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October 25, 2018

The Honorable Anthony Kern, Chair
Joint Legislative Audit Committee

The Honorable Bob Worsley, Vice Chair
Joint Legislative Audit Committee

Dear Representative Kern and Senator Worsley:

Our Office has recently completed a 24-month followup of the *Arizona Department of Education—Empowerment Scholarship Accounts Program* regarding the implementation status of the 16 audit recommendations (including sub-parts of the recommendations) presented in the performance audit report released in June 2016 (Auditor General Report No. 16-107). Although our initial followup found that the Department had taken some steps to strengthen oversight of Empowerment Scholarship Accounts Program spending, our work for the 24-month followup found that many of the issues related to misspending of program monies identified in the 2016 performance audit report persist and, in at least one case, has worsened. The attached follow-up report provides information on these issues, as well as the status of the Department's efforts to improve its oversight of program monies.

Although issues regarding the misspending of program monies and department oversight persist, the Department has made progress toward implementing 5 audit recommendations for improving its program eligibility determination process, appropriately safeguarding sensitive information, and better managing program information. As of October 2018, the Department has implemented 2 of these recommendations. In addition, it has partially implemented 1 recommendation by developing and implementing numerous policies and procedures for the Program's Information Technology (IT) system, but it does not plan to include historical spending information and correct inaccurate data transferred from its previous IT system. Finally, the Department is in the process of implementing 2 recommendations by finalizing policies and procedures for processing and safeguarding sensitive information and implementing its policies and procedures for terminating former employees' access to electronic records.

Our Office will conduct a 36-month followup with the Arizona Department of Education on the status of those recommendations that have not yet been fully implemented.

Sincerely,

Lindsey Perry, CPA, CFE
Auditor General

cc: The Honorable Diane Douglas, State Superintendent of Public Instruction
Arizona Department of Education

Arizona Department of Education Empowerment Scholarship Accounts Program

CONCLUSION: Although the Arizona Department of Education (Department) has taken some steps to strengthen oversight of the Empowerment Scholarship Accounts Program (Program) and safeguard program monies, many of the issues found during the 2016 Auditor General performance audit persist. The Department has not adequately monitored parents' spending, reviewed expenses in a timely manner, or taken timely enforcement actions to address misspending. The Department should continue its efforts to implement the recommendations from the 2016 performance audit report. The Department has implemented, partially implemented, or is in the process of implementing other recommendations from the 2016 performance audit to improve its eligibility determination process, appropriately safeguard sensitive program information, and better manage program information.

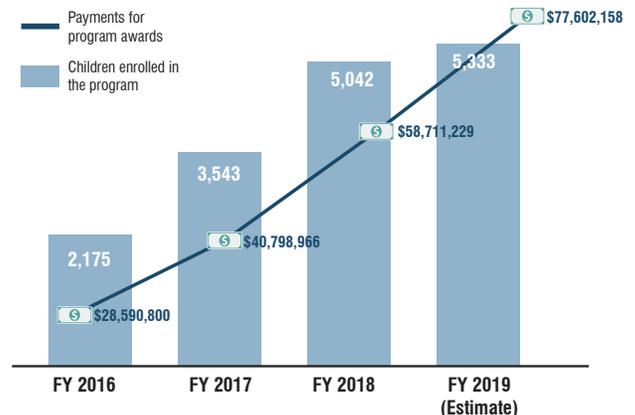
Program background

The Department administers the Program, which provides state education monies to parents to pay for statutorily allowed educational expenses of their children who are not attending public schools and provides these parents with debit cards to access program monies. To pay its program administration costs, statute allows the Department to retain 4 percent of the amount that would have been distributed to a child's prior public school, but these monies are subject to legislative appropriation. In fiscal year 2017, the Department reported that it retained approximately \$2 million for this purpose, and its program administration appropriation was approximately \$800,000. Similarly, the Department reported that it retained approximately \$2.6 million in fiscal year 2018, and its program administration appropriation was approximately \$1.2 million. Finally, the Department estimated that it would retain \$3.3 million in fiscal year 2019, and its program administration appropriation was approximately \$1.2 million.

Since the 2016 performance audit, the Department has increased program staffing from 10 full-time-equivalent (FTE) positions in fiscal year 2017 to 13 FTEs as of September 2018. This staffing consists of a program director, two program supervisors, an administrative assistant, seven program specialists who process program applications and provide customer service, and a program expense report specialist and a fraud auditor, who are each responsible for conducting spending reviews.¹

2016 audit found that Department should strengthen program oversight

The 2016 performance audit reported that the Department did not systematically monitor parents' debit card spending for unusual spending patterns, and some parents were able to successfully misspend program monies. The Department also did not review parents' expense reports in a timely manner. Although the Department had worked with the bank to establish debit card controls to automatically deny purchases at unapproved merchants, some parents were able to circumvent these controls. Finally, the Department had not consistently referred parents to the Arizona Attorney General's Office (Attorney General's Office) for fraud investigations or collections and collections efforts had recovered approximately \$14,500 of the \$102,602 the Department identified as misspent monies between August 1, 2015, and January 31, 2016. Since the 2016 performance audit, the number of children enrolled in the Program and the amount of program monies paid annually for program awards have more than doubled. The growth of the Program reinforces the need for the Department to establish effective program oversight to help protect program monies.



