Fund balances reduce interest expense or interim borrowings. In addition, stable fund balance history appeals more to underwriters and other creditors when construction projects are undertaken and the school must enter the bond market.

On June 23, 2017, PDE placed the District on the financial watch status.[11] Being placed on the financial watch status will allow the District to receive financial technical assistance from PDE. PDE's decision to place the District on financial watch is a public acknowledgment of the District's questionable long-term viability and PDE's concerns with the District's current financial state.

The District will need to make significant operational changes and reverse the current state of financial affairs to avoid losing local control of District operations. Without a fundamental change to the current operations to improve the fiscal condition, the District may be placed in Financial Recovery Status[12] in the future. A district placed in Financial Recovery Status loses local control of district operations. The District's Board of School Directors will no longer have the authority to provide oversight of District operations. School districts in financial recovery status have a PDE appointed chief recovery officer whose responsibilities include oversight of the district and the development of a district-wide financial recovery plan.

Another public acknowledgement of the District's grave financial condition was issued by the District's independent auditor. The District's independent auditor issued a going concern paragraph after review of the December 31, 2015 financial statements. Auditors issue a going concern paragraph when the entity's financial condition is such that there is doubt as to the entity's ability to continue operating for a period of time that is sufficient to carry out its commitments, obligations, and objectives. The going concern paragraph issued by the independent auditor stated, in part:

> The School District's financial statements have been presented on the basis that it is a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of operations. . . . The District's ability to continue as a going concern is dependent on its success to refinance current debt and to fund expenditures with available revenue. The District's ability to continue as a going concern is also

[11] 24 P.S. § 6-611-A; see also *22 Pa. Code § 731.2* ("Early Warning System—Statement of Policy") effective September 8, 2012.
[12] 24 P.S. § 6-601-A *et seq.*

Criteria relevant to the finding (continued):

The Pennsylvania Schools Boards Association in its Annual Overview of Fiscal Health for the 2013-14 school year provided the following information relevant to the following fiscal benchmarks:

- Financial industry guidelines recommend that fund balances be between 5 percent and 10 percent of annual expenditures.
- Operating position is the difference between actual revenues and actual expenditures. Financial industry guidelines recommend that the district operating position always be positive (greater than zero).

The indebtedness of any school district shall never exceed fifteen (15) per centum of the last assessed valuation of property taxable for school purposes therein.

> dependent upon the District implementing a strategic plan to control expenditures. . . .

The remainder of this finding discusses the specific financial concerns we identified in the following seven areas:

1. Operating Position
2. Expenditures
3. Other Financing Uses (Lawsuit Settlements)
4. Revenues
5. A) Other Financing Sources (Internal Fund Transfers)
   B) Other Financing Sources (Long Term Debt)
6. Budgeting
7. Monthly Financial Reports

1. ***__Operating Position:__*** **The District experienced a cumulative General Fund operating deficit of $25,675,483 over the four calendar years from 2012 to 2015**.

A school district's General Fund operating position (revenue minus expenditures) is an important indicator of a district's financial health. The result of total expenditures exceeding total revenues is an operating deficit. The District's cumulative operating deficit of more than $25 million was the primary factor of the significant decrease in the General Fund balance. The District's annual operating position is shown in the table below.

__Table 1__

Scranton School District General Fund Operating Position[13]			
Calendar Year ended December 31	Revenues	Expenditures	Operating Surplus/(Deficit)
2012	$117,275,610	$120,624,983	($3,349,373)
2013	$120,412,601	$126,556,892	($6,144,291)
2014	$124,970,081	$136,956,968	($11,986,887)
2015	$132,428,288	$136,623,220	($4,194,932)
Total:	**$495,086,580**	**$520,762,063**	**($25,675,483)**

[13] Information obtained from Independent Auditors Reports, statements of revenue, expenditures, and changes in fund balance.

2. ***Expenditures:*** **District expenditures increased almost 13 percent, or $16 million, over the period primarily driven by the 28 percent increase in instructional expenditures.**

The District's total expenditures increased by 13 percent over the period reviewed (**See Table 1**). While support services expenditures[14] increased 7 percent, the major cause of the District's rising expenditures was the 28 percent increase in instructional expenditures.[15] The District's instructional expenditures increased from $74.6 million in 2012 to $95.7 million in 2015. District officials attributed the significant increase in instructional expenditures primarily to the increase in the salary and benefits for staff members. However, another component of instructional expenditures is the District's share of pension costs for their employees. The District's required contribution to PSERS more than doubled from 2012 to 2015, as shown in **Table 2** below.

Table 2

Scranton School District PSERS Costs	
Calendar Year	Amount
2012	$2,158,399
2013	$3,081,035
2014	$3,984,675
2015	$4,396,464
Total:	**$13,620,573**

The District entered into three contracts with the majority of District personnel (instructional staff).[16] The first contract began in September 2011 and was in effect until August 2014. The second contract was a one-year contract effective September 2014 through August 2015. The third contract in effect during our audit period was a two-year contract effective September 2015 through August 2017.

[14] Support services are those services that provide administrative, technical (such as guidance and health), and logistical support to facilitate and enhance instruction.
[15] Instructional expenditures include all those activities dealing directly with the interaction between teachers and students and related costs, which can be directly attributed to a program of instruction.
[16] Instructional staff are positions that require a teaching license to provide a service for the District.

All three contracts included step increases[17] that average between 2.5 percent and 3.1 percent. These contracts also contained minimal co-pays for health benefits.

District officials also pointed to rising charter school tuition payments as another cause of the annual operating deficits and the increasing instructional expenditures. Charter school payments increased during the audit period from $2.0 million in calendar year 2012 to $3.8 million for the 2015 calendar year.

In addition to increasing expenditures, the District also incurred significant costs that were classified as "other financing uses."[18] These types of costs, which are discussed below, are considered outside of normal operating costs, and they contributed to the District's annual operating deficits during the audit period.

***3. <u>Other Financing Uses:</u>* The District spent over $2.7 million during the audit period to settle special education lawsuits.**

The District paid $609,796 in 2012 and $2,125,389 in 2015 to settle special education lawsuits. These settlements alone reduced the District's General Fund by over $2.7 million and contributed to the District's annual operating deficits.

The District attributed the causes of these lawsuits and subsequent settlements to a myriad of issues including a lack of internal controls over progress monitoring, communication, and delegating workload. The District also cited a lack of training to ensure personnel understood special education guidelines and paperwork requirements.

According to District officials, after it identified the issues noted above, it took several actions to address them. These actions included implementing additional programs, creating a training manual, and adding job coaches. The District hopes these actions will help to ensure legal compliance and a reduction in special education lawsuits.

[17] An automatic increase based on years of service.
[18] Other financing uses represent the disbursement of governmental funds not classified in other functional areas that require budgetary and accounting controls. These include items that are considered outside of the normal expenses incurred during school district operations.

4. ***Revenue:*** **Total revenues increased, but were still not enough to cover the increases in expenditures.**

Total revenues increased by 13 percent over the four-year period reviewed. However, expenditures consistently exceeded revenues for each year reviewed which resulted in the drastic drop in the General Fund balance.

Local, state, and federal revenues are the three components of the District's "Total Revenues." The following table shows the composition of "Total Revenues" for the District from 2012 to 2015.

Table 3

Scranton School District Revenues By Source					
Source	**2012**	**2013**	**2014**	**2015**	**Increase/(Decrease) 2012 to 2015**
Local	$55,166,896	$55,946,631	$56,609,208	$60,597,694	9.8 %
State	$54,824,901	$57,138,417	$61,276,611	$65,234,881	19.0 %
Federal	$7,283,813	$7,327,553	$7,084,262	$6,595,713	(9.4) %
Total	**$117,275,610**	**120,412,601**	**$124,970,081**	**$132,428,288**	**13.0 %**

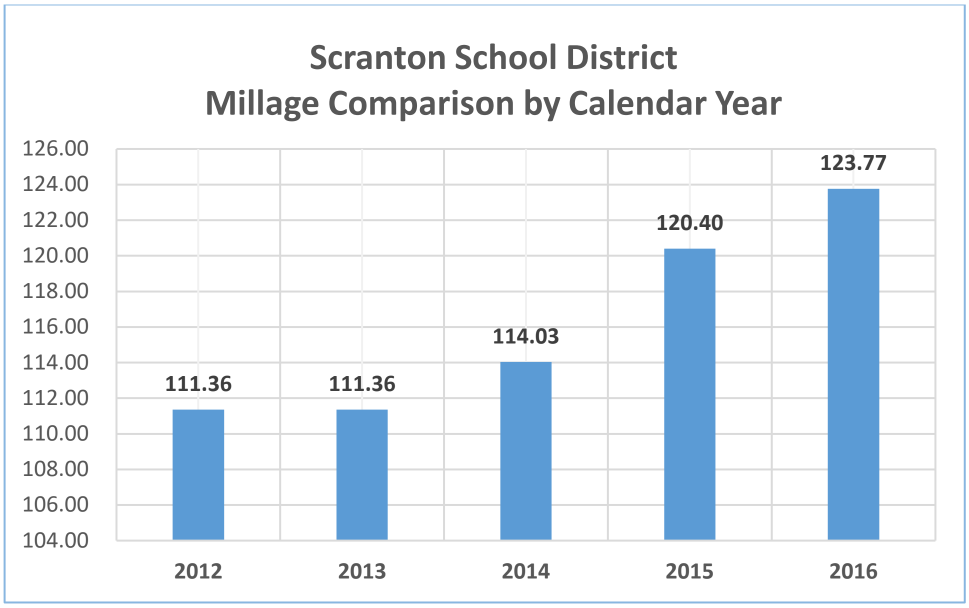
As the table above shows, state revenues increased by 19 percent, over the four-year period. By 2015, state revenues represented 49 percent of the District's total revenue. Table 3 also shows that local revenue increased, but not at the same rate as state revenue, while federal revenues, the smallest component of total revenues, decreased. The District was unable to fund daily operations without borrowing.

Local revenue is mainly comprised of property taxes and is the District's second largest revenue source. As shown in the chart below, the District did not raise millage rates in the 2013 year, even though it approved a budget for that year that estimated a year-end General Fund balance of $0.

However, the District did raise taxes for the next three consecutive years. We noted that the increases in 2014 and 2016 were equal to the Act 1 index for those years (2.4 percent in 2014 and 2.8 percent in 2016). In 2015, the District was able to increase millage rates to an amount above the Act 1 index by applying for and receiving exemptions from PDE due to increasing special education and retirement expenses.

The chart below shows the District's millage rates over the audit period and includes 2016.

Chart 2



We acknowledge that increasing the millage rate does not assure a corresponding increase in revenue due to the risk of a lower collection percentage. However, it is clear that during our audit period the District did not have a revenue generation plan to meet total District obligations. The failure to generate sufficient federal, state, and local revenues forced the District to turn to other financing sources.[19]

5a. <u>Other Financing Sources (Internal Fund Transfers):</u> **The District transferred from other District funds to sustain operations.**

As previously stated, without a sufficient General Fund balance to draw from, the District turned to transfers from other District funds to obtain the necessary funds to sustain operations. Normally, other financing sources would be a positive sign for a district, indicating revenue generation. However, in this case the District did not actually generate revenues but instead borrowed from its Capital Projects Fund. During the 2013 and 2014 calendar years, the

[19] Other Financing Sources are not classified as revenues in most fund types because the receipts are not earned by the school district. Other financing sources for a public school include proceeds from long term debt financing agreements, receipt from other funds of the school, and proceeds from the sale or compensation for the loss of fixed assets.

District transferred over $4 million from the Capital Projects Fund to meet debt service payments. The Debt Service Fund was replenished when the District engaged in long term borrowing during the 2015 year.

While interfund transfers are allowable per the PSC, the District's use of these transfers is concerning. While the transfers were needed to cover debt service payments, by transferring from the Capital Projects Fund, the District is, in essence, short term borrowing from itself and depleting both the General Fund and Capital Projects Fund. This "borrowing from Peter to pay Paul" is a short term maneuver that leads to unfunded working capital expenses and resulted in the District engaging in significant long term borrowing.

***5b. Other Financing Sources (Long Term Debt):* The District's operating deficits contributed to its significant long term debt.**

The District's cumulative operating deficits and deteriorating General Fund balance led to significant increases in its long term debt and future yearly debt service obligations. As of December 31, 2014, the District's total long-term debt was $132.4 million. In February 2015, the District borrowed another $62,055,000 which increased the total debt to more than $180 million.

The money borrowed in February 2015 was used to, among other things, replenish the General Fund, repay the District's outstanding Tax Anticipation Notes, and refinance previous bond issues. In 2016, the District borrowed nearly $8.5 million to offset the debt service payments.[20] The practice of continued borrowing to pay off previous borrowing is a troubling sign and shows the negative cycle that the District is in due to not being able to fund daily operations with its existing revenues.

One of the biggest concerns with increasing Long Term Debt is the borrowing costs that occur with significant bond issuances. For example, the District paid bond escrow costs of $11,530,000 and had additional bond issuance costs of $1,014,232 as a result of the debt incurred in February 2015. So while the District is paying principal

[20] The District confirmed that the following borrowing occurred in 2016. GO Notes 2016A in the amount of $5,625,000 and GO Bonds 2016B in the amount of $2,830,000. The purpose of both borrowings was to offset debt service payment in 2016 to balance the General Fund budget.

Criteria relevant to the finding (continued):

Section 609 of the PSC provides, in part:

"No work shall be hired to be done, no materials purchased and no contracts made by any board of school directors which will cause the sums appropriated to specific purposes in the budget to be exceeded." *See* 24 P.S. § 6-609.

District Board Policy 612, titled "Purchases Not Budgeted" states, in part: "The laws of the state and the interests of the community require fiscal responsibility by the Board in the operation of the school district. Appropriate fiscal controls shall be adopted to ensure that public funds are not disbursed in amounts in excess of the appropriations provided to the district."

and interest on the gross amount borrowed ($62,055,000), the net amount received after borrowing costs was less than $50 million.

Along with increasing total long term debt, the District has significant yearly debt service expenses. The following table shows the District's annual debt service expenses during the audit period and projected amounts up to and including the 2018 calendar year.

Table 4

Scranton School District Annual Debt Service Expenses	
Calendar Year Ending, December 31,	**Debt Service Expenses**
2012	$10,411,928
2013	$10,322,677
2014	$10,296,453
2015[21]	$5,000
2016	$13,805,278
2017	$14,600,917
2018	$15,165,789

The District's significant future debt service requirements will increase yearly expenditures and may compel the District to try to refinance yet again. Additional refinancing transactions would result in incurring additional refinancing costs, which would exacerbate the cycle of increasing debt and debt service to meet operational needs and lead to questions about the District's viability as an ongoing entity.

6. ***Budgeting:*** **The District was in noncompliance with the Public School Code when it spent more than the amounts budgeted in each year of the audit period.**

The PSC requires that all school districts develop a balanced General Fund budget each year. In addition, the PSC prohibits districts from spending more than the amount budgeted. While the District developed a balanced General Fund budget each year of our audit period, it

[21] The District had only $5,000 of yearly debt service expense in 2015 due to the $62,055,000 bond issuance that occurred in February of that year. This refinancing delayed debt service expenses to future years.

over-expended the budget by a significant amount in each year.

The following table shows the District's actual General Fund expenditures compared to budgeted amounts for each year.

Table 5

Scranton School District Comparison of Budget vs. Actual General Fund Expenditures			
Calendar Year Ending, December 31,	*Budgeted* Expenditures	*Actual* Expenditures	(Under)/Over Budget
2012	$114,957,445	$120,624,983	$5,667,538
2013	$120,425,990	$126,556,892	$6,130,902
2014	$126,269,675	$136,956,968	$10,687,293
2015	$134,693,606	$136,623,220	$1,929,614
Total:	**$496,346,716**	**$520,762,063**	**$24,415,347**

We reviewed the budgeted expenses for all line items and compared them to actual expenses and found that the "regular instruction" expenditure was significantly over budget. Over the four year period we reviewed, actual regular instructional expenses[22] were more than $16 million than budgeted. This one item alone represented 67 percent of the total $24.4 million of expenses exceeding the budgeted amount.

As discussed earlier in the finding, the District attributed the significant increase in instructional expenditures to the increase in the salary and benefits for staff members, along with an increase in charter school costs and mid-year program additions.

However, salary expenditures are a relatively known cost to the District and should have been more accurately budgeted. Actual costs exceeding budgetary amounts so significantly for salary and benefits is concerning. While under-budgeting instructional expenditures aided the District in preparing a balanced budget, adding new employees to the payroll after the budget was approved resulted in actual expenditures being considerably higher than budgeted.

[22] Includes but is not limited to teacher salary and benefit costs, professional and technical services, supplies, and other purchased services.

Criteria relevant to the finding (continued):

Section 440 (relating to Deposit of funds; monthly reports) of the PSC provides:

"The treasurer of each school district shall deposit the funds belonging to the school district in the school depository, if any, as directed by the board of school directors, and shall at the end of each month make a report to the school controller, if any, and to the secretary of the board of school directors, of the amount of funds received and disbursed by him during the month. All deposits of school funds by any school treasurer shall be made in the name of the school district." *See* 24 P.S. § 4-440.

The District is one of only two districts in the Commonwealth that operates on calendar year budget. We recognize that operating on a calendar year can complicate budgeting for expenditures since information for school year program additions and the need for new hires is not always available when the budget is approved in December. Therefore, the District should carefully consider the financial impact of mid-year program additions as well as adding new employees and it should try to limit them to only what is required and can be funded.

7. ***Monthly Financial Reports:*** **The District was in noncompliance with the Public School Code when it failed to timely submit the monthly treasurer's reports to the Board.**

We reviewed board meeting minutes for the four-year period and found that the District failed to provide the Board with timely treasurer's reports. The PSC requires that the monthly treasurer's reports be prepared and presented to the Board. The PSC further details the content of the reports. Of the 55 instances where a treasurer's report was due, 6 monthly reports were never provided and the remaining 49 were provided untimely. On average, the monthly treasurer's reports were submitted three months after they were due. Failure to timely provide monthly treasurers reports to the Board results in noncompliance with the PSC and it reduces the transparency of the financial operations. It is very concerning when a school board is not provided with timely financial reports. It is imperative that the Board requires timely treasurer's reports so financial activities can be more closely monitored.

As discussed throughout this finding, the District's financial position was severely deteriorating during this time. Therefore, it was imperative that the Board received timely Treasurer's reports to ensure it had enough information to make informed decisions. District officials indicated that, at times, the Board was provided with cash reports, but we found that those reports did not include the budget to actual detail of expenditures that is needed to monitor expenses to ensure the District's budget is not over-expended.

District officials attributed the tardiness of some of the Treasurer's reports to the bank reconciliation process and the budget stalemate that occurred from September 2015 through November 2015. However, our review showed the tardiness of the reports to be a habitual problem that occurred throughout the entire four-year audit period.

<u>Conclusion</u>

The District's failure to live within its annual budgets and control expenditures and generate enough revenue to meet expenditures without borrowing is very alarming. It resulted in a cumulative operating deficit that reduced the District's General Fund balance to negative $24 million. District expenditures, particularly in the area of instructional expenses, outpaced revenue annually and the resulting operating deficit and negative General Fund balance leaves the long term viability of the District in question.

