

PERFORMANCE AUDIT

Midland Borough School District Beaver County, Pennsylvania

September 2016



Commonwealth of Pennsylvania
Department of the Auditor General

Eugene A. DePasquale • Auditor General



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EUGENE A. DePASQUALE
AUDITOR GENERAL

Mr. Sean Tanner, Superintendent
Midland Borough School District
173 7th Street
Midland, Pennsylvania 15059

Mr. Richard Corradi, Board President
Midland Borough School District
173 7th Street
Midland, Pennsylvania 15059

Dear Mr. Tanner and Mr. Corradi:

Our performance audit of the Midland Borough School District (District) evaluated the application of best practices in the areas of finance and school safety. 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, 2010 through June 23, 2016, except as otherwise indicated in the audit scope, objective, and methodology section of the report. The audit was conducted pursuant to Section 403 of The Fiscal Code, 72 P.S. § 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.

Our audit found that the District applied best practices in the areas listed above and complied, in all significant respects, with relevant requirements, except as detailed in our two findings noted in this audit report. A summary of the results is presented in the Executive Summary section of the audit report.

Our audit findings and recommendations have been discussed with the District's management, and their pertinent 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 relevant requirements. We appreciate the District's cooperation during the course of the audit.

Sincerely,

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

Eugene A. DePasquale
Auditor General

September 21, 2016

cc: **MIDLAND BOROUGH 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.

Our audit scope covered the period July 1, 2010 through June 23, 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 2010-11 and 2011-12 school years.

Audit Conclusion and Results

Our audit found that the District applied best practices and complied, in all significant respects, with certain relevant state laws, regulations, contracts, and administrative procedures, except for two findings.

Finding No. 1: The District's General Fund Balance Decreased by \$1.0 Million from June 30, 2010 through June 30, 2015, Due to a Cumulative Operating Deficit. To assess the District's financial stability, we reviewed several financial benchmarks to evaluate changes in its financial position over a period of six years from fiscal year ending June 30, 2010 through June 30, 2015. The General Fund Balance decreased from \$2,916,296 on June 30, 2011, to \$1,851,966 on June 30, 2015. The decreasing General Fund Balance is the direct result of

operational deficits posted for three of the six years reviewed (see page 6).

Finding No. 2: The District and its Board Conducted Transactions with Related Organizations Which May Not Have Been Fiscally Responsible and Indicated Ineffective Governance and Lack of Transparency. As of June 30, 2015, the District had a \$1.5 million balance on a long-term, prepaid lease with a related local performing arts center. The prepaid lease was originated in 2005 for \$3 million and amortized annually over 20 years at \$150,000 for the use of space to host arts classes and occasional special events for District students, high school students who reside in Midland, and the community.

We believe that entering into this prepaid lease was not a fiscally responsible decision by the Board of School Directors (Board). As part of their key governance and management responsibilities, the District's governing Board and administrators have the duty of closely vetting and monitoring any of their contracts and leases, as well as any questionable related party transactions that could lead to actual or perceived conflicts (see page 13).

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

Background Information

School Characteristics 2012-13 School Year ^A	
County	Beaver
Total Square Miles	1.6
Resident Population ^B	2,635
Number of School Buildings	1
Total Teachers	21
Total Full or Part-Time Support Staff	3
Total Administrators	4
Total Enrollment for Most Recent School Year	359
Intermediate Unit Number	27
District Vo-Tech School	Beaver County CTC

A - Source: Information provided by the District administration and is unaudited.

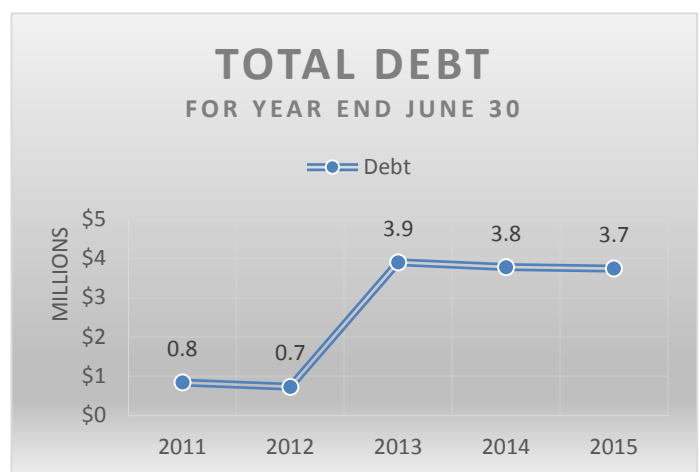
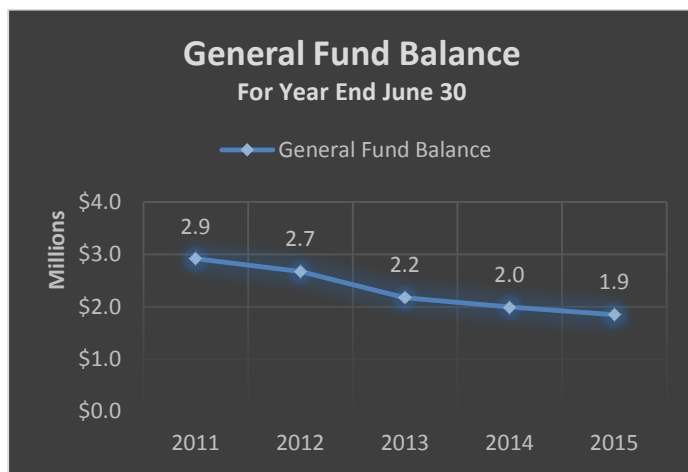
B - Source: United States Census
<http://www.census.gov/2010census>

