



A REPORT
TO THE
ARIZONA LEGISLATURE

Performance Audit Division

Performance Audit

Arizona Department of Education—

Administration and Allocation of Funds

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Debra K. Davenport
Auditor General

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August 10, 2006

Members of the Arizona Legislature

The Honorable Janet Napolitano, Governor

Mr. Tom Horne, State Superintendent of Public Instruction
Arizona Department of Education

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Arizona Department of Education—Administration and Allocation of Funds. This report is in response to Arizona Revised Statutes (A.R.S.) §41-2958 and was conducted under the authority vested in the Auditor General by A.R.S. §41-1279.03. I am also transmitting with this report a copy of the Report Highlights for this audit to provide a quick summary for your convenience.

As outlined in its response, the Department of Education disagrees with one of the findings and plans to implement all of the recommendations.

My staff and I will be pleased to discuss or clarify items in the report.

This report will be released to the public on August 11, 2006.

Sincerely,

Debbie Davenport
Auditor General

Enclosure

SUMMARY

The Office of the Auditor General has conducted a performance audit of the Arizona Department of Education (ADE), pursuant to the provisions of Arizona Revised Statutes (A.R.S.) §41-2958. This audit was conducted under the authority vested in the Auditor General by A.R.S. §41-1279.03. This is the second in a series of three reports regarding ADE. This audit focuses on specific aspects of ADE's administration and allocation of state and federal funds to Local Education Agencies (LEAs), which are primarily school districts and charter schools. The other two audit reports address ADE's accountability programs and information management function.

ADE operates under the direction of the Superintendent of Public Instruction to execute the policies set by the State Board of Education and the State Board for Vocational and Technological Education. ADE provides direct services, such as funding, training, and technical assistance, to approximately 1,430 schools in 244 locally governed school districts and 503 charter schools. ADE is responsible for administering and distributing state and federal education monies to LEAs. According to the *State of Arizona Appropriations Report* for fiscal year 2006, ADE was estimated to receive about \$5 billion in total funding for fiscal year 2006, including approximately \$3.5 billion appropriated from the General Fund and \$1.4 billion from federal and other funds. Over 97 percent of the total funding was designated as pass-through monies to LEAs, including over 99 percent of ADE's General Fund appropriation.

This audit reviewed ADE's processes relating to two areas involving LEA funding. For state education funds, ADE collects student attendance data from the LEAs. ADE uses this data to calculate the LEAs' Average Daily Membership (ADM), which it then uses in accordance with state statutes to calculate the appropriate level of state funding that each LEA receives. ADE also helps ensure that LEAs use federal grant monies so they are not returned to the federal government.

ADE should implement a comprehensive system to ensure the accuracy of LEAs' attendance data state-wide (see pages 7 through 13)

ADE should develop a comprehensive system to ensure the accuracy of LEAs' attendance data state-wide.¹ As the State's education agency, ADE is ultimately responsible not only for allocating General Fund monies to the LEAs, but for ensuring that these monies are allocated properly. The amount of state aid LEAs receive is tied directly to attendance data, so this data's accuracy is critical to ensure that the LEAs receive the proper level of funding. However, neither ADE nor any other entity verifies that this data is accurate state-wide, and several indicators point to many inaccuracies in the data, including limited reviews conducted by certified public accountants (CPAs), a special study conducted previously by the Auditor General's Office, and audits conducted by ADE's own staff.

Since the accuracy of LEAs' attendance data is so critical to ensuring proper payment of state aid to the LEAs, ADE should implement a comprehensive system to ensure that the data is accurate. If it is determined to be inaccurate, ADE should recover any overpayments and distribute any underpayments to the LEAs. There are different options that ADE could choose to implement, and other states have already implemented systems to better ensure the accuracy of their schools' attendance data. For example, ADE could seek statutory changes to have the CPA firms assess the accuracy of the attendance data as part of their financial reviews of the LEAs. Another approach could be for ADE's own audit unit to expand the work it currently performs, similar to the Texas Education Agency.

ADE's approach to identifying and administering federal grant monies generally appropriate (see pages 15 through 19)

ADE generally appears to have an appropriate process for obtaining and administering federal grant monies. While ADE receives and administers both formula (or entitlement) and discretionary (or competitive) grant monies from various federal agencies, about 99 percent of the nearly \$800 million in grant monies ADE spent or passed through the LEAs in fiscal year 2005 is from formula grants from the U.S. Departments of Education and Agriculture. The federal government allocates formula grants to the State based on certain factors, such as the number of children in poverty, and these grants are administered by ADE to LEAs. In contrast, discretionary grants are awarded to ADE through a competitive federal application

¹ Attendance data in this finding is defined as an LEA's electronic or paper attendance records.

process. ADE appears to be appropriately applying for and receiving all formula grant monies to which it is entitled. Similarly, ADE's process for identifying and obtaining discretionary grants also appears adequate based on auditors' review of this process. However, ADE should obtain, maintain, and use available feedback on unsuccessful grant applications. This information could help ADE make more informed decisions about whether to apply for the same or similar grants in the future.

In addition to appropriately obtaining federal grant monies, ADE ensures that the federal monies it distributes to LEAs are used rather than returned to the federal government. For calendar years 2002 through 2005, the amount of unspent federal grant monies from the U.S. Department of Education was well below 1 percent of total monies awarded. ADE's use of its online Grants Management Enterprise system for administering the federal grant monies, in conjunction with other grant-tracking reports, provides an effective process to ensure the use of these monies.

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INTRODUCTION & BACKGROUND

The Office of the Auditor General has conducted a performance audit of the Arizona Department of Education (ADE), pursuant to the provisions of Arizona Revised Statutes (A.R.S.) §41-2958. This audit was conducted under the authority vested in the Auditor General by A.R.S. §41-1279.03. This is the second in a series of three reports regarding ADE. This audit focuses on specific aspects of ADE's administration and allocation of state and federal funds to Local Education Agencies (LEAs), which are primarily school districts and charter schools. The other two audit reports address ADE's accountability programs and information management function.