The District must change the course of its current financial path. The District must work to live within its' annual budget as required by the PSC, and to strategically reduce expenditures so that operating expenses can be funded by current revenue streams without the District needing to incur additional costs through borrowing. Continuing the cycle of long term borrowing to meet operational expenses will only increase future costs and force future District stakeholders to deal with the negative financial consequences.

Recommendations

The *Scranton School District* should:

1. Prepare a multi-year budget that adequately reflects annual commitments to help ensure that the District is prepared to meet future obligations.

2. Evaluate all revenue streams and discuss the possibility of increasing local revenue through an increase in property taxes to help with the contracted increase in instructional expenditures.

3. Ensure that the District's Board is provided with sufficient, reliable, and accurate information in order to make informed decisions.

4. Develop a District policy that prohibits transferring from the Capital Projects Fund to subsidize General Fund operations.

Management Response

District management provided the following response (verbatim):

"The Scranton School District in March of 2017 through the efforts of the Superintendent of Schools and the Board of School Directors authorized a grant to allow PFM Group at the request of the Pennsylvania Department of Education to conduct a study and forecast projection for a multi-year plan. Prior to the study being released by PFM, the Pennsylvania Department of Education placed the District on Financial Watch Status. The Superintendent of Schools is working with the Department of Education to coordinate technical assistance for the School District. As of this date the School District is currently awaiting word for assistance from PDE.

The School District has been aware of the concerning financial condition and despite the outcomes has been attempting to make changes to resolve these financial conditions.

The District acknowledges that the General Operating deficit has grown since 2012. There were several renewals of contracts and additional staff that *[sic]* during this period that was necessary and not budgeted for. The School District was aware of the PSERS increases but was not in a position to address this issue for the future due to the fact that it was providing a high quality education and providing a workable budget and was trying to have the pension crisis addressed by the legislators who have adjusted the rates over the years to create this cost spike.

The School District acknowledges that during the audit period spending occurred to settle several Special Education lawsuits. The District Solicitor and Former Director of Special Education worked in limiting the District's exposure and to work through reducing the District's exposure to unnecessary litigation and costs.

The School District Board of Directors has in the past levied millage increase in an attempt to provide additional

Local Revenue to meet expenses. The Board of Directors take the responsibility of levying millage quite seriously due to the shrinking tax base that is within the city limits as well as the elderly population.

The School District acknowledges that in two consecutive years it transferred funds in order to pay debt service expenses that were budgeted for revenue but not received. The School District in 2014, hired a financial consultant to address this revenue shortfall through debt refinancing. The School District did and continues to address issues with long term debt issuance in accordance with the Local Government Unit Debt Act. All necessary State and Federal approvals were obtained in order to issue the long term debt. The School District is confident that it meets all the legal and financial requirements in issues of the long term debt and is in compliance with the Pennsylvania School Code.

The District acknowledges that it spent more money than budgeted during the audit period. Contrary to what is contained in the report, each of the adopted budgets were presented true and correct for approval and implementation in the beginning of each year. The annual budgets were not understated during any time. Estimates for Health Care and additional staffing needs contributed to the increased cost along with revenue estimates not received during the specific year.

The District acknowledges the delay in submitting the Treasurer's reports for School Board approval. While it appears past practice was to submit for Board approval 1 to 2 months after the close of the month some months were delayed more than others. While the District noted some possible reasons for the delay it does not state those were the sole cause and they were offered merely as an example. While we acknowledge that the timing of a scheduled Board meeting may impact the date of acceptance the District realizing the importance of timely and accurate reporting has instituted a policy that the School Board will be given a copy of the Treasurer's report immediately following the close of the month with a vote for approval happening at the next schedule Board meeting. The Administration prepares monthly revenue and expenditures reports that is submitted to the Board of Directors for review. This practice remains in effect and is provided to the Board of Directors during the year of over expenditures.

The School District is currently working with PFM Group and the Department of Education to provide multiyear budgets to identify areas that can be addressed in the future. The Scranton School District is well aware of the issues that it currently faces regarding the financial picture and are working to reduce unnecessary costs and maximize revenue. With cooperation from The Board of Directors, The Pennsylvania Department of Education, PFM Group and the Commonwealth that outcome can be attained."

Auditor Conclusion

We are encouraged that the District has acknowledged the myriad of financial issues that are presented in this finding. We are pleased that the District has begun working with a financial management group to develop action steps to help the District recover from its severely declining financial position. Further, we appreciate the corrective actions taken to implement strategies to reduce special education lawsuits and to provide timely treasurer's reports to the Board. During our next audit of the District, we will review and evaluate the effectiveness of these actions and any other corrective actions implemented by the District.

Finding No. 2	District Officials and the Board Failed to Perform Their Fiduciary Responsibilities Regarding a $26 Million Transportation Contract That Included Over $4 Million in Questionable Fuel Surcharges over a 10-Year Period

Criteria related to the finding:

Public School Code (PSC) Provision Relating to the Duties of the Board President

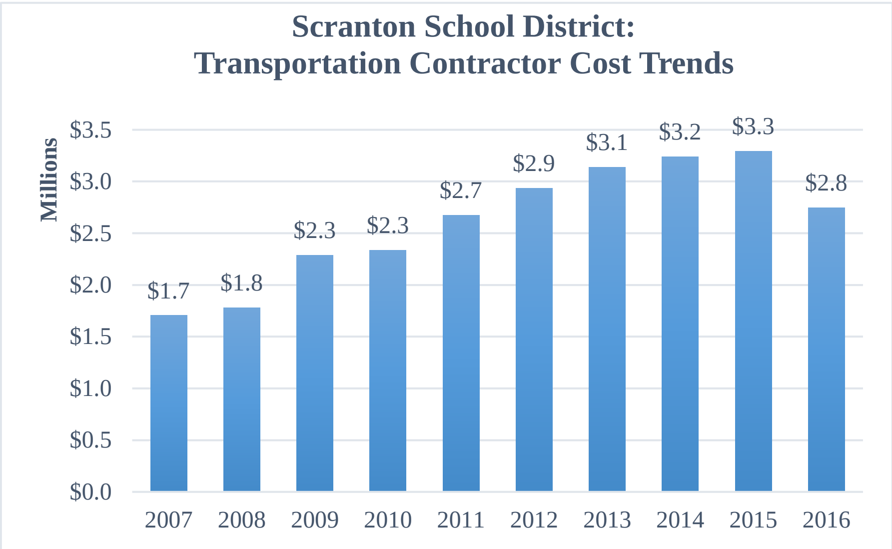
Section 427 of the PSC states that "[t]he [P]resident shall be executive officer of the board of school directors and as such he, together with the secretary, when directed by the board, shall execute any and all deeds, contracts, warrants to tax collectors, reports, and other papers pertaining to the business of the board, requiring the signature of the president." *See* 24 P.S. § 4-427.

Chapter 23 (relating to Pupil Transportation) of the State Board of Education Regulations provides that a school district's board of directors is responsible for the negotiation and execution of contracts or agreements with contractors, drivers of District vehicles, and common carriers. *See* 22 Pa. Code Chapter 23.

Section 23.4 (relating to Responsibilities of the district board of school directors) of the regulations states as follows, in part: "The board of directors of a school district is responsible for <u>all aspects</u> of pupil transportation programs, including the following: . . . (2) The selection and approval of appropriate vehicles for use in district service and eligible operators who qualify under the law and regulations . . .

The District continues to use the same primary transportation contractor (Contractor) since the 1990s. In the ten school years from 2007 through 2016, the District paid the Contractor $26.1 million. Most striking, however, was the trend of increasing payments during much of that period, as shown in the chart below.

<u>Chart 1</u>



The primary driver of the rising costs was the significant increases in the daily rate, which was the dollar amount that the Contractor billed to the District for each bus in operation each day. The District did not effectively monitor the annual daily rate, and the rate increased from a contracted rate of $193.13 in school year 2006 to $306.54 in 2016, a 59 percent increase over a ten-year period. We found that the daily rate increased not only because of a 3 percent annual increase in the daily rate that was built into the original contract, but also because of an additional, compounding 4 percent fuel surcharge levied in a 2006 addendum.

The contract in effect for the audit period was originally signed in May 2004 and was effective beginning with the

Criteria related to the finding (continued):

(7) The negotiation and execution of contracts or agreements with contractors, drivers of district's vehicles and common carriers and submission of pertinent documents to the Department for approval of operation." *See* 22 Pa. Code § 23.4(3) and (7). (Emphasis added.)

Scranton SD Board Policy 601 - States the following, in part:

"The Board recognizes its responsibility to district taxpayers to ensure that public monies expended by the school district are utilized for delivery of the educational program in a manner that mandates <u>full value to the taxpayers</u>, <u>and that adequate procedures and records are established to ensure that end</u>." (Emphasis added.)

Scranton SD Board Policy 610 – States the following, in part:

"It is the policy of the Board to obtain competitive bids and price quotations for products and services where such bids or quotations are required by law or may result in monetary savings to the school district."

Scranton SD Board Policy 616 - States the following, in part:

"It shall be the responsibility of the Business Manager or designee upon receipt of an invoice to verify that the purchase invoice is in order, goods were received in acceptable condition or services were satisfactorily rendered, funds are available to cover the payment, the Board had budgeted for the item, <u>and invoice is for the amount contracted</u>." (Emphasis added.)

2005-06 school year. Subsequently, an addendum was approved in 2006 and contract extensions were Board approved in 2012 and 2016, which ultimately extended the original contract through the 2021-22 school year. The May 2004 contract and each subsequent extension were never procured through a competitive bidding process.[23]

We reviewed the original contract, the subsequent addendum and the extensions, and then obtained and reviewed invoices to determine if the daily rates charged agreed to the contract terms. When we found language in the 2012 addendum erroneously indicating that the fuel surcharge was never implemented, we questioned District officials about this discrepancy. District officials stated that they were unaware that they had been paying the Contractor the fuel surcharge since the 2006-07 school year. We calculated that, from the 2006-07 through 2015-16 school years, the District had paid the Contractor more than **$4.0 million** for this fuel surcharge.

The remainder of this finding includes additional details regarding the issues we identified with the contract, the procurement process, the addendum establishing the fuel surcharge, the two contract extensions, and their effect on the amount paid to the Contractor.

<u>Flaws in the Contract and Procurement Process</u>

We identified the following issues related to the primary transportation contract.

- As stated earlier, the 2004 contract was never competitively bid; instead, the District approved an addendum and two extensions that lengthened the term of the contract to 17 years and prevented any competitive bidding over a long period of time.

- The provisions in the May 2004 contract were never updated to reflect bus driver qualification requirements related to recent amendments to the Child Protective Services Law, such as enhanced mandated reporting

[23] Soliciting bids for transportation services is not required by the Public School Code. However, bidding transportation contracts is highly recommended especially when contractor payments are based on daily rates not

requirements and related training[24] and the PSC amendments[25] brought about by, among others, Act 114 of 2006, Act 24 of 2011, and Act 82 of 2012, including the completion of the PDE-6004, *Arrest and Conviction Report and Certification Form.*[26] The original contract used catch-all wording stating that bus drivers will meet all requirements of law for school bus drivers for the term of this agreement.[27] Contracts should be updated to include specific legal requirements to ensure all current background check laws are recognized.

- Although approved by the Board, the August 2006 addendum and the February 2012 extension were not signed by the Board or by the Contractor.

- The February 2012 extension was poorly written, vague, and included false statements (which are further explained below).

2004 - Original Contract: The District executed a no-bid, five-year agreement with the Contractor in May 2004. The effective term of the contract was from school year 2005-06 through 2009-10. The payment terms of the contract included a provision for a daily rate per bus used. The contract specifically stated that the **"price per bus per day includes all costs of service including gasoline and other costs."** (Emphasis added.)

In addition, the contract included an annual 3 percent increase to the daily rate. The contract also contained the following provision:[28]

> This document contains all the agreements and conditions of the parties hereto and **no additions,**

reduced by any efficiency factors like the total miles driven or the number of pupils transported on each vehicle used.

[24] *See* http://www.keepkidssafe.pa.gov/about/cpsl/index.htm and http://www.education.pa.gov/Documents/K-12/Safe%20Schools/Act%20126%20%20Child%20Abuse%20Reporting/Act%20126%20Child%20Abuse%20Reporting%20-%20Frequently%20Asked%20Questions.pdf accessed September 13, 2017.

[25] 24 P.S. § 1-111. http://www.education.pa.gov/Teachers%20-%20Administrators/Background%20checks/Pages/default.aspx#tab-1 accessed September 13, 2017.

[26] All independent contractors and their employees, including school bus drivers, must provide written notice within 72 hours after a subsequent arrest or conviction for an offense enumerated under the PSC. *See* 24 P.S. §§1-111(e) and (f.1); PDE Basic Education Circular on Background Checks, issued December 12, 2011, page 4. *See* http://www.education.pa.gov/documents/teachers-administrators/background%20Checks/arrest%20or%20conviction%20form.pdf, accessed September 13, 2017.

[27] The original contract only included provisions for requirements already in place at the time of approval in May 2004.

[28] Article XXV of the May 3, 2004 contract.

> **alterations or changes in the document shall be binding unless set forth in writing signed by all parties hereto**. (Emphasis added.)

The May 2004 contract was appropriately signed by all parties and was Board approved.

2006 - Addendum: On August 11, 2006, one year into the five-year contract, the Board approved an addendum. The addendum contained three provisions that revised the terms of the original contract:

1. Fuel Surcharge – Effective as of the 2006-07 school year, a 4 percent fuel adjustment was added to the daily rate. This surcharge was levied in addition to the annual 3 percent increase required by the original contract, rather than in lieu of it.

2. Field trip base rate increase – The per bus base price increased by 33 percent, from $75 to $100.

3. Contract extension – The original contract was extended for two more years, which extended the effective date through the 2011-12 school year.

The August 2006 addendum was not signed by the Contractor or by anyone on the Board, which was a violation of the provisions of the original contract and raises the questions of the legal validity of the addendum. Furthermore, state regulations place responsibility for the execution of transportation contracts or agreements on the Board; therefore, the Board President should have, at a minimum, signed the addendum.[29]

We reviewed the August 2006 Board Meeting Minutes and found that the minutes only noted that the Board approved the two year extension but there was nothing noted about the fuel surcharge. We listened to the audio version of the Board meeting to determine if the fuel surcharge was discussed during the public meeting. Again, we found that the Board discussed the two-year contract extension but did not hear anyone present at the meeting discuss the fuel surcharge. Since there are no recordings or minutes for

[29] Since the State Board of Education's regulations state that school district's school board members are responsible for all aspects of pupil transportation programs, including the negotiation and **execution** of contracts or agreements with contractors, we believe that, **at a minimum**, this addendum should have been signed by the Board President. *See* 22 Pa. Code § 23.4(7). [Emphases added.]

committee meetings and executive sessions, we could not determine if the fuel addendum was discussed during those meetings. However, given that there was no discussion about the fuel surcharge at the board meetings, coupled with the fact that the Addendum was never signed by the Board, it appears that the Board may not have been fully aware of the fuel surcharge and/or did not consider the financial impact of the surcharge when it approved the Addendum.

Later in the finding, we discuss the financial impact in more detail.

2012 - Contract Extension #1: On February 6, 2012, the chairperson of the District's transportation committee presented a recommendation to the Board to approve a contract extension "as per the attached Addendum." The addendum was a one-page document entitled *Scranton School District Proposed Contract with [Contractor name]*. The document was not on the District's or the Contractor's letterhead and it did not contain any signatures.[30] Again, because the contract extension was not signed in accordance with the associated state regulations and with the original contract provisions, we question whether the contract extension was legally binding.

The document simply provided four bullet points that detailed the proposed changes. (A copy of this document can be found at the end of this finding). The Board—without seeking competitive bids from other vendors—approved another five-year extension to the original contract to include the 2012-13 through 2016-17 school years.

We found that the second bulleted statement was factually incorrect. It said, exactly:

> Effective 2006-2007 school year [Contractor] Transportation had a Fuel Claus [*sic*] in their contract which included a 4 percent increase for fuel adjustment and would continue yearly for the length of the contract which, they never acted upon meaning they never charged the district any fuel adjustment.

[30] Ibid.

Our review of payments to the Contractor confirmed that the 4 percent fuel adjustment increase, in fact, was added to the daily rate for five consecutive years beginning with the 2006-07 school year (See Table 1-A), and that surcharge cost the District almost $1.3 million during those years. It appears that the Board was provided with factually incorrect information, and it subsequently voted to approve a contract extension based, in part, on that incorrect information.

The significance of this oversight cannot be overstated. Because no one at the District was monitoring the Contractor's calculation of the annual daily rate increases, the District ended up approving an agreement that resulted in the District continuing to pay inflated daily rates due to the compounding of the fuel surcharges.

The third bulleted statement contained language about the daily rates being frozen at the 2010-11 rates for two years, and then the daily rate would be based on the Consumer Price Increase (CPI) for the next three years. We found, however, that the Contractor did not freeze the daily rate at the 2010-11 rate nor did it base rate increases in the other years on the CPI. Instead, we found that the Contractor twice increased rates by 4 percent which was higher than the CPI increase. A detailed analysis of the daily rates is provided later in this finding.

This contract extension was not signed by the Contractor, nor was it signed by any District officials. Considering that this extension represented a multi-million dollar contract, the District and its Board did not adequately perform their fiduciary responsibilities to ensure that the contract contained clear language (e.g., at least 1 of the 4 bulleted items were misleading) and was properly executed in accordance with contract provision and state regulations.

2016 - Contract Extension #2: On March 29, 2016, the Board's Transportation Committee chairman[31] recommended to the Board that the contract be extended once again for another five years through the 2021-22 school year. The recommendation letter referred to an attached proposal from the Contractor. The proposal was a

[31] In full disclosure, we note that this Transportation Committee Chairman is an employee of the Department of the Auditor General. However, his position with the Department is with a bureau separate from and not connected in any way to the Bureau of School Audits. The Chairman's activity as a board member is done on his personal time and is not conducted in any manner on behalf of the Department.

one-page memo, dated December 18, 2015, from the Contractor's general manager to the District's solicitor. The "proposal" was essentially a written attestation of a telephone conversation between the two parties to discuss how to reduce transportation costs for the District.

This document was the first indication of the District negotiating with the Contractor to attain more favorable terms. The proposal noted that for the 2015-16 school year the number of buses was reduced from 62 to 50 which should result in a savings to the District. The proposal also included a reduction in the District's 2015-16 daily rate per bus from $306.54 to $293 and a commitment to freeze that $293 rate for 2016-17. Further, the proposal included language about the daily rates for the five-year extension through the 2021-22 school years.

While the "proposal" memo was dated December 18, 2015, the Board did not take action on the proposal until March 29, 2016. A signature page was added to the proposal memo and contained the signatures of the Board President, the Board Secretary, and the Contractor. Although the proposal contained language about reducing the daily rate for the 2015-16 school year, we found that the rate was never reduced during that school year. [32]

The Compounding Impact of the Fuel Surcharge

Analysis of the Fuel Surcharge and Daily Rate: We performed an analysis of the actual daily rates charged by the Contractor beginning in the school year 2006-07. As previously stated, it appears that the District and the Board were unaware—until we brought it to their attention— that the Contractor's annual increases included a compounding annual 4 percent fuel surcharge. Because of this surcharge and other annual increases by the Contractor, the annual daily rate set forth in the original contract increased by 59 percent over a ten-year period.