Source: Information provided by the Department for fiscal year 2016 and Auditor General staff analysis of data from the Department's annual *County to District Associated Report* for fiscal years 2017 through 2019.

¹ According to the Department, it has assigned most of its program staff to process program applications because statute requires it to accept these applications throughout the fiscal year and enroll eligible applicants within 45 days after receipt of the application.

Department has not addressed several issues identified during audit

Department has inconsistently monitored for attempted misspending, and parents continue to misspend after initial attempts to do so are denied

The Department has developed a policy requiring program staff to monitor daily program scholarship bank account (bank account) transactions for attempts to misspend, including attempts to withdraw cash and automatically denied transactions at unapproved merchants. When enrolling a child in the Program, parents must agree in writing to use program monies only for the enrolled child's education, and the Department informs parents that attempting to withdraw cash or make purchases at unapproved merchants is grounds for removal from the Program. When department staff detect an initial attempt to misspend, they are required to send the parents a warning letter and conduct more frequent monitoring of the parents' spending. Additionally, according to department policy, if the parent makes a second attempt to withdraw cash, the parent should be terminated from the Program. However, the Department has not consistently implemented this policy, and parents have continued to successfully misspend program monies after initial attempts were denied. Specifically, auditors reviewed a judgmental sample of 19 of 62 accounts that had multiple attempts to withdraw cash and 12 of 1,766 accounts that had automatically denied transactions at unapproved merchants during fiscal year 2018 and found:²

- The Department did not send warning letters to parents for 3 of the 19 accounts reviewed with multiple attempts to withdraw cash. Additionally, although the Department sent two warning letters within 2 weeks of the parents' first attempt to withdraw cash, 14 of the warning letters were sent more than 200 days after the parents' first attempt to withdraw cash. The Department's failure to send warning letters in a timely manner may have contributed to all 14 parents again attempting to withdraw cash at least one additional time before the Department sent the warning letters. In fact, one parent attempted 6 additional cash withdrawals before the Department sent a warning letter, 219 days later.



- The Department did not send warning letters to any parents for the 12 accounts reviewed with automatically denied transactions. This included one account that had 433 denied transactions and another account that had more than \$136,000 in denied transactions.



Department records do not show that the Department conducted additional monitoring of future spending for any of the parents associated with the 19 and 12 accounts discussed above.

For those parents auditors reviewed, several attempted to withdraw cash multiple times or had automatically denied transactions but were able to misspend after their initial attempts to misspend were denied, including one parent who had multiple denied transactions at several travel websites and misspent more than \$10,000 of program monies by making noneducational purchases at approved merchants. Although the Department identified this misspending, it did so more than 4 months after the misspending when the parent did not submit a quarterly expense report. In addition, auditors reviewed several other parents who had questionable expenses after initial attempts to misspend were automatically denied, including purchasing noneducational music albums, Blu-Ray movies, cosmetics, and a transaction at a seasonal haunted house.

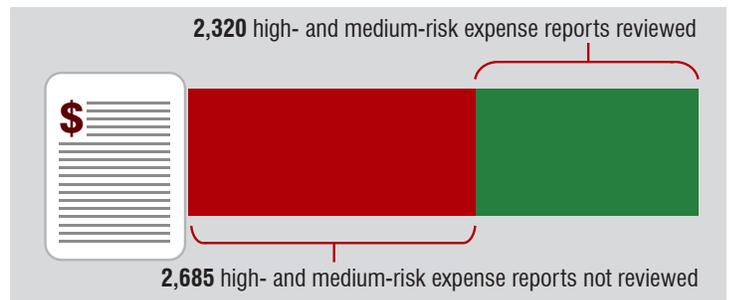
According to the Department, it did not consistently monitor program bank accounts for attempted misspending during fiscal year 2018 because it did not have a daily report detailing attempts to withdraw cash and automatically denied

² Auditors reviewed all 19 bank accounts that were still active as of June 30, 2018, that had multiple attempts to withdraw cash in fiscal year 2018; and 12 accounts that had more than 25 denied transactions and/or more than \$110,000 of denied transactions during fiscal year 2018.

transactions. As of July 25, 2018, the Department reported that it had begun using a newly developed report to track daily attempts to withdraw cash. As of August 12, 2018, the report had identified ten parents who had attempted to withdraw cash. However, as of August 23, 2018, the Department had sent warning letters to only four of the ten parents identified on the report. Additionally, one parent received a warning letter after seven attempts to withdraw cash, but later misspent more than \$4,700 for noneducational purposes over a period of 18 days. Auditors notified the Department of the misspending on August 23, 2018. The Department was unaware of this misspending prior to being notified, indicating that it had not conducted additional monitoring of this parent's spending. As of October 2018, the Department had taken some additional steps to improve its processes for monitoring parents' spending, including terminating at least one parent from the Program for attempting to withdraw cash multiple times and using a newly developed report to track purchases at some unapproved merchants.

