



Extraordinary Audit

of the
**Options for Youth, Inc. and
Opportunities for Learning, Inc.
Charter Schools**



**Commissioned by the Superintendent of Public
Instruction in Cooperation with the Los Angeles,
Orange, Sacramento, San Bernardino, and
Siskiyou County Offices of Education**

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Executive Summary

California Education Code Section 47600, et seq., also known as the “Charter Schools Act of 1992,” was enacted “... to provide opportunities for teachers, parents, pupils, and community members to establish and maintain schools that operate independently from the existing school district structure ...” Charter schools are a part of the public school system, but differ from traditional public schools in that they are exempt from many state laws relating to specific education programs. Because of these exemptions, charter schools have greater fiscal and programmatic flexibility than traditional public schools. Charter school governance usually involves teachers, parents, and community leaders. Specific goals and operating procedures for each charter school are detailed in an agreement (or “charter”) between the authorizing entity and charter organizers. Under California State law, a local school district governing board, a county school board, and the State Board of Education may authorize charters.

California state law authorizes the use of independent study programs as a voluntary alternative instructional strategy. These programs, which can be operated by both charter schools and traditional public schools, are structured to allow students to work independently, according to a written agreement, and under the general supervision of a credentialed teacher. Given their flexibility, independent study programs are required to meet the same instructional minute requirements as all other public schools and additional state regulations that center on the equitable provision of resources and services, student agreements, record keeping, pupil-to-teacher ratios, graduation, and state testing requirements. With the passage of Senate Bill 740 (SB 740) in 2001 and the authority given to the State Board of Education by Education Code Section 47634.2, nonclassroom-based charter schools also face separate state funding determinations for apportionment purposes based on the percentages they spend on instructional services and certificated staff. Charter schools that do not meet specified levels receive reduced funding.

In 1986, Mr. and Mrs. Hall (the Halls) started educating at-risk youth as contractors in a program at Hollywood High School. Two years later, in December 1988, the Halls registered Options for Youth, Inc. (OFY) as a California nonprofit entity serving students who dropped out of the public school system. The first of the Halls' independent study or nonclassroom-based charter schools, OFY was approved by Victor Valley Union High School District. The number of nonprofit OFY charter schools began to expand in 1996, with the addition of the OFY-Upland charter, which was soon followed, in order, by OFY-Long Beach, OFY-San Gabriel, and OFY-Burbank. At the end of 1997, OFY, Inc. changed its name to OFY-Victor Valley and reincorporated itself in January 1998 as a separate entity. In 1998, OFY-Mount Shasta was established under the OFY-San Gabriel charter and in 1999 OFY-San Juan was established under the OFY-Upland charter. All of the Hall-founded OFY organizations are nonprofit corporations. In June 1999, OFY-Long Beach ceased operating as a charter school. The Halls also created a management company called OFY, Inc. to consolidate several of the corporate and administrative functions then held

individually by the OFY charter schools. The Halls serve as either the president or the vice president of each of the OFY charter schools and OFY, Inc.

On January 8, 1998, just after the number of OFY corporations had grown to six, the Halls formed Education Management Systems. Although Education Management Systems offers management services similar to OFY, Inc., it is a wholly owned, for-profit corporation. Since its inception, Mr. Hall has been Education Management Systems' chief executive officer. According to Education Management Systems' attorney, in January 1999, Education Management Systems formed the California Charter School Group (CCSG) for the specific purpose of obtaining a charter that it would manage. The CCSG, as a separate entity, then submitted petitions to create charter schools in the William S. Hart Union High School District and the Hacienda-La Puente Unified School District. In both of those petitions, CCSG specified that it would contract with Education Management Systems, which would provide educational, management and related services, and equipment to the proposed charter schools. The petitions also stated that CCSG was a "California non-profit corporation;" however, CCSG did not submit its articles of incorporation with the California Secretary of State until January 7, 1999. The two proposed charter schools were to be called "Opportunities for Learning (OFL)," a service mark owned by Education Management Systems. The Hacienda-La Puente Unified School District governing board approved the OFL-Hacienda-La Puente charter school on February 25, 1999, and the William S. Hart Union High School District approved the OFL-William S. Hart charter school on April 28, 1999.

In February 2001, CCSG, Education Management Systems, and William S. Hart Union High School District agreed to assign OFL-William S. Hart to Education Management Systems-William S. Hart, a for-profit entity whose sole and managing partner is Education Management Systems. In May 2001, Education Management Systems received approval to operate the OFL-Baldwin Park charter school and received a renewal of the OFL-William S. Hart charter school. In March 2002, Education Management Systems received approval to operate OFL-Capistrano. Meanwhile, CCSG retained the Hacienda-La Puente charter, with the exception of five independent study home schools that were transferred to the OFL-Baldwin Park charter in November 2002.

During the same time that Education Management Systems was petitioning and receiving approval to operate the OFL charter schools, it formed three for-profit limited liability companies (LLCs) to operate the OFL-Baldwin Park, OFL-William S. Hart, and OFL-Capistrano charter schools. Education Management Systems, as the sole member of the LLCs, established operating agreements with the three Education Management Systems-LLCs and management agreements with three of the four OFL charters. There is no written agreement between Education Management Systems and OFL-Capistrano.

Following the successful expansion of their charter schools, the Halls created additional corporations and began providing services beyond charter school management. In January 2002, the Halls started Education Dynamics, Inc., and in 2003, they founded Partners in Special Education, Inc. Both Education Dynamics, Inc. and Partners in Special Education, Inc. provided fee services to the OFY/OFL charter schools. Also in 2002, the OFY charter schools donated nearly \$11 million toward the creation of an organization called Pathways in Education. The Hall entities¹ are interconnected by the Hall family members; several of the same corporate officers, directors, and staff; and the goods and services they sell to and purchase from one another.

In March 2005, California Department of Education (CDE), along with the county offices of education in Los Angeles, Orange, Sacramento, San Bernardino, and Siskiyou counties, initiated an audit of the ten OFY and OFL charter schools and their respective centers.² The audit request arose due to concerns the Advisory Commission on Charter Schools had highlighted to CDE regarding OFY/OFL's business practices. The CDE and five county offices of education contracted with the Fiscal Crisis and Management Assistance Team (FCMAT) to conduct the investigation, who in turn, contracted with MGT of America, Inc. (MGT). This report presents the findings from the FCMAT/MGT investigation.

Related-Party Transactions

The audit team found that both the OFY and OFL schools can strengthen their conflict-of-interest policies and that CCSG was unable to provide evidence that it actually had such a policy during fiscal years (FYs) 2002-03 and 2003-04 — despite reporting on its SB 740 forms that it had adopted a policy. Without an effective conflict-of-interest policy and practices, the schools cannot ensure they are receiving the best protection against potential improper transactions or the best value from related-party transactions.

Regarding related-party transactions, the audit team found that in most cases, the Hall entities adequately disclosed the Hall's financial interests, ensured that the Halls were not present during board meetings to vote on the transaction, and referred to comparable analyses in order to determine the benefits and fairness associated with each transaction. However, some of the related-party arrangements lacked agreements and board approvals, had agreements and board approvals that were questionable, were not paid for, or

¹ The audit team defines a Hall entity as an entity that any of the Hall family founded, owns, or works in as an officer or director.

² The original audit request did not include OFY-Long Beach (an 11th charter) because the charter was inactive during the periods reviewed by the audit team. However, OFY-Long Beach became a subject of the audit due to an apparent transaction with Pathways in Education, Inc.

resulted in the equivalent of an interest-free loan. Additionally, the audit team found that OFY, Inc. charges significantly higher fees than Education Management Systems does for providing the same charter school services. Moreover, certain members of the Hall family and other key individuals hold the majority of the board and officer positions for the Hall entities — several hold multiple positions concurrently — which increases the potential for related- or interested-party transactions to occur. A review of all major vendors for the entities revealed four interested-party vendors for which the transactions appeared reasonable and one related-party vendor for which the audit team was unable to fully assess the appropriateness.³ Finally, the audit team found that the salaries for Mr. and Mrs. Hall may be excessive based on the number of hours they work in each of the entities and because of the incomplete comparative analyses conducted by the boards to determine the reasonableness of the salaries.

Options for Youth Donation to Pathways in Education

In late January and early February 2002, the then chief operating officer of OFY, Inc., made presentations to the boards of OFY-Burbank, OFY-San Gabriel, OFY-Upland, and OFY-Victor Valley, saying that it was very possible that the state would require the charter schools to consume their financial reserves before providing additional funding to them. The chief operating officer explained that this was likely a result of the recent charter school funding legislation (SB 740). In each case, he proposed that the board contribute a portion of its reserves to Pathways in Education, another nonprofit organization that, according to the boards' minutes, he said, had the purpose of "...the promotion and accomplishment of educational pursuits." In fact, the chief operating officer submitted articles of incorporation to the California Secretary of State on behalf of Pathways in Education on January 28, 2002, just a few days before making his suggestion that OFY charter schools contribute their funds to Pathways in Education. The board meeting minutes do not indicate that the chief operating officer told the OFY boards that he had incorporated Pathways in Education. However, in each case, the boards authorized the charter schools' president and vice president, positions held by Mr. and Mrs. Hall, to contribute their respective school's reserve funds to Pathways in Education, keeping a 3 percent reserve floor.

Two OFY-Victor Valley board members also appear to have had or developed legal and/or ethical conflicts of interest during their tenures on the OFY-Victor Valley board that could have influenced their decisions and the depth of their oversight. The audit team believes that these two board members should not have participated in the decision to transfer funds to Pathways in Education because two days earlier, both were appointed to the board of directors of Pathways in Education.

³ Interested and related-party transactions are those in which an officer, director, or corporation has a financial interest and pre-existing relationship with the transacting entities. The difference between the two is that the latter is in a position to potentially influence the decision-making process.

Although the former chief operating officer of OFY, told four of the five charter schools' boards that Pathways in Education's purpose was "...the promotion and accomplishment of educational pursuits..." that was not Pathways in Education's purpose according to its articles of incorporation. The articles specify that the purpose of Pathways in Education was "...to engage in charitable and educational purposes..." and they further state that those purposes include "...the making of distributions to organizations that qualify as exempt [non-profit] organizations." According to Mr. Hall, the former chief operating officer suggested that OFY reserves be used to create a new educational nonprofit that would provide new avenues for servicing California's at-risk youth and to assist those students failed by the traditional educational model in California. Despite receiving \$10.8 million from the five charter school corporations, Pathways in Education has not spent much of this amount on programs for California youth. However, on October 1, 2002, Pathways in Education created a for-profit organization, R3 Learning Solutions, LLC. The audit team learned that as early as October 7, 2002, there was discussion of R3 Learning Solutions, LLC purchasing OFY, Inc.'s curricula assets. In fact, by that time an operating agreement between Pathways in Education and R3 Learning Solutions, LLC had already been prepared. Consequently, the audit team believes that Pathways in Education specifically created R3 Learning Solutions, LLC so that it could use the money it had received from the OFY charter school corporations to purchase OFY, Inc.'s curricula assets. In turn, R3 Learning Solutions, LLC planned to sell OFY, Inc.'s curricula to schools and educators nationwide. However, the audit team found no evidence that Pathways in Education ultimately transferred money to R3 Learning Solutions, LLC or that they purchased OFY, Inc.'s curricula. The activities conducted by Pathways in Education and R3 Learning Solutions, LLC raise questions about the intended use of OFY funds.

Moreover, it appears that Pathways in Education has been spending at least some of its funds on trying to establish an independent study school in Illinois. Specifically, an application submitted to the Chicago Public Schools states that Pathways in Education would loan Pathways in Education-Illinois \$750,000 and would provide financial support to pay for the \$125,000 per-year cost of Pathways in Education-Illinois' director of education in the first two years of the contract.

As evidenced above, through OFY's transfer of funds to Pathways in Education, the funds could be used for various purposes without being subjected to oversight under state laws. Exhibit E-1 (see page 11) summarizes this questionable transfer and other potential overpaid amounts discussed in this summary and throughout the report.

Finally, the audit team also found that OFY did not bill Pathways in Education for \$15,000 worth of books until March 2006 — more than two years after incurring expenses on Pathways in Education's behalf. Moreover, OFY did not bill Pathways in Education until the audit team brought this omission to its attention. The failure to promptly bill Pathways in Education could represent an interest-free loan to a related organization.

Charter School Funding and Financial Analysis Options for Youth

The audit team identified issues concerning the accuracy and reliability of data reported on the SB 740 funding determination forms submitted by the OFY charters for FYs 2003-04 through 2005-06. The issues include discrepancies in the data reported on the SB 740 forms, minor differences in financial data between the forms and the charters' accounting records, recording of expenses to incorrect accounting codes, and questionable accruals and expenses.

For example, the audit team found that the OFY charters had reported some of their expenses incorrectly by coding them to the wrong accounting categories on the SB 740 funding determination forms. The audit team traced 88 transactions from the general ledger to source documents and also vouched several dozen transactions per year at each charter from source documents to the general ledger. The audit team found in its testing that the charters had incorrectly recorded five items on the SB 740 funding determination forms. In some cases, the erroneous coding resulted in OFY overstating its instructional expenses and the related SB 740 funding determination form percentages. These errors did not individually impact the determination of funding levels for the charters. However, because the audit team only reviewed a sample of expense items, it could not determine whether other misclassified items exist in the larger population of expenses.

Further, the audit team identified several expenses that were correctly recorded on the SB 740 funding determination forms, but did not directly pertain to school operations. For example, during the three years covered by the audit, OFY paid more than \$32,000 for employee parties at Disneyland and spent \$4,500, including alcohol purchases of \$963, at the Ritz-Carlton in 2004-05 for a meeting of 23 board members and OFY staff. In one instance, OFY paid the entire \$5,243 cost of a luncheon and presentation that OFL employees also attended. The OFY's failure to bill OFL for its portion of the luncheon and presentation is more evidence of lax internal controls and potential inurement—a nonprofit providing benefit to a shareholder or individual (in this case a for-profit entity)—which is expressly prohibited by the Internal Revenue Service.

The audit team found numerous problems related to the executive staff usage of OFY company credit cards including incomplete or missing receipts to support the charges, purchase requisition forms, and coding to identify the accounting categories that OFY charged the purchases to, as reported on its SB 740 forms. As a result, the audit team could not determine the appropriateness or validity of many of the expenditures. This lack of internal control is significant considering that OFY paid several bills for six credit cards totaling \$156,435 in 2002-03 and \$221,361 in 2003-04.