ADE operates under the direction of the Superintendent of Public Instruction, who has the duty to oversee Arizona schools and to execute the policies set by the State Board of Education and the State Board for Vocational and Technological Education. As of November 2005, ADE reports providing direct services such as funding, training, and technical assistance to 1,430 schools in 244 locally governed school districts and 503 charter schools. ADE implements state academic standards; administers state-wide assessments; disseminates information; administers and allocates federal and state funds; and provides program improvement assistance to LEAs.

Local Education Agency (LEA)—School districts, charter schools, or any administrative unit at the local level that exists primarily to operate schools or to contract for educational services.

ADE administers and distributes state and federal education monies to LEAs

ADE is responsible for administering and distributing state and federal education monies to LEAs. According to the *State of Arizona Appropriations Report* for fiscal year 2006, ADE was estimated to receive about \$5 billion in total funding for fiscal year 2006, including approximately \$3.5 billion appropriated from the General Fund and \$1.4 billion from federal and other funds. Over 97 percent of this funding was designated as pass-through monies to LEAs, including over 99 percent of ADE's General Fund appropriations. ADE calculates most LEA funding using statutorily prescribed financial formulas. The funding formulas vary between districts and charter schools, but both formulas rely heavily upon an LEA's Average Daily

ADE calculates ADM using LEA attendance data from each school day, typically through the first 100 days in session.

Membership (ADM). ADE calculates ADM using enrollment minus withdrawals of each school day, usually through the first 100 days in session. An LEA's ADM is then multiplied by specific weights that take into consideration the relative associated cost of educating certain classifications of students. These weights take into account factors such as grade level, the LEA's size and location, and specific student needs, such as those for special education students. ADE then multiplies an LEA's weighted ADM by an amount set by the Legislature, called the base support level, to determine the LEA's funding.

For districts, this funding formula is intended to equalize per-pupil funding in maintenance and operation (see below), reduce disparities in tax rates, and decrease reliance on local property taxes to fund schools. ADE uses formulas in three key funding calculations for school districts:

- **Maintenance & Operation (M&O)**—The M&O budget is the budget for much of the LEA's day-to-day expenditures, including employee salaries and benefits, supplies, utilities, and maintenance.
- **Capital Outlay Revenue Limit (CORL)**—Capital-related funds include expenditures for acquisitions by purchase or lease of long-term capital items, such as land, buildings, and furniture.
- **Soft Capital Allocation (SCA)**—Districts can spend soft capital monies only for short-term capital items that are required to meet academic standards, such as technology, textbooks, and library resources.

Charter schools, which are more dependent on state revenues than school districts because they do not receive property taxes or county revenues, also receive state funding based on student enrollment and reported attendance. According to ADE, in fiscal year 2005, 83 percent of charter school funding came from the State. In contrast, 45 percent of district funding came from the State.

Additionally, ADE also administered and distributed federal grant monies to the LEAs (see Finding 2, page 15). In fiscal year 2005, ADE spent or passed through to LEAs nearly \$800 million in federal grant monies, about 99 percent of which came from the U.S. Departments of Education and Agriculture. While ADE administers a limited amount of federal grant monies that come through competitive discretionary grants, about 99 percent of the monies are from formula grants or entitlement grants. If the grant monies are either not used by ADE or the LEAs do not use the grant monies within 27 months, the monies are returned to the federal government.

ADE's Division of Business, Information, and Finance Services distributes monies to LEAs

ADE's Division of Business, Information, and Finance Services administers and allocates state and federal funds to LEAs for public education. The Division consists of the following units and, according to ADE, as of March 14, 2006, had 64 FTEs with 11 vacancies:

- **School Finance (28 FTEs with 3 vacancies)** handles all state-funding formula payments to schools. Because this unit is the main contact for schools, it provides extensive customer service to the LEAs.
- **Financial Services (21 FTEs with 2 vacancies)** maintains every account other than payroll for ADE, including all state and federal revolving funds. It also processes all cash receipts and claims, and performs all accounting functions for all ADE programs.
- **Strategic Planning & Budget (7 FTEs with 2 vacancies)** works with all program areas at ADE to assist in developing their budgets.
- **Grants Management (2 FTEs)** oversees the Grants Management Enterprise system, which allows LEAs to identify and apply for federal grant monies available through ADE.
- **Audit Resolution (6 FTEs with 4 vacancies)** conducts ADM audits of LEAs. As part of its fiscal year 2007 budget, ADE received funding for four additional ADM auditors. According to ADE, the four new ADM auditors will conduct ADM audits and help ADE to recover overpayments or erroneous payments to LEAs, and reduce the potential for fraud, waste, and abuse.

Audit Resolution
conducts ADM audits of
LEAs.

Scope and methodology

This audit reviewed ADE's efforts to ensure accurate attendance data from the LEAs, and ADE's efforts to obtain and track the LEAs' use of federal grant monies. The audit includes the following findings and associated recommendations:

- ADE should implement a comprehensive system to ensure the accuracy of LEAs' attendance data state-wide.
- ADE's approach to identifying and administering federal grant monies is generally appropriate.

Auditors used several methods to review the issues addressed in this audit. Specifically, auditors reviewed ADE's statutes, 2005 annual report, strategic plan, and Web site. Auditors also reviewed the Joint Legislative Budget Committee's 2006 Appropriations Report, and interviewed ADE management and staff. Additionally, to perform more specific audit steps, auditors used the following methods:

- To identify the potential for errors in schools' attendance data, auditors reviewed the results of the fiscal year 2004 audits conducted by independent certified public accounting firms on 158 districts and ADM audits conducted by ADE's Audit Resolution Unit, the results of ADE's Audit Resolution Unit's ADM audits from 2002 through 2005, and the Auditor General's 2004 report on two Joint Technological Education Districts. Auditors also analyzed the Arizona State Board for Charter Schools' results of the fiscal year 2004 audits conducted by independent certified public accounting firms on 334 charter schools. To identify how other states' departments of education verify the accuracy of their attendance data, auditors interviewed officials and reviewed documents from two other states—Michigan and Texas.¹ To assess how certified public accounting (CPA) firms that currently perform limited reviews of Arizona schools' attendance data could significantly expand their work to ensure accuracy of all schools' attendance data, auditors interviewed partners from two of these firms.² Additionally, to obtain ADE's perspective and the extent to which ADE's own audit unit could perform sufficient audits to ensure the accuracy of Arizona schools' attendance data, auditors discussed these issues with several ADE officials.
- To determine whether the Department is receiving all available federal grant money, auditors interviewed ADE staff and U.S. Department of Education staff and reviewed Web sites that list all available federal grants. Auditors then compared the list of available federal grants to the fiscal year 2005 *Schedule of Expenditures of Federal Awards* (SEFA), which lists federal grants to ADE. To determine whether ADE was effective in helping LEAs use their grant monies so they are not returned to the federal government, auditors reviewed the *U.S. Department of Education Grant Administration and Payment System (GAPS) Award Balance Report for 2002 to 2005*, which shows available balances on federal grants that ADE received. Additionally, auditors reviewed reports and processes, including those used as a part of ADE's Grants Management Enterprise system, to determine how ADE helps to ensure the use of federal grant monies passed through to LEAs.

¹ These states were selected based on input from ADE and information that these states had implemented approaches somewhat different from ADE for ensuring the accuracy of student attendance data.

² These two CPA firms combined conduct over 80 percent of the LEA reviews. Each of them has been conducting these audits since about 1986. As of June 2006, the larger firm had about 35 professional staff, while the smaller firm had about 14 professional staff.

- In addition, auditors obtained and reviewed unaudited budget and staffing documents that ADE provided for this Introduction and Background.

The audit was conducted in accordance with government auditing standards.

The Auditor General and staff express appreciation to the State Superintendent of Public Instruction and the staff of the Department of Education for their cooperation and assistance throughout this audit.

FINDING 1

ADE should implement a comprehensive system to ensure the accuracy of LEAs' attendance data state-wide

ADE should develop and implement a comprehensive system to ensure the accuracy of LEAs' attendance data state-wide. ADE, as the State's education agency, is ultimately responsible not only for allocating General Fund monies to the LEAs, but for ensuring that these monies are allocated properly. The amount of state aid LEAs receive is tied directly to attendance data, so its accuracy is critical to ensure that the LEAs receive the proper level of funding. However, while there are limited reviews, neither ADE nor other entities verify that the attendance data at the LEAs is accurate, and several indicators point to many inaccuracies in the data, including limited reviews conducted by independent certified public accounting (CPA) firms, a special study conducted previously by the Auditor General's Office, and audits conducted by ADE's own staff. ADE should implement a comprehensive system that ensures that the LEAs' attendance data state-wide is accurate and that when inaccuracies are identified, ADE should recover any overpayments to the LEAs and distribute additional monies to LEAs that were underpaid.

ADE needs accurate attendance data to properly allocate funding

Accurate attendance data is important to ADE because it affects billions of dollars in state financial assistance to LEAs. Appropriations to ADE represent the largest single allotment of the State's General Fund. ADE allocates the majority of its General Fund appropriation to the LEAs. According to the *State of Arizona Appropriations Report* for fiscal year 2006, ADE was estimated to receive about \$5 billion in total funding for fiscal year 2006, including approximately \$3.5 billion appropriated from the General Fund and \$1.4 billion from federal and other funds. Over 97 percent of this funding

Attendance data—paper or electronic attendance records at an LEA.

In fiscal year 2006, ADE distributed about 99 percent of its \$3.5 billion General Fund appropriation to LEAs.

was designated as pass-through monies to LEAs, including over 99 percent of ADE's General Fund appropriation.

ADE uses the LEAs' attendance data to calculate Average Daily Membership (ADM), which in turn determines the amount of aid each LEA receives. ADE calculates ADM by averaging the LEAs' attendance data from the first 100 or 200 days of the school year.¹ ADE then weights the data using statutory adjustments and then totals the weighted data by LEA to calculate the funds. Since LEA funding relies heavily on ADM data, even a small error in state-wide attendance data can have a multi-million-dollar impact. ADE reports that in fiscal year 2005, state-wide ADM was 970,985, and total Maintenance & Operation (M&O) expenditures were \$4,993,584,885. Therefore, if the ADM data was overstated or understated by just 1 percent (9,710), the funding error would have totaled at least \$49.9 million of M&O expenditures.²

Limited reviews of state-wide LEA attendance data identify inaccuracies

Although billions of dollars in aid are allocated to Arizona's LEAs based on their attendance data, ADE lacks a comprehensive process for verifying that the LEAs' attendance data state-wide is accurate. Several elements of a process are in place and they point to inaccuracies in the data. Specifically, limited reviews conducted by CPA firms, a special study conducted previously by the Auditor General's Office, and audits conducted by ADE's own staff have all identified inaccuracies in attendance data. However, while these reviews have revealed accuracy problems with the data, such reviews are limited by both their purpose and small sample size of LEAs' attendance data. None of these reviews was intended to assess the accuracy of LEAs' attendance data on a state-wide basis.

- **Limited reviews by CPA firms**—CPA firms conduct limited reviews of controls over attendance data as part of their overall financial audits of LEAs. A.R.S. §15-914(G) requires these reviews to be conducted to determine whether the attendance data is reported in compliance with state law and the *Uniform System of Financial Records for School Districts and Charter Schools*. In performing their work, the Auditor General requires CPA firms to review small samples—a minimum of 3 to 15 students—at the LEA to determine compliance.

In performing their reviews of the LEAs' controls over their attendance data, the CPA firms frequently identify problems, many of which suggest that internal controls may not be adequate to ensure accurate reporting of attendance data.

CPA firms conduct limited reviews of controls over attendance data.

¹ According to A.R.S. §15-902.02, LEAs that offer at least 200 days of instruction have the option of using the average of the first 200 days of the school year.

² The actual difference in funding would probably be greater than \$49.9 million because each full-time student usually counts for more than one ADM, and M&O is only one of the funding formulas that uses ADM in their calculations (see Introduction and Background, page 2).