Mission Statement^A

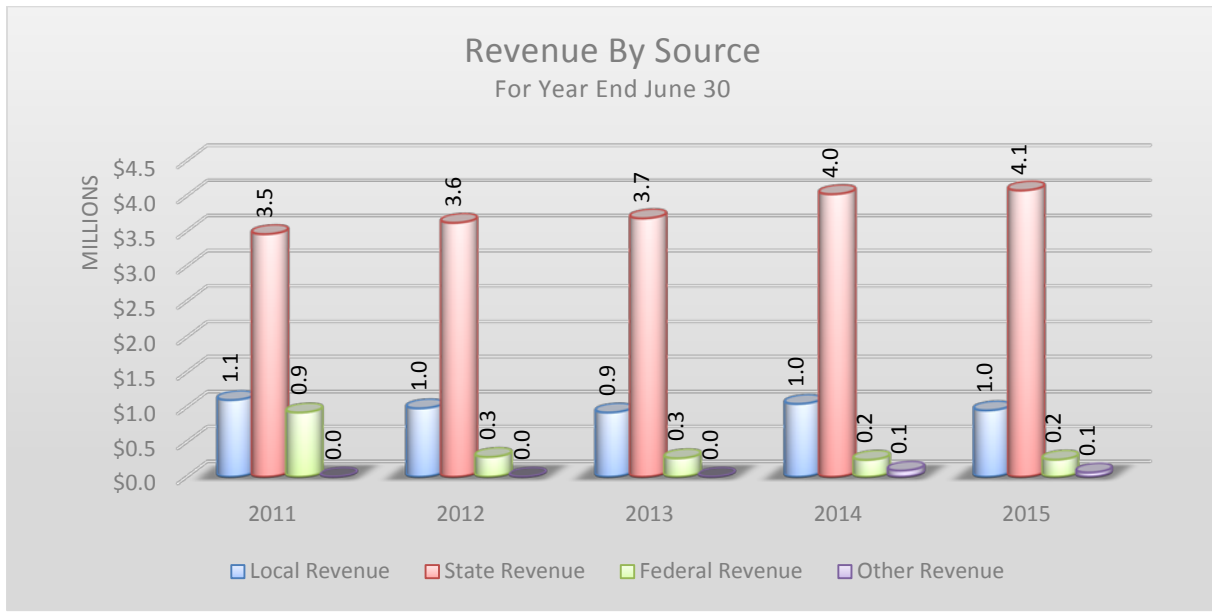
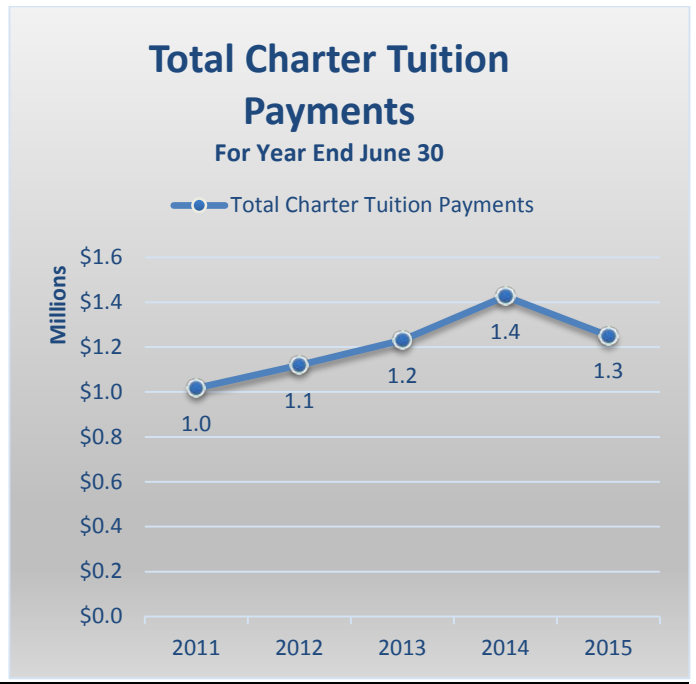
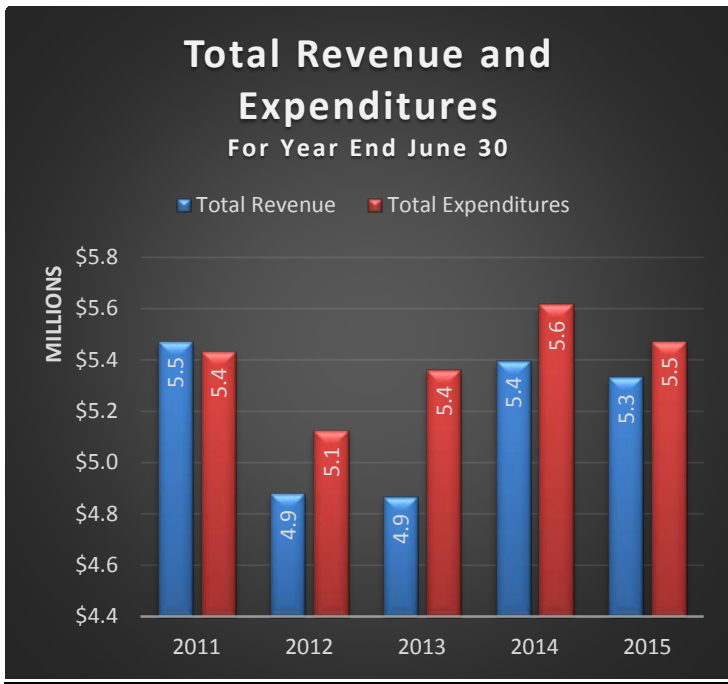
“The mission of Midland Borough School is to provide an academic environment in which our children may reflect upon their heritage and prepare themselves for both the challenges of the 21 Century and their future success.”