Finally, the audit team found that OFY used teacher bonuses, in part, to increase funding in subsequent years. Although OFY awarded and paid numerous bonuses to its teachers

during the FYs reviewed, OFY also accrued large amounts at year end to the bonuses payable account — amounts that were mostly reversed when it failed to obtain higher funding levels. Using teacher bonus accruals as a means to increase funding does not appear to comply with generally accepted accounting principles. Additionally, OFY increased its credentialed teacher expenses by reporting noncredentialed teacher and administrative staff bonus expenses as credentialed teacher bonus expenses. However, the SB 740 forms require schools to report expenses for credentialed teachers, credentialed administrators, and noncredentialed staff separately. The OFY's failure to follow this state requirement is evidence of poor internal controls and could result in an overclaimed funding apportionment.

Opportunities for Learning

The audit team identified issues with the financial data OFL charters reported on their FY 2003-04 through 2005-06 SB 740 funding determination forms. Many of these issues are similar to the issues identified at the OFY charters. In addition, the OFL charters inflated the amount of certificated salaries and benefits reported on their SB 740 forms by double-counting the salaries of certain certificated administrators and recording other expenses incorrectly to this expense category.

Specifically, the audit team determined that the OFL charters coded some of their expenses to incorrect categories on their funding determination forms. The audit team traced 90 transactions from the general ledger to source documents and also vouched several dozen transactions per year and charter from source documents to the general ledger. The testing revealed 16 items the charters had reported incorrectly on their SB 740 funding determination forms. For these items, the erroneous coding resulted in OFL overstating its certificated staff or instructional expenses and the related percentages on the SB 740 funding determination forms.

Further, in preparing the SB 740 forms for the OFL-William S. Hart and OFL-Baldwin Park charters, Education Management Systems erred in making adjustments related to its certificated staff. As a result, OFL double-counted the salaries for some of these staff, thereby inflating its SB 740 certificated staff percentages. Specifically, Education Management Systems included \$325,861 of expenses for OFL-William S. Hart and \$316,507 of expenses for OFL-Baldwin Park in both the certificated administrator and certificated teacher line items. Although these errors did not adversely affect the certificated staff ratios by themselves, combining these errors with the errors discussed in the next section can have a significant impact on the funding determination.

Of greater concern, in reviewing the documents used to compile expenses reported on the SB 740 forms for 2003-04 through 2005-06, the audit team found that OFL incorrectly included teacher automobile expenses, reimbursements, and education costs in the certificated salaries and benefits category. This apparent misallocation of expenses appears to

have resulted in OFL incorrectly calculating and reporting the certificated staff expense percentages for all three charters for each of the three years. In accordance with funding determination rules, neither OFL-Baldwin Park nor OFL-Capistrano would have been eligible for funding for the 2004-05 school year had OFL correctly categorized the expenses on that year's SB 740 forms. Instead, as shown in Exhibit E-1, the state paid \$6,317,319 to OFL-Baldwin Park and \$409,998 to OFL-Capistrano during that year based on OFL's improper claims.

Although there is indication that OFL, similar to OFY, attempted to use bonuses as a means of gaining additional funding, the audit team did not identify the magnitude because OFL did not always book into its accounting system the bonuses it included in its SB 740 funding determination forms and its bonus accrual entry methodology is structured in such a way that the audit team could not easily identify the amounts.

The California Charter School Group

Various financial reporting issues exist with the CCSG charter, OFL-Hacienda-La Puente. The audit team identified issues concerning the accuracy and reliability of data the charter reported on its SB 740 forms. The issues include discrepancies between the data reported on the SB 740 forms and the charter's general ledger, and recording of expenses to incorrect categories on the SB 740 forms. In addition, the charter's overstatement of its certificated staff expenses resulted in it receiving state funding when it failed to meet minimum required spending thresholds. For example, CCSG reported some items in the wrong accounting categories on its SB 740 form. The audit team traced 22 transactions from the general ledger to source documents and also vouched several dozen transactions per year from source documents to the general ledger. The audit team's review found three items the charter reported incorrectly on its SB 740 funding determination forms. For these items, the erroneous coding resulted in certificated staff expenses being overstated, thus resulting in the related percentages reported being higher than they should have been. Similar to the other OFL charters, CCSG also appears to have improperly reported the amount that OFL-Hacienda-La Puente spent on certificated employee salaries and benefits by including teacher automobile expenses, reimbursements, and education costs in this total. When the audit team recalculated the certificated staff percentage by removing the expenses of these three categories, it determined that the charter's percentage fell below the minimum threshold required for receiving any funding during the 2004-05 school year. As a result, OFL-Hacienda-La Puente may not have been eligible for any of the \$5,543,196 provided by the state that year, as summarized in Exhibit E-1.

Charter School Pupil-to-Teacher Ratios

The three charter-holding entities all utilize a formula whereby a full-time teaching assignment at their schools results in a 1.92 full-time equivalent (FTE) for the purpose of calculating the pupil-to-teacher ratios for funding apportionment. The OFY and OFL management contended that the teachers of the three charter holding entities work more days and

hours than a “typical” teacher due to their year-round calendar and longer school day. To determine whether the 1.92 methodology is permissible under existing laws and regulations, the audit team sought legal opinions from the CDE’s attorneys. The CDE’s attorneys opined that the 1.92 methodology does not comply with existing laws and regulations and that the charters should claim their teachers on a 1.0 FTE scale.⁴ In response, OFY and OFL sought their own legal opinion. The OFY and OFL attorney opined that the method used by the schools to calculate FTE teacher counts for the purpose of determining pupil-to-teacher ratios is consistent with current law.⁵ As a result of these differences in opinion, on February 15, 2006, OFY and OFL filed a lawsuit in the Superior Court of California in Los Angeles County against the State Board of Education, FCMAT, the State Controller, and the five county superintendents who requested the audit. The parties had not resolved this lawsuit by the end of the audit team’s fieldwork in May 2006.

As shown in Exhibit E-1, if the state prevails in the legal challenge regarding the FTE calculation method, the State may have overpaid OFY almost \$21.9 million, OFL nearly \$14 million, and CCSG more than \$4 million during FYs 2002-03 through 2004-05. In an attempt to determine the reasonableness of the 1.92 FTE rate for full-time teachers used by the charters, the audit team calculated the FTE rate and number of FTE needed based upon the average daily attendance (ADA) claimed by each of the charters. However, in most cases, these recalculations did not support either the 1.0 FTE claimed by CDE or the 1.92 rate and the FTE’s claimed by the charters.

To determine the validity of the FTE claimed by the entities, the audit team reviewed a sample of more than 100 of the FTE teachers and found that each teacher held a valid teaching credential during the time the teacher provided instruction. However, in comparing the lists of all teachers claimed as FTE on the SB 740 form to the support provided by the entities, the audit team found miscalculations in the FTE and the inclusion of several staff that may not qualify. Additionally, some of the pupil-to-teacher ratio calculations were wrong because of improper rounding, and the entities overstated in several cases the comparison pupil-to-teacher ratios for the largest unified school district. As a result, the charters may have been overpaid by the state.

Options for Youth

The OFY claimed nearly 43 questionable teacher FTEs during the three years reviewed. Specifically, OFY erroneously claimed FTE for several counselors and double-claimed six staff at up to 1.92 FTE each at two different charters. Moreover, the support OFY provided for its FTE claims did not always agree with the amount of FTE that OFY claimed on its

⁴ Please see Appendix C for the complete text of CDE’s legal opinion.

⁵ Please see Appendix D for the complete text of this legal opinion.

SB 740 forms. In fact, the support revealed lower FTEs in three cases and a higher FTE in one. The OFY also did not always round properly in its calculations. While claiming FTE for the questionable staff had no effect on OFY's funding determination, OFY's miscalculation of its pupil-to-teacher ratios does have an effect. Correcting OFY's rounding error and using verified pupil-to-teacher ratio numbers from the largest unified school district for OFY-Mount Shasta in 2002-03 and 2003-04 causes its actual pupil-to-teacher ratios to exceed that of the largest district. As a result, OFY-Mount Shasta appears to have been overpaid \$164,068 from the state.

Opportunities for Learning

The issues found at OFL were more significant. The OFL lacked support for 21 FTEs it claimed in 2002-03 and also claimed 25 questionable teacher FTEs during the three years reviewed. Specifically, OFL claimed administrators as FTE in 2002-03 and claimed several substitutes and floater teachers in each year. Among some of the questionable OFL staff recorded as FTE included two FTEs each (for a total of four) for Mr. and Mrs. Hall in FY 2002-03. Finally, OFL appears to have rounded incorrectly and utilized some inaccurate pupil-to-teacher ratio numbers from the largest unified school districts in its FTE/pupil-to-teacher ratio calculations—resulting in a possible overpayment of more than \$3.6 million from the state for the three years reviewed.

The California Charter School Group

The CCSG may have been overpaid nearly \$1.1 million in state funding because of rounding errors, inclusion of one unallowable teacher in its FTE, and comparisons to incorrect pupil-to-teacher ratios for the largest unified district.

Student Attendance Records

Moreover, the audit team found that OFY overclaimed 32, OFL overclaimed 529, and CCSG overclaimed 438 student attendance days pertaining to the 2003-04 school year. These attendance days were inappropriately claimed for various reasons, such as for coursework not included in the student agreements, attendance that took place prior to the agreement date, and the lack of sample work products in the student files. As summarized on Exhibit E-1, the state overpaid OFY by \$703, OFL by \$11,665, and CCSG by \$9,934.

Exhibit E-1
Summary of Potential Disallowed Funding for the Three Entities
Fiscal Years (FY) 2002-03 to 2004-05

Charter	Chapter 2		Chapter 3		Chapter 4						Chapter 5		All	
	Potential Amount of Disallowed Funding		Due to Not Meeting Funding Determination Thresholds		Due to Unallowable Full-Time Equivalent Certificated Teachers, Inaccurate Pupil-to-Teacher Ratios, or Errors in Rounding						Due to Student File Exceptions			Potential Amount of Total Cumulative Disallowed Funding ^a
	Due to Questionable Donation of Funds to Pathways in Education	FY 03-04	FY 03-04	FY 03-04	FY 02-03	FY 03-04	FY 04-05	Total, All Three Years	FY 02-03	FY 03-04	FY 04-05	Total, All Three Years		
Burbank	\$3,180,000	-	\$2,035,058	\$1,289,263	\$1,888,076	\$5,212,397	-	-	-	-	-	-	\$386	\$8,392,782
Mount Shasta	-	-	260,682	355,392	-	616,075	-	\$70,281	\$93,787	-	-	\$164,068	136	701,663
San Gabriel	1,600,000	-	724,723	353,916	579,870	1,658,509	-	-	-	-	-	-	181	3,258,691
San Juan	-	-	502,542	799,364	730,593	2,032,500	-	-	-	-	-	-	-	2,032,500
Upland	2,900,000	-	1,396,199	2,849,474	2,467,027	6,712,700	-	-	-	-	-	-	-	9,612,700
Victor Valley	3,100,000	-	1,325,951	1,899,356	849,325	4,074,632	-	-	-	-	-	-	-	7,174,632
Total, OFY	\$10,780,000	-	\$6,245,156	\$7,546,766	\$6,514,891	\$20,306,813	\$70,281	\$93,787	-	\$164,068	-	\$703	\$703	\$31,172,968
Baldwin Park	-	-	\$2,058,589	\$2,724,800	\$2,799,797	\$7,583,186	-	\$1,183,641	\$1,539,720	-	-	\$2,723,361	\$4,218	\$11,792,185
Capistrano	-	-	-	171,473	118,076	289,549	-	-	-	-	-	-	454	528,074
William S. Hart	-	-	1,497,626	2,003,241	2,595,999	6,096,866	-	718,441	-	-	\$194,935	913,376	6,993	6,579,576
Total, OFL	-	-	\$3,556,215	\$4,899,514	\$5,513,872	\$13,969,601	\$1,302,082	\$1,539,720	\$194,935	\$3,636,737	-	\$11,665	\$11,665	\$18,899,834
Hacienda-La Puente	-	-	\$1,424,485	\$2,598,912	-	\$4,023,396	-	\$388,189	\$770,669	-	-	\$1,158,858	\$9,934	\$7,169,862
Total, CCSG	-	-	\$1,424,485	\$2,598,912	-	\$4,023,396	\$388,189	\$770,669	-	\$1,158,858	-	\$9,934	\$9,934	\$7,169,862
Total, All If 1.92 Rate Is Deemed Invalid	\$10,780,000	-	\$11,225,856	\$15,045,192	\$12,028,763	\$38,299,811	\$1,229,454	\$1,252,175	\$101,529	\$2,583,158	\$101,529	\$22,302	\$22,302	\$57,242,665
Total, All If 1.92 Rate Is Deemed Valid	\$10,780,000	-	\$12,270,513	\$12,270,513	\$12,270,513	\$12,270,513	\$2,360,552	\$2,404,176	\$194,935	\$4,959,663	\$194,935	\$22,302	\$22,302	\$25,707,483

Note: In Chapter 3, the audit team is recommending the disallowance of all the funding for two OFL and the CCSG charters. Therefore, the other recommended disallowances are redundant and the totals here do not double-count these amounts. Further, if the state wins the lawsuit and the 1.0 methodology is deemed valid, the audit team FTE and pupil-to-teacher ratio findings will need to be reduced by dividing the totals by 1.92 (an approximation). The totals here reflect this reduction in the audit team findings.

Summary of Key Recommendations

To better ensure related-party transactions comply with existing laws, OFY and OFL should do the following:

- Strengthen existing conflict-of-interest policies to include designated parties that must disclose any business or personal interests that may influence their decisions and specific categories that must be disclosed. The policy should require interested persons to recuse themselves from decision-making.
- Ensure that the new policies are formally acknowledged and approved by the school boards of directors.
- Require board members to sign an affidavit stating that they have read, understood, and promise to adhere to the conflict-of-interest policies.
- Ensure that board minutes and contracts undergo review and quality control in order to avoid incorrect dates and information that challenges the validity of the documents.
- Establish formal agreements between OFY, Inc. and the OFY charter schools including detailed lists of services provided and costs involved.
- Establish formal service agreements between OFY, Inc. and the OFL schools for the curriculum purchases—including a methodology and terms related to the billing and payment for textbooks, curriculum, and associated overhead charges.
- Improve controls over collections and payment of related-party invoices.
- Review existing management fees for reasonableness by establishing fair market value and obtaining board approval.
- Consider different measures to better ensure the independence of board members; one method would be to implement independent elections.
- Conduct a comprehensive review of the compensation paid to Mr. and Mrs. Hall for each of the chartering entities, including their salaries from the management services companies, and compare to the salaries of superintendents of similarly sized organizations, including their respective hours worked, for reasonableness.

To ensure that the OFY charter schools have used state funds appropriately and in accordance with all applicable state laws, CDE should:

- Consider a referral to the appropriate authorities, such as the Attorney General or the Fair Political Practices Commission, to investigate the nature and legality of the transfer of funds between the OFY charter schools and Pathways in Education.