Expense report review remains untimely and does not adequately prioritize the highest-risk bank accounts—

The Department has developed a risk-based procedure for reviewing parents' quarterly expense reports for bank accounts classified as high, medium, or low risk and requires department staff to review expense reports for high- and medium-risk bank accounts quarterly and for low-risk bank accounts annually.³ However, as of August 2018, the Department had not yet reviewed the majority of expense reports submitted during the first three quarters of fiscal year 2018 for bank accounts it classified as high and medium risk. Some of these expense reports reflected spending from as early as July 2017. In fact, the Department's review of expense reports has been less timely than it was during the 2016 performance audit. Specifically, during the 2016 performance audit, department staff were reviewing spending that had occurred up to 6 months earlier. The untimely review of expense reports hampers the Department's ability to collect misspent funds. Guidance from the Attorney General's Office indicates that agencies should refer cases of uncollectible debt to it in a timely manner to increase the likelihood of collections.



The Department's assignment of limited staff resources to conduct these reviews has contributed to the untimely reviews. Specifically, in fiscal year 2018, the Department's risk-based procedure classified, on average, more than 1,600 bank accounts as high or medium risk each quarter; however, it assigned only one staff person to review these accounts, and this staff person also had responsibility for monitoring bank account transactions for attempted misspending.⁴ Additionally, because the Department's risk-based procedure classifies bank accounts with a wide range of risk scores as high and medium risk, it does not prioritize expense review for the highest-risk bank accounts. For example, during fiscal year 2018, several program bank accounts had risk scores higher than 20,000, indicating that they had a significant number of high-risk transactions, but these bank accounts had the same review priority as medium-risk bank accounts with risk scores as low as 100.

Lack of program debit card administration has allowed misspending to occur—

Although the Department reported that it has worked with the bank to address the issue of parents circumventing program debit card controls, program bank account transaction data for fiscal year 2018 includes more than 900 successful transactions at unapproved merchants totaling more than \$700,000. These merchants included computer technical support providers and athletic apparel and beauty supply retailers. As of September 2018, the Department was unable to explain why the bank approved these transactions and reported that it was investigating this issue. Additionally, auditors identified three parents who the Department removed from the Program for misspending but whose debit cards were not timely deactivated for more than a year after their removal from the Program. This included one parent who misspent more than \$3,100 of program monies after being removed from the Program but before his/her debit card was deactivated. In total, these three parents misspent approximately \$5,900 after they were removed from the Program while their debit cards remained active.

³ The Department assigns a risk score to each bank account transaction based on factors such as item purchased, dollar amount, and merchant type. It then totals the transaction risk scores for each bank account and, based on this total, classifies each bank account as high, medium, or low risk.

⁴ The Department reported that it hired an additional person, a program expense report specialist, in June 2018 to help review expense reports.

Enforcement and recovery efforts continue to be untimely and recover small amounts—Once the Department identifies misspending and this misspending remains unresolved after 10 days, department policy requires these cases to be sent to the Attorney General’s Office for collections. Although the Department identified numerous cases of misspending throughout fiscal year 2018 that it was unable to resolve, it did not refer these cases to the Attorney General’s Office for collections until May and June 2018. Some of this misspending occurred as early as July 2017 and the untimely referral of this misspending to the Attorney General’s Office may affect the likelihood of its collection. Based on the cases referred by the Department, as of July 2018, the Attorney General’s Office had 142 collections cases totaling approximately \$500,000. The Attorney General’s Office had closed two of these cases after the associated debt totaling approximately \$11,000 had been paid in full. The other 140 cases remained open, although some may have made partial payments.⁵

Department should continue efforts to implement recommendations from 2016 performance audit report

The Department still needs to take several steps to improve its overall administration and oversight of program spending, consistent with the recommendations made in the 2016 performance audit report. These steps include:

- More frequently and systematically monitoring program spending to identify attempts to withdraw cash or denied transactions;
- Taking steps to ensure it follows its established time frames for reviewing program scholarship bank accounts and expense reports based on their identified risk;
- Continuing to work with the bank and the Arizona Office of the State Treasurer to establish additional controls that would help prevent parents from spending at unapproved merchants by circumventing existing program debit card controls; and
- Taking timely and consistent action to address misspending, which would include developing and implementing policies and procedures for determining when to refer parents to the Arizona Attorney General’s Office for fraud investigations or collections, including time frames for doing so.

⁵ The Department also referred one parent to the Attorney General’s Office for a fraud investigation during fiscal year 2018. In April 2018, department staff determined that a parent misspent at least \$10,000 and referred the parent to the Attorney General’s Office for a fraud investigation that same month. This amount is included in the \$500,000 total. As of August 2018, this case was still under investigation.