Financial Information

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



Financial Information Continued



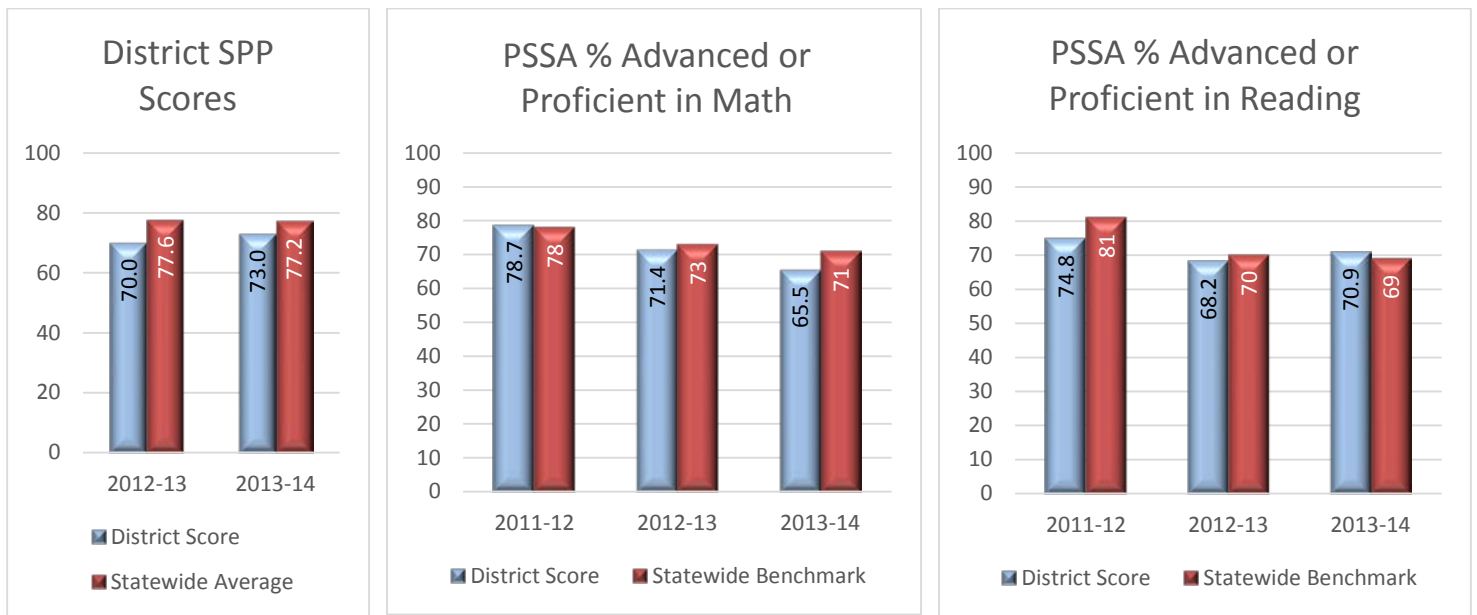
Academic Information

The following table and charts consist of School Performance Profile (SPP) scores and Pennsylvania System of School Assessment (PSSA) results for the entire District obtained from PDE’s data files.¹ These scores are presented in the District’s audit report for **informational purposes only**, and they were not audited by our Department.

SPP benchmarks represent the statewide average of all district school buildings in the Commonwealth.² PSSA benchmarks and goals are determined by PDE each school year and apply to all public school entities.³ District SPP and PSSA scores were calculated using an average of all of the individual school buildings within the District. Scores below SPP statewide averages and PSSA benchmarks/goals are presented in red.

Districtwide SPP and PSSA Scores

District	SPP Scores		PSSA % Advanced or Proficient in Math			PSSA % Advanced or Proficient in Reading		
	2012-13	2013-14	2011-12	2012-13	2013-14	2011-12	2012-13	2013-14
<i>Statewide Benchmark</i>	77.6	77.2	78	73	71	81	70	69
<i>Midland Borough SD</i>	70.0	73.0	78.7	71.4	65.5	74.8	68.2	70.9
<i>SPP Grade⁴</i>	C	C						



¹ PDE is the sole source of academic data presented in this report. All academic data was obtained from PDE’s publicly available website.

² Statewide averages for SPP scores were calculated based on all district school buildings throughout the Commonwealth, excluding charter and cyber charter schools.

³ PSSA benchmarks apply to all district school buildings, charters, and cyber charters. In the 2011-12 school year, the state benchmarks reflect the Adequate Yearly Progress targets established under No Child Left Behind. In the 2012-13 and 2013-14 school years, the state benchmarks reflect the statewide goals based on annual measurable objectives established by PDE.

⁴ The following letter grades are based on a 0-100 point system: A (90-100), B (80-89), C (70-79), D (60-69), F (59 or below).

Individual School Building SPP and PSSA Scores

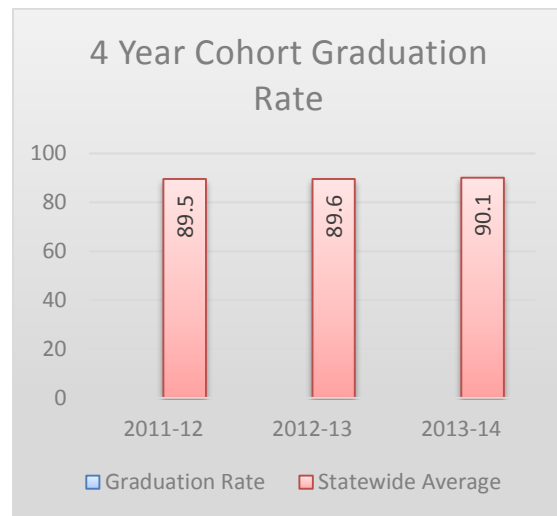
The following table consists of SPP scores and PSSA results for each of the District’s school buildings. Any blanks in PSSA data means that PDE did not publish a score for that school for that particular year.⁵

School Name	SPP Scores		PSSA % Advanced or Proficient in Math			PSSA % Advanced or Proficient in Reading		
	2012-13	2013-14	2011-12	2012-13	2013-14	2011-12	2012-13	2013-14
<i>Statewide Benchmark</i>	77.6	77.2	78	73	71	81	70	69
<i>Midland Elementary/Middle School</i>	70.0	73.0	78.7	71.4	65.5	74.8	68.2	70.9

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.⁶

Midland Borough School District does not have a high school; therefore, no graduation data is available for the District.



⁵ PDE’s data does not provide any further information regarding the reason a score was not published.

⁶ <http://www.education.pa.gov/Data-and-Statistics/Pages/Cohort-Graduation-Rate-.aspx#.V1BFCDTD-JA>.

Findings

Finding No. 1

The District's General Fund Balance Decreased by \$1.0 Million from June 30, 2010 through June 30, 2015, Due to a Cumulative Operating Deficit

Criteria relevant to the finding:

The Pennsylvania School Boards Association (PSBA) in its Annual Overview of Fiscal Health for the 2009-10 school year provided the following information relevant to the following fiscal benchmark:

- 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).