- Consider seeking reimbursement or withholding funding in the amount of \$10.8 million related to the OFY transfers to Pathways in Education—if it is determined there is a legal basis for doing so.

To ensure that OFL and CCSG have received an appropriate amount of funding, and are using a proper methodology to calculate funding determination ratios, CDE should:

- Make a determination regarding whether to seek reimbursement or withhold funds for any overpaid funds related to the potentially inaccurate or unsupported financial data on the SB 740 forms identified in this report. In particular, the CDE should determine whether Education Management Systems/OFL charters and the CCSG/OFL Hacienda-La Puente charter schools should reimburse the state for the \$6.7 million and \$5.5 million, respectively, which appears to have been improperly claimed during the 2004-05 school year.

To establish compliance with state requirements for funding determination, OFY and Education Management Systems/OFL should do the following:

- Maintain accurate and reliable documentation to support the expense percentages and pupil-to-teacher ratios used in the SB 740 forms.
- Establish procedures to ensure that staff properly record expenses to the correct accounting categories and perform periodic reviews to verify their accuracy.
- Implement the new credit card policy at OFY to improve controls over the use of credit cards and the documentation of expenses resulting from those transactions.
- Investigate all of the OFY credit card charges incurred during the three-year period of the audit to determine whether the charges were reasonable, appropriate for school business, and recorded appropriately in the financial statements.
- Discontinue the practice of accruing bonuses at year end simply as a means to increase the charters' opportunities for additional funding. The charters should ensure that they document and have a justifiable basis for paying bonuses during the upcoming year before accruing the related expenses.

To determine the proper methodology for calculating FTE, OFY and OFL should either:

- Seek a swift resolution of their FTE-related lawsuit against the state.
- Attempt to establish a common understanding with the state regarding the rules for calculating FTE.

To improve their controls and practices over the calculations of FTE and pupil-to-teacher ratios, OFY and OFL should establish appropriate monitoring and review of funding determination worksheets to ensure that they:

- Calculate FTE in accordance with established rules utilizing proper rounding techniques and maintain adequate support for FTEs claimed.
- Obtain accurate reports of the pupil-to-teacher ratios for the largest unified school districts, if applicable.

To ensure that OFY and OFL have received an appropriate amount of funding, and are using a proper methodology for calculating FTE, CDE should:

- Seek a swift resolution to the FTE-related legal action by OFY and OFL.
- Attempt to establish a common understanding with OFY and OFL regarding the rules for calculating FTE.
- Consider seeking reimbursement or withholding funds for any FTE-related overpaid revenue as determined by the court's ruling.
- Make a determination regarding whether to seek reimbursement or withhold funds for the potentially overpaid amounts related to the unallowable teachers included in the FTE counts and the improper FTE and pupil-to-teacher ratio calculations identified in this report.

To ensure compliance with state requirements for independent study and charter school apportionments, OFL, OFY, and CCSG should do the following:

- Reimburse the state for funds received as a result of the overclaimed attendance days identified in this report.

Finally, OFY and OFL should report their progress in addressing this report's recommendations to each of the charter-authorizing entities, the appropriate county offices of education, and CDE every six months until all recommendations have been fully addressed.

Introduction

Charter Schools in California

California Education Code Section 47600, et seq., also known as the “Charter Schools Act of 1992,” was enacted “...to provide opportunities for teachers, parents, pupils, and community members to establish and maintain schools that operate independently from the existing school district structure...” According to this act, the legislative intent of this law was to:

- Improve pupil learning.
- Increase learning opportunities for all pupils, especially those identified as academically low achieving.
- Encourage the use of different and innovative teaching methods.
- Create new professional opportunities for teachers.
- Provide parents and pupils with expanded choices in the types of educational opportunities that are available.
- Hold the schools accountable for meeting measurable pupil outcomes, and change from rule-based to performance-based accountability systems.
- Provide vigorous competition within the public school system to stimulate continual improvements in all public schools.

Charter schools are a part of the public school system, and may provide instruction in grades kindergarten through 12 (K-12). Charter schools differ from traditional public schools in that they are exempt from many state laws relating to specific education programs. Because of these exemptions, charter schools have greater fiscal and programmatic flexibility than traditional public schools. Charter school governance usually involves teachers, parents, and community leaders. Specific goals and operating procedures for each charter school are detailed in an agreement (or “charter”) between the authorizing entity and charter organizers. Under California State law, a local school district governing board, a county school board, and the State Board of Education may authorize charters.

Charter School Funding

Under California state law, both charter and traditional public schools use the same funding formulas. School districts and charter schools calculate each school’s ADA, which is based on student attendance divided by the total number of days (175) in the regular school year (reporting period), and report it to CDE three times a year. Once the ADA is reported, the State Superintendent of Public Instruction apportions state school funds to each school.

The determination of FTE teachers is an important facet of calculating ADA of students per teacher FTE and one statistic used to gauge the quality of education received by students. Title 5, Section 11704 of the California Code of Regulations defines a FTE as “... an employee who is required to work a minimum six-hour day and 175 days per fiscal year.” Meanwhile, part-time positions generate partial FTE on a proportional basis. These ratios are used by the state to ensure that students have an adequate minimum level of access to and interaction with a certified teacher, and to determine state funding levels.

Independent Study Programs

California State law authorizes the use of independent study programs as a voluntary alternative instructional strategy. These programs, which can be operated by both charter schools and traditional public schools, are structured to allow students to work independently, according to a written agreement, and under the general supervision of a credentialed teacher. Independent study is designed to offer flexibility to meet individual student needs, interests, and styles of learning.

Independent study programs account for student attendance differently from the methods used in traditional classroom-based instruction. Because of the nature of independent study, students do not generally attend classes daily, but instead meet with their teachers at regularly scheduled intervals throughout the academic term. Teachers assign attendance credit for each student based on their evaluation of whether the student has met the instructional requirements for earning attendance based on his or her independent study.

Given their flexibility, independent study programs are required to meet the same instructional minute requirements as all other public schools and additional state regulations that center on the equitable provision of resources and services, student agreements, record keeping, pupil-to-teacher ratios, graduation, and state testing requirements. With the passage of SB 740 in 2001 and the authority given to the State Board of Education by Education Code Section 47634.2, nonclassroom-based charter schools also face separate state funding determinations based on how they fund instructional and certificated staff.⁶ Charter schools that do not meet specified levels receive reduced funding.

The State Board of Education adopted regulations that implement the provisions of SB 740 and delineate which charter schools are required to participate in the funding determination process. The regulations define classroom-based instruction as occurring when all of the following four conditions are met:

1. The charter school’s pupils are engaged in education activities required of those pupils, and the pupils are under the immediate supervision and control of an

⁶ According to the California Code of Regulations, certificated employees in charter schools means employees who hold a certification from the California Commission on Teacher Credentialing.

- employee of the charter school who is authorized to provide instruction to the pupils within the meaning of Education Code Section 47605(1).
2. At least 80 percent of the instructional time offered at the charter school is at the school site.
 3. The charter's school site is a facility that is used *principally* for classroom instruction.
 4. The charter school requires its pupils to be in attendance at the school site at least 80 percent of the instructional time required pursuant to *Education Code* Section 47612.5(a)(1).

Any charter school that does not meet all of the requirements for classroom-based instruction is considered to offer nonclassroom-based instruction. All of the OFY/OFL schools discussed in this report are nonclassroom-based charter schools, and must be compliant with both independent study and SB 740 regulations.

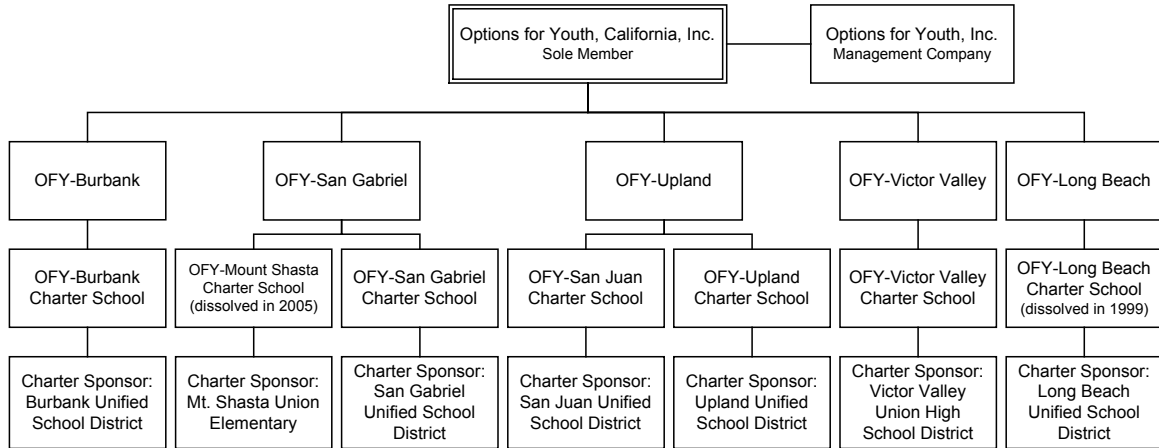
Options for Youth

In 1986, Mr. and Mrs. Hall started educating at-risk youth as contractors in a program at Hollywood High School. Two years later, in December 1988, the Halls registered OFY, Inc. as a California nonprofit entity serving students who dropped out of the public school system. The first of the Halls' independent study charter schools, OFY was approved by Victor Valley Union High School District.

The number of nonprofit OFY charter schools began to expand in 1996, with the addition of the OFY-Upland charter, which was soon followed, in order, by OFY-Long Beach, OFY-San Gabriel, and OFY-Burbank. At the end of 1997, OFY, Inc. changed its name to OFY-Victor Valley and reincorporated itself in January 1998 as a separate entity. In 1998, OFY-Mount Shasta was established under the OFY-San Gabriel charter and in 1999 OFY-San Juan was established under the OFY-Upland charter. All of the Hall-founded OFY organizations are nonprofit corporations. In June 1999, OFY-Long Beach ceased operating as a charter school; however, the dormant corporation has not been dissolved.

The Halls created the new OFY, Inc. to consolidate several of the corporate and administrative functions then held individually by the OFY charter schools. Mrs. Hall is the president and Mr. Hall is the vice president of each of the OFY charter schools except for OFY-Victor Valley, for which Mr. Hall is president and Mrs. Hall is vice president. The OFY, Inc. procedures call for allocating all its monthly expenses to the OFY schools through direct billing or, if costs are shared, based on each school's relative amount of ADA posted for each of the charters for that month. Exhibit I-1 depicts the structure of the OFY organizations.

Exhibit I-1
Overview of the Options for Youth Organizations



Source: Options for Youth, Inc.

The Halls established Options for Youth-California, Inc. (OFY-CA, Inc.) as a nonprofit corporation on October 27, 1999. According to the amendment and restatement of the OFY charter bylaws in 2001, OFY-CA, Inc. became the sole member of the four remaining OFY charter school corporations. The OFY-CA, Inc. is also the sole member for OFY, Inc. This designation gave the OFY-CA, Inc. governing board authority to appoint the boards of directors for all the OFY organizations.

The majority of the OFY schools' revenues come from the state. As depicted in Exhibit I-2, the amount of state funding received by the OFY schools has steadily increased over the three years covered by the audit team's review. The three OFY charters, OFY-Burbank, OFY-Upland, and OFY-Victor Valley received almost 75 percent of the total state funding received by the OFY charters.

Exhibit I-2
**State Payments to Options for Youth,
School Years 2002-03 Through 2004-05**

Options for Youth	2002-03	2003-04	2004-05	Total
Burbank	\$3,432,402	\$3,981,252	\$4,500,988	\$11,914,642
Mount Shasta	459,906	534,905	469,344	1,464,155
San Gabriel	1,523,771	1,890,433	2,036,270	5,450,474
San Juan	1,111,817	1,984,450	2,239,916	5,336,183
Upland	2,888,855	4,740,703	5,718,694	13,348,252
Victor Valley	3,026,786	3,564,644	4,510,312	11,101,742
Totals	\$12,443,537	\$16,696,387	\$19,475,524	\$48,615,448

Source: Nonclassroom Based Funding Determination reports, except OFY-Mount Shasta (2004-05 general ledger summary).

As a result of the Advisory Commission on Charter Schools' recommendations, the State Board of Education reduced funding to the OFY/OFL charter schools to 60 percent of full funding in 2002-03, and 70 percent of full funding for the 2003-04 through 2005-06 school years.

During the 2004-05 school year, the six OFY charters operated 26 centers in four counties and enrolled over 5,900 students in their programs.

Exhibit I-3, breaks out these numbers by OFY charter and shows that OFY-Burbank, OFY-Upland, and OFY-Victor Valley also comprise the bulk of the OFY centers and students.

Exhibit I-3
Options for Youth
Centers and Enrollment, 2004-05

Options for Youth	City	County	Centers	Enrollment
Burbank	Burbank	Los Angeles	6	1,522
Mount Shasta	Mount Shasta	Siskiyou	2	158
San Gabriel	San Gabriel	Los Angeles	3	607
San Juan	Carmichael	Sacramento	4	771
Upland	Upland	San Bernardino	5	1,572
Victor Valley	Victorville	San Bernardino	6	1,279
Totals			26	5,909

Source: The CDE and OFY, Inc. Web sites.

Education Management Systems-Opportunities for Learning and the California Charter School Group

On January 8, 1998, just after the number of OFY corporations had grown to six and six days before the California Secretary of State recorded OFY, Inc.'s reincorporation, the Halls formed Education Management Systems as a Delaware corporation. Although Education Management Systems offers management services similar to OFY, Inc., it is different because it does so as a wholly owned, for-profit corporation. Since its inception, Mr. Hall has been Education Management Systems'/OFL's chief executive officer.

According to Education Management Systems' attorney, Education Management Systems formed CCSG in January 1999 for the specific purpose of obtaining a charter to be managed by Education Management Systems. The CCSG, as a separate entity, then submitted petitions to create charter schools to the William S. Hart Union High School District and the Hacienda-La Puente Unified School District. In both of those petitions, CCSG specified that it would contract with Education Management Systems, which would provide educational, management and related services, and equipment to the proposed charter schools. The petitions also stated that CCSG was a "California non-profit corporation," although CCSG did not submit its articles of incorporation with the California Secretary of

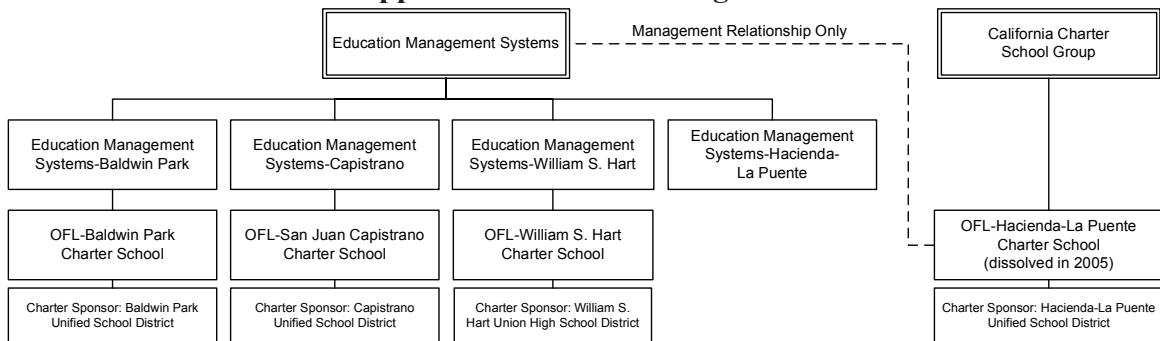
State until January 7, 1999. The proposed two charter schools were to be called “Opportunities for Learning (OFL),” a service mark owned by Education Management Systems.