We found that the daily rate increased at an excessive pace because compounding annual fuel adjustments were being made based on total transportation costs without regard to actual fuel costs, and nobody at the District was monitoring gas prices. Monitoring daily rates per the invoices and comparing them to the contract terms would have allowed

[32] The Contractor began charging the reduced rate in the 2016-17 school year.

the District to determine whether it was paying a fair price for the service provided. Finally, had the District monitored the daily rates, it would have known that the fuel surcharge was compounding, and then it could have worked with the Contractor to renegotiate the terms of the addendum.

The unmonitored, compounded fuel surcharges increased the total transportation cost by more than $4.0 million as shown in the following tables.

Table 1-A

Scranton School District 2006-07 through 2010-11 Fuel Surcharge Costs					
School Year	Daily Rate Paid to Contractor[33]	Actual Amount Paid to Contractor[34] (A)	Daily Rate Based on 3% Contracted Annual Increase[35]	Payment Based on Annual 3% Increase[36] (B)	Compounded Effect of the 4% Fuel Surcharge[37] (A-B)
2006-07	$206.88	$1,705,394	$198.92	$1,639,809	$65,585
2007-08	$221.61	$1,780,797	$204.89	$1,646,453	$134,344
2008-09	$237.39	$2,287,824	$211.04	$2,033,862	$253,962
2009-10	$254.30	$2,336,763	$217.37	$1,997,409	$339,354
2010-11	$272.41	$2,672,342	$223.89	$2,196,367	$475,975
Subtotal		**$10,783,120**		**$9,513,900**	**$1,269,220**

33 For the school years 2006-07 through 2010-11, the District was charged an annual 3 percent cost increase and a 4 percent gasoline cost adjustment, referred to in this finding as a fuel surcharge. The daily rate was computed by multiplying the previous year's daily rate by 1.03 percent and then 1.04 percent. Ex. 2006-07 daily rate of $206.88 x 1.03% x 1.04% = $221.61 for 2007-08.
34 Amount reported annually to PDE on transportation report PDE-2518.
35 Daily rate was computed by multiplying the previous year's daily rate by the 3 percent contracted increase for 2006-07 through 2010-11 school years. Ex. 2006-07 daily rate of $198.92 x 1.03% = $204.89. This calculation was done to show the cost of applying the gasoline adjustment to the daily rate.
36 Computed by multiplying the daily rate based on 3 percent increase times the number of buses times the number of days buses were used to transported students.
37 Computed by subtracting the amount that would have been paid to the contractor if gas clause was not applied from the actual amount the District paid to the Contractor.

Table 1-B

Scranton School District 2011-12 through 2015-16 Cost of Fuel Surcharge					
School Year	Daily Rate per Contractor Invoices[38]	Actual Amount Paid to Contractor	Daily Rate Excluding Compounded 4% Fuel Surcharge[39]	Payment Excluding Compounded 4% Fuel Surcharge	Compounded Effect of the 4% Fuel Surcharge
2011-12	$283.31	$2,934,525	$232.85	$2,411,860	$522,665
2012-13	$294.75	$3,137,317	$242.25	$2,578,509	$558,808
2013-14	$294.75	$3,239,597	$242.25	$2,662,570	$577,027
2014-15	$294.75	$3,293,241	$242.25	$2,706,659	$586,582
2015-16	$306.54	$2,782,469	$251.94	$2,289,322	$493,147
Subtotal		**$15,387,149**		**$12,648,920**	**$2,738,229**
10-Year Grand Total		**$26,170,269**		**$22,162,820**	**$4,007,449**

While fuel prices certainly fluctuated during the ten-year period, there was no evidence that District personnel monitored the fluctuation of gas prices to determine if the annual 4 percent fuel surcharge was necessary and reasonable.

Considering the fluctuation in gas prices, it would have been much more cost efficient for the District to pay for rising fuel costs based on actual gasoline costs and usage. Keeping in mind that the original contract's daily rate was to include "all costs for service including gasoline" and also factored in an annual 3 percent increase to the daily rate, the additional compounding, annual 4 percent fuel increase was extremely significant, particularly in light of the lower fuel costs in the last few years.

[38] The District was unable to explain why they were invoiced at a daily rate of $294.75 for the 2012-13 school year, when the daily rate was to remain frozen. Subsequent correspondence with District personnel noted they believed it was a fuel adjustment, however, the District was unable to provide any Board approved documents or changes to addendums which would account for the 2012-13 daily rate increase. Since the approximate 4 percent increase was never specifically identified as a gasoline or total cost adjustment to the daily rate for the 2011-12, 2012-13, and 2015-16 school years, we did not identify it as a gasoline adjustment to ensure we did not overstate the true effect of the gasoline adjustments that were applied to the daily rate from 2006-07 to 2010-11. The 2013-14 and 2014-15 school year rates remained at the previous year daily rate per contract. However, per contract, the 2014-15 rate was to increase by the Consumer Price Index (CPI) but the rate remained the same as the 2013-14 year.

[39] The daily rate was computed by multiplying the 2010-11 school year daily rate by the 4 percent increase that was charged for the 2011-12 school year. This was repeated for the 2012-13 and 2015-16 daily rates.

Conclusion

The District executed deficient contracts with a long-time bus contractor for at least the last 12 years. The District's leadership—particularly the Board—had numerous opportunities through the years to cast a wider net to solicit bids from other contractors and potentially obtain better pricing structures. The bidding process could have led to the current contractor providing more competitive rates. Bidding also would have caused the District and the Board to pay closer attention and reassess the terms of the current contract and addendums when comparing rates from other bidders. Instead, the District failed time and time again to solicit bids for this multi-million dollar contract

In addition to failing to solicit bids for transportation services, the District adopted a weak addendum and extensions to the existing contract, two of which were not even signed. Further, one unsigned extension contained factually incorrect statements. We must, therefore, question the legal validity of all three contract documents. We are also puzzled as to how the District's solicitors could have sanctioned the form and the legality of these contract documents.

Finally, the District and its Board failed to adequately monitor this multi-million dollar contract. It allowed for the establishment of daily rates that had no relationship to actual fuel costs, mileage, or occupancy of the buses, and it did not question the daily rates charged by the Contractor. As a result, the steadily increasing transportation costs incurred by the District, as a result of its payments to this Contractor, did not match the trend of fuel costs over the same period. Nor did other factors, such as miles driven or students transported, affect these costs. In the end, the District paid excessive surcharges for fuel that far surpassed the actual gas price trends for the period.

As a result of the poor governance of this multi-million dollar contract, a five-year contract signed back in 2004 resulted in a 17-year obligation that has cost the District millions of dollars in unnecessarily high transportation costs and will continue to do so through 2021. The terms of this ongoing arrangement clearly were not executed in the best interest of the District, its students, and the public.

Recommendations

The *Scranton School District* should:

1. Promptly establish procedures for regular monitoring of invoices submitted by the Contractor. These procedures should include verification of the daily rates in accordance with the current terms of its contract. Review and approval of invoices should occur *prior* to payment. It should also include a review and attestation by senior officials, as well as periodic review by the Board.

2. As soon as possible, solicit a request for bids or proposals for all District transportation services. This solicitation should encourage the submission of cost structures that will foster competitive pricing and factor in fuel cost trends, students transported, and miles driven. The terms could allow for periodic adjustments to prices based on sharp increases or decreases in fuel costs.

3. Consider the establishment of a contract policy prohibiting automatic renewal clauses, contract extensions, and addendums that extend the length of contracts, which effectively prohibit competition and best pricing on behalf of the District. The contract policy should also require, in addition to board approval, dated signatures and witnesses for contracts, agreements, and addendums to be valid.

4. Establish transportation contract terms that are clear and easily understood so District officials can analyze the terms for reasonableness before approval and so that subsequent costs can be verified and monitored for compliance.

5. Require the District's Solicitor to review all contracts and extensions to ensure they are properly executed, legally binding and in the best interest of the District.

6. Update current contract agreements to reflect bus driver qualification requirements related to amendments to the Child Protective Services Law, implemented subsequent to the May 2004 Contract.

Management Response

District management provided the following response (verbatim):

"The School District acknowledges that for the costs of providing services for Pupil Transportation of $26.1 million it did report and pay the Bus Contractor for the period of 2007 through 2016. This would have been an average cost over the ten year period of $2.6 million annually for student transportation. The statement does not take into consideration any additional services or vehicles that could have been added during those years that would have contributed to the costs over this ten year period.

As stated in the report with regards to Contract and Procurement Processes that goes back to May, 2004 in which questions the increases in costs and questions the fuel charge and addendums were approved by the Board of Directors in May, 2004 and in additional *[sic]* addresses the fuel issue in a 2006 Addendum were all approved by the Board of Directors. The School District proceeded as to what was authorized by the Contracts and Addendums which were both reviewed by three prior Audits that were prepared by the Office of the Auditor General for the years of 2004 up to and including 2011. All of the documentation was provided and reviewed without any finding as to issue of the potential overcharge for the fuel surcharge or the cost of the daily rate pursuant to the contract and addendum. The School District acknowledges that there was a finding that the School District did pay the contractor above the state reimbursement formula which was at the time and still is considered to *[sic]* by the Board of Directors as presented that the solicitor for transportation services is not required to solicit bids pursuant to Public School Codes.*[sic]*

The procedure is for any contract to be considered for approval reviewed *[sic]* is to be by the District Solicitor and be presented to the Board President for signature after the approval process. The original would be filed with the Board Secretary and a copy to be presented to the department that would be responsible for the administration of the contract. This contract would be with the Director of Transportation who would be responsible for monitoring and approving payments subject to the services being provided and in compliance with the contract. This *[sic]* based upon these procedures the former Director of Transportation would have authorized payments based on the understanding of the contract and addendums that were Board approved. This would have been further suggested by prior finding or observations regarding Pupil Transportation that have been audited in the past.

In September of 2009 the former Board Secretary/ Transportation Secretary was appointed to the position of Director of Transportation and assumed the duties and responsibilities. All responsibilities and approval processes from September 2009 to present is the responsibility of the Manager of Transportation and defined in the job description. All information that would have been contained in the addendum from 2012 would be received and presented to the Board of Directors by the Director of Transportation. The Director of Transportation would be the person responsible for checking and verifying that all the information is accurate prior to presenting to the Board of Directors consideration.

The procedures that are currently in place that has been in place since 1989 and continue to be implemented as of today. The Director of Transportation is the responsible individual for monitoring, reporting, verifying, and approving all necessary documentation relating to pupil transportation for both compliance and accuracy. It remains the assignment that the contract is being authorized based upon the past method of operations and no agency has indicated that the Scranton School District was not in compliance with the contract. The level of review has been consistent with what has been previous *[sic]* established and audited.

The School District Board of Directors are fully aware and have been aware regarding the bidding of a Transportation Contract. If upon the expiration of the existing contract should the directive be to solicit bids, the Administration will prepare bid specifications to include these items outlined in the report. The establishment of contract standards and requirements is the duty of the District Solicitor. The Board of Directors will continue to and has in the past continue *[sic]* to approve all contracts and addendums relating to the services for Pupil Transportation."

In addition to its response above, District management conferred with their Solicitor who provided the following response. At the request of the District, we've included the Solicitor's response verbatim below:

"Busing all *[sic]* addendums were presented and approved by the Board of Directors. The previous Director of the Transportation Committee negotiated and presented the same for full approval by the Board of Directors in 2012. The 2012 and 2016 contracts either froze per bus costs for 2012 or reduced per bus costs for 2016 resulting in reductions in costs over $1,000,000 dollars. As for costs for fuel that existed in contracts prior to my tenure and have been in this contract since 2006 some six years prior to my tenure. The Solicitor was instructed by the Board of Directors to negotiate a contract with savings. The previous Solicitor and board in 2006 added the questioned fuel clause. This was merely continued, however, the previous auditors since 2006 never cited it as a finding or discovered it as a problem.

At a published meeting I was instructed to negotiate a contract with the current vendor to save money. The per-bus price was reduced significantly saving the District about a million dollars. Secondly, I was part of the team that consolidated bus runs saving the District money. My instructions were to save money and that's what I did. The gas clause is something I will certainly look to change if possible.

Also, the very definition of a contract is offer and acceptance. The vendor offered a contract via a modification memorandum and the Scranton School District accepted via resolution approving the memorandum, creating contracts in both 2012 and 2016."

Auditor Conclusion

While there may have been additional services or vehicles that may have affected payments, we based our calculations of additional fuel costs on the actual number of buses multiplied by the number of days transported. This is the same method the District used to pay the contractor. Therefore, our compounded effect of the surcharge totaling over $4 million would not have been affected by these factors.

While the finding points out that the contract, addendum, and extensions were approved by the Board, we maintain that the Board's failure to execute signed contract agreements is very concerning. The transportation contract results in a multi-million dollar expenditure of public funds and therefore, it is imperative that the Board exercise its fiduciary duty related to that expenditure. While the addendums and extensions, as approved, may constitute a legal agreement, best business practices call for a more detailed contract that meets all requirements for form and legality. As previously stated, the Board approved a one-page document that contains only 4 bullet points—some of which are factually incorrect—and it contains no signatures and is not on either District or Contractor letterhead. The Board must do better in ensuring that all agreements it approves are executed in a manner that adequately safeguards public funds.

In its response, the District asserts that past audits of the transportation contract did not find any issues with the fuel addendum. That statement is simply not true. The prior audit Finding No. 2 presented the issue with the compounding effect of the fuel clause and concluded that the District overpaid the Contractor.[40] One of the related recommendations was that the District should establish a process for verifying that all contractor rates are properly calculated prior to the payment of invoices. During this current audit, we found that the District did not adequately address that recommendation, nor did the District implement the prior audit recommendation to solicit bids for transportation services. Because the District did not implement the prior recommendations, and to demonstrate to the Board and the District administration the full impact of the compounding effect of the fuel addendum, we calculated the total effect of the fuel adjustment over the ten year period.

We appreciate the efforts that the current Solicitor took to reduce the daily rate, and we acknowledge that those efforts resulted in some cost savings; however, we continue to recommend that the Board solicit bids for the next transportation contract. In the meantime, we also recommend that the Board discuss the possibility of renegotiating the terms of the current contract to address

[40] The prior audit incorrectly calculated the overpayment to the Contractor. The prior audit indicated the overpayment was $3,282 but that amount does not reflect the daily overcharge for all buses in operation for each day of each year.

the 4 percent cumulative fuel surcharges. During our next audit of the District, we will any review corrective actions implemented by the District.

Finding No. 2 - Copy of Contract Extension Approved in February 2012

Scranton School District Proposed Contract with [Contractor]

- The district currently has 59 buses for the 2011-2012 school year with Contractor @ a daily rate of $283.31 per bus.
- Effective 2006-2007 school year [Contractor] had a Fuel Claus in their contract which included a 4% increase for fuel adjustment and would continue yearly for the length of the contract which, they never acted upon meaning they never charged the district any fuel adjustment.
- [Contractor] has proposed that for the 2012-2013 and 2013-2014 school years the cost per bus would be frozen at the 2010-2011 rates. Then the rates would be based on the Consumer Price Increase for the 2014-2015, 2015-2016 and 2016-2017 school year.
- If State Legislation is approved regarding advertising on school buses the Scranton School District and [Contractor] . will develop an advertising policy which is subject to approval.

Finding No. 3 — The District's Transportation Expenditures Significantly Exceeded PDE's Final Formula Allowance

Criteria relevant to the finding:

Section 2541 of the Public School Code (PSC), 24 P.S. § 25-2541, states that school districts shall be paid by the Commonwealth for every school year for costs related to pupil transportation.

Daily miles traveled, the greatest number of pupils transported, days of service, and contractor cost are an integral part of the transportation reimbursement calculation. These factors must be reported accurately to PDE in order to receive the correct reimbursement.

Chapter 23 of the State Board of Education Regulations, 22 Pa. Code § 23.1 *et seq*., indicates a school district's board of directors is responsible for the negotiation and execution of contracts or agreements with contractors, drivers of district vehicles, and common carriers.

The Pennsylvania Department of Education's (PDE) "final formula allowance" provides for a per-vehicle allowance based on the year of manufacture of the vehicle chassis, the approved seating capacity, number of trips the vehicle operates, the number of days pupils were transported, the approved daily miles driven, any excess hours, and the greatest number of pupils transported. The final formula allowance is adjusted annually by an inflationary cost index.

The District receives the lessor of the final formula allowance for the vehicles or the actual amount paid to the contractor, multiplied by the District's aid ratio.

The District's transportation expenditures exceeded PDE's "final formula allowance" by more than $11 million during the 2012-13 through 2015-16 fiscal years. We found that the payment structure outlined in the District's transportation agreements were based on a per-vehicle daily rate, which did not align with the mileage calculations that PDE uses to reimburse school districts for transportation expenditures. As a result, the District had to use over $12 million in revenue, in addition to transportation reimbursement from PDE, to pay for transportation expenditures (See Table 3).

Payment Structure of Contracts with District's Primary Transportation Contractors

The District had agreements with two primary transportation vendors during the 2012-13 through 2015-16 fiscal years.[41] The District's agreements with both vendors were based on a per-vehicle daily rate and included annual increases to this rate that were not tied to the Consumer Price Index (CPI). The District's use of a per-vehicle daily rate that was not tied to the CPI was not in the financial best interest of the District.

The majority of the District's transportation services is provided by Contractor A.[42] As discussed in detail in Finding No. 2, the District has been in business with this vendor since the 1990's and bids were not solicited for the contract, addendums, and extensions discussed in this finding.

The contract executed in May 2004 with Contractor A, and all subsequent extensions/addendums, specified that payment would be based on a daily rate for each vehicle in service. Agreeing to pay a transportation contractor based on the number of vehicles in service, as opposed to actual mileage traveled or the number of students transported, requires a strategic plan to develop routes to ensure vehicles are filled as close to capacity as possible, while

[41] The District also had agreements with other providers but costs to those providers comprised only 1 percent of the District's total transportation costs.
[42] Payments to Contractor A represented 68 percent to 76 percent of the District's total annual transportation expenditures during the audit period.

also ensuring students are not in vehicles for an unreasonable amount of time.

The District's agreement with Contractor A included annual rate increases as well as annual fuel adjustment increases. The effect of these increases drove the daily rate up by 59 percent from the 2005-06 school year to the 2015-16 school year. If the District would have increased the daily rate at the rate of the CPI,[43] during the same time period, the daily rate would have increased only 23 percent.

If the District had more closely monitored the daily rates they were paying and negotiated a better payment structure with both transportation contractors, it could have realized significant savings and better maximized its transportation reimbursement from PDE.

Table 1 below shows the actual daily rate paid to Contractor A from the 2005-06 to 2015-16 school years. The table also shows the daily rates over this time if increases were aligned with the CPI and the monetary difference between these two daily rates.

[43] The CPI is a significant input in the PDE cost index, which is used to adjust maximum allowable transportation costs as specified in Chapter 23 of the Regulations of the State Board of Education.