The CPA firms reported that for fiscal year 2004, 149 out of the 158 school districts reviewed had at least one noncompliance issue, with a total of 681 noncompliance issues found. For fiscal year 2004, 765 attendance noncompliance issues were identified at 235 charter schools, according to an official from the Arizona State Board for Charter Schools.

Many of the noncompliance issues at the school districts involved differences between the information in the LEAs' data system and the supporting detail for entry, withdrawal, and partial absences. For example, the CPA firms sometimes identify that the LEA staff fail to properly withdraw a student once the student has 10 consecutive unexcused absences. The LEA may show the student as enrolled during the 10-day period, rather than going back and recording a withdrawal as of the first of the 10 days. This error allows the LEA to improperly receive funding for those 10 days.

While these limited reviews by the CPA firms show that the potential for errors exists at the LEAs, they do not measure the extent to which errors are actually occurring. Further, the CPA firms make no attempt to calculate any amounts of over- or underpayments.

- **Special study by the Auditor General's Office**—In December 2004, the Auditor General published a special study on two Joint Technological Education Districts (JTEDs): the East Valley Institute of Technology and the Northern Arizona Vocational Institute of Technology. Each of these districts is an LEA. The study found that these JTEDs overstated their attendance numbers, which resulted in an overstatement of their funding by about \$2 million and \$320,000, respectively, in fiscal year 2004 alone.

ADE was unable to recover these overpayments since a 2005 statutory change disallowed it from doing so.

- **Audits by ADE staff**—ADE's Audit Resolution Unit (ARU) conducts ADM audits of about 8 LEAs each year. According to ADE's records, ARU has identified approximately \$1.75 million in overpayments from May 2002 to October 2005. A review of ARU's records showed that overpayments were found in 13 of the 26 audits conducted.

However, although some of these audits identified inaccuracies in the data, they are designed to focus on certain sites at a school district or charter holder for which there is a high level of risk for reporting errors. According to its audit manual, ARU samples about 30 students from each of these high-risk sites in order to identify potential over- and underpayments. For example, students in 12th grade are more likely to be enrolled in both high school and community college courses at the same time or otherwise be part-time high school students, which raises concerns about how attendance for these students is

ADE's audits focus on groups of students with high risk for attendance errors.

counted. This can lead to inaccuracies, which can cause improper funding amounts to be allocated to that LEA. If ARU identifies an overstated attendance count at the LEA, it converts it into a dollar value, which it then subtracts from the LEA's future funding. However, the amount calculated is based only on the 30 or so students actually sampled, and neither the overstated attendance amount nor the overstated funding amount identified by the audit can be generalized to the LEA's entire student population.

ADE should take additional action to ensure accuracy of LEAs' attendance data state-wide

Since the accuracy of LEAs' attendance data is so critical to ensuring proper payment of state aid to the LEAs, ADE should implement a comprehensive system to ensure that the data is accurate state-wide. If it is determined to be inaccurate, ADE should recover any overpayments and distribute any underpayments to the LEAs. There are different options that ADE could choose to implement, and other states have already implemented systems to ensure the accuracy of their schools' attendance data. For example, ADE could seek statutory changes to require CPA firms to assess the accuracy of attendance data as part of their financial reviews of the LEAs. Another alternative is for ADE's own audit unit to expand the work it currently performs. Regardless of the system ADE chooses to implement, once ADE has ensured the accuracy of the LEAs' attendance data, ADE should then determine if any adjustments need to be made to the LEAs' funding.

CPA firms could assess accuracy of LEAs' attendance data—By statute, the reviews conducted by the CPA firms focus on whether the LEAs are complying with statutes and the *Uniform System of Financial Records for School Districts and Charter Schools*. However, the reviews do not assess the accuracy of the attendance data reported or calculate any over- or underpayments. ADE could seek the necessary changes in statute to require the CPA firms to perform more extensive reviews of the accuracy of the LEA attendance data with the intent of identifying over- or underpayments. ADE could then work with the Office of the Auditor General to define new requirements for the CPA firms. These reviews could take one of two forms: 1) to conduct enough work so that a total over- or underpayment amount could be calculated for the total attendance data submitted by the LEA, or 2) to conduct less-extensive work and calculate an over- or underpayment amount only for the data sampled. Specifically:

- To be able to review a sufficient amount of attendance data to allow generalization to the LEA, the CPA firms' reviews would need to include much larger samples of students than they currently use. The exact number required to assess the accuracy of an LEA's attendance data is specific to each school

ADE could seek statutory changes to increase the scope of the CPA firms' attendance data reviews.

and would need to be determined by the CPA firm according to a number of risk factors, such as the particular type of schools in the LEA and the type of students served by the LEA. According to two CPA firms' representatives whose reviews make up over 80 percent of LEA reviews in the State, their firms would be able to accomplish this work, although the reviews would take longer and cost more. The firms are paid for their services by the school districts, who in turn recover the nonfederal portion of the cost of the audits through a mix of additional state aid and property taxes. However, the overall costs to perform this additional work could be reduced if the reviews were conducted on a rotational basis with a certain number of LEAs reviewed every year.

- Another approach could require the CPA firms to perform less extensive work, which could result in smaller samples. Although reviewing smaller samples would not allow generalization to the entire student population, it would at least give ADE some better knowledge about the accuracy of that LEA's attendance data. Additionally, ADE could use the results to calculate over- or underpayments to that LEA for that sample. If ADE chose to implement this approach, it could require the CPA firms to target specific student populations based on potential risk of attendance data inaccuracies. For example, it could require that the firms determine if a particular grade of students appears to have particularly high or low attendance, which could potentially indicate inaccuracies.

Michigan's 760 LEAs have the option to either use their own auditors or use CPA firms to perform attendance data audits. According to an official from the Michigan Department of Education (MDE), the auditors review samples of about 2 to 20 percent of three different populations of students depending on whether the risk associated with their attendance data is classified as low, moderate, or high. However, auditors cannot generalize their results to the entire population of students within the LEA. When auditors identify inaccuracies, they make adjustments to the student counts, which allows MDE to modify the amount of funding allotted to the LEA. Additionally, according to an MDE official, MDE's auditors conduct quality control reviews of the LEA's work on a 3-year cycle.