The Hacienda-La Puente Unified School District governing board approved the OFL-Hacienda-La Puente charter school on February 25, 1999, and the William S. Hart Union High School District approved the OFL-William S. Hart charter school on April 28, 1999.

In February 2001, CCSG, Education Management Systems, and William S. Hart Union High School District agreed to assign OFL-William S. Hart to Education Management Systems-William S. Hart, a for-profit entity whose sole and managing partner is Education Management Systems. In May 2001, Education Management Systems received approval to operate the OFL-Baldwin Park charter school and received a renewal of the OFL-William S. Hart charter school. In March 2002, Education Management Systems received approval to operate OFL-Capistrano. Meanwhile, CCSG retained the Hacienda-La Puente charter, with the exception of five independent study home schools that were transferred to the OFL-Baldwin Park charter in November 2002.

During the same time Education Management Systems was petitioning and receiving approval to operate the OFL charter schools, it formed three for-profit LLCs to operate the OFL-Baldwin Park, OFL-William S. Hart, and OFL-Capistrano charter schools. Education Management Systems, as the sole member of the LLCs, established operating agreements with the three Education Management Systems-LLCs and management agreements with three of the four OFL charters. There is no written agreement between Education Management Systems and OFL-Capistrano and Education Management Systems did not charge OFL-Capistrano for its management services during the review period. Exhibit I-4 depicts the structure of the Education Management Systems/OFL entities.

**Exhibit I-4
Education Management Systems, California Charter School Group, and the Opportunities for Learning Schools**



Source: Education Management Systems-Opportunities for Learning, LLC.

In November 1999, Education Management Systems entered into a service agreement with OFY, Inc., in which OFY, Inc. provided services to Education Management Systems, including accounting, purchasing, and curriculum development. In turn, Education Management Systems passed these services on to the OFL charter schools. Once Education Management Systems became more established, the service agreement was renewed and limited to information technology and curriculum-related services.

The Education Management Systems management agreements established a fixed monthly fee for each school operated by the OFL charters, plus lease and utility expenses. The agreements stipulated that Education Management Systems would provide nearly all administrative services to the charter schools. While the three Education Management Systems-LLCs were part of Education Management Systems, CCSG had separate ownership and was the holder of the charter for the OFL-Hacienda-La Puente schools. In the fall of 2004, CCSG and Education Management Systems agreed to terminate their management contract on June 30, 2005. In accordance with this agreement, the parties terminated the contract on June 30, 2005, and the OFL-Hacienda-La Puente charter school ceased operating. On July 5, 2005, Education Management Systems/OFL opened very similar programs in the same locations with many of the same teachers.

Education Management Systems also formed the Education Management Systems-Hacienda-La Puente division, a division to account for Education Management Systems costs associated with setting up the OFL-Hacienda-La Puente charter locations that belonged to CCSG. Eventually, the Education Management Systems-Hacienda-La Puente division transformed into a “pass through” whereby vendor invoices received by Education Management Systems that related to more than one of the Education Management Systems charters were paid by the Education Management Systems-Hacienda-La Puente division and costs were allocated to the charters based on usage. The charters would then reimburse the Education Management Systems-Hacienda-La Puente division.

Similar to OFY, the majority of the OFL schools’ revenues come from the state and the amount of state funding received by the OFL schools has steadily increased over the three years covered by this review. As depicted in Exhibit I-5 (see next page), the OFL-Baldwin Park and OFL-Capistrano charters have consistently been the largest and smallest OFL charters, respectively.

Exhibit I-5
State Payments to Opportunities for Learning Schools,
School Years 2002-03 Through 2004-05

Opportunities for Learning	2002-03	2003-04	2004-05	Totals
OFL-Baldwin Park	\$3,985,515	\$5,451,859	\$6,738,034	\$16,175,408
OFL-Capistrano	59,573	195,203	217,812	472,588
OFL-William S. Hart	3,848,029	4,937,120	4,416,366	13,201,515
California Charter School Group				
OFL-Hacienda-La Puente	3,470,394	4,560,928	4,877,730	12,909,052
Totals	\$11,363,511	\$15,145,110	\$16,249,942	\$42,758,563

Source: Nonclassroom Based Funding Determination reports, except OFL-Hacienda-La Puente for 2004-05.

The amount of state funding received by the charters is indicative of the number of centers they operate and the number of students they serve. During the 2004-05 school year, the four OFL charters operated 35 centers in Los Angeles and Orange counties and enrolled over 4,500 students in their programs. Exhibit I-6, which breaks out these numbers by OFL charter, shows that Baldwin Park operates more centers than the other three charters combined, although its students comprise 37.5 percent of the OFL schools' total enrollment.

Exhibit I-6
Opportunities for Learning
Centers and Enrollment, 2004-05

Opportunities for Learning	City	County	Centers	Enrollment
OFL-Baldwin Park	Baldwin Park	Los Angeles	18	1,715
OFL-Capistrano	Dana Point	Orange	1	96
OFL-William S. Hart	Santa Clarita	Los Angeles	8	1,355
California Charter School Group				
OFL-Hacienda-La Puente	La Canada	Los Angeles	8	1,409
Totals			35	4,575

Source: The CDE Web site and Education Management Systems.

Other Related Entities

Following the successful expansion of their charter schools, the Halls created additional corporations and began providing services beyond charter school management. In January 2002, the Halls started Education Dynamics, Inc., and in 2003, they founded Partners in Special Education, Inc. Both Education Dynamics, Inc. and Partners in Special Education, Inc. provided services to the OFY/OFL charter schools. Also in 2002, the OFY charter schools donated money toward the creation of an organization called Pathways in Education.

Education Dynamics, Inc. Education Dynamics, Inc., a wholly owned, for-profit corporation that specializes in education software, was established by Mr. and Mrs. Hall in January of 2002. Education Dynamics, Inc. provides its clients with iSIStrac, a student-tracking software that is designed for use by independent-study charter schools. Education Dynamics, Inc.'s clientele include the OFY schools, Education Management Systems, and other

school districts. Education Dynamics, Inc. began as a technology purchasing division of Education Management Systems, and was ultimately spun off into a stand-alone entity. Education Dynamics, Inc. entered into agreements with the OFY charter school companies and Education Management Systems to provide services for a flat monthly fee per student file maintained.

Partners in Special Education, Inc. Partners in Special Education, Inc., also a wholly owned, for-profit Hall corporation, was created to provide special education services to the OFY/OFL charter schools. Since its inception in May 2003, Mr. and Mrs. Hall served as Partners in Special Education, Inc. directors as well as its chief executive officer/chief financial officer and secretary, respectively. The Education Management Systems director of special education became the president of Partners in Special Education, Inc. Shortly after Partners in Special Education, Inc.'s creation, the OFY/OFL charter school governing boards voted to have Partners in Special Education, Inc. replace their special education provider.⁷ Partners in Special Education, Inc. continued to provide special education services to the OFY/OFL schools and additional school districts during the 2003-04 and 2004-05 school years until it discontinued operating in late 2005.

Pathways in Education, Inc. On January 28, 2002, the chief operating officer of OFY, Inc. filed articles of incorporation as a nonprofit organization for Pathways in Education with the California Secretary of State. According to the articles of incorporation, its mission was to engage in charitable and educational purposes, including the making of distributions to organizations that qualify as nonprofit organizations. At that time, OFY-CA, Inc., which was created by Mrs. and Mr. Hall, was the sole member of Pathways in Education. On April 11, 2002, CCSG became the sole member of Pathways in Education. As described in more detail in Chapter 2, the OFY-Burbank, OFY-Long Beach, OFY-San Gabriel, OFY-Upland, and OFY-Victor Valley contributed reserve funds totaling nearly \$11 million to Pathways in Education in April, June, and July 2002. In April 2004, Pathways in Education's governing board voted to make Education in Motion the sole member of Pathways in Education. On July 27, 2004, Catherine D., a member of Pathways in Education's governing board, submitted articles of incorporation of Education in Motion as a nonprofit organization with the California Secretary of State. As of April 24, 2006, Education in Motion had not registered with the California Attorney General's Registry of Charitable Trusts as generally required by Government Code Section 12585.

Options for Youth/Opportunities for Learning School Program Types

The OFY/OFL charter schools offered two types of independent study, or nonclassroom-based instruction. Both OFY and OFL charter schools focus primarily on providing aca-

⁷ The CCSG was unable to provide minutes showing that the CCSG board approved its contract with PSE.

ademic recovery programs. Academic recovery programs are organized to be more flexible than a more traditional classroom setting and rely on the student's ability to self-direct and self-motivate. This instructional model allows students to choose their own core and elective courses and to control the content and pace of their learning. The schools assign each student to a teacher at one of the OFY/OFL centers (schools), which are primarily located in retail shopping centers.

The academic recovery program requires students to meet with their teacher twice a week—for one hour per visit. During these visits, students are expected to submit work product, continue their studies, and ask the teacher any questions they may have. In this process, instruction occurs on a one-to-one basis, rather than the formal classroom-based instruction of traditional schools. Instead, much of the transfer of knowledge occurs via OFY's curriculum, which is divided into units that are to be completed at a minimum rate of one per week.⁸ If a student does not complete the work product on a timely basis, the president or a designee makes a determination on whether to allow the student to continue in the program.

The OFY and OFL also offered their services to parents that taught their children at home (home study). According to OFY/OFL, this was to maintain contact between the school system and the families as well as to provide the home study families with access to curriculum and certificated teachers. As with other home school educators, OFY/OFL claimed ADA for the home study students. The program required home study students to submit course work once per month and to provide verification of at least a 75 percent attendance and assignment completion to remain in the program. The OFL also offers one experiential learning center, at which students learn via direct, "hands on" experiences.

In the 2003-04 school year, OFY charters operated 26 academic recovery and 3 home study programs, and OFL charters operated 24 academic recovery, 5 home study programs, and an experiential learning center.

Twelve-Month Multitrack Schedule

The OFY/OFL programs operate 12 months per year, via a multitrack system that enables students to go to school up to 240 days throughout the year. This approach is beneficial to the schools and students in several ways. By being open 65 more school days per year (240 versus 175) than a traditional school, the schools are able to boost capacity and accessibility. The impact of funding for these 12-month programs is mixed. The benefit is that they receive the funding that accompanies an increased ADA that results from students who start later in a year still receiving a full year (175 days) of instruction. However, the OFY/OFL schools effectively educate any student that attends beyond 175 school days for no additional state funding. From the student perspective, the year-round schedule may help keep them engaged in school and allow them to catch up on unfinished work. This is

⁸ The OFL and CCSG schools also use OFY's curriculum.

important to the predominantly dropout, at-risk student population served by the OFY/OFL schools.

The multitrack approach also allows schools to capture more ADA than a traditional school that does not operate school calendars with school days during the summer months—resulting in increased state funding for multitrack schools. This increase in ADA helps offset the costs of educating the students 65 additional days. Although this system allows students to enroll year round, the state limits all schools, including OFY and OFL in the amount of ADA that may be claimed per student per year at 175 days, the state-established minimum for charter schools. Therefore, much of the benefit of this schedule is derived from the school’s ability to enroll additional students during a given year.

One result of OFY/OFL’s year-round schedule is the increased number of hours worked by the OFY/OFL teachers. As a result of working a 240-day school year compared with the traditional 175-day school year, the OFY/OFL charter schools claim higher FTE per teacher than do many traditional schools. In effect, the increased workload allows OFY/OFL to maintain adequate pupil-to-teacher ratios with nearly one-half as many teachers as a traditional school. Given the unique aspects of the OFY/OFL teacher workload, increased annual hours, and minimal student interaction, the calculation of FTE has become a point of contention between the OFY/OFL charters and the CDE.

Request for an Audit of Options for Youth and Opportunities for Learning

In March 2005, the CDE, along with the county offices of education in Los Angeles, Orange, Sacramento, San Bernardino, and Siskiyou counties, initiated an audit of the ten OFY and OFL charter schools and their respective centers.⁹ The audit request arose due to concerns the CDE had regarding OFY/OFL’s business practices.

The CDE and five county offices of education contracted with FCMAT to conduct the investigation; FCMAT, in turn, contracted with MGT. This report presents the findings from FCMAT/MGT’s investigation.

Scope and Methodology

Following the OFY/OFL request for an audit in February 2005, FCMAT and MGT were asked to investigate several issues related to the OFY and OFL, (including OFL-Hacienda-La Puente) charter schools’ business operations. Included in this request were investigations into compliance with independent study requirements and the existence of related-

⁹ The original audit request did not include OFY-Long Beach (an 11th charter) because the charter was inactive during the periods reviewed by the audit team. However, OFY-Long Beach became a subject of the audit due to an apparent transaction with Pathways in Education, Inc.

party transactions—including related-party compensation amounts. Also included were investigations into the charters’ administrative expenses paid, certificated staff and instructional expenses, and calculations of pupil-to-teacher ratios. The audit team took a multifaceted approach to complete each task outlined in the audit work plan. Exhibit I-7 presents these issues, as well as the objectives associated with each.

Exhibit I-7
Scope of Investigative Audit (Summarized)

Issue	Objectives
Investigate Compliance with Independent Study Requirements	Determine whether OFY and OFL comply with independent study requirements (Chapter 5).
Investigate Related-Party Transactions	Determine whether related-party transactions or conflicts of interest exist between the OFY and OFL schools and the businesses that provide goods and services, directly or indirectly, to the charter schools (Chapters 1 and 2).
Investigate Charter School Administrative Expenses Paid	Determine whether disparities exist in the administrative costs assigned to each school and identify excess costs that were claimed (Chapter 1).
Investigate Certificated Staff and Instructional Expenses	Determine the accuracy of the ratios of certificated staff compensation and instructional costs to the amount of total public revenues for the 2002-03 through 2004-05 school years, as reported to the state. Calculate the proportion of any overclaimed revenues from the state (Chapter 3).
Investigate Pupil-to-Teacher Ratios	Validate the accuracy of the OFY and OFL calculation of the ratio of independent study teachers to average daily student attendance generated through full-time independent study pursuant to state law. Calculate the amount of any overclaimed revenues from the state (Chapter 4).