Best Business Practices and/or general financial statement analysis tools require the following:

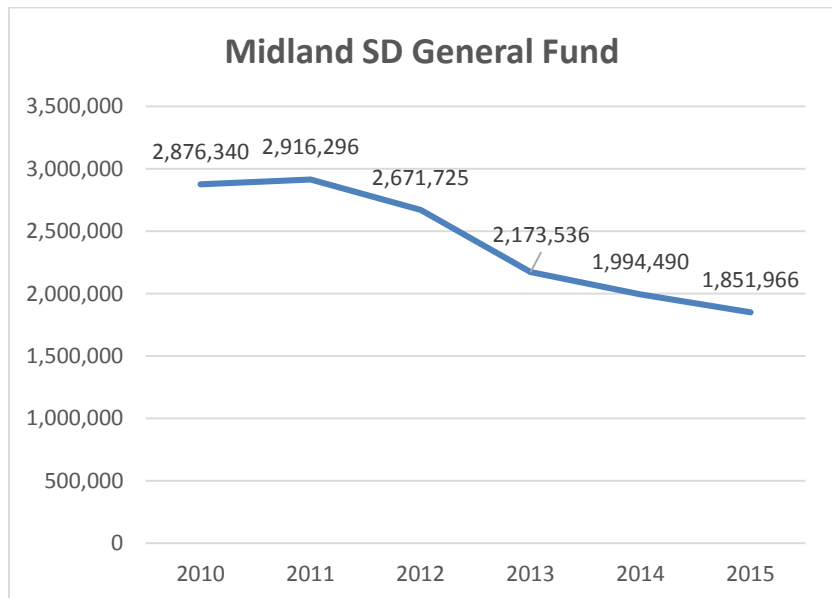
- A school district should maintain a trend of stable or increasing fund balances.
- The costs for a school district student attending a charter school is paid out of the sending district's operating funds. This results in a reduction of the funds available for use in providing educational services to the District's students that remained in the traditional public school. This scenario continues until the number of students attending charter schools is so large that the district can reduce costs by closing a school building and reduces the number of staff employed by the District.

To assess the District's financial stability, we reviewed several financial benchmarks to evaluate changes in its financial position over a period of six years from fiscal year ending June 30, 2010 through June 30, 2015. The benchmarks used are discussed below and include the following:

- General Fund Balance
- General Fund Operations
- Charter School Costs

General Fund Balance

The General Fund Balance decreased from \$2,916,296 on June 30, 2011, to \$1,851,966 on June 30, 2015. The following graph illustrates the District's General Fund Balance decrease over this period.



During this time frame, the District’s General Fund decreased by \$1,064,330, representing a 36.5 percent decline in the General Fund Balance. In addition, the General Fund Balance went from a high of 53.7 percent of total expenditures for the fiscal year ending June 30, 2011, to its current position of 35.3 percent of the District’s expenditures for the fiscal year ending June 30, 2015, representing a steady decline. The Government Finance Officers Association recommends that a school district’s General Fund Balance should not fall below 10 percent of expenditures.

Just as individuals should have a “rainy day fund” to deal with emergencies, or unforeseen needs, school districts should also have reserve funds to deal with emergencies, unanticipated expenses, and disruptions to its revenues.

The decreasing General Fund Balance is the direct result of operational deficits posted for three of the six years reviewed. Without an increase in revenue or decrease in expenditures, the General Fund Balance will continue to decline.

General Fund Operations (Operating Position)

During the period of June 30, 2010 through June 30, 2015, the District’s total expenditures exceeded total revenues for three years. When expenditures exceed revenues, the District’s General Fund Balance decreases.

The following chart documents the District’s declining operating position:

Midland SD Operating Position			
Year Ended June 30	Total Revenue	Total Expenditures	Surplus/ (Deficit)
2010	\$ 5,195,854	\$ 5,114,452	\$81,402
2011	5,473,926	5,433,970	\$39,956
2012	4,881,261	5,125,832	\$(244,571)
2013	4,857,721	5,355,910	\$(498,189)
2014	5,332,067	5,413,626	\$(81,559)
2015	5,278,450	5,248,182	\$30,268
Total:	\$31,019,279	\$31,691,972	\$(672,693)

The District’s administration attributed the District’s financially declining state to both decreases in revenue and increases in expenditures over the period reviewed. The District specifically cited the reduction of federal revenue in fiscal years 2012, 2013, and 2014. On the expenditure side, the District stated that increases in retirement costs, health care costs, special education costs, charter school tuition costs (addressed in detail below), and debt service payments have driven District expenditures higher than expected.

District officials stated that the Board had no option but to draw down the fund balance. It did not consider requesting tax increase waivers for retirement costs and special education. While the District has a fund balance policy, the policy does not disclose an optimum fund balance or an acceptable low or high fund balance amount.

Charter School Costs

Charter school tuition costs increased from approximately \$862,000 for year ending June 30, 2010, to approximately \$1.25 million at June 30, 2015, an increase of approximately \$400,000, or 46 percent.

With charter school costs increasing, it will be imperative for the District to monitor that they are being billed correctly by individual charter schools where District students are enrolled.

The following chart documents the District’s increasing charter school costs:

Midland SD Charter School Cost Growth <i>(As a Percentage of Total District Expenditures)</i>			
Year Ended June 30	Tuition Paid to Charter Schools	Total District Expenditures	Charter Costs/ Total Costs
2010	\$ 862,254	\$5,114,452	16.86%
2011	1,017,239	5,433,970	18.72%
2012	1,120,259	5,125,832	21.86%
2013	1,231,294	5,355,910	22.99%
2014	1,426,856	5,413,626	26.36%
2015	1,250,772	5,248,182	23.83%

District officials believe this rate of increase will continue due to the overall growth of charter schools in Pennsylvania. In addition, due to the most unique situation befallen Midland Borough dating back to the 1970s, a high school is no longer accessible to students at the District. When the steel industry began declining and steel mills were closed, Midland Borough's populace lost their jobs and moved away from the area.

When the number of high school students decreased to just 150 by 1985, the Board determined that it would be more cost efficient to close the high school and began contracting with neighboring school districts. The first contract was in effect from 1985 through 1990, and was terminated due to demographic issues, and the second, with an Ohio based school district, was in effect from 1990 until the contractor decided not to renew it in 2015. With no educational services available to high school students, and with the increase in charter school and cyber charter school options available, this trend will likely continue, according to District officials.

The District's General Fund has decreased over our review period and will continue to decrease without a business model that aligns total District expenditures to total District revenues.

Recommendations

The *Midland Borough School District* should:

1. Amend its fund balance policy to discuss optimum fund balance levels and to set policy for maximum levels of fund balance, minimum acceptable levels of fund balance, and the planned drawdown of excessive levels of fund balance.
2. Develop a business plan that aligns District expenditures to total District revenues.
3. Monitor the costs and student information on all charter school invoices to ensure that only District students are being invoiced to the District and that the proper number of days and tuition are reported on the invoices.

Management Response

District management provided the following as part of their response:

The District is mindful of the decrease in the fund balance and is more than willing to address the recommendations (3) listed in the audit. More specifically:

Management Response to Recommendation No.1:

The Fund Balance Policy will be discussed among the finance committee and the board will establish maximum and minimum levels. However, at this time, based on funding challenges at the state and local level, Management and the Board continuously addresses the needs of the fund balance for future budgets.

