



NAZARETH AREA SCHOOL DISTRICT
NORTHAMPTON COUNTY, PENNSYLVANIA
PERFORMANCE AUDIT REPORT

APRIL 2013

COMMONWEALTH OF PENNSYLVANIA

EUGENE A. DEPASQUALE - AUDITOR GENERAL

DEPARTMENT OF THE AUDITOR GENERAL





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EUGENE A. DePASQUALE
AUDITOR GENERAL

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

Mr. Lorin B. Bradley, Board President
Nazareth Area School District
One Education Plaza
Nazareth, Pennsylvania 18064

Dear Governor Corbett and Mr. Bradley:

We conducted a performance audit of the Nazareth Area School District (NASD) to determine its compliance with applicable state laws, contracts, grant requirements, and administrative procedures. Our audit covered the period December 17, 2009, through August 17, 2012, except as otherwise indicated in the report. Additionally, compliance specific to state subsidy and reimbursements was determined for the school years ended June 30, 2010, and June 30, 2009. Our audit was conducted pursuant to 72 P.S. § 403 and in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States.

Our audit found that the NASD complied, in all significant respects, with applicable state laws, contracts, grant requirements, and administrative procedures, except as detailed in one finding noted in this report. In addition, we identified one matter unrelated to compliance that is reported as an observation. A summary of these results is presented in the Executive Summary section of the audit report.

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

Sincerely,

/s/

EUGENE A. DEPASQUALE
Auditor General

April 3, 2013

cc: NAZARETH AREA SCHOOL DISTRICT Board Members



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Executive Summary

Audit Work

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

Our audit scope covered the period December 17, 2009, through August 17, 2012, except as otherwise indicated in the audit scope, objectives, and methodology section of the report. Compliance specific to state subsidy and reimbursements was determined for school years 2009-10 and 2008-09.

District Background

The NASD encompasses approximately 48 square miles. According to 2010 federal census data, it serves a resident population of 27,963. According to District officials, in school year 2009-10 the NASD provided basic educational services to 4,709 pupils through the employment of 344 teachers, 183 full-time and part-time support personnel, and 27 administrators. Lastly, the NASD received more than \$15 million in state funding in school year 2009-10.

Audit Conclusion and Results

Our audit found that the NASD complied, in all significant respects, with applicable state laws, contracts, grant requirements, and administrative procedures, except for one compliance-related matter reported as a finding and one matter unrelated to compliance that is reported as an observation.

Finding: Pennsylvania Department of Education Has Failed to Reimburse the School District \$16,520 for Driver's Education. Our review of the NASD's driver education records for the 2009-10 and 2010-11 school years found the NASD was eligible for reimbursement of \$9,135 and \$7,385, respectively. NASD has been working with the Pennsylvania Department of Education (PDE) to complete the 2009-10 driver's education report on-line since the summer of 2010. The inability to complete this report caused the NASD not to be able to enter the 2010-11 report. In June of 2012, NASD personnel were informed by PDE that the data could not be entered because servers were changed and PDE could not access the data (see page 6).

Observation: The District Financed Some of Its Debt with Interest-Rate Management ("Swap") Agreements, Which Could Have Jeopardized Taxpayer Funds. On May 22, 2006, NASD entered into a swap agreement related to its issue of \$25,000,000, Series of 2007 variable-rate general obligation bonds (see page 9).

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

Audit Scope, Objectives, and Methodology

Scope

What is a school performance audit?

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

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

Our audit covered the period December 17, 2009, through August 17, 2012.

Regarding state subsidy and reimbursements, our audit covered school years 2009-10 and 2008-09.

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

Objectives

What is the difference between a finding and an observation?

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

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

- ✓ In areas where the District receives state subsidy and reimbursements based on pupil membership (e.g. basic education, special education, and vocational education), did it follow applicable laws and procedures?
- ✓ Does the District have sufficient internal controls to ensure that the membership data it reported to the Pennsylvania Information Management System is complete, accurate, valid and reliable?

- ✓ In areas where the District receives state subsidy and reimbursements based on payroll (e.g. Social Security and retirement), did it follow applicable laws and procedures?
- ✓ Did the District, and any contracted vendors, ensure that their current bus drivers are properly qualified, and do they have written policies and procedures governing the hiring of new bus drivers?
- ✓ Are there any declining fund balances that may impose risk to the District's fiscal viability?
- ✓ 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 does the current employment contract(s) contain adequate termination provisions?
- ✓ Were there any other areas of concern reported by local auditors, citizens, or other interested parties?
- ✓ Is the District taking appropriate steps to ensure school safety?
- ✓ Did the District have a properly executed and updated Memorandum of Understanding with local law enforcement?
- ✓ Were votes made by the District's board members free from apparent conflicts of interest?
- ✓ Did the District take appropriate corrective action to address recommendations made in our prior audits?