ADE's audit unit could ensure accuracy of LEAs' attendance data—

Another option ADE could implement to ensure the accuracy of the LEAs' attendance data is expanding the size and coverage of its Audit Resolution Unit. This could be done by either 1) requiring ARU to assume the primary role of auditing the attendance data of all LEAs rather than the CPA firms, or 2) requiring ARU to conduct more extensive audits of those LEAs found by the CPA firms to have the most problematic attendance data.

Relying on ARU to audit all LEAs may not be feasible simply because of the sheer number of audits to be performed. According to ARU's audit director, as of March

ADE could require CPA firms to target student populations at greater risk for attendance errors.

2006, ARU had 2 audit staff whose primary function was performing audits of attendance data. However, to audit all of the 244 school districts and 368 charter holders in Arizona, ARU would need to be significantly expanded.¹ ADE received funding for 4 additional audit staff as part of its fiscal year 2007 budget. Additionally, ARU is funded for 4 other staff who can perform attendance data audits in addition to their other responsibilities. However, according to ARU's director, ARU would require 12 additional audit staff in order to provide audit coverage state-wide, auditing each school district and charter holder once every 4 years. Further, if ARU wanted to calculate the total over- or underpayment for an LEA, it would need to review much larger samples than it currently uses as part of its limited audits, which would also require more resources.

A second option would be for ARU to coordinate its audit work with the results of the audits performed by the CPA firms. For example, if the CPA firms were conducting audits using smaller samples, or performing the audits on a rotational basis, ARU could conduct more extensive and more frequent audits of those LEAs found by the CPA firms to have the most inaccurate attendance data.

The Texas Education Agency (TEA) uses its 9 audit staff to audit about 10 percent of the state's approximately 1,200 LEAs annually. According to an official at TEA, the audits are either conducted on-site at the schools or are "desk audits," which are equivalent to on-site audits except that the auditors conduct the audits at TEA and the schools send the auditors the necessary documentation. According to TEA, about 10 percent of its 125 annual audits are on-site and the remainder are desk audits. If the audits identify inaccuracies, TEA makes adjustments to the district's future funding. According to TEA personnel, TEA recovered approximately \$30 million in 2005. Texas, like Arizona, has a large database of student data, which auditors use to identify higher-risk schools that will be audited. Specifically, TEA's Division of Financial Audits identifies schools with attendance reporting anomalies for each school year by running automated queries against automated attendance records for each district.

ADE should implement a system to ensure the accuracy of schools' attendance data—Whatever approach it chooses, ADE should develop and implement a comprehensive system to ensure that schools' attendance data is correct and make funding adjustments based on the results. In March 2006, ADE put together a group of stakeholders from the districts and ADE to study the issue and develop recommendations for ADE to consider. The goal is to have final recommendations to ADE management by the fall of 2006.

Once ADE has implemented a comprehensive system to determine that the LEAs' attendance data is accurate, ADE should use the results to make needed payment adjustments. If an LEA was overpaid for student membership, ADE would need to reduce that LEA's future funding. Conversely, if an LEA was underpaid for its student membership, ADE would need to increase that LEA's future funding or distribute additional monies to it.

¹ The term charter holder refers to the administrative entity serving one or more charter schools and is similar to a school district.

Recommendations:

1. ADE should implement a comprehensive system to ensure the accuracy of schools' attendance data state-wide. ADE should consider:
 - a. Seeking statutory revisions to require that CPA firms, as part of their financial audits of LEAs, determine the accuracy of attendance data, and work with the Office of the Auditor General to define the new requirements; and/or
 - b. Expanding the number of attendance data audits conducted by its Audit Resolution Unit.
2. Once it has implemented a comprehensive system to ensure the accuracy of LEAs' attendance data state-wide, ADE should make state aid payment adjustments based on the results.

FINDING 2

ADE's approach to identifying and administering federal grant monies generally appropriate

ADE's approach to identifying and administering federal grant monies—both formula and discretionary—is generally appropriate. ADE's process for obtaining federal formula grants appears appropriate in that it is receiving all of the grants it is eligible for. ADE also competes for a limited number of discretionary federal grants, and its process is generally adequate. However, ADE can make a relatively minor improvement to this discretionary grant process by obtaining and maintaining additional records concerning past grant activities to help it make more informed decisions about similar grants in the future and generally improve future grant applications. Additionally, ADE ensures that LEAs use the U.S. Department of Education federal grant monies it receives to avoid returning them to the federal government.

ADE receives and administers federal grant monies

ADE's financial management duties include obtaining and administering state and federal grant monies. As shown in Table 1 (see page 16), ADE received and administered federal grants totaling nearly \$800 million during fiscal year 2005. While ADE receives federal grant monies from a variety of sources, most of its funds come from the U.S. Department of Education and the U.S. Department of Agriculture.

The majority of ADE's grant money is from formula grants, which make up over 99 percent of the nearly \$800 million ADE received in federal funds in fiscal year 2005. In general, ADE passes formula grant monies to the LEAs, aiding them in delivering various services to Arizona's children. In fiscal year 2005, the largest formula grant ADE received was the Title I-A Improving Basic Programs grant for \$229,883,044 from the U.S. Department of Education. This grant is designed to improve the

Federal Grant Types

Formula—Also known as entitlement grants, these grants are awarded to states or other entities based on certain factors, such as the number of children in poverty.

Discretionary—These are awarded to states or other entities on a competitive basis based on information submitted in an application to the granting agency; for example, the U.S. Department of Education.

Almost all of ADE's grants are formula grants from the U.S. Departments of Education and Agriculture.