Table 1

Scranton School District Actual Transportation Costs Compared to Costs Based on CPI							
School Year	**Actual Daily Rate Paid Per Bus**	**% Increase**	**Actual Amount Paid to Contractor**	**Daily Rate Using CPI**	**% Increase**	**[44]Amount Paid Per Year at Daily Rate Using CPI**	**Difference Between Actual Amount Paid and CPI**
2005-06	$193.13	N/A	$1,636,970	$193.13	N/A	$1,636,970	$0
2006-07	$206.88	7.1%	$1,705,394	$199.70	3.4%	$1,646,177	$59,217
2007-08	$221.61	7.1%	$1,780,797	$204.69	2.5%	$1,644,823	$135,974
2008-09	$237.39	7.1%	$2,287,824	$213.08	4.1%	$2,053,549	$234,275
2009-10	$254.30	7.1%	$2,336,763	$213.29	0.1%	$1,959,960	$376,803
2010-11	$272.41	7.1%	$2,672,342	$219.05	2.7%	$2,148,911	$523,431
2011-12	$283.31	4.0%	$2,934,525	$222.34	1.5%	$2,304,613	$629,912
2012-13	$294.75	4.0%	$3,137,317	$229.01	3.0%	$2,437,571	$699,746
2013-14	$294.75	0.0%	$3,239,597	$232.90	1.7%	$2,559,828	$679,769
2014-15	$294.75	0.0%	$3,293,242	$236.40	1.5%	$2,641,250	$651,992
2015-16	$306.54	4.0%	$2,782,469	$238.29	0.8%	$2,162,934	$619,535
Total		**59%**	**$27,807,24**		**23%**	**$23,196,58**	**$4,610,65**

The annual 7.1 percent increase in the daily rate from the 2006-07 to 2010-11 school years raised the daily rate to an amount that was $60 more than the CPI daily rate in the 2011-12 school year. Although the daily rate increased at a lower percentage after 2010-11 school year, the actual contracted daily rate paid was considerably more than the CPI daily rate for those years due to the compounding effect of the earlier increases.

PDE's transportation reimbursement

As stated in the criteria box, PDE reimburses school districts for transportation expenditures. PDE calculates a "final formula allowance" by using, among other items, the number of days students were transported and the approved daily miles driven. The "final formula allowance" is then multiplied by the District's aid ratio[45] to determine the

[44] The amount paid per CPI was computed by multiplying the CPI daily rate X the number of vehicles X the days vehicles were used to transport students.

[45] *Aid ratio* is the general term for three numerical values market value aid ratio (MV AR), personal income aid ratio (PI AR), and market value/personal income aid ratio (MV/PI AR) -- calculated in accordance with Section 2501(14) and (14.1) of the Public School Code. Various state subsidies use aid ratios in their calculations. The MV/PI AR represents the relative wealth (market value and income), in relation to the state average, for each pupil in a school district.

reimbursement amount. School districts are reimbursed at the lessor of the actual amount paid to the contractor or the "final formula allowance" multiplied by the District's aid ratio.

To maximize the use of state subsidies, school districts should try to align their transportation expenditures as close to the "final formula allowance" as possible to reduce the amount of other district funds necessary to pay this expense. To that end, school districts that outsource transportation services will commonly use a payment structure that is based on the actual miles traveled and the number of students transported, as opposed to a per vehicle daily rate.

Reported contractor costs significantly greater than reimbursement amount

As shown in Table 2, the District's contracted transportation costs exceeded PDE's final formula allowance each year. Furthermore, the District's cost was more than double the final formula allowance amount for 2 of the 4 years reviewed.

Table 2

Scranton School District Contracted Transportation Costs Comparison to PDE Allowance				
Fiscal Year	**Cost Reported to PDE**[46]	**Final Formula Allowance**	**Amount Contractor Costs Exceeds Formula**	**Percentage that Contractor Costs Exceeded Formula**
2012-13	$4,108,666	$1,335,572	$2,773,094	**208%**
2013-14	$4,494,040	$1,453,533	$3,040,507	**209%**
2014-15	$4,642,653	$1,575,575	$3,067,078	**195%**
2015-16	$3,707,885[47]	$1,546,248	$2,161,637	**140%**
Total:	**$16,953,244**	**$5,910,928**	**$11,042,316**	

[46] These amounts include both District's primary contractors along with multiple other minor contractors for each year.
[47] The decrease in cost for the 2015-16 school year was mainly due to a reduction of 12 buses used to transport the same number of students. Due to a change in school start and end times effective with the 2015-16 school year, the District was able to consolidate routes.

The per-vehicle payment structure with increases that surpassed the CPI for both primary transportation contractors was the principal factor in the District's contracted costs significantly exceeding the "final formula allowance."

When contractor costs exceed the "final formula allowance" school districts have to use other revenues to meet transportation expenditures. As shown in the table above, the District's contractor costs significantly exceeded the "final formula allowance" for the 2012-13 through 2015-16 fiscal years. As more revenue is needed to fund District transportation expenditures, less revenue is available to be used for academic and other operational needs. Table 3 depicts the amount of other District revenue used for transportation costs.

Table 3

Scranton School District Contracted Transportation Costs Comparison of PDE Reimbursement vs. District Share			
Fiscal Year	**Contractor Cost Reported to PDE**	**Transportation Reimbursement Received[48]**	**District Share from Other Revenue**
2012-13	$4,108,666	$994,200	$3,114,446
2013-14	$4,494,040	$1,089,714	$3,404,326
2014-15	$4,642,652	$1,187,038	$3,455,614
2015-16	$3,707,884	$1,178,241	$2,529,643
Total:	**$16,953,244**	**$4,449,193**	**$12,504,051**

According to the figures shown in Table 3, only 26 percent of the District's transportation costs are reimbursed through PDE. Therefore, 74 percent of total transportation costs are funded by other District revenue.

Almost half of the District's total revenues come from local property taxes. One mill[49] of property taxes would have been needed to generate approximately $395,400[50] in local tax revenue for the 2015-16 school year. Therefore, approximately six mills of property taxes were needed to

[48] Transportation Reimbursement Received was PDE's final formula allowance from Table 1 multiplied by the District's aid ratio.
[49] One mill is equivalent to $1 in taxes per $1,000 in taxable value.
[50] During the 2015-16 school year, one mill generated approximately $395,400 in local revenue received from taxpayers. For the Scranton School District, millage is based on a calendar year and not the school year, therefore we note $395,400 is an estimate.

pay for the District's share of transportation expenditures in the 2015-16 fiscal year.

Conclusion

The District's contracted payment structure, coupled with the lack of diligent monitoring by the District to ensure transportation costs were minimized, resulted in the District spending approximately $11 million more than the "final formula allowance" for the four-year period 2012-13 through 2015-16 (See Table 2).

Our two previous audits of the District contained observations about this same issue of paying its transportation contractors more than the state formula allowance.[51] In both audits, we recommended that the District consider bidding out its transportation contracts to help ensure costs align more closely with the PDE reimbursements or at least to determine if other contractors could reduce the District's transportation expense. We found that the District did not implement this recommendation and it continues to use the same primary Contractor and pay an inflated daily rate. (See Finding No. 2 for more details)

With the District's current dire financial condition, it is imperative that the District try to control costs where possible and ensure that transportation expenditures are more closely aligned to PDE's "final formula allowance" for transportation.

Recommendations

The Scranton School District should:

1. Ensure all future District transportation contracts contain a payment structure that is based on actual mileage traveled and number of students transported as opposed to a daily rate.

2. Consider using a competitive bidding procurement process for all future transportation contracts to help ensure that the District is obtaining the best price for the service provided.

[51] The two prior audits are dated October 30, 2013, and February 24, 2012, respectively.

Management Response

District management provided the following response (verbatim):

"The Scranton School District continues to utilize its current contractors to provide pupil transportation. The School District has been aware of the potential short fall in reimbursement by the state formula and believes that the current contract gives the best value to the School District. The District, during the last four years, has both renegotiated and renewed its contracts with its two major providers as opposed to soliciting bids. The School District believes that in spite of the State Funding Formula that Scranton, being of an urban setting and having some buses and vans traveling less than two miles in one direction and due to special need students it is highly impossible to achieve maximum state reimbursement.

The School District disagrees with the analysis that all transportation contracts can be achieved with the final maximum formula allowance. This analysis assumes that all vehicles would be at maximum formula allowance, which in an urban setting is not possible due to the specific needs of the School District. The School District's urban setting and the Special Transportation needs of mileage requests and special needs students make it unattainable to receive maximum funding.

The Scranton School District in its management of Pupil Transportation costs have currently and in the past have directed the Manager of Pupil Transportation Services to monitor both bus and van utilization. The School District has mandated that the busses run multiple runs and compensate the contractor based upon the cost of the bus on a daily rate as opposed to the per run formula driven payment. The School District has mandated that all Special Education Van runs be based upon a daily basis also. The Special Education Vans are providing Pupil Transportation to students on a door to door basis. This is specialized transportation with the maximum number of students per van is no greater than seven students and some vehicles run less than two miles per run.

The Scranton School District Board of Directors is aware of this and will determine in the future as to whether or not to bid out the Pupil Transportation Contracts and incorporate the recommendations as contained in this report."

Auditor Conclusion

We appreciate the District's comments about its desire to ensure the unique needs of District's students are met. While we recognize the challenges that the final formula allowance presents to urban school districts, we continue to believe that the District can and should do more to closely align its transportation expenditures with the state reimbursement. Further, we believe that reassessing the current payment arrangements, analyzing other methods of payments, and soliciting bids for transportation services would provide assurance to the public that the District is getting the best service, at the best cost, without affecting the needs and safety of the students.

Finding No. 4 — The District Incorrectly Reported the Number of Charter School and Nonpublic Students Transported Resulting in an Overpayment of $128,590

Criteria relevant to the finding:

Supplemental Transportation Subsidy for Public Charter School and Nonpublic Students

The Charter School Law (CSL), through its reference to Section 2509.3 of the PSC, 24 P.S. § 25-2509.3, provides for an additional, per student subsidy for the transportation of charter school students. *See* 24 P.S. § 17-1726-A (a).

Section 1726-A(a) of the CSL [already cited to above], addresses the transportation of charter school students by providing, in part: "Students who attend a charter school located in their school district of residence, a regional charter school of which the school district is a part or a charter school located outside district boundaries at a distance not exceeding ten (10) miles by the nearest public highway shall be provided free transportation to the charter school by their school district of residence on such dates and periods that the charter school is in regular session whether or not transportation is provided on such dates and periods to students attending schools of the district. . . ."

The District was overpaid a total of $128,590 in transportation reimbursement from PDE. This overpayment was due to the District over reporting the number of charter school and nonpublic students transported by the District during the 2012-13 school year and over reporting the number of nonpublic students in the 2013-14 and 2014-15 school years. No errors were found in our review of the 2015-16 school year. PDE should recover the overpayment by reducing the District's future transportation reimbursements.

According to the PSC, a nonpublic school is defined, in part, as a nonprofit school other than a public school within the Commonwealth.[52] The PSC requires school districts to provide transportation services to students who reside in its district and who attend a charter school or nonpublic school, and it provides for a reimbursement from the Commonwealth of $385 for each nonpublic school student transported by the district. This reimbursement was made applicable to the transportation of charter school students pursuant to an equivalent provision in the CSL[53] that refers to Section 2509.3 of the PSC.

[52] *See* Section 922.1-A(b) (pertaining to "Definitions") of the PSC, 24 P.S. § 9-922.1-A(b).
[53] A charter school is a public school and educates public school students in the Commonwealth. *See* 24 P.S. § 17-1703-A (pertaining to "Definitions").

Criteria relevant to the finding (continued):

Section 1726-A (a) further provides for districts to receive a state subsidy for transporting charter school students both within and outside district boundaries by providing: ". . . Districts providing transportation to a charter school outside the district and, for the 2007-2008 school year and each school year thereafter, districts providing transportation to a charter school within the district shall be eligible for payments under section 2509.3 for each public school student transported."

Section 2509.3 of the PSC, 24 P.S. § 25-2509.3, provides that each school district shall receive a supplemental transportation payment of $385 for each nonpublic school student transported. This payment provision is also applicable to charter school students through Section 1726-A (a) of the CSL.

Annual Filing Requirement

Section 2543 of the PSC, 24 P.S. § 25-2543, sets forth the requirement for school districts to annually file student transportation data with PDE in order to be eligible for the transportation subsidies.

Additionally, instructions provided by PDE, to complete the Summary of Students Transported form (PDE-2089) specify that districts are to report the total number of nonpublic and charter school students transported to and from school.

The following table summarizes the District's reporting errors by school year and student classification and the resulting cumulative overpayment:

Scranton School District Transportation Data Errors			
School Year	**Nonpublic Students Over Reported by District**	**Charter School Students Over/(Under) Reported By District**	**Ineligible Amount Received by District (# Students x $385)**
2012-13	95	(35)	$23,100
2013-14	149	0	$57,365
2014-15	125	0	$48,125
Total	**369**	**(35)**	**$128,590**

The District reported transporting zero charter school students during the 2012-13 school year. All 35 charter school students were reported as nonpublic students. Further, the District reported some nonpublic students multiple times to PDE for reimbursement.

The District correctly reported the number of charter school students transported during the 2013-14 and 2014-15 school years. However, the District reported the charter school students transported during the 2013-14 (66) and 2014-15 (91) school years as both charter school and nonpublic students. Along with this error, the District reported some nonpublic students multiple times for reimbursement and reported some public school students as nonpublic students during the 2013-14 and 2014-15 school years.

When we met with the District administrator responsible for entering this information to discuss the transportation reporting errors cited in this finding, the administrator stated that she was unfamiliar with nonpublic student reporting procedures until training was provided during the 2015-16 school year. After this training, the District has strengthened procedures around the reporting of charter school and nonpublic school students. Since the District receives $385 for each nonpublic student transported, it is vital that the District maintains and closely track current lists of charter school and nonpublic students who were provided transportation for each school year.

We provided PDE with reports detailing the nonpublic student reporting errors made by the District for the 2012-13, 2013-14, and 2014-15 school years. We also provided PDE with reports detailing the charter school student reporting errors made by the District for the 2012-13 school year. PDE requires these reports to verify the overpayment to the District. The District's future transportation subsidies should be reduced by the amount of the overpayment.

Recommendations

The *Scranton School District* should:

1. Maintain and closely track current lists of charter school and nonpublic students who were provided transportation, by building, for each school year.

2. Perform yearly reconciliations of bus rosters to student requests for transportation forms to ensure accurate reporting of charter school and nonpublic students transported.

The *Pennsylvania Department of Education* should:

3. Adjust the District's allocation to recover the transportation reimbursement overpayment of $128,590.

Management Response

District provided a response agreeing with the finding and with the recommendation. District management did not provide detailed comments related to this finding.

Auditor Conclusion

We are encouraged by the corrective actions taken by the District in the 2015-16 school year. While these actions contributed to the District's correct reporting of nonpublic and charter school pupils in the 2015-16 school year, we continue to maintain that the District should implement a better system of tracking the charter and nonpublic students to help ensure continued accurate reporting going forward.

Finding No. 5 — For Over Twelve Years, the District Circumvented Payment Procedures, Improperly Provided Health Benefits, and Failed to Issue any of the Required Tax Documents to the IRS for a Mechanic Performing Services as a Non-Employee of the District

Criteria relevant to the finding:

District Policy No. 616, *Payment of Bills*, states, in part:

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

According to the *2017 Internal Revenue Service (IRS) Instructions for Form-1099-MISC*, the District must file for "each person to whom [it] paid during the year at least $600 in . . . services performed by someone who is not [its] employee . . ." and "medical and health care payments."

For years, the District improperly paid a mechanic without an appropriate board-approved agreement and without issuing the annual Internal Revenue Service (IRS) Form 1099.[54] According to District personnel, they were unable to obtain a completed IRS W-9 Form from the mechanic. The failure to file the IRS Form 1099 and to obtain the IRS W-9 Form from the mechanic may have resulted in unreported income paid to the mechanic.[55] In addition, the District did not follow standard operating procedures when it paid this mechanic on the basis of irregular and vague invoices. Purchase orders and invoices from this mechanic were approved in the business office and circumvented the maintenance department, which would have been able to verify the work performed.

The mechanic, who was not an employee of the District, also received District provided health insurance since January 2006. The District provided medical and dental benefits to the mechanic and his spouse, a benefit that was both improper and *not* board-approved.

<u>Vague Arrangement Approved by the Board</u>

On August 22, 2005, the District's Board approved the following resolution by a unanimous vote: "Be it resolved, that [the mechanic] be appointed as Fleet Manager for all School District repairs to vehicles . . ."

Comments by a District official, documented in the minutes of that meeting, indicated that this mechanic would be paid for the hours spent working on vehicles, unless the Board wanted another arrangement. No other arrangement

[54] According to IRS guidelines: employers must "[f]urnish Form 1099-MISC to payees for non-employee compensation. Most Forms 1099 must be furnished to payees by January 31, but some can be furnished by February 15." IRS (Circular E), Employer's Tax Guide https://www.irs.gov/pub/irs-pdf/p15.pdf p. 8 accessed on August 8, 2017.

[55] The District made the payments to the mechanic's business establishment and not to the mechanic as an individual.

Criteria relevant to the finding (continued):

Once an employer has determined that a person paid by them is an independent contractor, "the first step is to have the contractor complete Form W-9, Request for Taxpayer Identification Number and Certification. This form can be used to request the correct name and Taxpayer Identification Number, or TIN, of the worker. A TIN may be either a Social Security Number (SSN), or an Employer Identification Number (EIN). **The W-9 should be kept in your files for four years for future reference in case of any questions from the worker or the IRS**." IRS (2016). Forms and Associated Taxes for Independent Contractors. [Emphasis added.] *See* https://www.irs.gov/businesses/small-businesses-self-employed/forms-and-associated-taxes-for-independent-contractors

was discussed or documented. A District official told the Board that the mechanic was "not an employee of the district." There was no discussion or authorization of a specific hourly rate or other compensation, such as health benefits. Also, there was no discussion of the length of the agreement. District officials confirmed that the mechanic was never paid as an employee of the school district through the payroll system.

Payments for the Mechanic's Services

Our review of the District's available vendor reports[56] found that the District paid the mechanic more than $672,000 in seven years, as shown in Figure 1 below. We could not determine how much this mechanic was paid since the 2005 resolution through 2009, because District officials said those records were no longer available.

Figure 1

Calendar Year Ending December 31,	Total Payments to Mechanic
2010	$106,473
2011	$124,878
2012	$111,914
2013	$167,491
2014	$73,320
2015	$48,022
2016	$40,223
Total Payments	**$672,321**

A District official explained that the significant decrease in payments to the mechanic beginning in 2014 was possibly due to the District shifting most of the work in-house rather than having it done by the mechanic.

Circumvention of Accounting Procedures

According to officials, all purchase orders (POs) for the mechanic were prepared in the business office. We reviewed POs and found the District's Chief Financial Officer (CFO) was the sole authorizing signature approving work to be performed by the mechanic. These POs

[56] We reconciled the actual invoices to the vendor reports for two of the seven years, 2012 and 2016, and determined the reports to be reliable. The Appendix further addresses objectives, scope, and methodology.