Management Response to Recommendation No. 2:

The District does this annually as part of its budget process. Further, the budget process considers changes in the future funding sources, changes in personnel and administrative expenses and other known or expected changes in the law and regulations that could affect the budget.

Management Response to Recommendation No. 3:

The District will develop a reconciliation procedure that will be performed on a monthly basis to ensure proper number of days and tuition are being reported.

Further Points of Consideration:

- The District's local tax has dropped significantly during the Audit years in question. And there is the real potential of another large business [vendor removed] leaving the area permanently.
- The State and Federal funding is continuously decreasing while the District must continue to be operational.
- The District's share of PSERS ballooned to \$400,000 per year.

- Due to the well-publicized State impasse the District was forced into tapping into the fund. This crisis was even commented on by Auditor General DePasquale.
- The District, as well as all other Districts, are faced with the continual increase in health care.

The District has always been fiscally responsible and never shirking from their duty to do so. However, to quote the auditor in his report the Fund Balance is to be used as follows: **“Just as individuals should have a “rainy day fund” to deal with emergencies, or unforeseen needs, school districts should also have reserve funds to deal with emergencies, unanticipated expenses, and disruptions to its revenues.”**

And as one will note from the facts as presented in the “Further Points of Consideration” this is exactly what the Board had utilized the monies for; unforeseen needs, emergencies as well as disruptions to its revenues.

The District would respectfully request this Finding be downgraded to a Comment in light of the above-mentioned and the fact the District does have a Fund Balance Policy.

Auditor Conclusion

While we acknowledge that the District has faced an increase in retirement contributions, coupled with a decreasing local tax base and uncertainty regarding state subsidies, we continue to recommend that the District develop a multi-faceted business model that aligns expenditures with available revenues. Uncertainty in regard to future revenue amounts should lead the District to reevaluate all variable expenditures and develop an operating budget that results in a yearly surplus.

Finding No. 2

The District and its Board Conducted Transactions with Related Organizations Which May Not Have Been Fiscally Responsible and Indicated Ineffective Governance and Lack of Transparency

Criteria relevant to the finding:

According to the Pennsylvania School Boards Association (PSBA), to govern effectively, school directors collectively and individually:

- Adhere to an established set of rules and procedures for board operations.
- Develop, adopt, revise, and review policy.
- Align decisions to policy.
- Differentiate between governance and management, delegating management tasks to administration.
- Allocate finances and resources.
- Ensure compliance with local, state, and federal laws.

PSBA.

<https://www.psba.org/about/principles/> (Accessed July 15, 2016)

According to PSBA, the role of the superintendent and administrative staff is:

- The staff is employed by the board to administer and operate the schools under its direction.
- The superintendent is a partner of the board. No policy should be adopted without the superintendent's recommendations. The superintendent should be at all board meetings, except possibly those fixing his or her salary.

As of June 30, 2015, the District had a \$1.5 million balance on a long-term, prepaid lease with a related local performing arts center (Arts Center). The prepaid lease was originated in 2005 for \$3 million and amortized annually over 20 years at \$150,000 for the use of space to host arts classes and occasional special events for District students, high school students who reside in Midland, and the community.⁷

We believe that entering into this prepaid lease was not a fiscally responsible decision by the Board. As part of their key governance and management responsibilities, the District's governing Board and administrators have the duty of closely vetting and monitoring any of their contracts and leases, as well as any questionable related party transactions that could lead to actual or perceived conflicts.

In fact, the District may not be using the Arts Center often enough to justify this arrangement, and it should formally review its use of the space, its accountability of that usage, and consider collecting the \$1.5 million balance of the prepaid lease from the Arts Center. If it should rent space from the Arts Center in the future, after an open and public process that includes ample transparency to the taxpayers, it should pay for the cost in the year it incurs the expense rather than obligating taxpayers to a long-term, prepaid cost for space that may or may not be available.

⁷ Since the District does not have a high school, Midland students attend other public school district high schools, public charter schools, or private schools.

*Criteria relevant to the finding
(continued):*

- The superintendent is the leader of the staff.
- The superintendent links the board with all other school employees.
- The superintendent and the administrative staff must strive to use the resources of the board, the teachers and the community in effecting changes in educational policy.
- The superintendent and staff must interpret the needs of the school system.
- The superintendent and staff must interpret board decisions to school personnel and the community.
- The superintendent must work with or hire central staff who have unique skills and abilities to perform the many services needed in fulfilling the tasks of the school district.
- The superintendent of schools is employed by the board of education as its executive agent -- a professional adviser to the board, the chief administrator of the schools, the leader of the staff and the focal point of responsibility in the district.
- Building principals are the educational leaders in the various schools. Their position is to inspire their staff to provide the best education possible, consistent with overall school district policy. They must share responsibilities for selection, improvement and dismissal of personnel. They should be a professional resource to the board, and they should be able to identify the resources necessary to aid teaching and learning in their respective schools.

PSBA Archives.

<http://archive-org.com/page/542691/2012-10-28/http://www.psba.org/new-members/resources/understanding-basics.asp>

(Accessed July 19, 2016)

The District also rents out its own gymnasium and six classrooms for approximately \$45,000 per year to a performing arts charter school (Arts Charter School) that is housed in the Arts Center. We believe this may be a related party transaction and, at a minimum, further calls into the question the District's prepaid lease with the Arts Center.

There may be another related party transaction which involved the District paying a related management company almost \$800,000 in the past six years for management services without utilizing an open and public process.

We believe that this related party transaction and possible conflicts should have been evaluated and, if necessary, ended by the governing Board and District administrators. Both of these arrangements are discussed later in the finding.

All of the following transactions caused concerns about ineffective governance and a lack of transparency because of the governing Board and administrators' failure to properly assess and monitor them as part of their basic governance responsibilities:

- The former Superintendent of the District (1995-2007) is credited with founding the Arts Center and serving as its executive director (2002-2006). He also founded the Arts Charter School, housed in the Arts Center, and served as an officer, according to the Arts Center's IRS Form 990s. He also founded and served as past president of the management company (2005-2008).
- The District's director of student services (2011-2014) was also a trustee of the board of the Arts Center (2011-2013) and a former board president of the management company (2010-2011). These roles overlapped during the audit period. The director of student services' spouse was also listed as an employee of the management company's primary vendor during the audit period (2011).