Table 1: Arizona Department of Education Expenditures
By Dollars Received from Federal Agencies
Fiscal Year 2005

Federal Agency	Percentage of Total Dollars	Number of Awards	Amount
Education	66.89%		
Formula		25	\$529,352,638
Discretionary		10	<u>2,609,009</u>
Total		<u>35</u>	<u>531,961,647</u>
Agriculture	32.58		
Formula		8	258,981,850
Discretionary		2	<u>106,599</u>
Total		<u>10</u>	<u>259,088,449</u>
Labor	0.36		
Formula		3	2,837,838
Discretionary		-	-
Total		<u>3</u>	<u>2,837,838</u>
Health and Human Services	0.06		
Formula		-	-
Discretionary		2	<u>499,581</u>
Total		<u>2</u>	<u>499,581</u>
Corporation for National and Community Service	0.06		
Formula		-	-
Discretionary		1	<u>438,369</u>
Total		<u>1</u>	<u>438,369</u>
Interior	0.05		
Formula		-	-
Discretionary		1	<u>390,998</u>
Total		<u>1</u>	<u>390,998</u>
Totals			
Formula		36	<u>791,172,326</u>
Discretionary		16	<u>4,044,556</u>
Total	<u>100.00%</u>	<u>52</u>	<u>\$795,216,882</u>

Source: Auditor General staff analysis of Arizona's Fiscal Year 2005 *Schedule of Expenditures of Federal Awards* (SEFA).

teaching and learning of students who are failing (or are at risk of failing) to meet state academic standards. By contrast, an example of a discretionary grant is the Transition to Teaching grant that ADE was awarded for \$377,868, which is designed "to support the recruitment, training and placement of talented individuals from other fields into teaching positions in K-12 classrooms and support them during their first years in the classroom."

ADE's process for administering and maximizing formula grants appears appropriate

ADE's process for obtaining federal formula grants appears appropriate in that ADE is receiving all of the federal formula grants it is eligible for. The federal government

appropriates and allocates grant monies to states or other entities based on certain factors, such as the number of children in poverty. In order to receive the formula grant monies, a state must submit proper documentation to the granting federal agency and receive approval. Internally, ADE then channels these monies to the specific program areas responsible for the programs associated with the grant monies. These program areas then make the formula grant monies available to the LEAs in the form of various state-level formula and discretionary grants as determined by federal guidelines. LEAs must then apply for these grant monies through ADE. ADE coordinates the LEAs' application process using its online Grants Management Enterprise (GME) system.¹

LEAs apply to ADE for federal grant monies.

To determine whether there may be additional federal formula grants that ADE is eligible for but not receiving, auditors searched the *Catalog of Federal Domestic Assistance* and the U.S. Department of Education's *Guide to Education Programs* for formula grants that ADE is eligible to receive and compared the list with grants listed in Arizona's 2005 *Schedule of Expenditures of Federal Awards* (SEFA). While there appeared to be a few formula grants that ADE was eligible for but not receiving, auditors determined that these grants were already being obtained and administered by other state agencies. For example, the grant "Special Education—Grants to Infants and Families with Disabilities," provided by the U.S. Department of Education, with an average award of more than \$8 million for each state, is obtained and administered by the Arizona Department of Economic Security. Auditors' analysis did not identify any formula grants that ADE is eligible for but not receiving.

ADE's discretionary grants process could benefit from minor improvement

While ADE appears to have an appropriate process for obtaining federal discretionary grants, it can make a minor process improvement by obtaining and using information from past grant applications to improve its effectiveness in applying for similar future grants. ADE uses a multifaceted approach for identifying which discretionary grants to apply for. ADE has one full-time position—the Federal Relations Liaison—dedicated to this process. Fulfilling grant application requirements can be a complex and lengthy process, including activities such as establishing partnerships with LEAs or other state agencies, developing programs, planning for evaluation, and coordinating responsibilities within ADE. As such, it is important for ADE to identify potential grants to apply for early on. According to ADE's Federal Relations Liaison, in identifying potential grants to apply for, ADE focuses on the U.S. Department of Education's Forecast of Funding Opportunities (Forecast), which provides a forecast of virtually all potential grant opportunities offered by the U.S. Department of Education, often before the application period is open. This allows ADE to plan for potential grants before the actual application period begins.

¹ This does not apply to USDA grants, which are not included in the GME system.

In addition to the Forecast, ADE uses a second source—the Web site and e-mail notification service Grants.gov—to identify other potential grant opportunities, including those offered by agencies other than the U.S. Department of Education. All federal agencies are required to post grant opportunities on Grants.gov, providing a “common face” for potential grantees to identify discretionary grant opportunities. ADE’s Federal Relations Liaison receives an automatic e-mail notification of new federal grant opportunities through Grants.gov, helping to ensure that ADE is aware of other available federal grants in addition to those offered by the U.S. Department of Education.

A second component of ADE’s process is its procedure for deciding which grants to pursue. According to ADE personnel, out of the pool of potential grants, management and staff of each program area determine which grants the programs are eligible to apply for and discuss these possibilities with the Federal Relations Liaison. In deciding whether to pursue a particular grant, several factors are considered. These include whether ADE has the staff resources available to implement the grant, the dollar amount and number of potential awards, federal requirements, whether a partnering agency is required, whether the grant would make provisions for administrative costs associated with implementing the grant, and whether the grant requires any matching state dollars. ADE has decided not to pursue grants requiring any matching state dollars to avoid additional state spending. Once grants are awarded to ADE, discretionary grant monies are administered in various ways based on the stipulations of the individual grants, rather than being generally disbursed or awarded to LEAs similar to formula grants. For example, a discretionary grant may require a partnership between ADE and one or more specific LEAs.

While generally effective in carrying out its discretionary grants program, ADE should obtain and maintain additional records concerning past grant activities and use them to make better decisions about future grant applications. Such information could include information about why it chose not to pursue grants it was eligible to apply for, and especially why it was turned down for any grants it applied for. This information could help ADE to make more informed decisions about whether to apply for similar grants in the future and generally improve future grant applications. Although it does track the names of such grants, it does not keep detailed or consistent records or notes about these grants, or request feedback from a granting agency on denied applications.

ADE does not regularly request information on grant applications that were denied.