In addition, the scope of the audit included a review of the age of students. This was in response to Title 5, Section 11960 of the California Code of Regulations, which limits the extent to which students over the age of 19 can matriculate in California charter schools. However, the audit team only reviewed school compliance with this provision for one year because this regulation did not take effect until 2004-05. Based on this review, the OFY and OFL schools appear to comply with the age provisions from Title 5.

The audit team applied a number of approaches to obtain the information necessary to accomplish the objectives of this audit. To develop an in-depth understanding of the issues and potential outcomes pertaining to each task, the audit team interviewed current and former employees and board members. To identify concerns among the local community regarding the charter schools’ business operations, the audit team developed a Web site to solicit information from the public regarding current and past concerns related to the charter schools. For those allegations that fell within the scope of the audit, the audit team conducted further investigation.

The audit team also developed specific audit procedures to address each of the tasks identified in the audit scope. For each task, the audit team evaluated whether OFY, OFL, and CCSG, and/or affiliated individuals complied with applicable rules and regulations, and the audit team focused the audit efforts on identifying particular areas of concern. The audit team performed various tests and analyses to identify and substantiate instances of potential violations of funding requirements, inappropriate expenditures, related-party transactions or conflicts of interest, and compliance with independent study requirements. As part of the investigation, the audit team conducted an extensive document review of contract and vendor files, financial statements, accounting records, invoices, personnel files, student files, electronic student attendance tracking information, and records available through outside entities such as the Office of the Attorney General, California Secretary of State, and Lexis Nexis. Appendix A (at the end of this report) provides a more detailed scope and methodology.

The scope of the audit was restricted to the OFY, OFL, and CCSG schools, limiting the audit team's access to documentation and information held by OFY, Inc., OFY-CA, Inc., Education Management Systems, Inc., Education Management Systems-Hacienda-La Puente, Inc., Pathways in Education, Education Dynamics, Inc., Partners in Special Education, Inc., and R3 Learning Solutions LLC. Given the prominent roles sometimes played by these organizations in the operations and finances of the charter schools, the audit team was unable to operate with full information. However, the audit team did occasionally obtain access to information from some of these entities, as indicated throughout the report.

One of the most important audit standards is that of independence. In all matters relating to the audit work, the audit organization and the individual auditor should be free from external impairments to independence. External impairments to independence occur when auditors are deterred from acting objectively and exercising professional skepticism by pressures, actual or perceived, from management and employees of the audited entity. In such cases, the auditors may not have complete freedom to make an independent and objective judgment and the audit may be adversely affected.

On more than one occasion, an officer from OFL threatened directly and indirectly litigation due to disagreements related to the audit. The threat of litigation constitutes grounds for reporting a potential impairment to the independence of the audit imposed by the management of the audited entity. However, despite the attempts to influence the audit team, the independence of the audit team and the audit report was not compromised in this case. While the audit team took into consideration issues and concerns raised by officers of OFL and OFY, the audit team did not allow the threats of litigation to affect its professional judgment or unduly affect the findings included in the audit report. In addition, as indicated by the responses from OFY and OFL, the entities withheld information from the audit team. As such, the audit team has concerns that the entities were not entirely forthcoming with information. This audit report represents the audit team's findings uncovered

during a thorough review of available information, including all information provided by the entities during the course of the audit.

The audit was conducted in accordance with generally accepted government auditing standards promulgated by the Comptroller General of the United States. These standards pertain to the auditor’s professional qualifications, the quality of the audit effort, and the characteristics of professional and meaningful audit reports. Specifically, the audit followed the general standards pertaining to qualifications, independence, and due professional care. The standards pertaining to conducting the audit fieldwork and preparing the audit report were also followed. By following these standards, the audit team ensured the independence and objectivity of the audit team, the analysis, and the resulting findings and recommendations offered in this report.

Audit Team

For FCMAT	For MGT
Joel Montero, Chief Executive Officer	Fred S.C. Forrer, Chief Executive Officer
Frank Fekete, FCMAT General Counsel	Karin Bloomer, Western Region Director
Laura Haywood, Public Information Specialist	Tyler Covey, CPA, CMA, Senior Associate
	Linus Li, CPA, CMA, CFM, Senior Associate
	Ann K. Campbell (former CFE), Contractor
	Celina Knippling, CPA, Senior Consultant
	Michael Hearn, Consultant
	Jonathan Finley, Consultant

Chapter I: Related Parties

The Hall entities¹⁰ are interconnected by the Hall family members; several of the same corporate officers, directors, and staff; and the goods and services they sell to and purchase from one another. To describe this network accurately, the audit team has analyzed all the Hall entities together in this chapter.

Both the OFY and OFL schools can strengthen their conflict-of-interest policies and CCSG was unable to provide evidence that it actually had such a policy during FYs 2002-03 and 2003-04—despite reporting on its SB 740 forms that it had adopted a policy. Without an effective conflict-of-interest policy and practices, the schools cannot ensure they are receiving the best protection against potential improper transactions or the best value from related-party transactions.

Regarding related-party transactions, the audit team found that in most cases, the Hall entities adequately disclosed the Hall’s financial interests, ensured that the Halls were not present during the vote, and referred to comparable analyses in order to determine the benefits and fairness associated with each transaction. However, some of the related-party arrangements lacked agreements and board approvals, had agreements and board approvals that were questionable, were not paid for, or resulted in the equivalent of an interest-free loan. Additionally, the audit team found that OFY, Inc. charges significantly higher fees than Education Management Systems does for providing similar charter school services. Moreover, the Hall family and certain key individuals hold the majority of the board and officer positions for the Hall entities (several hold multiple positions concurrently) which increases the potential for related- or interested-party transactions to occur. A review of all major vendors for the entities revealed four interested-party vendors for which the transactions appeared reasonable and one related-party vendor that needs further investigation.¹¹ Finally, the audit team found that the salaries for Mr. and Mrs. Hall may be excessive based on the number of hours they work in each of the entities and because the comparative analyses conducted by the boards to determine the reasonableness of the salaries are questionable.

Criteria and Policies for Related-Party Transactions

The California Government Code and California Corporations Code similarly define a related-party transaction, also known as a “self-dealing transaction,” as a transaction to which the officer or corporation is a party and in which any of its officers or directors has or may foreseeably have a financial interest. This definition of interest also extends to the directors’ family members if those family members are not in the class of persons intended to benefit by the charitable purpose for which the corporation is created. While related-party transactions are not inherently illegal, the heightened potential for unjustified favoritism

¹⁰ The audit team defines a Hall entity as an entity that any of the Hall family founded, owns, or works in as an officer or director.

¹¹ Interested- and related-party transactions are those in which an officer, director, or corporation has a financial interest and pre-existing relationship with the transacting entities. The difference between the two is that the latter is in a position to potentially influence the decision-making process.

requires organizations to take extra steps to ensure the fairness and reasonableness of any self-dealing transaction. This includes providing justification of the fair market value of the transaction and gaining governing board approval. While not legally required, to better ensure the board reaches an independent and fair decision, the related party(ies) should not be present during the approval process.

The existence of related-party transactions that unfairly benefit those involved in the decision-making process can have a significant and negative impact on the financial and legal status of the involved organizations and their members. Several California codes address these types of transactions. Specifically:

- Education Code Section 47604.5(b): Authorizes the Superintendent of Public Instruction to recommend and the State Board of Education to take appropriate action upon finding illegal or substantially improper use of charter school funds for the personal benefit of any officer, director, or fiduciary of the charter school.”
- Government Code Section 87100 et seq.: Prohibits a public official from participating in any decision of a public body if it is reasonably foreseeable that the official will gain a material economic benefit from the decision. Section 87300 goes on to require every agency to adopt and promulgate a conflict-of-interest code pursuant to California Government Code.
- Title 5, California Code of Regulations, Section 11963.3(b): States, in part, that a complete determination of a charter school funding request shall include a certification that the governing board of the charter school has adopted and implements conflict-of-interest policies and that all of the charter school’s transactions, contracts, and agreements are in the best interest of the school and reflect a reasonable market rate for all goods, services, and considerations rendered for or supplied to the school.
- California Corporations Code 5233: Defines a self-dealing transaction as one in which “...the corporation is a party and in which one or more of its directors has a material financial interest...” It also states that the interested director(s) may be required by the court to return related funds or property gained through a self-dealing transaction to the corporation.
- Taxpayer Bill of Rights 2, Section 1311 (previously Internal Revenue Service [IRS] Intermediate Section Regulation 4958): The IRS may impose sanctions on a 501(c)(3) organization that participates in a transaction that constitutes excess benefits to a related party. Excess benefits are defined as those whose value exceeds the value received for providing such benefit.
- The 1992 Charter Schools Act: A charter school that provides independent study is required to comply with the provisions of law that are otherwise applicable to the governing board of a school district or a county office of education that offers independent study.

- Government Code Section 1090 states that “Members of the Legislature, state, county, district, judicial district, and city officers or employees shall not be financially interested in any contract made by them in their official capacity, or by any body or board of which they are members. Nor shall state, county, district, judicial district, and city officers or employees be purchasers at any sale or vendors at any purchase made by them in their official capacity.

“As used in this article, ‘district’ means any agency of the state formed pursuant to general law or special act, for the local performance of governmental or proprietary functions within limited boundaries.”

- Title 2, California Code of Regulations, Section 18730 (also known as the Fair Political Practices Commission Regulation 18730) contains all of the provisions related to the terms of the conflict of interest code. These include definitions, the designation of employees, disclosure categories, statements of economic interests, the manner of reporting, the prohibition on receipt of gifts and loans, disqualification, the assistance of the commission and counsel, and violations. This code has the force and effect of law.

Conflict-of-Interest Policies

Both the OFY and OFL schools can strengthen their conflict-of-interest policies and CCSG was unable to provide evidence that it actually had a policy during FYs 2002-03 and 2003-04—despite reporting on its SB 740 forms that it had adopted a policy. Without effective conflict-of-interest policies and practices, the schools can neither ensure they are receiving the best protection against potential improper transactions nor the best value from related-party transactions.

The OFY conflict-of-interest policy, adopted by the OFY charter school boards in January and February 2002, only requires employees to “... ensure that its transactions are consistent with California law governing the operations of non-

Conflict-of-Interest Policy Components Promulgated by California Law

- A written conflict-of-interest policy requiring that the terms of Fair Political Practices Commission Regulation 18730 are referenced and adhered to.
- A list of positions that make or participate in making decisions.
- Categories for which designated parties must disclose interests that may influence decisions.
- Third-party evaluation and approval of transactions.
- Any interested party must be recused from the decision-making process.
- The transaction is fair and reasonable.
- The transaction is germane.
- Any interested party fully discloses his or her conflict of interest.
- Code must be approved by organization’s code reviewing body.

Source: The Fair Political Practices Commission Regulation 18730, Government Code 87303, and California Corporations Codes 300 and 5233.

profit corporations and to ensure that the corporations' transactions are in the best interest of the charter school." Although the OFY charter school petitions provide a more detailed conflict-of-interest policy, these might not be as accessible and may not be reviewed and approved by the board members. As described earlier, independent study charter schools must comply with more than the conflict-of-interest laws that only apply to nonprofit corporations. In addition, due to the number of California laws related to conflicts of interest, the vagueness of OFY's policy may increase the likelihood that school governing board members and employees will not fully consider or understand all the pertinent rules and regulations regarding disclosure, and the proper steps needed to protect against improper related-party transactions. The OFY schools can improve their conflict-of-interest policy by making specific reference to all of the pertinent laws and by adopting policy components that are promulgated by California law, as shown in the text box on the previous page.

The Education Management Systems/OFL conflict-of-interest policy, adopted by the three OFL charter school boards in November 2003, is better. The Education Management Systems/OFL policy designates positions, defines financial interests, and makes mention of the need to distribute the policy to the affected parties.

However, OFY and Education Management Systems/OFL could strengthen their policies by adding specific guidelines to ensure that boards are composed of independent members, that any interested parties recuse themselves from the decision-making process, and that the directors and officers sign a statement acknowledging the policy and disclosing their own interests. Both the OFY and Education Management Systems/OFL financial officers agreed that their conflict-of-interest policies could benefit from the increased detail outlined above.

Of greater concern, the current president of CCSG could not provide a conflict-of-interest policy for the OFL-Hacienda-La Puente schools prior to his involvement with CCSG, starting in September 2004. This is despite the fact that the OFL-Hacienda-La Puente schools reported to the state (on the SB 740 funding determination forms) that a policy did exist.

Background on the Agreements and Allocation of Costs Between Hall Entities

As summarized in Exhibit 1-1 (see next page), several Hall entities conduct business with one another on a regular basis, and have often paid each other significant sums during FYs 2002-03 through 2004-05.

Exhibit 1-1
Options for Youth/Opportunities for Learning School^a
Payments to the Hall Entities
2002-03 Through 2004-05

Vendor	OFY Charter Schools	Education Management Systems/OFL Charter Schools	CCSG-OFL-Hacienda-La Puente
Options For Youth, Inc.	\$27,852,689	\$3,842,068	0
Education Management Systems	0	6,071,444	\$2,435,455
Education Dynamics, Inc.	1,150,416	1,335,912	378,545
Partners in Special Education	107,854	372,273	109,832

Source: Check history reports, audited financials, and Education Management Systems.

^a In 2002, OFY schools donated over \$10 million to Pathways in Education, an organization that will be discussed in more detail in Chapter 2.

For example, during the 2002-03 through 2004-05 FYs, the OFY charter schools paid OFY, Inc. more than \$27.8 million. According to OFY, Inc.'s chief financial officer, it allocates all of its costs pertaining to the OFY schools either directly – if attributable to specific charters – or based on student ADA, if all the charters receive a benefit.¹²

As discussed in the Introduction section, Education Management Systems manages the OFL schools. It charges OFL-Baldwin Park and OFL-William S. Hart a flat fee of \$9,625 per learning center, per month. It managed OFL-Hacienda-La Puente for a flat fee of \$11,475 per learning center, per month, but did not charge OFL-Capistrano for its services. As also described in the Introduction section of the report, Education Management Systems contracted with OFY, Inc. to obtain services related to information technology and curriculum purchasing for the OFL charter schools. As shown in Exhibit 1-1, the four OFL schools paid OFY, Inc. over \$3.8 million for these services and curriculum.