Example A

included the pre-typed names of the Chief Operating Officer (COO) and the Day Foreman as the requestor for services. However, according to the COO, neither he nor the Day Foreman actually participated in the PO process so they were not aware of the charges for the mechanic's services.

In addition, all invoices from the mechanic went directly to the business office and were, according to the COO, never received by the maintenance department to document the receipt of service.

We obtained and reviewed the mechanic's invoices for the years 2012 and 2016. We found that none of the invoices contained adequate details of the specific services provided, the labor rates charged per hour, or the actual time spent performing services. For instance, one invoice for $3,210 (Example A), dated May 14, 2016, listed the services but it did not provide any breakdown of the charge for each service or any documentation of the time spent or the hourly rate applied. Another invoice for $1,932.10 (Example B), dated May 18, 2016, listed 10 gallons of antifreeze and a thermostat along with a brief description of services, and again, provided no breakdown of the costs of supplies, parts, or services.

We compared the procedures and documentation described above to the District's procedures for other similar services. The purchase orders and invoice approvals for other vehicle maintenance and comparable services provided by other vendors were generated and signed by maintenance department officials. Thus, the procedures implemented for the mechanic contradicted the procedures governing other vendors who provided similar services.

Approving invoices such as these and circumventing the routine authorization and payment procedures weakened internal controls and left the District exposed to the potential for fraud, waste, and abuse of public funds.

District Officials Unaware of Arrangement with the Mechanic

During the audit, several senior officials at the District repeatedly claimed that the only compensation paid to the mechanic in exchange for his work was the benefit of medical and dental coverage (discussed in the next section). Numerous officials asserted that they believed it had been authorized by the Board years ago. However, no one could provide any evidence of Board authorization to provide healthcare benefits to this mechanic.

This lack of awareness about what was actually being paid to the mechanic and how his invoices were processed depicts a weak internal control system and the negative effect of keeping a long-term relationship with a business without a written agreement specifying payment terms and deliverables. District officials and the Board should have periodically and publicly reviewed the arrangements with this business during the more than 12-year relationship. This review should have included a determination of whether the compensation arrangements were appropriate and in the best interest of the District and its taxpayers.

Improper Medical and Dental Benefits

Our review of District records revealed that the mechanic—who was not an employee District—and his spouse received District-paid medical and dental insurance coverage for more than 11 years, beginning January 1, 2006, and up until April 30, 2017.

We were unable to determine the actual cost of providing health insurance to the mechanic and his spouse. The District utilizes a self-insurance plan where it pays actual claims rather than a per-employee premium, and we could not obtain the total cost of the medical and dental claims it paid on behalf of the mechanic and his spouse due to privacy constraints.

However, a retired employee who elected to continue the same District health insurance coverage, for retiree and spouse, over the same five year period would have to contribute a total of $96,131.[57] The payments due from retired employees are based on yearly actuary estimates of premiums for like coverage if the District was not self-insured. Therefore, the rate for retired employees would be more equivalent to an amount paid by the average taxpayer for like coverage.

[57] Annual insurance rates over the 5 year period (2012 through 2016) varied, but the total over the period was $96,131. These rates include the medical, dental, and prescription benefits which were provided to the mechanic and his spouse.

In comparison, District records showed that the mechanic's insurance rate was $1,690 per year, the same as the rate for a full-time District employee and spouse. We verified that the mechanic paid all of his contributions totaling $8,450 from January 2012 through December 2016.[58] The mechanic paid $87,681 less than the average citizen and District retirees, while enjoying cost sharing benefits and lower copays negotiated for active District employees.

In addition, the District budgets estimated yearly claims on the amount of prior year claims less employee and retiree contributions. All employee and retiree contributions are pooled together to share the total cost of actual claims. Claims in excess of these contributions are paid by the District's use of taxpayer funds. Allowing the mechanic to pay such a reduced rate increased the likelihood of added cost to the taxpayers.

We found that there was no board policy allowing non-employees doing business with the District to be included on the District's medical insurance plans. Also, there is no PSC provision allowing school districts to provide health insurance to non-employees. While providing health benefits to District full-time employees is standard practice, neither the Board nor the District had the explicit authority to provide District-paid health benefits to non-employees

Considering the District's financial position, the cost of providing the medical and dental benefits to the mechanic was an unnecessary burden to the taxpayers.

<u>Incomplete and Irregular Enrollment Forms</u>

The mechanic's benefit enrollment application forms, which were completed back in 2005, also showed possible errors or irregularities. For instance, the mechanic was listed as a full-time, active, management employee. In addition, the following required information was missing from the *Dental Enrollment Form* completed by the mechanic:

- Date originally hired.
- Employee Number.
- Employer's signature and date.

[58] We did not review contributions paid prior to that period.

The absence of the above information further supports the fact that the mechanic was not a District employee.

Further, the *Medical Enrollment Form* explicitly stated that all information must be filled out in its entirety *before* enrollment will be processed. Yet, the following required information was not provided on the form completed by the mechanic:

- Date originally hired.
- An answer to the question of whether someone else was financially responsible for the applicant.
- An answer to the question of whether the spouse had other group health insurance or Medicare.

<u>Current Status</u>

After we questioned District officials about its practice of providing this non-employee with health benefits, the District cancelled the medical and dental coverage for the mechanic and his spouse, effective May 1, 2017. The cancellation noted that the termination of benefits was due to a change in employment status. The cancellation stated in relevant part:

> After a review of our policies and the circumstances of your employment status with the district, we have determined it necessary to remove you from our medical and dental coverage plan. Effective May 1, 2017, you will no longer be covered for health and dental benefits.

<u>The District's Persistent Failure to File the Required IRS Forms</u>

Because this mechanic was not an employee of the District, the District was required to file an annual 1099-MISC form with the IRS and with the state Department of Revenue.[59]

[59] https://revenue-pa.custhelp.com/app/answers/detail/a_id/2999/kw/independent%20contractor%20state%20income%20tax/session/L3RpbWUvMTUwMjQ2NjEyOC9zaWQvOGU0bGhVcG4%3D Accessed on August 8, 2017.

Further, the District should have obtained a completed IRS W-9 Form[60] from the mechanic but failed to do so. This form should have been provided prior to making any payments to the mechanic. Information on the W-9 form is necessary to complete the 1099-MISC Form. The District should maintain W-9 Forms as evidence that payments to independent contractors, which are not subject to payroll taxes, were not payments to employees, which are subject to payroll taxes.

For each year that the District paid the mechanic more than $600, it should have reported all required payments on IRS Forms 1099. This should have included both the payments to the mechanic for services rendered, and the insurance benefits provided by the District on behalf of the mechanic and his spouse.

As previously stated, we found the mechanic was paid over $672,000 since 2010; therefore, the District should have issued IRS Forms 1099 for at least the seven year period we reviewed, and it failed to do so. Additionally, the District provided health benefits, and based on the average annual cost to cover an employee and spouse as mentioned above, it is reasonable to surmise that the mechanic received a taxable benefit of more than $600 each year.

The failure of the District to file the required annual IRS Forms 1099 for payment and benefits to the mechanic can lead to possible tax implications for both the District and the mechanic.

Conclusion

The District's arrangements with the mechanic, who provided repairs and service for the District's fleet, were not transparent. Hundreds of thousands of dollars of public funds were spent without sufficient authorization and accountability by the Board and the District's administrators over a span of at least twelve years. As stated in this finding, these payments totaled more than $672,000 over the 7-year period of 2010 to 2016.

[60] Internal Revenue Service (2016). Forms and Associated Taxes for Independent Contractors. Retrieved from https://www.irs.gov/businesses/small-businesses-self-employed/forms-and-associated-taxes-for-independent-contractors. Accessed on August 8, 2017. Form W-9, is used to request the correct name and Taxpayer Identification Number, or TIN, of the worker. A TIN may be either a Social Security Number (SSN), or an Employer Identification Number (EIN). The W-9 should be kept in the District's files for four years for future reference in case of any questions from the worker or the IRS.

Also payments and health benefits were provided to the mechanic without the amounts being properly reported to the IRS as required. In addition, the District improperly provided the mechanic (as well as his spouse) with medical and dental insurance even though he was not an employee. The District should immediately investigate this arrangement and the payments made to the mechanic, and it should take steps to correct its failure to report the payments to the IRS and to implement procedures to prevent such an arrangement from occurring again.

Recommendations

The *Scranton School District* should:

1. Immediately investigate all transactions, including payments for mechanic services and medical claims paid by the District on behalf of the mechanic and his spouse, and contact the IRS about whether it should retroactively file IRS Forms 1099 to the mechanic.

2. Immediately review its procedures for paying vendors and independent contractors and for filing the annual IRS Form 1099.

3. Immediately institute a policy disallowing payment to any applicable vendors/independent contractors until all required tax forms have been completed and properly submitted.

4. Review its District Policy No. 616, *Payment of Bills,* to determine whether it should be updated to provide more specific guidance regarding authorization and payment procedures. The procedures should ensure appropriate segregation of duties, and they should require all vendors and contractors to provide sufficient documentation to support the goods and services provided.

5. Review with business office staff all policies and procedures related to contracts and payments of invoices to ensure compliance.

6. Review the list of its participants in insurance programs to ensure that only full-time employees are participating.

Management Response

District management provided the following response:

"The Board of School Directors in January of 1992 directed the Director of Facilities and Grounds and the [Chief Financial Officer (CFO)] that the School District would begin to utilize a different business establishment to perform work on School District vehicles. The School District Board of Directors communicated to the Director of Facilities and Grounds that he would be responsible for having the work scheduled and completed and that the [CFO] was to verify and authorize payments to ensure that the payment that would be made would be true and accurate. The School District continues to use this method of operations from January 1992 to present. During this period of time methods of operations were brought up by the [CFO] and Director of Facilities and Grounds to review the procedure to determine if a change should be made. All Directors of Facilities and Grounds requested that the procedure established by the Board of School Directors remain in place. None stated in the past or currently that there were any issues since they were scheduling and coordinating the work. The School District issued payments to the actual Business establishment and not to "mechanic performing services" as indicated in the finding.

During this period of time the Scranton School District through the Director of Facilities and Grounds would rent equipment for services, anti-skid, and snow removal services, the School District would be invoiced for such that in turn would be paid to the business establishment. These services would have been requested by the Director of Facilities and Grounds and he would have authorized the work Payment would be approved by the [CFO] pursuant to the Board's directive.

The Business Office will review with the Independent Auditor and Solicitor as to whether a 1099 should have been issued to the Business Establishment. If this is confirmed, the District will issue 1099 forms for the period as well as to all other Business establishments that have provided goods or services which the Scranton School District did not issue 1099's to these previously. As previously stated the School District will review and expand its requirements for issuing 1099's from now on into the future.

In response to the issue of Health care Benefits to the mechanic, in August of 2005, the individual identified was appointed to the position of Fleet manager. Included in the report was that a District official told the board that this was not an employee of the District. Without the knowledge of what was said and communicated from the Board of Directors to the former Manager of Personnel Services, the individual received Health Care Benefits as an employee. As to the issue of what was the intent of the resolution that would need to be determined by the former Board of Directors, Solicitor, Former Manager of Personnel Services as to the determination of *[sic]* providing Health Care to said individual was warranted.

In response to *[sic]* question regarding providing a 1099 for Health Care, it is apparent that there was no communication from the Personnel Office to the Business Office that a 1099 for Health Care would need to be issued to the individual. There would be no identifying way other that *[sic]* notification from Personnel to issue an individual a 1099 for Health Care. The Business Office has no method in determining who is on the Health Care bill or any other benefit that would be subject to a 1099. The School District does not currently issue a 1099 and / or a W-2 for Health Care Coverage.

The School District will review with its Benefits Consultant and District Solicitor as to whether or not the individual was hired as an employee. This is a legal question that the Business Office cannot determine. Once the legal question has been decided the School District will proceed accordingly."

Auditor Conclusion

In its response, District management asserts that the Board directed the method of authorizing payment for the mechanic to the CFO. While we cannot determine the validity of that assertion, we are concerned that District officials indicated that they do whatever the Board instructs them to do, even when those instructions circumvent established internal controls. We maintain that the Board does not have the authority to request the CFO to be the sole authorizer and the only one to verify receipt without going through standard procedures that were applicable to all other vendors.

It is also concerning that District officials assert that the employment status of the mechanic was uncertain. It is apparent that there was a breakdown in communication between the Board, the business office, and the human resources office and that lack of communication is troubling. The benefits provided to a non-employee cost the District tens of thousands of dollars and this expense was overlooked for too long. Further, neither the Board nor District officials had the authority to provide full health and dental insurance to a non-employee and his spouse.

We are encouraged that the District stated they will investigate the IRS form 1099 requirements for the mechanic, as well as his business, and determine if the 1099's should be filed retroactively. We are also encouraged that the District took the necessary actions to cancel the mechanic's insurance after we questioned the benefit. We will review the District's corrective actions, including retroactive filling of IRS forms 1099, during our next audit.

Finding No. 6	**The District Offered Two Enhanced Retirement Incentives, One with Flawed Language, Both Without a Cost Analysis, Resulting in Increasing General Fund Liabilities**

Criteria relevant to the finding:

PSERS Retirement

PSERS offers a defined benefit plan to its members. To receive full retirement benefits, the minimum normal retirement requirements are age 60 with 35 years of service. PSERS allows for early retirement if you are at least age 55 and have 25 or more years of credited service but the retirement benefits are reduced based on scaled penalties.

PSERS also provides for possible health insurance premium assistance of up to $100 per month depending on the retiree's years of service and age. The allowance is only available for out of pocket expenses and if the retiree obtains health insurance through a district plan or PSERS.

Twice in three years, while the District was clearly in a declining financial position, it offered enhanced retirement incentives without a commitment to specific offsetting costs and without a prior cost-benefit analysis. As a result, the District added more than a million dollars to its ongoing General Fund liabilities, for the 2015 calendar year, without first demonstrating specific, projected cost savings or desired results.

While District officials indicated that they used an analytical tool to project potential savings based on various scenarios, the District did not prepare a comprehensive analysis to include its specific goals. The District should set more detailed goals such as desired savings, future program needs, and develop other strategies to ensure the cost of incentives are offset by enough reductions to make the incentives worthwhile.

Historically, the District offered retirement incentives through its contracts with teachers, administrators, clerical, and maintenance personnel. The terms in the contracts required payments over several years causing the District to incur an ongoing liability for future retirement incentive payments. The two enhanced incentives were offered through Memorandums of Understanding (MOUs) that replaced the contracted incentive for that specific year. The District's total retirement incentive liability for the four years included in our review is shown in Figure 1 below.[61]

Figure 1

Scranton School District Retirement Incentive Liability[62]				
	2012	**2013**	**2014**	**2015**
Due Within 1 Year	$2,469,405	$2,185,000	$2,179,500	$2,252,000
Due Beyond 1 Year	$7,053,000	$6,389,000	$5,741,000	$6,891,500
Total Liability	**$9,522,405**	**$8,574,000**	**$7,920,500**	**$9,143,500**

[61] As of the end of our audit work in August 2017, the 2016 financial statements were not yet issued, so the amount of the liability for that year was not yet available.
[62] Source: The Statement of Net Position on the District's independently audited annual financial statements for the respective calendar year. The liability for each respective year included all yearly and future obligations for those who retired up to 7 years prior. It also included the contracted incentive payments for clerical, maintenance, and non-teacher retirees. We did not audit these numbers to verify their accuracy.

Criteria relevant to the finding (continued):

Collective Bargaining Agreement (CBA):

Article 74 of the CBA, effective September 1, 2011, through August 1, 2014, and September 1, 2015, through August 31, 2017, both provide the following:

> "Employees who retire under the provisions of the Pennsylvania School Employee's Retirement System (PSERS) who have twenty (20) or more years of service shall receive ten thousand dollars a year for seven (7) years, subject to the below stated conditions. Employees who retire under the provisions of the Pennsylvania School Employee's Retirement System (PSERS) who have attained age 62 with ten years of service, but not twenty years of service, shall receive two thousand dollars a year for five (5) years, subject to the below stated conditions.
>
> Qualified retirees shall receive seven (7) ten thousand dollar ($10,000) payments over seven years (or $2,000 per year over five years, if applicable), beginning in April of the year after retirement, qualified only by subparagraph (B) of this article.
>
> The incentive hereunder shall be paid annually by the District to the employee in April of the year following his/her retirement in a single payment . . ."

We also found that the first of the two enhanced retirement incentives, provided for in the 2014-15 school year, did not contain any minimum age or service requirements. The failure to include such language led to 5 employees retiring with less than 20 years of service and 2 more with less than 10 years of service.

Early retirement incentives typically contain such minimums to increase the likelihood that, over time, the added incentives paid to those particular retirees are more than offset by the reduced compensation and benefits paid to the new hires who replaced them. As a result of the lack of such minimums in the incentive, the total cost over time of the added incentives may not be offset by reduced compensation and benefits paid to new hires.

Background

According to District officials, the contracted retirement incentives were not attracting a sufficient number of employees to accept the offer. Therefore, in an effort to reduce payroll costs, the District approved the two MOUs to further enhance the benefit to hopefully increase the number of employees choosing to retire early. While it appears that the District's goal was to reduce payroll costs, as discussed later in this finding, we found that the District failed to perform an adequate long-term cost-benefit analysis and set specific goals before approving the MOUs so it could not evaluate the effectiveness of the program.

Early retirement incentives increase the economic value of the standard retirement benefit. As members of PSERS, District employees can retire with full benefits with 35 years of service. Employees can opt to retire early—at age 55 with 25 years of service—but the benefit amount is reduced by penalties. District officials indicated that its retirement incentives are offered as a means to cover those penalties for employees that choose to retire early.

Criteria relevant to the finding (continued):

Section C. Health/Dental insurance Option

> All retirees will be allowed to participate in all the District's health/dental care insurance programs offered to members of the bargaining unit; the total cost of these health insurance premiums shall be borne by the retiree based on rate determined by the carrier.
>
> Should a retiree opt out of the District's health/dental insurance plan he/she may not re-enter.
>
> For those who continue with the option, the District will advance on their behalf the cost of their health insurance premium from the date of their retirement through April of the following year, if requested to do so in writing by the employee. To the extent the premium should exceed the incentive payment, the retiree shall be billed accordingly.
>
> The funds advanced for the insurance health premiums will be deducted from the employee's initial retirement incentive. Thereafter, the annual premium for retirees who participate in the health/dental care option shall be withheld from their annual incentive payment.

<u>MOU 2014-15</u>

The MOU between the teachers' union and the District, adopted May 26, 2015, allowed for a special incentive for bargaining unit members choosing to retire during the 2014-15 school year, who notified the District on or before May 1, 2015, of their intent to retire under the provisions of PSERS. The special incentive replaced the retirement incentive contained in Article 74 of the CBA, for the 2014-15 school year only.

When considering early retirement incentive, best practices recommend that several actions be taken prior to offering the incentive.[63] These actions include:

- *Goal-setting* – an explicit statement of goals is needed to judge the ultimate success of the incentive and to develop performance measures.

- *Cost/Benefit analysis* – an assessment of potential costs and benefits should be performed and the analysis should be linked to the goals.

- *Budgetary considerations* - an estimation of the incremental cost of the incentive is necessary in order to develop accurate budgetary estimates.