ADE helps ensure LEAs use grant monies

ADE uses a multi-faceted approach in helping LEAs use their formula and discretionary grant monies from the U.S. Department of Education. According to ADE staff, all federal grants administered at ADE, except USDA grants, are managed in its

online grants management system, the GME system. This GME system has several uses:

- It helps LEAs identify, apply for, receive, and use federal grant money available through ADE.
- It enables LEAs to log on to a network and manage grants accounts from their own location.
- It allows ADE to monitor LEAs' usage of the available grant monies, including whether they are applying for and using monies made available through ADE.

ADE uses several methods to help ensure that the LEAs use their grant monies. First, ADE uses its GME system to identify LEAs who have not applied for federal grant monies or who are not using available grant monies quickly enough before the 27-month close date for U.S. Department of Education Grants. Additionally, ADE uses phone calls and e-mails to notify specific LEAs of the need to use the available money. Further, ADE has developed grant-tracking reports to aid in determining the dollar amounts available for U.S. Department of Education grants awarded. These reports, the GME system, and the policy of spending the older money first appear to help ADE to ensure that the grant money is used within the 27-month period allowed by the U.S. Department of Education before the grant is closed.¹ As illustrated by Table 2, less than 1 percent of federal grant monies awarded by the U.S. Department of Education went unspent for calendar years 2002 through 2005. The unspent amounts were either never "drawn down" (requested) from the federal government for use by ADE, or were drawn down and subsequently returned because they were not actually spent by either ADE or an LEA.

Table 2: Unspent Federal Grant Monies
Calendar Years 2002 through 2005
As of January 31, 2006

Year	Amount Awarded ¹	Amount Unspent	Percentage Unspent
2002	\$365,973,829	\$968,225	0.26%
2003	327,853,668	545,259	0.17
2004	453,865,921	655,555	0.14
2005	532,682,058	550,485	0.10

¹ These amounts reflect grants that closed during the years presented.

Source: Auditor General staff analysis of *U.S. DOE Grant Administration and Payment System (GAPS) Report*, as of January 31, 2006.

Recommendation:

1. In carrying out its discretionary grants program, ADE should obtain and maintain additional records concerning past grant activities and use them to make better decisions about future grant applications.

¹ If ADE does not use or obligate the grant money within the 27 months, the grant closes and ADE can generally no longer use the money.

AGENCY RESPONSE



State of Arizona
Department of Education

Tom Horne
Superintendent of
Public Instruction

August 4, 2006

Ms. Debra K. Davenport, CPA
Auditor General
Office of the Auditor General
2910 North 44th Street, Suite 410
Phoenix, Arizona 85010

Dear Ms. Davenport:

The Arizona Department of Education is providing the enclosed response to the Auditor General's performance audit for the following area:

- Administration and Allocation of Funds

We appreciate your work on this performance audit, your consideration of our previous comments and suggestions and your acknowledgement of the quality and variety of work already provided by the Arizona Department of Education.

Please feel free to call me at (602) 364-2339 if any additional information is needed.

Sincerely,

Margaret Garcia Dugan
Deputy Superintendent

Enclosure



State of Arizona
Department of Education

Tom Horne
Superintendent of
Public Instruction

ADE GENERAL COMMENT

While the Arizona Department of Education (ADE) welcomes recommendations that will lead to improved administration and allocation of funds, it does not believe that the Auditor General Performance Audit Division's report fully acknowledges all aspects of ADE's efforts to ensure that student attendance data is accurate and monies are appropriately allocated to Local Education Agencies (LEAs). ADE does indeed have a system in place to help ensure that State aid is appropriately allocated.

Expanded Audit Unit - ADE's Audit Resolution Unit (ARU) conducts audits of student attendance records, and will need to hire additional auditors in order to expand the scope and/or number of audits they conduct. The State Legislature approved four additional auditor positions for FY07, but additional audit staff will need to be requested to comply with the recommendations in this performance audit. Over the past three years, the ADE's audit process has identified approximately \$1.75 million in over-reported Average Daily Membership (ADM) by school districts and charter holders.

SAIS and School Finance Unit Critical Activities - The School Finance Unit and the Student Accountability Information System (SAIS) perform critical functions to help ensure accurate LEA attendance data. SAIS requires extensive edit, i.e., integrity checks to ensure that student attendance data submissions by Local Education Agencies (LEAs) meet State law and ADE business rules. School Finance provides extensive training via its System Training and Response (STaR) Team to LEAs regarding business rules and proper procedures for uploading student attendance information into the automated SAIS. School Finance data analysts provide extensive technical assistance and review integrity errors identified by the SAIS. They then will work with the LEAs to correct the erroneous student attendance data. Funding related to specific integrity errors is withheld until the student attendance data errors are corrected. Pursuant to Arizona Revised Statutes (ARS) § 15-915, School Finance staff process approved corrections initiated primarily by LEAs to their prior year student attendance data.

Other Needed Tools Being Developed - The ADE continues to assess and develop other critical tools needed to help ensure appropriate fund allocation. First, to address the problem of some LEAs not maintaining original student attendance source documentation, ADE recently issued School Finance Memorandum 07-004 on July 14, 2006, entitled, "Records Retention Relating to Original Student Attendance Source Documentation." This policy will help LEAs comply with statutory requirements, and help ensure that auditors have sufficient information to accurately determine whether LEA funding adjustments are needed. Second, ADE continues to develop policies and procedures related to student attendance and Average Daily Membership (ADM), and will contract for a policy development/rules writer. Third, ADE is currently researching the viability of using statistical sampling for auditing LEAs with an ADM exceeding 500. If feasible, this would more efficiently utilize audit resources, and further enhance state-wide coverage. Fourth, to improve audit efficiency for smaller LEA's, ADE will be developing more streamlined audit procedures for LEAs with an ADM of less than 500. Fifth, ADE has established the School Finance Advisory Committee (SFAC) comprised of ADE and LEA representatives to address various funding issues. An SFAC subcommittee has been assigned to determine solutions to address shortcomings in certain student management systems that are unable to separately capture original student attendance entries verses subsequent student attendance entries.