Education Dynamics, Inc. provides a student information tracking software called iSISTrac to the OFY schools for a flat fee of \$8 per student, per month. Education Dynamics, Inc. also provides iSISTrac software to Education Management Systems for a flat fee of \$11.95 per student, per month. However, Education Management Systems passes these costs on to the OFL charter schools through its monthly fee.

Partners in Special Education, Inc. provided special education services to the OFY/OFL charter schools until September 30, 2004. The costs of Partners in Special Education, Inc.'s services are based on a fixed market rate schedule and the hours and types of special education services they provide each school.

¹² According to the California Ed-Data Partnership, ADA is "...the total number of days of student attendance divided by the total number of days in the regular school year."

Exhibit 1-2 (see next page) depicts the business relationships between the various Hall entities.

Related-Party Transactions

To examine the appropriateness of the related-party transactions between the Hall entities, the audit team reviewed board meeting minutes and the resulting contracts or agreements. In most cases, the Hall entities adequately disclosed the Hall's financial interests, ensured that the Halls were not present during the vote, and referred to comparable analyses in order to determine the benefits and fairness associated with each transaction. However, the audit team found some of the related-party arrangements lacked agreements and board approvals, had agreements and board approvals that were questionable, were not paid for, resulted in the equivalent of an interest-free loan, or resulted in duplicate charges.

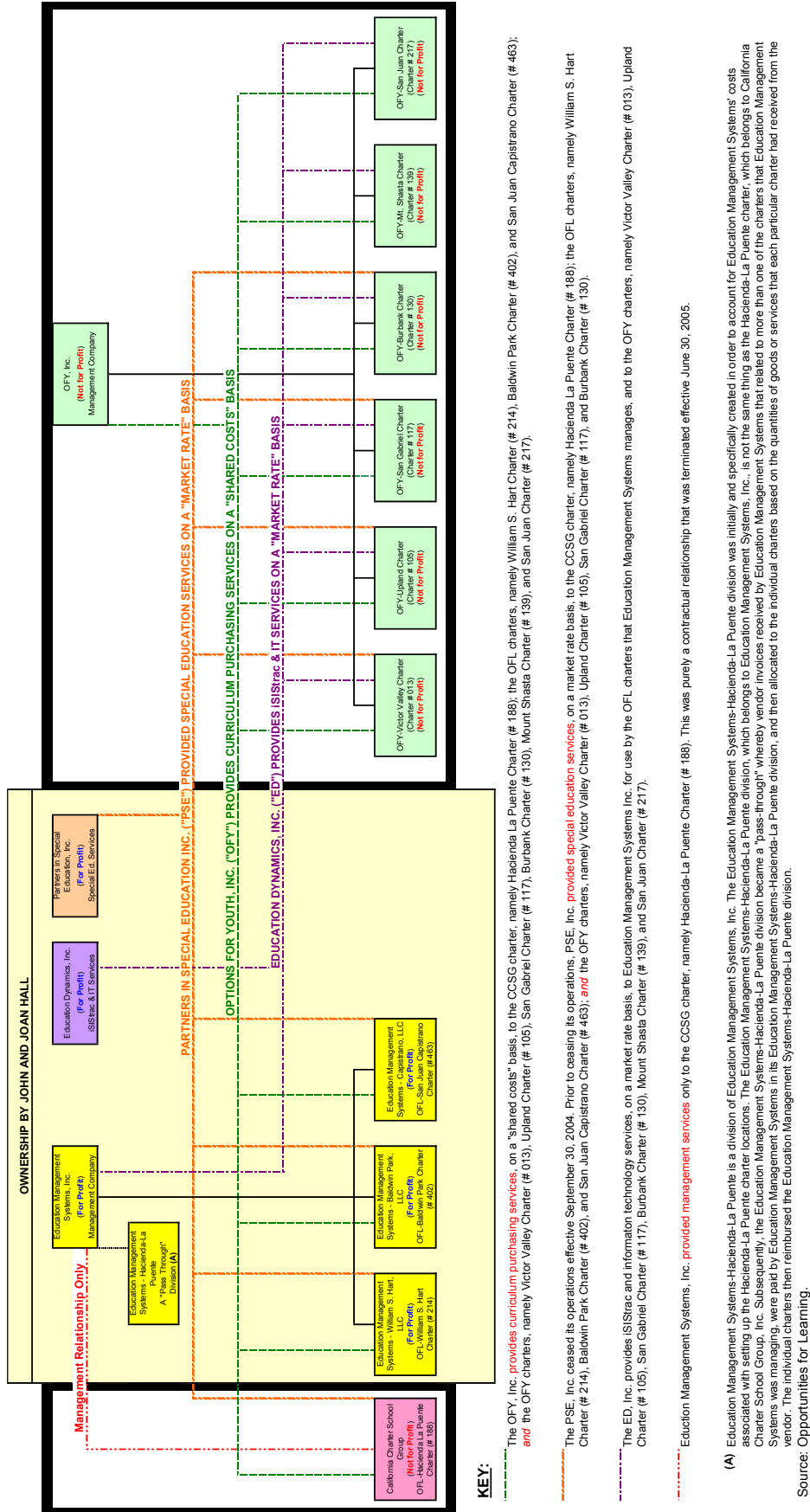
Formal Agreements and Board Approval of Related-Party Transactions

Two cases exist in which there are no formal agreements or board minutes authorizing the dealings between the related Hall entities. Without such agreements and approvals in place, it is difficult to verify the veracity of the resulting transactions.

For instance, OFY, Inc. has no formal agreement with the OFY charter schools for management and procurement services. In spite of this lack of agreement, the charter schools paid OFY, Inc. more than \$27.8 million for operating costs and "management services" during the 2002-03 through 2004-05 FYs. The audit team could not verify if the schools received fair value because an agreement outlining OFY, Inc.'s services and fees does not exist. However, as discussed later in this chapter, OFY, Inc.'s annual charges to the OFY schools exceeded the Education Management Systems charges to the OFL schools.

Although OFY, Inc. and Education Management Systems have an agreement (as discussed further in this report), the individual OFL schools that OFY, Inc. bills directly for the book purchases do not. Without a formal agreement, determination of fair value, and board approval, the schools cannot ensure these related-party transactions are in their best interests.

Exhibit 1-2 Diagrammatic Explanation of Contractual Relationships Between the Hall Entities



Supporting Documents for the Related-Party Transactions

When OFY was agreeable to providing board minutes and contracts to support its related-party transactions, the documents sometimes contained errors and some appeared unoriginal. For instance, the last page of the June 18, 2002 board minutes for OFY-Upland appears to be an exact copy of the last page of the minutes from another charter—OFY-Burbank. Specifically, this last page reports that directors of the OFY-Burbank board—whom the minutes do not list as being present at the meeting—moved and voted to adjourn the meeting. These minutes are clearly in error as they also indicate that the meeting ended two hours before it supposedly began. The audit team also found references to the OFY-Upland charter in the executed service agreements with Education Dynamics, Inc. for the other OFY charters—an error that the governing board should usually catch during the review and approval process. A contributing factor to such errors may be OFY’s apparent practice of copying board minutes and contracts for similar meetings or transactions. In fact, the audit team found several instances in which large sections of the board minutes and contracts of the different charter schools were identical to one another with only the board members’ names, dates, and times changed. While copying service agreements and contracts may be practical, it is important to carefully review the final documents to be sure that they are accurate. The specific minutes referred to, dated in January and June of 2002, are important in that these minutes evidence each of the OFY school board’s approvals of Mr. and Mrs. Hall’s compensation, the conflict-of-interest policies, the transaction with Pathways in Education, several of the contracts with related entities, noncompetition and expansion agreements, and information technology services. Because of these errors and practices, the authenticity and accuracy of some of OFY’s agreements and minutes are questionable.

Review of Board Justifications to Conduct Related-Party Business

In addition to these reporting errors, the audit team found one decision made by the governing boards to conduct related-party business questionable. Specifically, in the fair value analysis reviewed by the OFY boards related to vendors who provide student information services, the related company – Education Dynamics, Inc. – had the lowest relative costs with its iSIStrac system during the first year of operation. However, Education Dynamics, Inc.’s costs in the analysis for years two and three far exceeded those of the two products offered by the unrelated competitor in the comparison. According to OFY’s chief financial officer, the other benefits of iSIStrac, such as lower transition costs and independent study-specific functions outweighed the extra future costs of contracting with Education Dynamics, Inc. However, it concerns the audit team that only OFY-San Gabriel recognized the cost difference. Furthermore, the OFY chief financial officer’s response was that the analysis did not represent all costs. The audit team feels that such analysis should better represent the true costs of a vendor to better serve the boards relying on the analysis when making a decision. Education Management Systems fees include Education Dynamics, Inc. costs and because Education Management Systems would not provide its agreement with Education Dynamics, Inc., the audit team did not review the Education Management Systems and Education Dynamics, Inc. agreement.

Billing, Payment, and Record-Keeping Practices for Related-Party Transactions

In addition to reviewing the procurement process, the audit team reviewed, compared, and contrasted the terms and conditions of the related-party agreements and the resulting transactions. Questionable billing and payment practices exist and the record-keeping practices can be improved, particularly among those transactions lacking a formal agreement. As a result, it was difficult in some cases to determine the propriety of transactions.

In some cases, the Hall entities did a poor job of verifying invoices from other Hall entities. The audit team found examples of invoices that lacked adequate detail to verify the goods or services received. Specifically, when Education Management Systems/OFL purchased books from OFY, Inc. many of the invoices lacked descriptions of the titles and quantities of books purchased. Although the team was able to gather such lists from OFY, Inc., it is disconcerting that Education Management Systems did not require this detail before paying the invoices. The Education Management Systems' director of finance was less concerned about such transactions, stating that because OFY, Inc. is a related entity, there exists an element of trust and, as a nonprofit, he believes that OFY, Inc. would not overcharge them for book purchases. However, given that the book sales from OFY, Inc. to Education Management Systems/OFL comprise over one-half of the transactions between the two entities, the audit team was concerned with the informality of the transactions. To their credit, the entities have since resolved this issue.

Another area of concern is the overhead charges OFY, Inc. included on its invoices for books. Since its inception, Education Management Systems has entered into two contracts with OFY, Inc. According to the first, which terminated in 2002, OFY, Inc. was to provide numerous services to Education Management Systems, including the purchasing and delivery of books, materials, and office supplies. In turn, Education Management Systems was to pay approximately 40 percent to 50 percent of OFY, Inc.'s purchasing department expenses. The second agreement scaled back OFY, Inc.'s services to only attendance reporting and curriculum services. For the curriculum services, Education Management Systems paid OFY, Inc. for cost plus 10 percent for markup. However, in the Education Management Systems/OFY, Inc. agreement there is no provision for books and their associated costs.

Education Management Systems had initially purchased curriculum on behalf of the four OFL charters from OFY, Inc. and then allocated costs among the OFL charters via Education Management Systems-Hacienda-La Puente Division. However, in August 2003, Education Management Systems requested that OFY, Inc. begin selling the books directly to the OFL schools. The OFY, Inc. book markup charges increased dramatically and began varying widely in both percentage and dollar amount from month to month. The markup charges reflect the OFL pro rata share of OFY, Inc.'s curriculum division's costs. While

this may be a reasonable methodology for computing overhead, the OFL boards did not have the opportunity to approve the new arrangement, which resulted in the markups ranging from 20 percent to 51 percent—much higher than the 10 percent rate approved with Education Management Systems. For example, the markup rate charged increased from 27 percent to 51 percent between May and June 2004; however, the net amount charged only increased by \$1,000. In contrast, OFY charged a 25 percent markup rate in both September and October 2003, but the amount charged increased by roughly \$23,000 due to the change in book volumes. Further, the OFL boards did not have an opportunity to review competing proposals to determine if purchasing through OFY, Inc. results in a fair value. To OFY's credit, it engaged an outside audit firm to review their practices for calculating these markups. The audit firm helped to establish a base rate of 25 percent for the markup with a process for truing up the charges at the end of the year.

Timeliness of Invoicing and Payments for Related-Party Transactions

Numerous delayed payments by Education Management Systems for books purchased from OFY, Inc. are indicative of the poor collection efforts of OFY, Inc. and the poor payment practices of OFL. The Education Management Systems and OFL school records revealed that in some cases they did not pay OFY, Inc. for the books until several months after receiving an invoice. For instance, the audit team found examples of delays ranging from three to 11 months between book delivery and payment. According to the OFY, Inc. electronic customer account detail, between October 2004 and June 2005, OFY, Inc.'s expenditures on behalf of OFL exceeded the payments it received from OFL by nearly \$313,000. This amount is over 25 percent of the total amount OFY, Inc. incurred on behalf of OFL during that period. Because OFL did not directly pay any interest for these purchases made on its behalf by OFY, Inc., payment delays resulted in the equivalent of short-term, interest-free loans from OFY, Inc. – a nonprofit organization to a for-profit organization. According to the Education Management Systems director of finance, there were also instances in which they did not receive invoices from OFY, Inc. for several months. As a result, he believes that both sides are partially at fault for such delays.

The OFL schools are not the only related entity that has benefited from OFY's faulty internal controls. As discussed in more detail in Chapter 2 of this report, OFY, Inc. also purchased books for Pathways in Education—but failed to collect money from Pathways in Education. According to the OFY chief financial officer, this error was unintentional and OFY, Inc. has since billed Pathways in Education for this amount. Had the audit team not brought this to OFY, Inc.'s attention, Pathways in Education might not have been billed for more than \$15,000 in book purchases made by OFY, Inc. on its behalf.

Comparison of the Administrative Structure and Operational Costs Between Options for Youth and Opportunities for Learning

The lack of contracts existing between OFY, Inc. and the OFY schools leaves the schools with little control over their relationship with OFY, Inc. According to their chief financial officer, OFY, Inc.'s average operational cost per learning center, per month was \$11,300 in 2003-04 and 2004-05. In contrast, Education Management Systems charged OFL-Baldwin Park and OFL-William S. Hart only \$9,625 per learning center, per month—a difference of more than \$20,000 per year, per learning center for similar services. In addition, the OFY schools pay additional fees, averaging \$1,643 per month to Education Dynamics, Inc. for student information system services. Because Education Dynamics, Inc. fees are included in the \$9,625 for OFL-Baldwin Park and OFL-William S. Hart schools, OFY schools are paying nearly \$40,000 more per year, per learning center than OFL schools for similar services. One possible reason for the large difference in fees is that Education Management Systems appears to operate with fewer staff and cheaper facilities than OFY, Inc. The audit team also did not find any evidence of the OFL schools being charged for any of the burden for executive automobiles as found at OFY. The Education Management Systems director of finance contends that the large difference in costs is due to the fact that Education Management Systems has not changed its fees for several years and therefore absorbs some of the OFL charter school expenses—artificially deflating the appearance of the OFL management fees. However, as he pointed out, the audit team would not be able to verify the latter assertion because “[The audit team] could not see Education Management Systems.” The OFY chief financial officer believes the audit team findings indicate that Education Management Systems should be charging higher fees to the OFL schools. Given that Education Management Systems provides these services at a significantly lower rate, the audit team is concerned that OFY Inc.'s costs may be excessive compared to the fair market value. However, OFY-CA and Education Management Systems/OFL sole member status does not allow for the individual schools to seek alternative management providers.