- *Implementation considerations* – performance measures should be used to ensure goals are met. Direct and indirect costs and benefits should be tracked to determine if goals are met.

While the District set a general goal of reducing personnel costs and officials indicated that they attempted to budget as accurately as possible, a more comprehensive approach should have been taken to ensure the District realized actual savings over the 7-year incentive payment periods.

Contracted Retirement Incentives

The District has separate collective bargaining agreements (CBAs) and contracts with all personnel classifications including teachers, administrative, clerical, and maintenance personnel. We found that the District's agreements include standard retirement incentives—a benefit that is not typically found in CBA's at school districts in the commonwealth.

The District's CBA with the most participants is with its teachers' union. Therefore, the remainder of this finding will address the retirement incentives related to the CBA and the MOUs with the teachers' union.

[63] Advisory issued by the Government Finance Officers Association. The link to the web page addressing these recommendations is http://www.gfoa.org/evaluating-use-early-retirement-incentives. Accessed on September 6, 2017.

Criteria relevant to the finding (continued):

Employees who were eligible for the retirement under the provisions of PSERS and who complied with the notice requirements to the District were eligible for the Special Incentive.

Those eligible participants who elected the Financial Option shall receive a payment of $15,000 per year for a total of 7 years. Health options remained the same, as in the CBA. The total cost of the premiums are borne by the retiree at a cost determined by the carrier.

As an alternative to the financial option, an employee may have opted to take healthcare (including dental) coverage for 7 years, in lieu of the payment option. The healthcare plan is the same plan that is available to active professional employees. . . . retiree shall be required to contribute toward the cost of the healthcare premium in the amount equal to that contributed by active employees.

MOU 2016-17

The MOU between the teachers' union and the District, adopted March 23, 2017, allowed for a special incentive for bargaining unit members choosing to retire during the 2016-17 school year, who notify the District on or before April 1, 2017, of their intent to retire under the provisions of PSERS. The special incentive shall replace the retirement incentive contained in Article 74 of the CBA, for the 2016-17 school year only.

Employees eligible for the retirement under the provisions of PSERS who are on step 16 and have reach age 55 by December 31, 2017, and who comply with the notice requirements to the District identified above shall be eligible for the Special Incentive.

The District's Standard Retirement Incentive in the District's CBAs

The District's CBA historically has included a built-in retirement incentive.[64] The built-in retirement incentive that has been offered since 2002 is shown in Figure 2 below.

Figure 2

Scranton School District CBA Retirement Incentive—Per Employee				
Minimum Years of Service[65]	Minimum Age	Annual Incentive Payment	Total Years	Total Incentive
20	None	$10,000	7	$70,000
10	62	$2,000	5	$10,000

In addition to the monetary incentive noted in Figure 2, the incentive allowed retirees to continue to participate in the same health/dental insurance program offered to active members of the bargaining unit. The cost of health insurance is paid by the retiree and that cost is based on rates determined by the insurance carrier.[66] Because the District is self-insured, it is then responsible for paying the actual cost of medical claims for those retirees.[67]

First MOU - The 2014-15 Retirement Incentive

On May 26, 2015, the Board approved an MOU, offering an enhanced retirement incentive for the 2014-15 school year. This MOU replaced the regular contracted incentive for the 2014-15 school year only.[68] The resulting modified terms increased the payout amounts from the contracted incentive as shown in Figure 3 below.

[64] We verified that incentives were included in CBAs dating back at least nineteen years to 1998.
[65] Minimum years of service for early retirement are established by PSERS. To retire with a minimum of 10 years of service, the minimum age must be 62.
[66] The retirees receive incentive payments over seven years. They receive medical benefits for up to those seven years. Deductions for insurance payments are made from the incentive, and any balance due is to be paid by the retiree. These insurance payments are higher than those of an active employee.
[67] The District is self-insured and has stop loss provisions of $225,000 per individual per year; however, the potential maximum cost per retiree depends upon whether the coverage is single or includes a spouse and/or family.
[68] The District did not offer a similar enhanced retirement incentive for the administrators; however, an MOU was provided to the maintenance/clerical employees. It provided maintenance employees at the top of their classification the option to retire with $10,000/per year for 7 years OR 7 years of full medical coverage up to age 65. Clerical employees need a minimum of 10 years to get $6,500 per year for 3 years.

Criteria relevant to the finding (continued):

Those eligible participants who elect the Financial Option shall receive a payment of $15,000 per year for a total of 7 years. Health options remained the same, as in the CBA – offered at the cost borne by the retiree.

As an alternative to the financial option, an employee who is eligible may opt to take healthcare coverage (including dental) coverage for 7 years, in lieu of the payment option. The healthcare plan will be the same plan that is available to active professional employees….retiree shall be required to contribute toward the cost of the healthcare premium in the amount equal to that contributed by active employees.

The coverage for the employee shall continue until the date on which the retired employee reached age 65, unless sooner terminated by death of the employee or should the employee reach the seven year maximum period of coverage....

As an alternative to the financial option, an employee who is eligible may opt to take healthcare coverage (including dental) coverage for 7 years by selecting the insurance option. The healthcare plan will be the same plan that is available to active professional employees.

An additional incentive, for those retiring between the age of 55 and 57, has been added to the 2016-17 MOU, as described on page 6 of this finding.

Figure 3

Scranton School District 2014-15 Retirement Incentive—Per Employee				
Minimum Years of Service	Minimum Age	Annual Incentive Payment	Total Years	Total Incentive
None	None	15,000	7	$105,000

For those retirees who still wanted medical insurance, the MOU provided two options. One was continued participation in the health insurance plan for 7 years or until age 65 with the full cost of coverage borne by the retiree. Under this option, the retiree could have their annual incentive payment reduced by the cost of the health insurance. The other option, which differs from terms in the CBA, was continued medical coverage in lieu of the annual incentive payment. Using this option, the retiree would pay the same rate as an active employee.

The District had not performed a cost-benefit analysis, based on goals and desired results, *prior* to offering the 2014-15 retirement incentive to determine if this was a prudent economic choice to offer. District officials indicated that they did not prepare a specific cost-benefit analysis but they would see the savings in the "budget presentation as a whole." Given the multiple options within the MOU and the various scenarios that could have played out, the District should have at least attempted to prepare some type of long-term cost-benefit analysis and plan to measure the effectiveness of the MOU over the 7 year period.

We also found that the District did not prepare a cost analysis *after* the MOU was offered to determine the extent of actual savings until we specifically asked for one. Officials then prepared an analysis comparing the total one-year cost of the retirees' salaries and benefits—net of the total first year cost of the incentive payments owed to the retirees—to the total first-year salary and benefits costs of the newly hired employees. Their analysis showed that 34 employees retired and the District hired 32 new teachers to replace those that retired. While this analysis showed an estimated net savings of approximately $1 million, the analysis could not adequately account for all the costs associated with the medical insurance options and the costly future incentive payments to be paid over the course of the 7-year incentive period (See Figure 1).

As previously stated, the first enhanced retirement incentive increased the District's liability by more than a million dollars. District officials noted that this increased liability may be offset by the savings from reduced salaries for new hires. However, actual savings, if any, cannot be determined without a long-term reconciliation. The District does not know the actual cost benefit of providing incentives over the span of years the incentives were provided.

Second MOU - The 2016-17 Retirement Incentive

On March 23, 2017, the Board approved an MOU offering a retirement incentive for the 2016-17 school year. Unlike the previous MOU, this incentive included minimum age and service requirements. The minimum service requirements were linked to the employee's salary step, which increases over time, generally one step per year. The minimum step requirement was 16 and the minimum age was 55, and employees would have to have achieved both by December 31, 2017.

Similar to the 2014-15 incentive, qualifying employees could elect to receive $15,000 per year for 7 years, with or without opting in to the District's medical insurance coverage; or elect to receive medical coverage for 7 years at the reduced rate for employees. Additionally, this incentive was further enhanced by extending the payment terms and period, as follows:

- If retiring at age 55, at the end of the 7-year payment period, the retiree would receive an additional $10,000 per year for 3 years.

- If retiring at age 56, after 7 years, the retiree would receive an additional $10,000 per year for 2 years.

- If retiring at age 57, after 7 years, the retiree would receive an additional $10,000 for one year.

Again, the District provided no evidence of having set long–term goals, other than reducing salaries, for the MOU or considered any estimated long-term cost-benefit comparisons ahead of its offer. Nor did it commit to any other cost offsets to the retirement incentive, even though the District knew of its declining financial position at the time the MOU was offered.

Conclusion

As noted in our finding, best practices recommend goal setting, cost/benefit analysis, and budgetary analysis prior to offering early retirement incentives. Yet, when its financial position was already precarious, the District did none of the above. The District enhanced its built-in retirement incentive on two separate occasions, once in 2014-15 and again in 2016-17, which increased the District's current and future liabilities. These enhanced incentives were offered to employees without District officials first considering the increased costs or making any commitment to offset those increased costs with reductions in other expenditures. As a result, the incentives were offered without implementing best practices in the management of public funds.

Recommendations

The *Scranton School District* should:

1. Preemptively analyze the potential long-term costs related to retirement incentives *before* it makes such offers so that it can ultimately increase its transparency and accountability to the public. Its analysis should project potential costs and savings over the course of the incentive period so that the full potential impact on the General Fund can be evaluated.

2. Ensure that its incentive offers and any other agreement that legally and financially creates an obligation for the District are complete, accurate, and thoroughly reviewed prior to execution.

3. Ensure that the solicitor conducts a comprehensive review of all offers and agreements for form and legality prior to presenting to the Board for approval.

Management Response

District management provided the following response:

"The School District for both of the early retirement incentives performed a cost analysis over the life of the incentive period in order to determine the validity of the offer prior to offering the incentive. The objective was to reduce the total size of the payroll and this was accomplished.

The School District, through the use of the two early retirement incentives, used the incentives as a specific goal to reduce staff, if possible, and to reduce the overall cost of the total payroll. This has been accomplished by utilizing both incentives. The School District has been able to achieve both reduction in costs and staff for both of the early retirement incentives.

A review of the audit findings indicated that it would cost the School District approximately one million dollars more than the previous year. This chart comparison analyzed the cost from 2014 to 2015 calendar year. The costs went from $6,891,500 in 2015 to $5,132,500 as of December 31, 2016. Therefore, any analysis that is based on not accurately removing each ending year and adding on the next year on a year to year basis would not accurately reflect the true impact of the early retirement incentives. To further illustrate the overall goals of reducing costs were met can be validated with the audit for 2016 which was not available until October 6, 2017."

Auditor Conclusion

While the District asserts that it performed a cost analysis for both of the enhanced retirement incentives, it is important to note that we requested, but did not receive, any long-term analysis of incentive benefit calculations for the 2015 incentive. District Officials did provide an actual one-year reconciliation that was developed ***after*** our request for the benefit analysis. As stated in the finding, best business practices recommend goal setting and a detailed cost-benefit analysis ***before*** an incentive is offered. The District indicated that the incentive was offered as a way to reduce staff, yet we found that the District replaced 32 of the 34 employees that accepted the 2015 incentive. The District could have achieved this small of a staff reduction through normal attrition.

We acknowledge the 2016 Independent Auditor's Report shows a reduction in liabilities; however, the liability amount does not depict the full picture of what the incentives cost the District. Without an all-inclusive long-term analysis of expenditures under the standard contracted or MOU-enhanced incentives, along with a corresponding salary reduction analysis over the 7-year incentive period, we cannot determine the cumulative effect of the costs provided through these incentives. During our next audit of the District, we will review and evaluate corrective actions, if any, implemented by the District.

Finding No. 7 The District Continued to Provide Health Insurance to Former Employees After the Employees Failed to Pay Their Premiums

Criteria relevant to the finding:

"Section 513. Group Insurance Contracts.--(a) Any school district may make contracts of insurance with any insurance company, or nonprofit hospitalization corporation, or nonprofit medical service corporation, authorized to transact business within the Commonwealth, insuring its employees, their spouses and dependents <u>and retired employees</u>, or any class or classes thereof, under a policy or policies of group insurance covering life, health, hospitalization, medical service, or accident insurance, and may contract with any such company granting annuities or pensions, for the pensioning of such employees, and may contract with any such company insuring members of the school board under policies of travel and accident insurance while on the official business of the board, including travel to and returning from meetings of the board or committees thereof, and for such purposes may agree to pay part or all of the premiums or charges for carrying such contracts, and may appropriate out of its treasury any money necessary to pay such premiums or charges or portions thereof." [Emphasis added.] *See* 24 P.S. § 5-5139(a).

We found that the District failed to timely request and obtain overdue health insurance payments due from three former employees. Further, the District did not cancel health insurance coverage when payment was not received; therefore, the District was exposed to additional costs for former employees that should have been dropped from the insurance plan. Finally, our review of payment records for the three former employees disclosed that one of these prior employees still has an outstanding balance of $17,896 that the District failed to collect.

This finding details the District's actions related to collecting health care insurance payments from each of the former employees.

<u>Former Employee 1:</u>

This former employee retired in June 2009. His first health insurance payment was due by December 31, 2010. The former employee failed to make any payments and, by December 31, 2012, he was $17,910 in arrears. We found that the District did not take action to notify the employee of his delinquency and attempt to collect the payments due until February 2013, when the newly appointed Human Resources Director identified the missed payments and sent a letter. Even after that first letter was sent, the employee failed to make another annual payment due in December 2013, bringing the total owed to $29,499. Despite a delinquency that spanned more than three years, the District did not cancel the insurance coverage nor did it aggressively pursue collection. In fact, Former Employee 1 remained on the District's health insurance plan until March 31, 2017, when he became eligible for Medicare.

In April 2014, the District sent the former employee another letter instructing him to contact the District to resolve the late payments to avoid termination. Soon after, the employee submitted his first health insurance payment to the District.

Table 1 shows the payment schedule and balances due from Former Employee 1.

Table 1

Scranton School District Insurance Payment Schedule Former Employee 1			
Payment Due Dec 31,	**Amount Due from Employee**	**Amount Paid by Employee [69]**	**Cumulative Balance Due From Employee**
2010[70]	$10,086	$0	$10,086
2011	$0 /a	$0	$5,830
2012	$12,080	$0	$17,910
2013	$11,589	$0	$29,499
2014	$11,633	$23,236	$17,896
2015	$11,633	$11,633	$17,896
2016	$14,885	$14,885	$17,896

/a – The employee's retirement incentive allowance exceeded the insurance payment due for 2011 by $4,256. This credit was applied to the 2010 balance of $10,086, reducing the balance owed for 2010 to $5,830.

A review of payment records show that the former employee made payments for three years; however, based on our calculations, he still has an outstanding balance of $17,896.

We presented this discrepancy to District officials and they contend that the former employee does not have an outstanding balance. However, according to the records provided for our review, there was a clerical error that was not identified by the District that resulted in the outstanding balance of $17,896. The District should carefully examine its records and take immediate action to collect this delinquent payment.

[69] Each insurance coverage payment is due by December 31st immediately following the effective date of the insurance term. The only exception is the first payment which is due December 31st of the next calendar year. The former employee, in this case, did not make payments until April and May 2014, May 2015, and May and August 2016.
[70] The insurance term for retirees is April 1 through March 31 of each year. The insurance term for the first year for this retiree is September 1, 2009, through March 31, 2010, and April 1, 2010, through March 2011, with payment due December 31, 2010.

Former Employee 2:

Former Employee 2 separated from employment with the District effective December 1, 2011. The Board approved a Transition Agreement with the former employee that contained provisions that included full health care coverage for three months. The District then offered continued health coverage under COBRA,[71] effective March 1, 2012. The former employee accepted the coverage and was to make monthly premium payments. The first payment was due April 15, 2012.[72]

The former employee failed to make his payments to the District for five months in a row, but the District did not send a delinquency notice to the former employee until September 2012. The notice informed the former employee that he owed $12,723, but the notice did not provide a deadline for payment nor did it contain language about terminating insurance coverage for failure to pay the outstanding balance.

The former employee did not respond to the first delinquency notice and the District sent another notice on October 11, 2012. The outstanding balance was now $14,540, and the District informed the former employee that failure to make payment would result in cancellation of his health insurance, retroactive to March 1, 2012.

Even though the former employee still did not make any payments at that time or for the next five months, the District did not cancel his insurance. Then on March 27, 2013, the District sent another letter stating that coverage will be cancelled if payment is not received within ten days. The former employee once again did not make any payment.

On May 31, 2013, the District sent an invoice to the former employee requesting payment for the full 16 months of

[71] The federal Consolidated Omnibus Budget Reconciliation Act of 1986 (COBRA) amended the Public Health Service Act, the Internal Revenue Code, and the Employee Retirement Income Security Act (ERISA) to require employers with 20 or more employees to provide temporary continuation of group health coverage in certain situations where it would otherwise be terminated.

[72] The initial premium payment must be made within 45 days after the date of the COBRA election by the qualified beneficiary. Payment generally must cover the period of coverage from the date of COBRA election retroactive to the date of the loss of coverage due to the qualifying event. Premiums for successive periods of coverage are due on the date stated in the plan with a minimum 30-day grace period for payments. Payment is considered to be made on the date it is sent to the plan. Source: https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/faqs/cobra-continuation-health-coverage-compliance

insurance coverage. The outstanding balance had risen to $27,662.

The District still did not receive any payments and the insurance coverage was cancelled, effective June 30, 2013. Finally, in September 2013, the former employee made his first payment by submitting $2,000 to the District—nearly three months after his insurance was cancelled. The remaining balance was not paid until March 2014.

Although the District sent some notices requesting payments, the former employee ignored their repeated warnings. The District waited too long to send the notices and it failed to take action and follow through with cancellation of coverage when payments were not received.

<u>Former Employee 3:</u>

Former Employee 3 retired from the District, effective December 31, 2012. This former employee's first insurance coverage payment was due no later than December 31, 2013. However, according District officials, they failed to send out the original payment notification at the time of the former employee's retirement.

The missed payment was initially identified by the District and was subsequently verified through an audit conducted by the District's healthcare advisors. On May 13, 2014, the District sent a letter notifying the retiree that she owed $12,450 and requested payment by June 30, 2014. The former employee provided the District with payment in full on May 23, 2014.

Inadequate internal controls and personnel turnover caused the oversight and allowed it to be undetected by the District for five months. The District should ensure its insurance payment processing and collections procedures are strengthened so it can timely identify non-payments and send appropriate notices to its former employees.

<u>Conclusion</u>

Due to the District's financial crisis (see Finding No. 1), it is essential that the District strengthen its internal controls over the collection of insurance payments and enforce termination of coverage when payments are late. Each time the District fails to cancel former employees' insurance coverage in a timely manner, the District is exposed to unnecessary expenses and the risk of paying medical costs up to $225,000 per individual, per year.[73] Ensuring the timely collection of insurance premiums is a necessary component to ensure adequate funds are available for payment of all medical claims.

Recommendations

The *Scranton School District* should:

1. Review its procedures governing the collection of medical insurance premiums from separated employees to ensure the procedures are sufficient to timely detect overdue payments. The District should develop standardized, written procedures and ensure they are implemented and that employees responsible for collecting and accounting for premiums are trained in those procedures. The procedures should include routine monitoring by senior management and periodic reporting to the Board.