These roles may have presented a conflict of interest or at least the appearance of a conflict.

Criteria relevant to the finding (continued):

Best practices for publicly-funded organizations commonly recommend competitive selection procedures for procurement of professional services. *See* among other best practices, the IBM Center for the Business of Government. "Effectively Managing Professional Services Contracts: 12 Best Practices." 2006.

Section 1102 of the Ethics Act,

65 Pa.C.S. § 1102, defines the terms public official, immediate family member, and conflicts of interest.

Subsection (f) of Section 1103 of the Ethics Act, 65 Pa.C.S. § 1103(f), states, in part: "No public official...or his spouse or child or **any business in which the person** or his spouse or child is associated shall enter into any contract...with the governmental body with which the public official...is associated or any subcontract...unless the contract has been awarded through an **open and public process**, including prior public notice and subsequent public disclosure of all proposals considered and contracts awarded. In such a case, the **public official** or public employee **shall not have any supervisory or overall responsibility** for the implementation or administration of the contract..." [Emphases added.]

- Two members of the District's Board were employed by the management company during the audit period (2010-2012). One was employed as a warehouse manager, and the other was employed as director of maintenance.
- The current Board President of the District also served as a board of trustee member and officer of the Arts Center during the audit period (2010-2012) raising concerns about an appearance of a conflict given the nature of the prepaid lease.

The Prepaid Lease

Two separate prepaid lease agreements for the Arts Center, each with 20-year terms, were signed on May 9, 2005, one by the District and the other by a cyber charter school with headquarters located in the same town as the District. The cyber charter school was founded by the former Superintendent of the District who also previously served as executive director of the Arts Center (mentioned in the first bullet above).

Except for the dollar amounts and signatories, the two leases were identical. Both leases were for the use of 88,000 square feet of a performing arts center that was under construction at the time of the lease signings. The leases do not further specify when and how the center was to be used by the District and the cyber charter school. The Arts Center opened during the summer of 2006. The District prepaid \$3 million, and the cyber charter school prepaid \$10 million.

In June 2009, the cyber charter school converted its prepaid lease to a 25-year note receivable partly because the Arts Charter School experienced significant enrollment growth and needed more space. The District's independent audited financial statements as of June 30, 2014, showed that it also converted the remaining balance of the prepaid lease of \$1.8 million to a 40-year note receivable.⁸ However, the District's Superintendent stated that was an error and there was no conversion to a note receivable, and the District continues to use the Arts Center for arts classes, music

⁸ Midland Borough School District, Financial Statements for Fiscal Year Ended June 30, 2014, DeLuzio & Company, LLP., Note 4, p. 24.

classes, and special events like graduation ceremonies and musical performances.

When we asked the District to provide documentation of its use of the Arts Center, it provided us with letters on District letterhead announcing occasional special events, such as Arts Charter School graduation ceremonies (sponsored by the District even though the District itself doesn't have high school students) and musical performances.

We believe the governing Board and the District should have utilized an open and public process for the lease of special event space and for arts and other classes to increase transparency to the taxpayers and to implement best practices in its use of public funds.

As of June 30, 2015, the balance of the prepaid lease was \$1.5 million. The Board and District should review its use of the Arts Center's space, the associated costs, and determine whether the arrangement is beneficial to the District and represents an implementation of best business practices governing the use of public funds.

Rental of Gymnasium and Classroom Space

As mentioned earlier, the local Arts Charter School experienced significant enrollment growth early on. As a result, since at least 2009, it required more space to conduct its classes and educational services. Consequently, the District rented out its own gymnasium and six classrooms surrounding the gymnasium to the Arts Charter School for approximately \$45,000 per year. The gymnasium itself is shared between the District and the Arts Charter School. The six classrooms are used only by the Arts Charter School. This arrangement is authorized annually by a Memorandum of Understanding signed by both parties.

We question the fact that the District leases physical space from the Arts Center for \$150,000, but the primary tenant of the Arts Center, the Arts Charter School, is now leasing space from the District due to outgrowing the space available at the Arts Center. This arrangement reinforces our belief that entering into the original prepaid lease was not a fiscally responsible decision by the Board.

The District’s management and its Board should formally review this arrangement to determine whether it is implementing best business practices in its use of public funds.

Financial Services Provided by Management Company

Another arrangement that may be questionable without close Board and District administrator review and monitoring relates to the District’s payments to the related management company. According to the administration, the District pays the management company, which in turn, provides professionals from a local accounting firm (the firm also provides accounting services to the management company). The employees of the accounting firm assist the District’s business office. The chart below highlights the total annual payments to the management company.

Payments by District to Management Company	
Fiscal Year	Paid to Management Company
2009-10	\$123,295
2010-11	\$149,826
2011-12	\$171,724
2012-13	\$102,664
2013-14	\$121,494
2014-15	\$120,054
Total	\$789,056

Since current and former board members are or were also employees of the management company, this raises concerns about the Board and District’s lack of adherence to best practices when they did not procure these services through an open and public process.

Best business practices dictate that the Board and the District administrators should solicit public bids for business office services. It should also consider paying the

accounting firm directly rather than through the management company, which may result in an increased cost of services.

Summary. In conclusion, we found ineffective board and administrator governance practices that occurred relative to the prepaid lease and several related party transactions. We also question whether best practices were adhered to and have concerns about a lack of transparency and possible conflicts.

We believe that the District's prepaid lease with the Arts Center was not in the best interest of taxpayers. Our belief is strengthened by the District's decision to lease space to the charter school housed in the same Arts Center. With the possible related party transactions, the District should ensure all transactions with the Arts Center are carefully reviewed and monitored, as well as that any contracts and leases are procured through an open and public process in conformance with best practices.

The District's ongoing arrangement with a local management company to provide accounting services also raises the potential appearance of a related party transaction. The fact that current and former Board members are and have been employed by the management company raises concerns about this relationship. The District, in an effort to maintain transparency, should go above and beyond the Public School Code to ensure that all services are procured through an open and public process.

As part of their key governance and management responsibilities, the District's governing Board and administrators have the duty of closely vetting and monitoring any of their contracts and leases, as well as any questionable related party transactions that could lead to actual or perceived conflicts. Adhering to these responsibilities will lead to improved governance and greater transparency with taxpayer funds.