ADE COMMENTS REGARDING FINDING 1: PAGES 7 – 13

Finding 1's conclusion that "ADE should implement a comprehensive system to ensure the accuracy of LEAs' attendance data state-wide" may inappropriately imply a greater need for ADE involvement in day-to-day LEA student attendance reporting activities. In the State of Arizona, there are approximately 2,000 schools with grades kindergarten through twelve, comprising nearly 1,000,000 students. By statute, LEAs self-report student attendance data to the SAIS in timeframes ranging from daily up to 20 days. Based on that uploaded data, ADE issues funds to districts monthly, except for August and November, and to charter holders on a monthly basis. Other than the aforementioned training provided to LEAs by the ADE School Finance Unit, few practical opportunities exist to ensure the accuracy of student attendance data until after the data is submitted and subject to SAIS quality control measures. Further, ADE and independent CPA firm audit activities involving student attendance data are conducted after the end of the school year, and thus examine prior year data. ADE auditors test whether previous year's student attendance data processed by the SAIS is substantiated by original student attendance source documentation retained by the LEA. Once this test work is completed, auditors determine whether an LEA was either over-funded or under-funded.

Finding 1, Recommendation 1

ADE should implement a comprehensive system to ensure the accuracy of schools' attendance data state-wide. ADE should consider:

- a. Seeking statutory revisions to require that CPA firms, as part of their financial audits of LEAs, determine the accuracy of attendance data, and work with the Office of the Auditor General to define the new requirements; and/or
- b. Expanding the number of attendance data audits conducted by its Audit Resolution Unit.

ADE Response

The finding of the Auditor General is not agreed to, but the recommendation will be implemented.

- a. ADE will work with the Auditor General to define CPA firms' requirements to help determine student attendance data accuracy. ADE believes the most cost effective use of CPA firms is to enhance their current duties as outlined in the three compliance questionnaires. ADE will review the questionnaires and develop specific proposals for consideration by the Auditor General. ADE will also request any needed statutory changes to implement those proposals.

ADE does not believe that using CPA firms to perform ADM audits would be cost effective. CPA firms' average billing rates are nearing \$100 per hour. That billing rate combined with the number of additional hours needed to accurately assess student attendance data would be cost-prohibitive. However, CPA firms' limited review of student attendance data could be expanded. This would provide additional information regarding LEA non-compliance for use by ADE's Audit Resolution Unit to select LEAs for audit. In addition, CPA firms could be better utilized to assess the adequacy of internal controls over the availability and retention of original student attendance data.

- b. ADE is taking a two-pronged approach to expand the number of ADM audits. To improve audit efficiency and effectiveness, ADE is 1) assessing the viability of utilizing statistical sampling for larger LEAs; and 2) developing more streamlined audit procedures for smaller LEAs. In addition, ADE will continue to develop policies to address school attendance issues, and contract for a policy writer to assist in that effort.

After efficient and effective audit procedures have been implemented, ADE will request additional staff to ensure that all LEAs are audited on a regular audit cycle. ADE will also review other states' procedures as part of its analysis to determine the most cost effective audit cycle and staffing level. ADE will then develop a legislative budget request for those additional ADM auditors.

Finding 1, Recommendation 2

Once it has implemented a comprehensive system to ensure the accuracy of LEAs' attendance data state-wide, ADE should make state aid payment adjustments based on the results.

ADE Response

The finding of the Auditor General is not agreed to, but the recommendation will be implemented.

Under ADE's current process, any known overpayments are recovered and any known underpayments are distributed.

ADE COMMENTS REGARDING FINDING 2: PAGES 15 - 20

Finding 2, Recommendation 1

In carrying out its discretionary grants program, ADE should obtain and maintain additional records concerning past grant activities and use them to make better decisions about future grant applications.

ADE Response

The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Currently, the ADE has a centralized process that identifies all grants for which the ADE has applied, all grants ADE has received and the grants that were not awarded to the ADE. In FY 2006-2007 and future fiscal years, the ADE will also maintain additional records concerning grant activities. These additional records should answer the following two questions. Why did the ADE choose not to pursue a grant for which the ADE was eligible to apply? Why did the Federal agency not award a grant for which the ADE applied? Finally, any additional information that would assist the ADE to improve future grant applications will be maintained.

Performance Audit Division reports issued within the last 24 months

04-06	Department of Environmental Quality—Waste Programs Division	05-05	Department of Economic Security—Service Integration Initiative
04-07	Department of Environmental Quality—Air Quality Division	05-06	Department of Revenue—Audit Division
04-08	Department of Environmental Quality—Sunset Factors	05-07	Department of Economic Security—Division of Developmental Disabilities
04-09	Arizona Department of Transportation, Motor Vehicle Division— State Revenue Collection Functions	05-08	Department of Economic Security—Sunset Factors
04-10	Arizona Department of Transportation, Motor Vehicle Division—Information Security and E-government Services	05-09	Arizona State Retirement System
04-11	Arizona Department of Transportation, Motor Vehicle Division—Sunset Factors	05-10	Foster Care Review Board
04-12	Board of Examiners of Nursing Care Institution Administrators and Assisted Living Facility Managers	05-11	Department of Administration— Information Services Division and Telecommunications Program Office
05-L1	Letter Report—Department of Health Services— Ultrasound Reviews	05-12	Department of Administration— Human Resources Division
05-01	Department of Economic Security—Division of Employment and Rehabilitation Services— Unemployment Insurance Program	05-13	Department of Administration— Sunset Factors
05-02	Department of Administration— Financial Services Division	05-14	Department of Revenue— Collections Division
05-03	Government Information Technology Agency (GITA) & Information Technology Authorization Committee (ITAC)	05-15	Department of Revenue— Business Reengineering/ Integrated Tax System
05-04	Department of Economic Security—Information Security	05-16	Department of Revenue Sunset Factors
		06-01	Governor's Regulatory Review Council
		06-02	Arizona Health Care Cost Containment System— Healthcare Group Program
		06-03	Pinal County Transportation Excise Tax
		06-04	Arizona Department of Education—Accountability Programs
		06-05	Arizona Department of Transportation—Aspects of Construction Management

Future Performance Audit Division reports

Arizona Department of Education—Information Management Function

Arizona Supreme Court—Administrative Office of the Courts—Information Technology and FARE Program