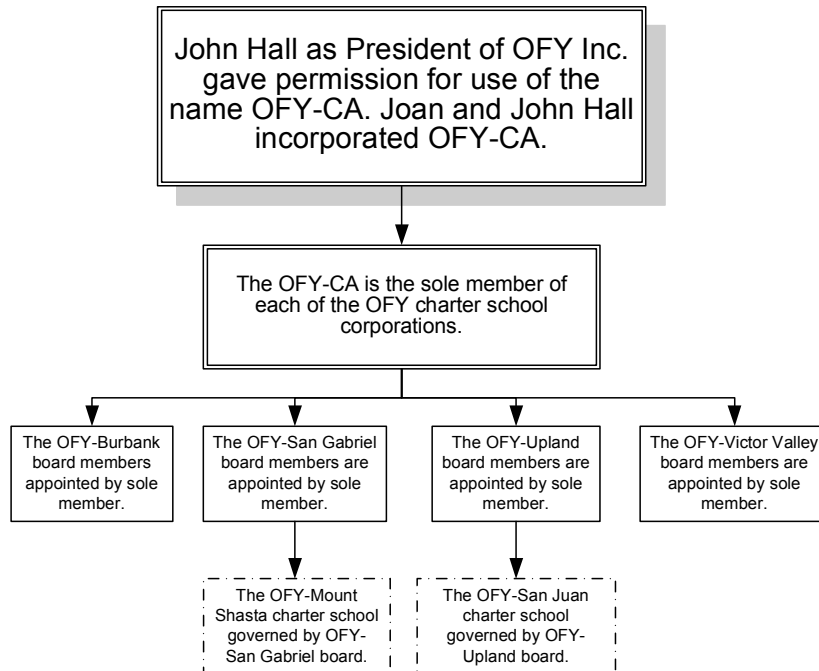
The Officers and Directors of the Hall Entities

The organizational structure of OFY and OFL places most of the decision-making authority with the officers of the OFY-Inc. and Education Management Systems. The entities solicit board of director input for decisions such as those associated with company policy or related-party transactions. However, because the sole member of the OFY entities elects their board members and the sole shareholders of Education Management Systems and OFL (Mr. and Mrs. Hall) elect their board members, the audit team has more concerns about the independence of these boards than it would had the school teachers and/or parents independently elected the boards.

Nonprofit corporations with boards of directors oversee the OFY charter schools. The Halls are the founders and executive officers of the OFY companies and are responsible

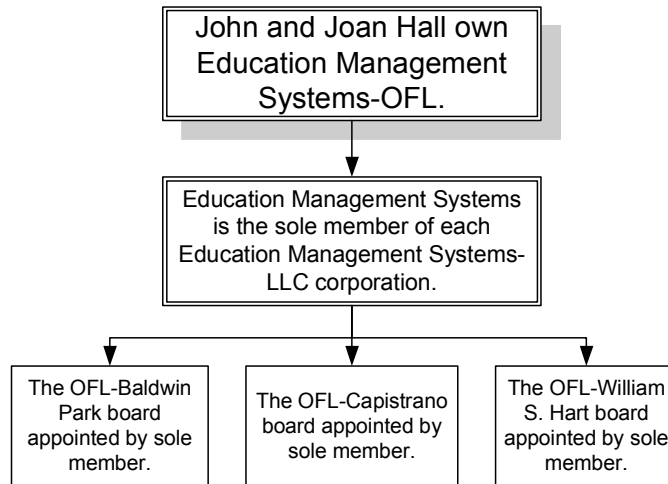
for the day-to-day operations. They also created OFY-CA, which is the sole member of the OFY charter school corporations. As shown in Exhibit 1-3 OFY-CA elects the boards of the various OFY charter school corporations.

Exhibit 1-3
Controlling Structure of Options for Youth Charter Schools



In contrast to the OFY nonprofit corporations, as stated in the Introduction section of the report, three of the OFL charter schools are run by for-profit Education Management Systems LLCs. A board of managers oversees these LLCs. In fact, all three of the LLCs have the same board. As shown in Exhibit 1-4 (see next page), since the Halls are the sole shareholders in the Education Management Systems/OFL group of companies, their potential influence on the makeup and decisions of the Education Management Systems/OFL boards is significant.

Exhibit 1-4
Controlling Structure of Opportunities for Learning Charter Schools



The Halls established OFY-CA and Education Management Systems as the sole member of their respective charter schools. The sole member (OFY-CA and Education Management Systems, respectively) of each of the OFY nonprofits and the Education Management Systems-LLCs have direct control over the OFY nonprofit and Education Management Systems-LLC boards. The audit team believes this business structure allows the Halls to maintain control of all of the companies by maintaining the ability to appoint and terminate the organizations’ directors. The chief financial officer for OFY, Inc. partially confirmed this conclusion by explaining that “A sole member’s primary purpose is to ensure the purpose or mission of the entity is retained and followed, particularly from board manipulation.” The chief financial officer also explained that Mr. Hall – using his own personal financial resources – had previously founded a charter organization in Minnesota. However, due to the lack of sole member status, the board of directors was able to seize control of that organization from Mr. Hall. When the organization subsequently failed, it left Mr. Hall with all the personal debt he incurred in founding the school. However, the OFY, Inc.’s chief financial officer disagrees that the Halls can control the OFY since neither of them currently sit on the board of OFY-CA.

Specifically, according to the OFY schools’ bylaws, “... directors shall be designated by the Sole Member [OFY-CA].” Similarly, the Education Management Systems operating agreements state that the Education Management Systems-LLC “... managers shall be elected by the affirmative vote or written consent of the Member [Education Management Systems].” Both OFY and OFL agreements state that the sole member may remove these directors/managers at any time, with or without cause.

The one OFL charter school entity not structured this way is CCSG. According to Education Management Systems' attorney, Education Management Systems formed CCSG for the specific purpose of obtaining a charter to be managed by Education Management Systems. In fact, CCSG is not legally a part of Education Management Systems. Although CCSG has its own board of directors and presumably oversees its charter – OFL-Hacienda-La Puente – the audit team believes that the Halls have exercised significant control over the CCSG and the OFL-Hacienda-La Puente charter. For example, from 1999 until July 2002, the contract with Education Management Systems for management services allowed Education Management Systems to receive "...99 percent of all charter school revenues..." and have "...sole discretion to manage the business, property, and affairs of the charter school..." thereby limiting CCSG's control over OFL-Hacienda-La Puente.¹³ In addition, OFY, Inc.'s chief operating officer was the first president of CCSG. Mr. Hall was president of OFY, Inc. and therefore the chief operating officer's manager. Further, the individual who incorporated CCSG had a business relationship with Mr. Hall that went back as far as 1980.

The OFY and OFL school board members ostensibly can have significant influence over the schools' transactions. Specifically, the operating agreements between Education Management Systems and the Education Management Systems-LLCs grant the OFL boards "...full, complete and exclusive authority, power and discretion to manage and control the business, property, and affairs of the Company." This includes the ability to appoint officers. The OFY board members similarly are to "...manage the business and affairs of the corporation."

In fact, a governing board should serve the important role of an independent third party in evaluating and approving the related-party transactions described earlier in this chapter. The audit team believes that the boards' ability to fulfill this role may be compromised by the fact that the Halls – who are often the related-party in inter-company dealings – appear to have significant influence over them. According to Mr. Hall, OFY and OFL try to find community members to serve on the schools' boards. Although the boards occasionally consisted of sponsoring district representatives, teachers, and students, the audit team believes that conducting independent elections and opening the board positions to more teachers, parents, and other members of the public will benefit the schools by better ensuring impartiality and increasing community access and involvement.

In addition to the Halls' control over the OFY and OFL charter school organizations, they also exercise control over a number of other entities, including Education Dynamics, Inc. and Partners in Special Education, Inc. As shown in Exhibit 1-2 on page 35, both

¹³ According to the Education Management Systems director of finance, these revenues paid for OFL-Hacienda-La Puente's management fees as well as for employees, curriculum, rent, and utilities. Starting in 2002, CCSG began paying Education Management Systems for only the management fees and took over the payment of any other costs.

of these for-profit corporations have provided services to OFY and OFL charter schools. Another organization that the audit team believes the Halls may have influenced is Pathways in Education, the organization discussed in Chapter 2. Although the audit team could find no evidence that Mr. or Mrs. Hall created or served on the Pathways in Education board, their daughter, Ja. Hall, is the Pathways in Education executive director. In addition, as discussed on page 53, the OFY, Inc.'s chief operating officer incorporated Pathways in Education. There is conflicting information about the governance of Pathways in Education. Although the Halls told CDE that CCSG was the initial sole member of Pathways in Education, as described on page 55, OFY-CA's board appointed two individuals to the Pathways in Education board, indicating that OFY-CA was Pathways in Education's sole member. In April 2002, CCSG became Pathways in Education sole member. This report has already addressed the extent to which the audit team believes the Halls controlled OFY-CA and CCSG. In March 2003, CCSG's board of directors resolved that it no longer was willing to serve as Pathways in Education's sole member. In April 2004, Pathways in Education's board of directors voted to create a sole member board consisting of Catherine D., Marsha A., and Jamie C. In July 2004, Catherine D. submitted articles of incorporation for a new entity, Education in Motion, which the document named as the sole member of Pathways in Education. As of April 2006, Catherine D. was president, Marsha A. was secretary, and Jamie C. was the chief financial officer of Education in Motion, according to records filed with the California Secretary of State. Because these individuals are among those who serve as officers or directors of other Hall entities, the audit team believes that the Halls have at least indirect influence over Pathways in Education. The next section further describes these individuals and others.

Key Positions in the Hall Entities

As shown in Exhibit 1-5 (see next page), the audit team found that during the 2002-03 to 2004-05 FYs, the same individuals held many of the key positions in the Hall entities. For example, Catherine D. has been a director for OFY-CA, Pathways in Education, Pathways in Education-CA, and Education in Motion, as well as the president of Education in Motion (currently the sole member of Pathways in Education). In addition, Catherine D. was a director of OFY-Upland in 1999. Meanwhile, Marsha A. has served on the boards of OFY-Upland, Pathways in Education, and Education in Motion. Education Management Systems and Pathways in Education also employed Marsha A. as the director of experiential learning. Some individuals held these key positions concurrently, while others moved from position to position. In some instances, the board members shown in Exhibit 1-5 appointed each other as officers of other Hall organizations. This situation is a concern to the audit team because of the potential for board members to authorize transactions that are or may be in their own interests.

**Exhibit 1-5
Examples of Shared Officers, Directors, Members, and Staff
Among the Hall Entities, 2002 Through 2005^a**

Shared Officers(O), Directors(D), Members (M), and Staff (S)	Hall Entity									
	EA Board	OFY-CA, Inc.	OFY, Inc.	OFY Schools	Education Management Systems	OFL-Baldwin Park, Capistrano, William S. Hart	Partners in Special Education, Inc.	Pathways in Education	Pathways in Education- CA	Education in Motion
Al An.		D	S	D				O/D		
Catherine D.		D						D	D	O/D
Don R.		O/S	S	O						
Emma S.					S		O			
Jamie C.				O/D						O/D
Karen J.	M			S				O/D		
Karen N.		O/D	O/D							
Marsha A.				D	S			D/S		O/D
Peter L.	M					D		D		
Ralph A.			S	D				O/D		

Source: The OFY, OFL, and CCSG board minutes, public filings, form 990s, and employee rosters.

a See page 46 for a listing of the positions held by Hall family members. The EA Board means Educational Advisory Board.

Non-Hall Major Vendors

The audit request included a provision to review OFY, OFL, and CCSG records to identify major and questionable vendors. This process consisted of reviewing vendors that received at least \$50,000 from the OFY, OFL, and CCSG schools, and determining whether any improper relationships existed between the vendors and the schools’ directors and officers.¹⁴ The OFY, Inc. and OFY charter school corporations paid 64 vendors at least \$50,000 in one or more of school years 2002-03 through 2004-05. The OFL entities had 23 major vendors and CCSG had eight major vendors during the same period. Appendix B lists the vendors to which OFY, OFL, and/or CCSG paid at least \$50,000 in one or more of the three years reviewed by the audit team.

While the audit team found several instances of OFY, Education Management Systems/ OFL, and CCSG conducting business with organizations in which board members were interested parties, ultimately only the Hall entities and one other vendor were determined to be related parties.

¹⁴ When charter schools submit their application for state funding, they must disclose the contractors to whom they paid \$50,000 or more, unless the expenditures are for books, supplies, equipment, facility acquisition, construction, or salaries and benefits of certificated and classified staff.

Specifically, in September 2002, OFY, Inc. conducted business with a company for which Karen N. worked when she was OFY-CA, Inc. chief executive officer and director. According to the current OFY chief financial officer, he could find no record that this relationship or transaction was ever discussed by or disclosed to the board. Most of the transactions with the related company – ePlus Group, Inc. – occurred prior to the scope of this audit, with only about \$30,000 in business occurring in FY 2002-03. In addition, the audit team noted that OFY, Inc. paid ePlus Group, Inc. at least \$100,000 during the 2001-02 FY. Because these payments were outside the period covered by the review, the audit team was unable to determine if the relationship was disclosed or the payments approved. These transactions concern the audit team because of the influential positions Karen N. held with OFY-CA, Inc. at the time. Karen N. also had been an employee of ePlus Group, Inc. and an ePlus Group, Inc.-related company, MLC Group, Inc. Because the OFY boards were not made aware of this relationship and did not conduct a competitive analysis, the audit team cannot conclude that these transactions were in the best interests of the schools.

Moreover, OFY and Education Management Systems/OFL conducted business with organizations in which Education Advisory Board members were interested parties. The audit team reviewed the invoices, checks, and contracts, if any, between the Hall entities and the organizations. In three instances, OFY, Inc. was the only entity that made payments to the organizations. In another case, the OFY and OFL schools paid several hundred thousand dollars to fund scholarships for their teachers at National University to assist them in attaining proper credentials. In each of the cases for which the audit team had documents, the agreements, invoices, and services provided appeared reasonable. However, because Education Management Systems would rarely provide its financial documents, the audit team cannot conclude that these vendors did not also contract with Education Management Systems.