Recommendations

The *Midland Borough School District* should:

1. Re-evaluate its prepaid lease agreement to determine whether the agreement aligned with best business practices and whether its actual use of the Arts Center's space warrants the amortized cost of \$150,000 per year. It should consider requiring repayment of the \$1.5 million balance from the Arts Center.
2. Review its own space requirements along with its gymnasium rental agreement with the Arts Charter School and its use of the Arts Center's space to determine whether it is implementing best practices.
3. Develop and approve detailed procurement procedures for goods and services, including professional services as a best business practice.
4. Conduct an open and public process that includes ample transparency to the taxpayers of business management services.

Management Response

District management provided the following as part of their response:

“The District did not conduct transactions with related organizations, which may not have been financially sound and/or indicated ineffective governance and lack of transparency.

Midland Borough School District and its agents respectfully and strongly object to the characterization that any of its operations and agreements were “related party transactions,” and requests that this entire finding be struck from the final report. The unique and very challenging circumstances that Midland has faced over the last several decades required that the district take prudent, innovative action in assuring its financial and academic integrity and stability. The appropriateness of these actions is clearly evidenced in its relatively secure financial position over the last decade, and the high academic achievement of its students. To the contrary, Midland has taken advantage of, and in some cases helped to create, a number of locally

based opportunities for the good of its students. It has always maintained its independence of operations, observed and adhered to the highest ethical standards and requirements, and provided sound stewardship of its resources. With respect, we believe the inclusion of these characterizations as a finding in this audit is fundamentally unfair and misleading, and demeans the good work and valued service our board and administration have offered in assuring a quality education to all of our students. In addition, we offer the following points of context, clarification and correction.

--First, as a matter of context, it is essential to understand that the entire population of Midland stands at around 2,000 people - including our children. With such a small pool of expertise and experience from which to draw, and given the reality of population trends which show that people who are born and raised in a particular community desire to stay in that community, it is to be expected that the same people are called to serve in more than one capacity or role. That service (and the interests of those people) is offered for the good of the community and the students and families of our school district, and not for any personal pecuniary gain or other private benefit. We believe our board and administration, both collectively and as individuals, have always acted in the best interests of the school district, and in accordance with the highest degree of ethical standards and accountability. It should be further noted that the same members being accused of a potential conflict of interest are outstanding members within the community in which they sit on multiple other community-based boards, as well serve in positions within Midland Borough.”

The district also provided the following points of clarification and corrections to the list of transactions causing concern with a lack of transparency:

“--Although the former superintendent was the founder of some of the entities discussed within the report, he was guided by the premise of getting Pennsylvania children out of Ohio schools and back into Pennsylvania schools. Furthermore, he and the boards had acted upon the advice of the then sitting attorneys of the various entities. This feat was only possible by relying on the small handful of education-minded community leaders within the forgotten district. In accordance to the laws, the district members

abstained from any votes that may have created a conflict of interest with their other entities.”

“--The roles that two district board members played within the management company had no senior administrative responsibilities that can be classified as the "highest level of management." Moreover, their positions within the management company offered them mere supervisory roles over other people in charge of the warehouse and/or maintenance departments. It should be noted that the years in question, 2010-2012, are well beyond the years pertaining to any issues contained within this audit.”

“--The final allegation is nothing more than a comment as an appearance of a conflict of interest does not give rise to a conflict of interest.”

“One must look at the totality of the circumstances: Pennsylvania students being educated out of state; state administration officials wanting education dollars to remain in state; a very small community often brushed aside because of a poor and black population; and a small group of well-rounded community leaders who were very educationally driven, as opposed to a narrow group who sat on the board. The mere fact that a few members have been cross-pollinated with multiple boards does not equate to related party transaction or a conflict of interest. Although these entities grew into large, successful, proven and well-managed educational vehicles, we must be mindful that this was achieved locally by several members of a very small community wanting the very best for their kids of the community, and at the request of the state. Their tireless efforts have proven successful in that the arts center is a one-of-a-kind facility built with the collective efforts of local, county and state collaboration; the district has been recognized as a Blue Ribbon facility; and the performing arts charter school has been recognized as one of the best in the state. In the end, this sort of recognition could not have happened but for the few that stood tall against all odds, and did so in open, advertised and public meetings where they were often jeered.”

Prepaid Lease

“Any connotation of an impropriety is completely and utterly denied, especially since the aforementioned lease has been listed in the district's audit on a yearly basis. As

earlier stated, the construction of this facility was a complete and total collaboration of local, county and state efforts. The construction of this facility was for its intended purpose as it is being utilized now and always has been. Midland School District was afforded the opportunity to utilize the facility for its various school and after-school functions. To date, it has been a great success that the auditors were invited to witness at multiple school events. Some of the activities for which the school uses the facility include weekly classes, after-school events, and an annual senior dinner to show appreciation for and recognize resident Midland students who graduated from various high schools.

The leases, being identical in form, should not cause any consternation, as most commercial leases within the same building are a mirror image of each other. Furthermore, the best business/commercial practice is to utilize mirror image documents when involving multi-tenant facilities. It should be noted that if it were not for the prepaid lease of the arts center, the school would not have such access due to the unavailability of space as a direct result the explosion of enrollment of the performing arts charter school. The prepaid lease was a product of the state requesting all of the entities to come forward with a plan to show they had the financial ability to fund their portion of the costs to utilize the contemplated building. The state was unwilling to fund its portion, well over \$6 million, of the build-out without said leases in place.

Furthermore, the county was requesting the same documentation prior to committing its multi-million dollar pledge. All in all, this endeavor could not have happened without the local, county and state support, which was monitored and audited by the Department of Community and Economic Development.

The prepaid lease note conversion, as stated by the current superintendent and outside auditor, did not go beyond anything more than a discussion point. The yearly amortization, as spelled out in the finding, is an accurate assessment of a fair arm's length transaction for said space. Furthermore, the art's center, at that time, was the only space in that immediate market available to serve the intended uses of the school.”

Rental of Gymnasium and Classroom Space

“The MOU between the school and the performing arts charter school is another fair- arm's-length transaction that benefits the school. This particular facility, constructed in the 1950's, was underutilized and virtually mothballed by the school. The MOU allows the district to continue its school functions while being able to receive rents from the performing arts charter school. In addition, the performing arts charter school provides the upkeep and maintenance on the facility. Recently, the school was able to benefit from a newly refurbished gym floor at no cost to the school. Again, the individual boards made these decisions in their publicly advertised meetings, and district members would have abstained from voting if any of conflict of interest existed.”