Methodology

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

What are internal controls?

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

- Effectiveness and efficiency of operations;
- Relevance and reliability of operational and financial information;
- Compliance with applicable laws, contracts, grant requirements and administrative procedures.

NASD management is responsible for establishing and maintaining effective internal controls to provide reasonable assurance that the NASD is in compliance with applicable laws, contracts, grant requirements, and administrative procedures. In conducting our audit, we obtained an understanding of the District's internal controls, including any IT controls, as they relate to the District's compliance with applicable state laws, regulations, contracts, grant agreements and administrative procedures 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 control that were identified during the conduct of our audit and determined to be significant within the context of our audit objectives are included in this report.

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

Our audit examined the following:

- Records pertaining to bus driver qualifications, and financial stability.
- Items such as board meeting minutes, and reimbursement applications.
- Deposited state funds.

Additionally, we interviewed selected administrators and support personnel associated with NASD operations.

Findings and Observations

Finding

Pennsylvania Department of Education Has Failed to Reimburse the School District \$16,520 for Driver's Education

Public School Code section relevant to the finding:

Section 2504.1 of the Public School Code provides:

Every school district or joint school organization complying with the standardized driver-education program established by the department shall be paid, by the Commonwealth from the Motor License Fund, an amount to be determined by multiplying the number of pupils who have completed the high school standardized driver-education program conducted by any given school district or joint school organization by a basic figure of thirty-five (\$35) dollars per student.

Our review of the Nazareth Area School District's (NASD) driver education records for the 2009-10 and 2010-11 school years found the NASD was eligible for reimbursement of \$9,135 and \$7,385, respectively.

The Driver and Traffic Safety Education Program Guide, published by the Pennsylvania Department of Education (PDE), requires school districts to provide pupils with a minimum of six clock-hours of behind-the-wheel instruction. Additionally, it provides a limit of one-hour of behind-the-wheel instruction in vehicle operation any calendar day.

According to NASD officials, the school has been working with PDE to complete the 2009-10 driver's education report on-line since the summer of 2010. The inability to complete this report caused the NASD not to be able to enter the 2010-11 report. In June of 2012, the NASD was told by PDE that the data could not be entered because servers were changed and PDE could not access the data.

Recommendations

The *Pennsylvania Department of Education* should:

Adjust the NASD's allocations to resolve the net underpayment of \$16,520 to the District.

Management Response

Management stated the following:

Since the summer of 2010, our High School Office has been working with PDE to complete the 2009-2010 Driver's Ed Report on-line. The inability to complete this report had a domino effect on the 2010-2011 report. The first report must be completed and submitted before the second can be started.

The issue was with the PDE on-line reporting. Our High School staff would get an error message when entering the data, which prevented the processing of the data. The High School staff called [an individual] at PDE repeatedly. He stated, repeatedly, that there were issues with the system, but they were working on them.

The Business Office continued to monitor the situation with our High School. In March 2012, it was determined that we needed to speak with someone in authority at PDE. We also contacted PASBO for assistance in resolving this issue with PDE. We were unsuccessful in determining who to speak with next and securing assistance from PASBO. The Business Office then contacted [a state representative]. In March, prior to speaking with [a state representative], the High School staff contacted [an individual] at PDE. They were told he was waiting to find out when the system could be accessed.

[A state representative] contacted [an individual] at PDE and was told the same thing we were. The system was not working properly and there was no definite date for its repair. [A state representative] was also told that this issue affected 20 school districts. (We have since polled school districts and found this issue goes back to 2005 for some.) [An individual] at PDE told [a state representative] the system would be fixed in three weeks. The Business Office received an unpleasant call from [an individual] at PDE asking why [a state representative] was sent to him.

After three weeks (beginning of May 2012), after no progress has been made, we contacted [a state representative]. He contacted PDE and ultimately contacted [another individual] at PDE. After this conversation, we were contacted by [an individual] at PDE. The High School staff stated they gave him the 2009-2010 [data]. He was to contact our staff when the report was completed and we could enter the 2010-2011 [data]. [An individual] at PDE had to take the data over the phone because we were unable to enter the data ourselves.

In June of 2012, we were told the system was fixed. Our High School staff contacted [an individual] at PDE to find out the status of our report. They were told he could not enter the data because servers were changed and he could not access the data. The High School staff informed [an individual] at PDE that we would be raising the issue with

the State Auditors when they arrived. He said that was fine; they would understand his position.