2. Review its employee separation procedures and revise accordingly to ensure that those employees opting to continue insurance coverage are timely and properly notified of their obligations regarding timely payments to continue insurance coverage. These procedures should be standardized and written, and senior management should conduct periodic monitoring procedures to ensure notifications were provided in a timely manner.

3. Routinely review its roster of insureds to determine whether individuals are paying premiums timely, and if not, provide delinquent or lapsed insureds sufficient notice of impending termination of coverage; it should then follow through with termination when premiums are not brought up to current status within a clearly stated deadline.

4. Collect the outstanding balance of $17,896 owed from Former Employee 1.

[73] The District has Stop-loss Insurance which limits the District's liability to $225,000 per covered individual per year.

5. Consider revising current procedures to require monthly, rather than annual, insurance payments to ensure the District is not exposed to the unnecessary risk of not receiving payment after expenses have already been incurred.

Management Response

District management provided the following response (verbatim):

"Former Employee 1: Upon reporting to the Personnel Office in January 2013, I was not aware of the delinquency from 2010-2012. Efforts were made to contact the former employee during 2013 and early 2014. I had met with the retiree and their investment advisor and it was agreed that what was thought to be the total outstanding balance would be paid, in full, once two C.D.s matured. As agreed, the 2013 and 2014 payment was made and subsequent payments were made timely.

The clerical error was not discovered until this audit and efforts will be made to collect the outstanding balance.

Former Employee 2: This delinquency was reported to me approximately February/March 2013. Attempts were made to collect and insurance coverage was cancelled in June 2013. Continued attempts resulted in a partial payment and eventual full payment plus interest.

Former Employee 3: This situation involved a special circumstance because even though they retired December 31, 2012, by agreement, they were entitled to earnings in 2013. This meant that the first retirement incentive payment was not due until April 2014. Since these payments are usually applied to insurance costs, we discovered the discrepancy while preparing the 2014 incentive payments and immediately took action for collection. As stated, the matter was resolved in ten (10) days.

Summary: We agree that a defined policy should be drafted and adopted. Retirees that are subject to insurance payments will be advised of the terms (i.e.: automatic termination after 90 days of delinquency).

A report will be developed and list all those that owe and payment schedules, so that delinquencies are visible. This will be provided to the Superintendent on a regular basis."

Auditor Conclusion

We are encouraged that the District has taken corrective actions regarding the prior health insurance payment delinquencies. Further, we are pleased that the District intends to implement corrective actions to ensure timely payments for future health insurance benefits as well as timely termination procedures when applicable. During our next audit of the District, we will review and evaluate these and any other corrective actions implemented by the District.

Finding No. 8 — The District Entered Into Two Separatation Agreements With Former Employees That Resulted In Questionable Use of Taxpayer Funds and Possible Inadequate Reporting of Retirement Wages.

Criteria relevant to the finding:

Section 1073 of the Public School Code, 24 P.S. § 10-1073, states, in relevant part:

"(3) No agreement between the board of school directors and a district superintendent or assistant district superintendent for a negotiated severance of employment prior to the end of the specified contract term shall provide for severance compensation to the district superintendent or assistant district superintendent, including the reasonable value of any noncash severance benefits or postemployment benefits not otherwise accruing under the contract or pursuant to law, that:

(i) If the agreement takes effect two (2) years or more prior to the end of the specified contract term, exceeds the equivalent of one (1) year's compensation and benefits otherwise due under the contract…"

Section 609 of the PSC provides, in part:

"No work shall be hired to be done, no materials purchased and no contracts made by any board or school directors which will cause the sums appropriated to specific purposes in the budget to be exceeded."

The Board of School Directors (Board) voted to enter into separation agreements with its former Superintendent and former Solicitor, with each agreement containing provisions for transitional services and compensation. However, the District could not provide evidence of any work performed to justify the compensation.

In addition, our review of the District's former Superintendent's agreement and payroll records found that the District may have improperly reported ineligible retirement wages and service time to the Public School Employees' Retirement System (PSERS) for the period from July 1, 2014 to October 1, 2014.

The Former Superintendent's Separation

The former Superintendent's employment contract was effective July 1, 2013, through June 30, 2018. Just one year into his five-year contract, the Board voted at its June 23, 2014 meeting to enter into a settlement agreement with this employee. The agreement stated the former Superintendent's contract would expire, by mutual agreement of the parties, on October 1, 2014. The agreement also provided, in part:

1. From June 30, 2014, until October 1, 2014, the Superintendent shall reasonably assist the District with transitional services from his home office.

2. From October 2, 2014, until June 30, 2015, the Superintendent shall be employed[74] by the District to provide reasonable transitional administrator services to the District on a part-time, as-needed basis from his home office at the rate of $2,350 per month.

[74] While the agreement notes the former superintendent shall be "employed" by the District, his resignation was effective October 1, 2014. Therefore, after October 1, he was a consultant and not an "employee" of the District. According to District payroll records, none of this compensation was reported as retirement wages.

Criteria relevant to the finding (continued):

The PSERS Employer Reference Manual (ERM) Chapter 2 states to be eligible for PSERS membership as a full-time employee, the employee must work 5 hours or more a day, 5 days a week or its equivalent. It further states to be eligible as a part-time employee, the employee must be contracted to work less than 5 hours a day, 5 days a week or its equivalent and must have their salaries and retirement deductions reported to PSERS through monthly Work Report Records. Additionally, the PSERS ERM states that independent contractors are not eligible for PSERS membership.

3. The Superintendent will receive a severance payment equal to a full year of his Superintendent's salary. The severance payment shall be paid in full on or before October 1, 2014. (The former Superintendent's 2014-15 salary was $146,373.)

As a result, and as shown in Figure 1 below, the former Superintendent was paid a total of $205,098 as part of the settlement agreement. Further, the $37,575 in payroll paid for the period from July 1, 2014, through October 1, 2014, plus the $21,150 paid as consultation fees from October 2, 2014, through June 30, 2015, was supposed to be for work provided to the District. Yet, the District could provide no evidence that any work was performed by the former Superintendent during any of that time. Also, on July 28, 2014, the Board authorized the Supervisor of Secondary Education to perform the duties of Acting Superintendent.

Figure 1

Scranton School District Payments to Former Superintendent		
Payroll: 7/1/14-10/1/14	$ 37,575	Regular payrolls
Lump Sum Severance: 10/1/14	146,373	Paid 10/1/14[75]
Transition Fees: 10/2/14-6/30/15	21,150	$2,350/month
Total Cost of Separation[76]	**$205,098**	

In addition, the former Superintendent received PSERS service credit for the quarter he was on payroll (July 1, 2014, through October 1, 2014) even though the District had not submitted the required monthly work report records.[77] We contacted PSERS to inquire about whether the former Superintendent was eligible for PSERS membership during this period. PSERS is responsible for making that determination, therefore PSERS must evaluate the information reported to determine eligibility.

Finally, according to PSERS personnel, the active contract record for the former Superintendent showed that he worked at another District beginning on January 12, 2015.

[75] The period covered by the lump-sum salary payment was not specified in the agreement. Records indicate it would be for October 2, 2014, through September 30, 2015.
[76] Excluding the cost of the insurance benefits.
[77] Service credits are used to determine the percentage of salary a former employee would receive in retirement payments. According to the criteria included in the PSERS Reference Manual, a consultant is not eligible for PSERS membership if paid as an independent contractor.

Therefore, the District continued to pay monthly stipends, totaling $14,100, to the former Superintendent after he began working for and receiving wages from another school district.

In conclusion, while the settlement agreement did not specifically require evidence of the work performed, the District should ensure that any expenditure of public funds is supported by appropriate documentation. There was no evidence that Superintendent worked during the final three months that he remained on the District's payroll, and there was no evidence that he provided any services to the District to justify the $21,150 he received from October 2014 through June 2015.

<u>The Former Solicitor's Separation</u>

On December 1, 2011, the Board voted to enter into a transition agreement with its former Solicitor who was an employee of the District. The agreement stated the following, in part:

1. Legal services will continue for ninety days.

2. The Solicitor will cooperate in transition, supply updates and summarize *[sic]* on all active files.

3. The Solicitor will be paid $3,500 per month, beginning in December. There will be 3 payments.

4. The Solicitor will receive fully paid health care for three months.[78]

5. The agreement will terminate on February 29, 2012.

For the period December 1, 2011, through February 29, 2012, the former Solicitor received compensation of $3,500 per month totaling $10,500 for the three months.[79]

The Board approved agreement did not contain provisions that required the former solicitor to submit any documentation providing evidence of services provided during the transition period. As a result, there was no

[78] Also, see the Finding No. 7 regarding to the former solicitor making late payments for health care provided by the District after the three month period.
[79] Excludes the cost of the three months' additional health insurance benefits.

evidence to demonstrate that the former Solicitor had performed any work during the three-month period.

Also, on December 1, 2011, the Board appointed an Interim law firm to act as the District's solicitor for $2,500 per month for Board meetings plus $85 per hour for additional legal services, as needed. Since a new law firm was providing services, the former Solicitor's services may not have been necessary.

Review of the District's Board minutes showed that the new law firm was present at Board meetings subsequent to December 1, 2011. It appears that the new firm was providing legal services right away, and because there was no documentation to evidence any work performed by the former Solicitor during this same time frame, the $10,500 additional fees provided to the former Solicitor may have been an unnecessary expense.

<u>Conclusion</u>

The District's agreements with the former Superintendent and the former Solicitor did not contain provisions that required the employees to provide documentation of the work performed. The District paid these former employees for an extended period of time yet could not provide evidence that any work was actually performed to justify the payments. The Board's failure to establish detailed performance measures and reporting requirements during transition periods allowed for the potential waste of public funds.

According to District personnel, the roles of the former Superintendent and former Solicitor, for the periods where transitional services were to be provided, were only to be available upon request and on an as needed basis. If employees transitioning out of an organization are contracted to work on an as-needed basis or upon request, then they should only be paid for the work that was performed as needed or upon request. And that work and the corresponding time should be documented. So too, this arrangement may not have met PSERS requirements for service time resulting in questionable PSERS wages reported for the former Superintendent.

Recommendations

The *Scranton School District* should:

1. Ensure that any employee separation agreements that contain clauses requiring transitional employees to perform services for the District, that the work be defined in the agreement and then documented and approved by District officials before payment.

2. Include a stipulation in employment and separation agreements prohibiting continued payments for consulting fees to transitioning employees once they have obtained other employment.

3. Review contracts with solicitors to ensure that the payment of fixed monthly fees are for specified services and/or require supporting documentation of time and services provided each month.

4. Review PSERS requirements with payroll personnel to ensure only eligible wages are reported to PSERS.

PSERS should:

5. Review the former Superintendent's retirement wages and adjust service time if it is determined that the compensation paid to the former Superintendent for the period from July 1, 2014, through October 1, 2014, was ineligible.

Management Response

District management provided the following response:

"The Scranton School Board of Directors at public meetings approved two (2) separate agreements with the former Superintendent and former Solicitor. The two (2) separate agreements were both drafted and reviewed by the District Solicitor and Counsel representing the two (2) former employees. These agreements were then presented to the Scranton School Board of Directors for their review and consideration. Both of these agreements were publically voted upon by the Scranton School Board of Directors and approved at public meetings in which there was open public comment. Upon approval of the two (2) agreements the School District Administrators executed the terms and conditions as agreed upon by all parties and as approved by the Scranton school Board of Directors.

The former Superintendent's agreement listed in the report contains payments pursuant to the agreement that was approved biweekly payrolls to October 1, 2014 pursuant to the agreement. The separation agreement also called for a monthly on-call consulting fee of $2,350.00 per month from October 2, 2014 through June 30, 2015 the administration was advised that this was a consultation payment for the remainder of the agreement through June, 2015. The agreement did not call for proof or evidence that any consulting that *[sic]* was performed or that such proof or documentation be submitted. Therefore, there was no directive by the Personnel Office for payroll to receive any documentation. The payments were made in accordance with the approved agreement.

With regard to the former Solicitor's separation, the School District Administration was directed to and followed the Board of Directors approved separation agreement. The former Solicitor was compensated pursuant to the agreement. The former Solicitor, prior to the final payment, was required to cooperate, communicate, and furnish all the Scranton School District's files in his possession to the new solicitor. This was done and completed prior to final payment being made. Once again the Scranton School District Administration acted according to the approved separation agreement. The School District believes that all payments to the former Superintendent and former Solicitor were done according to the agreements that were approved by the Board of School Directors.

The School District will communicate the recommendation contained in this report to the District Solicitor for his review and clarification should there be a need for this type of agreement in the future. The Scranton School District, as it has in this case, will continue to publically approve such agreements."

In addition to its response above, District management conferred with their Solicitor who provided the following response. At the request of the District, we've included the Solicitor's response verbatim below:

"District Solicitor and former Solicitor communicated regularly as there was a collective bargaining agreement pending. The same was settled in February 2012. Further, the solicitor and former solicitor communicated regularly on pending especial education cases and other matters. The former Solicitor's contract was a monthly retainer with an ending date, some three months after he was removed as Solicitor.

The former superintendent regularly communicated with staff during his term of employment and after his term of employment as a consultant.

The Scranton School District uses these transitional agreements to assist new employees in key positions."

Auditor Conclusion

As we stated in the finding, these publically approved agreements did not require the District to maintain documentation of services provided. However, in the interest of transparency and accountability for the expenditure of public funds, we maintain that the District should have maintained supporting evidence to demonstrate that the payments to former employees are necessary and earned. Without such supporting evidence, a determination cannot be made as to whether the payments provided under these agreements were reasonable and necessary. While the Solicitor stated that some services were provided by the former employees, without documentation, we cannot confirm the accuracy of those statements.

During our next audit of the District, we will review separation agreements, if any, to determine if the agreements require documentation that payments were necessary and if the District maintains such documentation.

Finding No. 9 — The District Had Weak Controls over IT Inventory.

Criteria relevant to the finding:

Public School Code, Section 801 (relating to Purchases; use in schools; rules and regulations) states, in part:

> The board of school directors of each school district shall purchase all necessary furniture, equipment, textbooks, school supplies, and other appliances for the use of the public schools, or any department thereof, in their respective districts, and furnish the same free of cost for use in the schools of the district, subject to such rules and regulations regarding the use and <u>safe-keeping thereof</u> as the board of school directors may adopt. . . ." (Emphasis added.) *See* 24 P.S. § 8-801.

The District's IT Department was responsible for purchasing and receiving IT equipment, controlling its distribution and disposal, and maintaining inventory records. However, the Business Office, the Superintendent, and the Board did not provide sufficient oversight of IT equipment inventory processes. The District does not maintain a full master inventory list accounting for equipment from receipt to disposal. Inventory for equipment that is assigned or in for repair is maintained separately by type and serial number. We were not provided with an inventory list to track items placed in reserve stock or deemed as waste. As a result, we found that the IT inventory records for unassigned equipment were incomplete and unreliable, thus increasing the risk of loss, theft, and misuse.[80]

We determined that the District did have some controls in place as evidenced by the results of one procedure we conducted. Specifically, we selected a sample of computers from a large purchase order and we were able to physically locate all assigned items and items being repaired in our sample. However, further review of the District's IT inventory controls identified gaps in the existing controls, including the lack of specific policies governing the purchasing and accounting for its IT equipment inventory. The deficiencies we identified are detailed in the following sections.

<u>Lack of Timely Inventory Recordkeeping Procedures</u>

One of the more significant problems we found with the current IT inventory system was the lack of timeliness in adding purchased equipment to the inventory records. The District did not record an item in inventory until it was assigned to an employee or classroom. In other words, from the time of purchase until the time it was assigned to an employee or classroom, the item was never recorded into inventory. The failure of the District to account for equipment *upon receipt* created an opportunity for items to

[80] The acronym *IT* stands for *information technology* and, in this finding, refers to laptop computers, desktop computers, and digital tablets. We did not review inventory record-keeping for other IT equipment, such as, printers, wireless hot spots, and cell phones with "smart" technology.

Criteria relevant to the finding (continued):

Federal Code of Federal Regulations, Title 2 - Grants and Agreements, Subpart A - Acronyms and Definitions.

> § 200.33 Equipment. "*Equipment* means tangible personal property (including information technology systems) having a useful life of more than one year . . ." (Emphases added.) *See* 2 C.F.R. § 200.33.

Federal Regulations, Title 34 – Education, Part 80 (applies to awards before December 26, 2014:

> § 80.32 Equipment. (a) *Title.* (4) . . . (d) *Management requirements.* Procedures for managing equipment (including replacement equipment), whether acquired in whole or in part with grant funds, until disposition takes place will, as a minimum, meet the following requirements: (1) Property records must be maintained that include a description of the property, a serial number or other identification number, the source of property, who holds title, the acquisition date, and cost of the property, percentage of Federal participation in the cost of the property, the location, use and condition of the property, and any ultimate disposition data including the date of disposal and sale price of the property. (2) A physical inventory of the property must be taken and the results reconciled with the property records at least once every two years. (3) A control system must be developed to ensure adequate safeguards to prevent loss, damage, or theft of the property. Any loss, damage, or theft shall be investigated. *See* former 34 C.F.R. § 80.32. (Emphasis added.)

be lost or stolen during the time lag between the physical receipt of the equipment in the IT Department and its eventual distribution to employees.

Problems with the Inventory of Reserve Stock

The IT Department maintained a reserve stock of digital tablets so that it could quickly replace those that became damaged and/or needed repair. We found that the District did not maintain adequate records identifying those tablets designated for reserve stock due to the procedures described in the paragraph above. There is no detailed inventory identifying serial numbers of tablets designated for reserve stock. As a result, we found that officials could not timely identify where some of the reserve inventory items that had been subsequently distributed or determined waste, were located. We also found that items still held as reserve stock were not always accounted for, rendering the reserve stock inventory record unreliable.

Waste Items

When an item of IT equipment was determined to be unusable, it was removed from the recycling/ repair inventory, which is accounted for by serial number, and held at a designated receiving area until a recycling company picked up the equipment for proper disposal. This equipment held in the receiving area was designated as waste and recorded only by model and type. Once District personnel has time, they periodically re-inventory some stacks of items to prepare for disposal. The District did not account for this equipment consistently with the way it accounted for other equipment, thereby reducing accountability about what equipment was moved from the recycling/repair list and designated as waste for eventual disposal.

Other IT Equipment Purchases:

In addition to bulk purchases of IT equipment made by the IT Department, we also found that single and smaller purchases of IT equipment were requested directly by school principals. These purchases were processed through the District's business office rather than the IT Department. Principals maintained separate lists of purchases, but that inventory was not entered into the District's IT Department's inventory. The IT Department only recorded

Criteria relevant to the finding (continued):

Please note that on December 19, 2014, the U.S. Department of Education published the new Uniform Grant Guidance (UGG). These federal requirements became effective for new and continuation federal awards issued on or after December 26, 2014. See https://www2.ed.gov/policy/fund/guid/uniform-guidance/index.html

the inventory in its own records if assistance was requested for setting up the separately purchased equipment.

Otherwise, officials waited until the summer break to perform its physical inventory count, adding any items not on inventory to the master list. The delay in accounting for those IT purchases increased the risk of loss or theft of this equipment.