Financial Services Provided by Management Company

“It should first be noted that the management company does not manage the financial services of the district; rather, it provides consulting services to the district's management team and board. The fees associated with the management company encompass a variety of services, which are at or below the prevailing market cost. Furthermore, there is no requirement of the district to bid professional services, namely financial consultants, attorneys, etc. Therefore, the district agrees that there is no violation of the Ethics Act and will continue to abide by the “best business practice.””

Legal Conclusion

“The finding statement: *"have concerns about possible conflicts"* is contrary to ample case law and invalid on its face. The entities mentioned in this finding do not fall within the characterization of a related entity. The allegation of such is unfounded, as the cross pollination of one or two board members does not signify a related party relationship. Furthermore, there is no proof that said individuals had or were able to exert such influence on the rest of the board and/or executive-level people. The simple fact is that these issues are 10 years old, and still being discussed without substantiating evidence. Additionally, they had appeared on every year-end audit and were previously discussed (verbally or otherwise) in all prior audits with no findings, comments and/or observations.

The compelling fact is that no harm to either entity, self-dealing transactions, and/or financial wrongdoings, occurred during the audit years in question; rather, all of the entities are performing extraordinarily and are being recognized for their performance through state agencies.”

“In closing, the Board will take under advisement the recommendations of this audit in reviewing and developing policies and procedures, with its outside professionals, to further its goal of educating children in continuation of an open and transparent forum.”

Auditor Conclusion

This finding clearly shows that over the audit period the District conducted multiple transactions with entities who had close ties with District officials. “With such a small pool of expertise and experience from which to draw,” it is even more imperative that the District strive to be more even transparent than required by the Public School Code. The taxpayers of the District and the public at large deserve the assurance that the District did all it could to avoid conflicts impacting on the use of public monies. The only way to meet this standard is to use the best practice of soliciting bids for all services regardless of requirements contained in the Public School Code. We also encourage the District to document in public meetings all instances where the District transacts with an entity that has close ties with a District official.

In regard to the prepaid lease arrangement, it is clearly not in the best interest of the District to prepay \$3 million to the Arts Center to use the exact same space as a cyber charter school in the area. The District was also unable to provide specific examples of when the District used this space. Without this evidence, the prepaid lease agreement looks more like a construction loan as opposed to a prepaid lease. Furthermore, it does not make logical sense that the District would need additional space in the Arts Center when the District is leasing out District owned space to other educational entities in the area.

Finally, we are encouraged that the Board will take our recommendations under advisement when reviewing and developing policies and procedures. We believe these recommendations will further the District's transparency and help assure that taxpayer money is being spent responsibly.

Status of Prior Audit Findings and Observations

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

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 Section 403 of The Fiscal Code,⁹ 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, 2010 through June 23, 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 controls¹⁰ to provide reasonable assurance that the District is in compliance with certain relevant state laws, regulations, contracts, grant requirements, and administrative procedures (relevant requirements). In conducting our audit, we obtained an understanding of the District's internal controls, including any information technology controls, that we consider to be significant within the context of our audit objectives. We assessed whether those controls were properly designed and implemented. Any deficiencies in internal controls that were identified during the conduct of our audit and determined to be significant within the context of our audit objectives are included in this report.

⁹ 72 P.S. § 403.

¹⁰ 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, grant requirements, 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, financial reports, annual budgets, and new or amended policies and procedures. 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
- ✓ Related Parties Transactions
- ✓ Transportation Operations
- ✓ Data Integrity
- ✓ Bus Driver Requirements
- ✓ School Safety

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 fiscal benchmarks, 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, budget, independent auditor's reports, summary of child accounting, and general ledger for fiscal years 2010 through 2015. The financial and statistical data was used to calculate ratios and trends for 22 benchmarks which were deemed appropriate for assessing the District's financial stability. The benchmarks are based on best business practices established by several agencies, including the Pennsylvania Association of School Business Officials, the Colorado Office of the State Auditor, and the National Forum on Education Statistics. Finding No. 1 describes the exceptions noted during our review.
- ✓ Did the District ensure its board members and administrators are in compliance with the Public School Code and the Ethics Act?
 - To address this objective, we interviewed the District's administration and reviewed board meeting minutes to see if board members and administrators, or their immediate family members, entered into transactions with the District. Finding No. 2 describes the exceptions noted during our review.

- ✓ Did the District establish internal controls to ensure compliance with applicable laws and regulations governing transportation operations and whether the District has received correct reimbursements from the state?
 - To address this objective, for the 2011-12 school year, we selected for review all three LEA buses and all three contractor buses used to transport students. We examined the certificate of insurance as proof that current coverage is being carried on all vehicles used in transporting pupils. In addition, we verified bus odometer readings, board approved route descriptions, pupil rosters, total mileage verification, year to date expenditure ledger, contractor invoices, school calendar, and district work papers for weighting of students and miles. Our review of this area did not disclose any reportable issues.

- ✓ Did the District ensure that the student membership data it reported in the Pennsylvania Information Management System was accurate, valid, and reliable?
 - To address this objective, we randomly selected 10 out of 372 total registered students (5 resident and 5 non-resident) from the vendor software listing for the 2011-12 school year and verified that each child was appropriately registered with the District. In addition, we reviewed the District's only school term reported on the Summary of Child Accounting and verified the school days reported on the Instructional Time Membership Report and matched them to the School Calendar Fact Template. Our review of this area did not disclose any reportable issues.

- ✓ Did the District ensure that bus drivers transporting District students had the required driver's license, physical exam, training, background checks, and clearances as outline in applicable laws?¹¹ Also, did the District have adequate written policies and procedures governing the hiring of new bus drivers?
 - To address this objective, we reviewed all four of the bus drivers hired by both the District and the District's bus contractor, during the school years July 1, 2012 through June 30, 2014, and reviewed documentation to ensure the District complied with bus driver's requirements. We also determined if the District had written policies and procedures governing the hiring of bus drivers and if those procedures were sufficient to ensure compliance with bus driver hiring requirements. Our review of this area did not disclose any reportable issues.

- ✓ Did the District take appropriate actions to ensure it provided a safe school environment?
 - To address this objective, we reviewed a variety of documentation, including safety plans and anti-bullying policies, as well as the PA State Police Assessment. In addition, we conducted an on-site review at the District's only school building to assess whether the District had implemented basic safety practices. The results of our review of school safety are shared with District officials and, if necessary, PDE.

¹¹ 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.

Distribution List

This report was initially distributed to the Superintendent of the District, the Board of School Directors, and the following stakeholders:

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