In July we discussed this with the State Auditor. He took the issue to his superiors. The Business Office received another phone call from [an individual] at PDE assuring us the system was up and running. The State Auditors requested the Driver's Ed data. When the Business Office received the data from the High School, they obtained access to the Driver's Ed system. They were able to enter the information and complete both 2009-2010 and 2010-2011 data. Both reports were finally submitted. All documentation was provided to the State Auditors.

Observation

The District Financed Some of Its Debt with Interest-Rate Management (“Swap”) Agreements, Which Could Have Jeopardized Taxpayer Funds

Criteria relevant to the observation:

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

On May 22, 2006, the Nazareth Area School District (NASD) entered into a swap agreement related to its issuance of \$25,000,000, Series of 2007 variable-rate general obligation bonds.

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

In theory, swaps allow school districts to enter into variable-rate debt financing, and thereby take advantage of low interest rates, while at the same time mitigating the possibility of those same interest rates rising. In reality; however, swaps are complicated, risky financial instruments that can needlessly waste taxpayer funds if the District bets incorrectly on which way interest rates will move. Likewise, districts can end up wasting funds on financial advisors, legal fees, and underwriting fees, especially if these services are not competitively bid and evaluated for independence. Additionally, swaps can cause districts to pay large termination fees to the investment banks.

For example, our department’s November 2009 special investigation of the Bethlehem Area School District’s 13 swaps, which were related to \$272.9 million in debt, found that the District’s use of 2 of its 13 swaps cost taxpayers \$10.2 million more than if it had issued a standard fixed-rate bond or note, and \$15.5 million more

than if the District had simply paid the interest on the variable-rate note without any swap at all. The Bethlehem Area School District's losses were largely due to excessive fees and other charges, especially a \$12.3 million payment that it made to an investment bank for terminating one of the two agreements. The potential financial impact associated with the Bethlehem Area School District's other 11 swaps could not be determined because the agreements were still in effect at the time of the investigation. The experience of this one school district illustrates the potential financial cost to entities that enter into swaps, particularly if they have to be terminated for any reason when the interest rates are not in the party's favor.

As a result of our investigation of the Bethlehem Area School District, we sent all 500 of the Commonwealth's school districts a letter on December 17, 2009, urging them to terminate their active swaps and to refinance them with conventional debt instruments as soon as it is fiscally responsible to do so. Our letter also advised the districts that they should avoid getting into these or any other exotic financial instruments in the future, and that it should assess the financial consequences that would transpire if it suffered the same negative experience with swaps as the Bethlehem Area School District and others. In addition, we encouraged the District to hire financial advisors through a competitive selection process and to periodically evaluate the quality, cost, and independence of the services provided.

To its credit, the District has refinanced the \$25,000,000, Series of 2007 variable-rate general obligation bonds with a General Obligation Notes, series of 2011 with a partial swap termination of \$9,995,000. Proceeds of the bond were used to refund and redeem a portion of the outstanding amount of \$24,985,000 of which \$8,180,000 was redeemed and a payment of \$1,636,000 for partial termination payment for the 2007 Swap. While we would have preferred that the District had never engaged in these risky investments in the first place, we are encouraged by the District's decision to partially terminate their swap agreement.

Recommendations

The *Nazareth Area School District* should:

1. Avoid entering into any new swap agreements in the future.
2. Terminate its swap agreement as soon as it is fiscally responsible to do so, and refinance if necessary with conventional fixed-rate bonds.

Management Response

Management stated the following:

The State Legislators made swaps a legal debt option for districts in Pennsylvania. The administration and board worked very closely with our financial advisors, bond counsel, and solicitor throughout this process. Over the past five years, our total payments have been \$897,106 under budget, thereby saving taxpayers funds.

Auditor Conclusion

While the NASD partially terminated their Swap agreement, the cost to NASD was \$1,636,000. We are pleased that the NASD has heeded part of our advice and now is almost fully divested from swap agreements. We urge the NASD to eliminate the remaining swap agreement as soon as it is fiscally responsible to do so.

Status of Prior Audit Findings and Observations

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

Distribution List

This report was initially distributed to the superintendent of the school district, the board members, our website address at www.auditor.gen.state.pa.us, and the following:

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This report is a matter of public record. Copies of this report may be obtained from the Pennsylvania Department of the Auditor General, Office of Communications, 231 Finance Building, Harrisburg, PA 17120. If you have any questions regarding this report or any other matter, you may contact the Department of the Auditor General by accessing our website at www.auditorgen.state.pa.us.