Conclusion

While the District had implemented an internal control system over its IT inventory equipment, we found gaps in that system that should be addressed in order to reduce the risk of loss, theft, or misuse. The District failed to properly and timely account for its IT inventory, and part of the reason was that it failed to fully develop and implement written procedures and to ensure that it provided sufficient oversight of the IT Department.

Recommendations:

The *Scranton School District* should:

1. Develop a formal policy governing the purchasing, accounting, distribution, maintenance, and disposal of its IT equipment inventory.

2. Develop a master list of all current IT equipment, by serial number.

3. Develop standardized, written procedures to establish adequate accounting of all IT equipment, including purchases made through the District's General Fund.

    a. For purchases made hereafter, the master list of inventory should at least include the acquisition date, description of the equipment, a serial number or other identification number, funding source, location, and the date of transfers or disposal.

    b. Procedures should require that all acquisitions be recorded upon receipt followed by a routine review by the business office.

4. Require the administration to periodically report to the Board on its IT equipment inventory, including reports on unannounced periodic inventory tests which should occur during the school year and not just during summer break.

Management Response

District management provided the following response in relevant part:

"We maintain separate inventories for Apple, Chrome OS and Win products simply because of the differences in the manageability of those different platforms and serial numbers are maintained within those lists."

"**Reserve**. Reserve is a quantity of items we generally set aside in a large purchase that enables us to swap out non-functioning items in a timely manner. For the reserve items in question they were and are inventoried in our Apple inventory."

Repair/Recycle. "The process that we follow is as such: an item(s) come in for repair/replacement. We separate by model number/type. We then scan all of the same model naming the spreadsheet the same as the computer model. We then import that into the current intake list. We will then go through, over the summer months, each stack and determine what is worth keeping. All items that are beyond repair are again separated by model and put in a room for storage and marked as junk. Before the items are taken by a recycler we scan all items (again by model) and put them in a waste spreadsheet. At some point we then reconcile the intake and the waste spreadsheet."

Our process for purchasing and accounting for IT equipment is as follows:

> "Purchase orders are issued, a copy of the receiver is sent to our receiving facility. When items arrive the quantity and type is checked against the purchase order by physically counting. Items are then stored in a secure location.
>
> Typically a Principal has requested a certain number so when our tech people are in his building the same employee who did the equipment counts delivers the

items to our tech people in the building. The Principal and the technology staff know how many units are to be delivered. At that point the Items are enrolled in their respective management console by our technology staff which automatically pulls the serial number and other information from the device."

"This system for us is a much more efficient model given our staffing levels and it has been used without issue. Admittedly, we do not inventory on receipt primarily because we have no person at the delivery point all day and sometimes for several days so there is a lag time."

"Waste. Waste items were scanned before being picked up by the recycler. Devices come in all summer and are gone through as time allows. Regardless, all items that were received at South Intermediate were scanned for serial numbers and scanned again before going to the recycler."

"Purchasing Of ltems. While it is true that this sometimes does happen, it is much less and becoming less and less frequent as time goes on."

In response to the audit recommendations:

1. While we have some written procedures and a policy on the disposal of equipment, we agree we should have additional policies.

2. We will endeavor to implement an inventory on receipt system

Auditor Conclusion

We appreciate that District personnel acknowledged the gap in its procedures due to the lag time between receipt of equipment and recording items in the inventory records. We are encouraged that the District will consider implementing an "inventory on receipt" system.

With regard to recycled items, the District's response noted that all items that are beyond repair were again separated by model (not serial number) and put in a room for storage and marked as junk. Before the items are taken by a recycler, they are scanned (again by model) and put in a waste spreadsheet. It is during the time when they are separated by model and before they are scanned for the recycler that we found a lag where items in for repair may be deleted before inventoried for the recycler. During our next audit of the District, we will review the proposed corrective actions and any others implemented by the District.

Status of Prior Audit Findings and Observations

Our prior audit of the District released on October 30, 2013, resulted in three findings and two observations, as shown below. As part of our current audit, we determined the status of corrective action taken by the District to implement our prior audit recommendations. We reviewed the District's written response provided to PDE, interviewed District personnel, and performed audit procedures as detailed in each status section below.

Auditor General Performance Audit Report Released on October 30, 2013

Prior Finding No. 1: **Membership Reporting Errors and a Lack of Internal Controls Resulted in the District Not Receiving Their Entitled Subsidy (Resolved)**

Prior Finding Summary: During our prior audit of the District's pupil membership reports submitted to PDE for the 2009-10 and 2008-09 school years, we found that the District lacked the internal controls necessary to ensure that the data reported was complete and accurate. This lack of proper internal controls resulted in the District being overpaid $31,860 over the two year period.

Prior Recommendations: We recommended that the District should:

1. Establish internal controls that include reconciliations of the data that is uploaded into the Pennsylvania Information Management System (PIMS).

2. Verify that the Preliminary Reports from PDE are correct and if not correct, revise and resubmit child accounting data so that the Final Reports from PDE are correct.

We also recommended that PDE should:

3. Revise all reports that have been incorrectly completed and adjust the District's subsidies affected by the errors.

Current Status: During our current audit, we found that the District has implemented our recommendations regarding pupil membership reporting. The District developed procedures to reconcile data prior to uploading to PIMS. They also revised child accounting reports for years subsequent to our prior audit. On June 1, 2016, PDE adjusted the District's net subsidy to account for the overpayment of $31,860.

Prior Finding No. 2: **Transportation Reporting Errors Resulted In Reimbursement Underpayments to the District Totaling $260,111 and Inadequate Contract Monitoring Resulted in Overpayments to a Contractor[81] (Unresolved)**

Prior Finding Summary: Our prior audit of pupil transportation records found errors in the reports submitted to the PDE for the 2009-10 and 2008-09 school years. These errors resulted in net reimbursement underpayments of $113,596 and $146,515 for the 2009-10 and 2008-09 school years, totaling $260,111. Additionally, we found that the District overpaid a transportation contractor because the District did not monitor the daily rate increases related to a contract addendum which allowed for fuel adjustments in addition to the inflationary increase. We also found that the District did not ensure that a contract extension was signed by all parties.

Prior Recommendations: We recommended that the District should:

1. Review mileage records, pupil counts, and contractor payment data for vehicles providing transportation to and from school to ensure accurate reporting of data that is in compliance with PDE reporting guidelines.

2. Implement a system of final review to ensure accurate reporting of transportation data to PDE.

3. Review transportation reports submitted for subsequent years and submit revisions, if necessary.

4. Establish a process for verifying all transportation contractor rates are properly calculated prior to the payment of invoices.

5. Require all parties agreeing to a contract extension to sign the contract extension.

6. Request repayment from the contractor for amounts overbilled for the 2008-09 and 2009-10 school years.

We also recommended that PDE should:

7. Adjust the District's transportation allocation to resolve the net underpayment of $260,111.

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[81] The prior finding title and narrative contained errors. The actual title of the prior finding was, *Transportation Reporting Errors resulted in Reimbursement Underpayments to the District Totaling $260,111 and Overpayments to a Contractor Totaling $3,282*. The overpayments to the Contractor were significantly understated and were due to the District's failure to monitor the daily rates charged by the Contractor. Please see footnote 43 in current Finding No. 2 for more details about the calculation error.

Current Status: During our current audit, we found that although the District did implement some corrective actions, we again identified deficiencies related to the transportation subsidy. These deficiencies related to the District's reporting of nonpublic and charter school students (see Finding No. 4). In January 2016, based on its determination of the net underpayment, PDE adjusted the District's transportation allocation by $262,448, thereby resolving the net underpayment.

Our current audit also found that the District did not verify that contractor rates were properly calculated prior to the payment of invoices. Since the District did not implement our prior audit recommendations related to this transportation contract, we performed a more thorough analysis of the District's payments to the Contractor since the fuel adjustment was added in 2006. The results of our analysis can be found in Finding No. 2 and Finding No. 3 of this current report.

Prior Finding No. 3: Continued Errors in Health Services Data Resulted in Reimbursement Overpayments of $125,011 (Resolved)

Prior Finding Summary: Our prior audit of the District's health services reimbursement requests found that in the reports the District filed with the Pennsylvania Department of Health (PDH), the District inaccurately reported average daily membership (ADM). These errors resulted in reimbursement overpayments of $120,088 for the 2009-10 school year, and $4,923 for the 2008-09 school year, for a grand total of $125,011 in overpayments.

Prior Recommendations: We recommended that the District should:

1. Report ADM for all students for whom comprehensive health records are maintained.

2. Perform an internal review of the membership and health services data prior to submitting reports to PDH.

3. Review reports for school years subsequent to the audit period and, if similar errors are found, submit revised reports to PDH.

We also recommended that PDH should:

4. Adjust the District's allocations to resolve the reimbursement overpayments of $125,011 for the 2009-10 and 2008-09 school years.

Current Status: During our current audit, we found that the District did implement our recommendations regarding the reporting of health services data. In addition, based on its determinations, PDH adjusted the District's allocations by $111,884 to resolve the overpayments. Finally, the District worked with PDH to revise reports that were submitted subsequent to the 2009-10 school year.

Prior Observation No. 1: Transportation Contractors Paid Significantly Over State Formula (Unresolved)

Prior Observation Summary: Our prior audit of the District's transportation records for the 2009-10 and 2008-09 school years found that the District paid two of its bus contractors significantly more than the state formula allowance calculated by PDE. This action may have resulted in an unnecessary expenditure of taxpayer funds.

Recommendations: We recommended that the District should:

1. Consider bidding transportation contracts to determine if taxpayers would benefit from a more favorable contract for the District.

2. Be cognizant of the state's final formula allowance prior to negotiating transportation contracts.

Current Status: During our current audit, we found the District did not solicit bids for transportation services and instead the District extended the contracts with its current providers. We again found that the District paid its transportation contractors significantly over the state formula allowance. (See Finding No. 3)

Prior Observation No. 2: The District Financed Some of Its Debt with Interest-Rate Management ("Swap") Agreements (Resolved)

Prior Observation Summary: On November 22, 2004, the District entered into swap agreements related to its issuance of $9,860,000 and $56,420,000 of bonds (Series of 1998) and (Series of 2001), respectively. 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. Therefore, it is not always prudent for school districts to utilize swaps.

Recommendations: We recommended that the District should:

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

Current Status: During our current audit, we found the District did implement our recommendation to address the financing of debt with Swap agreements. The District restated its 2011 Swap, when it refinanced its 2014 Series E bond issue. There were no termination fees, but there were refinancing fees. District officials stated they have no intention of entering into additional Swap agreements. At this time, they cannot terminate the remaining Swap agreement because it is too costly. If, at some point, interest rates allow termination without a loss of funds, the District will consider terminating the agreement.

Appendix: Audit Scope, Objectives, and Methodology

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, PDE, and other concerned entities.

Our audit, conducted under authority of Sections 402 and 403 of The Fiscal Code,[82] is not a substitute for the local annual financial 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. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit.

Scope

Overall, our audit covered the period July 1, 2012, through June 30, 2016. In addition, the scope of each individual audit objective is detailed on the next page.

The District's management is responsible for establishing and maintaining effective internal controls[83] to provide reasonable assurance that the District is in compliance with certain relevant state laws, regulations, contracts, and administrative procedures (relevant requirements). In conducting our audit, we obtained an understanding of the District's internal controls, including any information technology controls, which 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.

[82] 72 P.S. §§ 402 and 403.
[83] 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; and compliance with certain relevant state laws, regulations, contracts, and administrative procedures.

Objectives/Methodology

In order to properly plan our audit and to guide us in selecting objectives, we reviewed pertinent laws and regulations, board meeting minutes, academic performance data, annual financial reports, annual budgets, new or amended policies and procedures, and the independent audit report of the District's basic financial statements[84] for the fiscal years July 1, 2012, through June 30, 2016. We also determined if the District had key personnel or software vendor changes since the prior audit.

Performance audits draw conclusions based on an evaluation of sufficient, appropriate evidence. Evidence is measured against criteria, such as laws, regulations, third-party studies, and best business practices. Our audit focused on the District's efficiency and effectiveness in the following areas:

- ✓ Financial Stability
- ✓ Contracting
- ✓ Transportation Operations
- ✓ Hiring
- ✓ Retirement Incentives and Retiree Benefits
- ✓ Contract Buyouts
- ✓ Procurement Cards
- ✓ Information Technology Inventory
- ✓ Bus Driver Requirements

As we conducted our audit procedures, we sought to determine answers to the following questions, which served as our audit objectives:

- ✓ Based on an assessment of financial indicators, was the District in a declining financial position, and did it comply with all statutes prohibiting deficit fund balances and the over expending of the District's budget?

    - To address this objective, we reviewed the District's annual financial reports, board-approved annual budgets, independent auditor's reports, treasurer's reports submitted to the Board, summary of child accounting reports, and the general ledger for fiscal years beginning July 1, 2012, through June 30, 2016. The financial and statistical data were used to calculate ratios and trends for benchmarks that represented the District's most problematic areas, which were deemed appropriate for assessing the District's financial stability. The benchmarks are based on best business practices established by several agencies, including PASBO, the Colorado Office of the State Auditor, and the National Forum on Education Statistics. Budgeted revenues and expenditures were compared to actual revenue and expenditure figures. See Finding No. 1 for the results of this review.

[84] The District's financial statements are presented on a calendar year basis of January 1 through December 31.

- ✓ Did the District ensure that its significant contracts were current and were properly obtained, approved, executed, and monitored?

    - o To address this objective, we reviewed the District's procurement and contract monitoring policies and procedures. We obtained a vendor list for the 2014 and 2015 school years. We judgmentally selected for detailed testing, contracts for 6 of the 807 vendors based on high risk factors, such as total value of contract or potential issues identified during our review of board meeting minutes. Testing included a review of the documents to determine if the contract was procured in accordance with the Public School Code and District policies. We also reviewed documents and interviewed District personnel to determine if the District monitored the selected contracts. Finally, we reviewed board meeting minutes and the Board's Statements of Financial Interest to determine if any board member had a conflict of interest in approving the selected contracts. We did not identify reportable deficiencies with five of the contracts we reviewed; however, we found significant deficiencies related to the contract with the primary transportation provider. See Finding No. 2 for the results of this review.

- ✓ Did the District accurately report student data for transportation services to PDE? Did the District receive the correct amount of transportation reimbursement from the Commonwealth?

    - o To address this objective, we determined whether miles reported to PDE were accurate by randomly selecting 14 of the 93 buses used by the District's two major contractors, to transport students during the 2014-15 school year. We reviewed monthly mileage sheets submitted by the bus drivers and compared to the daily miles transported on PDE reports used to calculate the District's reimbursement. We also reviewed bus rosters, requests for transportation, and other supporting documentation for the 2012-13 through 2015-16 school years to determine if all nonpublic and charter school students transported were accurately reported to PDE and the District received the correct subsidy for these students. We also determined the amount paid to the transportation contractors and compared that amount to the final formula allowance. See Findings No. 3 and 4 for the results of this review.

- ✓ Did the District comply with the Public School Code[85] and the District's policy and procedures when hiring new staff?

    - o To address this objective, we obtained and reviewed the District's hiring policies and procedures. We randomly selected ten employees of various classifications hired by the District during the period July 1, 2012, through March 15, 2017, and reviewed documentation to determine if the District complied with the Public School Code and the District's policy and procedures when hiring new employees. Our procedures for this objective did not disclose any reportable issues.

[85] 24 P.S. § 5-508, 24 P.S. § 11-1106, and 24 P.S. § 11-1111

- ✓ 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 employment contract(s) comply with the Public School Code[86] and PSERS guidelines?

    - o To address this objective, we reviewed the Board minutes and found two administrative employees left during the audit period of July 1, 2012, through June 30, 2016. We verified the reason for the separation and whether the total costs of the separation agreements were made public through board meeting minutes. We reviewed the employment contracts and settlement agreements to ensure they complied with appropriate provisions of the PSC regarding inclusion of termination, buy-out, and severance provisions and to ensure payments were made in accordance with agreements. We reviewed their payroll records to ensure compensation was correctly reported to PSERS. See Finding No. 8 for the results of this review.

- ✓ Did the District develop long-term goals and procedures to ensure enhanced retirement incentives were achieving the intended outcome?

    - o We interviewed District officials to determine the process employed when offering retirement incentives. We reviewed employee contracts, MOUs, and other documents related to the costs incurred for those employees who accepted the retirement incentives. See Finding No. 6 for the results of this objective.

- ✓ Did the District have adequate procedures over tracking medical insurance premiums for retirees?

    - o We interviewed District personnel to determine the process for tracking health insurance premium payments for retirees. We reviewed monitoring procedures over collection of medical insurance payments due from retirees during the 2016 calendar year. See Finding No. 7 for the results of this review.

    - o After we determined that the District was also providing health insurance to a non-employee, we obtained and reviewed records related to premiums paid by the non-employee. We reviewed board meeting minutes to determine the employment status of the individual. We also reviewed documentation to support payments to this individual for services provided and then determined if the District was filing the appropriate tax forms to report payments and benefits provided to this individual. See Finding No. 5 for the results of these procedures.

[86] 24 P.S. § 10-1073(e)(v)

- ✓ Did the District have adequate internal controls, including board-approved policies and procedures, over its procurement cards in order to safeguard the use of public funds?

    - o We reviewed the District's procurement card policy and procedures, as well as the District's responses to a questionnaire related to its procurement card practices. We also interviewed the District's CFO and Assistant Business Manager to obtain an understanding of the District's procedures and internal controls. We reviewed the District's list of procurement card transactions for the five calendar year period of 2012 through 2016 to identify any purchases that appeared to be excessive, recurrent, or not for District purposes. We compared the total monthly procurement card amounts reported on bank statements to the monthly list of transactions for the entire 2016 calendar year to verify the reliability of the lists. While our review identified minor deficiencies that were verbally communicated to District officials and to the Board, our review of this objective did not disclose any reportable issues.

- ✓ Did the District have adequate controls over its inventory of IT equipment, and did it comply with board-approved policies and/or procedures?

    - o To address this objective, we interviewed District officials and requested board policies to evaluate the District's internal controls over IT equipment. We obtained and reviewed IT equipment inventory records and found that the District does not maintain a master inventory listing. We conducted physical observations of the receiving department and of the IT equipment recycling/waste areas. We attempted to track IT equipment from purchase to disposal and identified gaps in the recordkeeping that hindered our ability to test the accuracy of the inventory records. See Finding No. 9 for the results of this review.

- ✓ Did the District ensure that bus drivers transporting District students had the required driver's license, physical exam, training, background checks, and clearances as outlined in applicable laws?[87] Also, did the District have written policies and procedures governing the hiring of new bus drivers that would, when followed, provide reasonable assurance of compliance with applicable laws?

    - o To address this objective, we selected 5 of the 18 bus drivers, hired by the District's transportation contractors, during the 2015-16 and 2016-17 school years, and reviewed documentation to determine if the District ensured that the bus drivers complied with the requirements. We also reviewed the District's written policies and procedures governing the hiring of bus drivers and found them to be adequate to ensure compliance with bus driver hiring requirements if followed. Our review of this objective did not disclose any reportable issues.

[87] 24 P.S. § 1-111, 23 Pa.C.S. § 6344(a.1), 24 P.S. § 2070.1a *et seq.*, 75 Pa.C.S. §§ 1508.1 and 1509, and 22 *Pa. Code Chapter 8*.

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