The Halls' Compensation

During the 2002 through 2005 time period, Mr. and Mrs. Hall and several of their relatives—P. Hall (sister), Ja. Hall (daughter), two other daughters, and a son – worked for the Hall entities in some capacity. As shown in Exhibit 1-6 (see next page), Hall family members often served as officers or board members.

The audit team reviewed the employment history of each involved Hall family member to determine the reasonableness of his or her employment and compensation. While the nature of the employment for each of the family members appeared practical, the reasonableness of the level of compensation paid to Mr. and Mrs. Hall by the OFY and OFL schools is questionable.

Exhibit 1-6
Hall Family Involvement Fiscal Years 2002-03 through 2004-05

Position	Hall Entity						
	OFY-CA, Inc.	OFY, Inc. and/or OFY Schools	Education Management Systems and/or OFL-Baldwin Park, Capistrano, and William S. Hart	Education Dynamics, Inc.	Partners in Special Education, Inc.	Pathways in Education	Pathways in Education-CA
Owner/Founder	Mr. Hall/ Mrs. Hall	Mr. Hall/ Mrs. Hall	Mr. Hall/ Mrs. Hall	Mr. Hall/ Mrs. Hall	Mr. Hall/ Mrs. Hall		
President/ Executive Director	Mrs. Hall	Mr. Hall/ Mrs. Hall	Mr. Hall	Mr. Hall	Mr. Hall	Ja. Hall	Ja. Hall
Vice President		Mr. Hall/ Mrs. Hall	Mrs. Hall				
Secretary	Ja. Hall/ Mrs. Hall	Ja. Hall/ P. Hall	Ja. Hall	Mrs. Hall	Mrs. Hall		Ja. Hall
Chief Financial Officer	Mrs. Hall	Ja. Hall	Mrs. Hall	Mrs. Hall	Mr. Hall		Ja. Hall
Director		P. Hall	Mr. Hall/ Mrs. Hall	Mr. Hall/ Mrs. Hall			

Source: The OFY, OFL, and CCSG board minutes, public filings, form 990s, and employee rosters.

Note: Individuals who were not Hall family members also held several of these positions between 2002 and 2005.

Options for Youth Compensation

In addition to founding each of the OFY entities, Mr. and Mrs. Hall serve as president and vice president of each of the OFY schools. The Halls entered into board-approved employment contracts with OFY-Burbank, OFY-San Gabriel (including OFY-Mount Shasta), OFY-Upland (including OFY-San Juan), and OFY-Victor Valley. Each charter agreed to pay \$40,000 per year to the president and \$30,000 per year to the vice president, reflecting a total combined annual salary of \$280,000. With the exception of OFY-Victor Valley, the OFY school boards each referred to a salary survey as evidence of the reasonableness of the Halls' compensation. The salary survey looked at the average compensation of officers of nonprofit organizations with similar operating budgets. As shown in Exhibit 1-7, the Halls' actual compensation aligned with the amounts specified by their contracts. As with other indirect costs, the Halls' pay is allocated across the OFY schools based on the schools' relative ADA claimed.

Exhibit 1-7
Mr. and Mrs. Hall's Compensation

		Annual Contract Amount 2002-2005	Actual Compensation		
			2002-03	2003-04	2004-05
Options for Youth Schools	Mr. Hall	\$130,000	\$120,577	\$124,296	\$123,834
	Mrs. Hall	150,000	120,776	123,274	124,746
	Combined	280,000	241,353	247,570	248,580
Opportunities for Learning Schools	Mr. Hall	\$220,000	\$123,077	\$186,923	\$197,693
	Mrs. Hall	180,000	123,077	186,923	197,693
	Combined	400,000	246,154	373,847	395,385
Total OFY/OFL Schools		\$680,000	\$487,507	\$621,417	\$643,965

Source: The OFY Form 990 filings and Education Management Systems, Inc. records.

The Halls also received various benefits from the OFY charters. These benefits included not only retirement, health, dental, and vision, but also an automobile and reimbursement for its operating and repair expenses. While the invoices reviewed by the audit team showed that the Halls were reimbursed for such expenses, they also raised concerns over the reasonableness of the expenses. For example, OFY paid the leases for Mrs. Hall's Lexus sport utility vehicle and Mr. Hall's Chevrolet Suburban. Furthermore, the Halls' OFY employment contracts stated that the charters would reimburse "all out-of-pocket expenses reasonably incurred" while performing their duties. Within this vague clause, the Halls were able to be reimbursed for such things as airline tickets, hotel rooms, meals, and other retail and online items. The audit team finds this reimbursement policy to be very lenient and opens the door to potential abuse, which may have occurred – as discussed in Chapter 3. In addition, the audit team is concerned that the OFY-funded vehicles may also be used for Education Management Systems/OFL-related business. Given that the OFL employment agreements do not mention the reimbursement of Hall vehicle operation and repair, this may constitute an instance in which Education Management Systems/OFL, a for-profit entity, is benefiting from the nonprofit OFY funds. This may be a case of inurement, which, as described more fully in Chapter 3, is illegal.

Education Management Systems/Opportunities for Learning Compensation

According to the Education Management Systems director of finance, the Halls received compensation from two of the four OFL charters, OFL-Baldwin Park and OFL-William S. Hart. Both school boards approved and entered into employment agreements with the Halls in which they each agreed to employ Mr. Hall as president/superintendent for \$9,166.67 per month (approximately \$110,000 per year from each charter) and Mrs. Hall as vice president for \$7,500 per month (\$90,000 per year from each charter). The OFL boards referred to a CDE-produced management bulletin containing statewide salary aver-

ages for superintendents based on ADA levels in order to establish the reasonableness of the Hall's compensation. As depicted in Exhibit 1-7 (see previous page), the Halls' actual compensation generally aligned with the amounts specified by their contracts. The two times that Mrs. Hall's salary exceeded the contracted amount, the Halls' combined compensation remained within their combined contracted limit.

Although the Halls are compensated for their superintendent duties by OFL-Baldwin Park and OFL-William S. Hart, they also receive compensation from Education Management Systems, the OFL schools' management company. For instance, according to the Education Management Systems director of finance, in 2003-04, the Halls each received \$93,462 from Education Management Systems. This amount was in addition to the \$186,923 the Halls had each received from OFL-Baldwin Park and OFL-William S. Hart that same year. Because OFL-Baldwin Park and OFL-William S. Hart pay Education Management Systems for management services, the Education Management Systems payment constituted an additional \$64,302 paid by OFL-Baldwin Park and OFL-William S. Hart for the Halls' services.¹⁵

While it may be argued that Education Management Systems compensates the Halls for oversight of the administrative functions of the schools and OFL-Baldwin Park and OFL-William S. Hart compensate the Halls for their oversight of the charters' educational programs, the OFL-Baldwin Park and OFL-William S. Hart school boards failed to take this additional compensation into account when making comparisons to the compensation received by superintendents that provide both administrative and educational oversight. The result was increased levels of compensation for the Halls.

It should be noted that because Education Management Systems and the OFL schools are private for-profit corporations, the amount the Halls receive in compensation during profitable years is less relevant. This is because the Halls, as owners, have the option to receive the additional money either in the form of compensation or as shareholder distributions. However, in those years that Education Management Systems and the OFL schools are not profitable, this distinction is more important, because even though shareholder distributions may decrease, the schools will remain responsible for paying the compensation amounts agreed to in the employment agreements.

Analysis of Compensation Levels

Although the school boards approved the OFY and OFL employment contracts, the audit team believes the amount of compensation received by the Halls may be excessive given

¹⁵ This figure was arrived at by allocating the \$93,462 paid to the Halls by Education Management Systems to each of the OFL charters based on the relative amount of management fees they paid to Education Management Systems in 2003-04. This method attributed \$36,731 to OFL-Baldwin Park, \$27,571 to OFL-William S. Hart, \$0 to OFL-Capistrano, and \$29,160 to OFL-Hacienda-La Puente.

the amount of work they do for each charter. As stated in the OFY school board minutes, the Hall’s compensation for a part-time position was based on a salary survey for full-time officers. For example, the OFY charters reported in their 2003 and 2004 tax returns that Mr. and Mrs. Hall each worked approximately three hours per week, per charter. As shown in Exhibit 1-8 (see next page), the annual salaries received by the Halls are less than those received by the average superintendent of a comparable school district in California. However, assuming that the average superintendent is a full-time employee, the amount of time worked by the Halls is significantly less. As a result, an OFY charter that pays its president only \$40,000 per year is actually paying \$256 per hour, four times more than the average school district pays its superintendent that works 40 hours per week. Assuming that the Halls work the same amount of time per OFL charter, OFL-Baldwin Park and OFL-William S. Hart each pay the Halls 12 times more than a comparable full-time superintendent in California. This figure does not include the amount the schools paid through Education Management Systems, as discussed previously. The excessiveness of these amounts makes the audit team question the charter school boards’ impartiality and their analyses that established these salaries as fair, reasonable, and comparable to other superintendents.

**Exhibit 1-8
Options for Youth/Opportunities for Learning and
Statewide Superintendent Hourly Compensation Rates**

	Salary	Hours Per Week	
		3	40
OFY Charter	\$40,000	\$256	
OFL Charter	\$110,000	\$705	
2003-04 State Average ^a	\$121,653	N/A	\$58

Halls' Salary
Average Superintendent's Salary

^a The 2003-04 state average for superintendents of high school districts with similar ADA is used because it is the most up-to-date figure produced by CDE.

Furthermore, the audit team believes that the Halls’ numerous commitments to their nine charter schools and other entities may negatively affect their ability to serve as superintendents. For example, in 2003, in addition to the three-hours worked per week, per charter, the Halls claimed to work an average of 40 hours per week at OFY, Inc. Consequently, without taking into account the time worked for the Education Management Systems entities, Education Dynamics, Inc., and Partners in Special Education, Inc., the Halls reported being committed to an average of 58 hours per week. In 2004, according to their tax Form 990, the amount the Halls worked at OFY, Inc. dropped to three hours per week. Regardless of this decrease, the audit team believes that the Halls have limited time to tend to the superintendent-related issues of their charters given the numerous schools and their other business commitments.

Compensation of Other Hall Family Members

The compensation levels for the other Hall family members generally appeared reasonable. However, given the general autonomy of Mr. and Mrs. Hall in each of the organizations,

each of the respective boards needs to exercise extra vigilance to reduce the chances for improprieties by reviewing and approving their positions and compensation levels.

Specifically, as shown in Exhibit 1-6 (on page 46), P. Hall (Mr. Hall's sister) has served as secretary and director of OFY-Victor Valley, secretary of OFY-Long Beach, and director of public relations and director of student services of OFY, Inc. Her salary – around \$80,000 – did not appear unreasonable given her 18 years of experience at OFY, teaching credential record, and her experience training for Western Association of Schools and Colleges accreditation.

As also shown in Exhibit 1-6, Ja. Hall has served as chief financial officer to OFY-Long Beach and Pathways in Education-CA, secretary to OFY-CA, OFY-Burbank, OFY-San Gabriel, OFY-Upland, OFY-Long Beach, Education Management Systems, and Pathways in Education-CA, and executive director of Pathways in Education and Pathways in Education-CA. Ms. Ja. Hall also served as director of human resources for Education Management Systems. The OFY records show that Ja. Hall did not receive any compensation for her OFY-related positions. However, Ja. Hall was compensated for her positions at Education Management Systems and Pathways in Education. Her salary, which increased to near \$75,000 at Education Management Systems in February 2003, does not appear unreasonable. According to her resume, prior to becoming the Education Management Systems/OFL human resources director in 2001, Ja. Hall served approximately one year as the human resources assistant – her first year out of undergraduate school.

Three other Hall siblings worked for Education Management Systems. One daughter served temporarily as a paid intern and another daughter and son were temporary, unpaid volunteers. The audit team did not find any issues related to their employment or volunteer work.

Although the audit team does not take issue with the employment of Mr. and Mrs. Hall's family members, it does find it a concern that none of the boards reviewed and approved their positions and compensation levels. The hiring of employees, like vendors, may constitute a related-party transaction and deserve the same amount of attention from the board members. In fact, when such employment gives the employee decision-making authority over an organization, the boards need to take extra measures to ensure that no improprieties occur.

Recommendations

To better ensure related-party transactions comply with existing laws, OFY and OFL should do the following:

- Strengthen existing conflict-of-interest policies to include designated parties that must disclose any business or personal interests that may influence their decisions and specific categories that must be disclosed. The policy should require interested persons to recuse themselves from decision-making.
- Ensure the new policies are formally acknowledged and approved by the school boards of directors.
- Require board members to sign an affidavit stating that they have read, understood, and promise to adhere to the conflict-of-interest policies.
- Require that any related-party transactions, whether with vendors or employees, are approved by the school boards and result in a formal agreement. Further, the meeting minutes should include a discussion of whether the transaction is fair and reasonable, is germane and necessary, and all costs and relevant factors related to the competing options are taken into account.
- Ensure that board minutes and contracts undergo review and quality control in order to avoid incorrect dates and information that challenges the validity of the documents.
- Establish formal agreements between OFY, Inc. and the OFY charter schools including detailed lists of services provided and costs involved.
- Establish formal service agreements between OFY, Inc. and the OFL schools for the curriculum purchases—including a methodology and terms related to the billing and payment for textbooks, curriculum, and associated overhead charges.
- Require that any related-party transactions occurring between the Hall entities and OFY, Inc., OFY-CA, Inc., OFL, and Education Management Systems that impact OFY/OFL school management or are paid for with OFY/OFL school management fees are disclosed to the school boards and records are maintained.
- Ensure that the OFY calculates and the OFL pays a reasonable rate of interest for all delayed curriculum payments.
- Improve controls over collections and payments of related-party invoices.
- Ensure that all invoices include adequate support and are verified prior to their payment, particularly when occurring between related parties.
- Review existing management fees for reasonableness by establishing fair market value and obtaining board approval and submit the results to CDE.
- Consider different measures to better ensure the independence of board members; one method would be to implement independent elections.

- To avoid both the potential for and appearance of improper related-party transactions, OFY and OFL and the other Hall entities should attempt to minimize the sharing of staff, directors, and officers.
- The OFY should commission an independent audit of all ePlus Group, Inc. transactions for propriety and submit the results to CDE.
- Obtain board approval of all Hall family member employment and compensation agreements.
- Conduct a comprehensive review of the compensation paid to Mr. and Mrs. Hall for each of the chartering entities, including their salaries from the management services companies, and compare to the salaries of superintendents of similarly sized organizations, including their respective hours worked, for reasonableness.

Chapter 2: Options for Youth and Pathways in Education

Options for Youth Donation of Funds to Pathways in Education

In late January and early February 2002, Don R., then chief operating officer of OFY, Inc., made presentations to the boards of OFY-Burbank, OFY-San Gabriel, OFY-Upland, and OFY-Victor Valley, saying that it was very possible that the state would require the charter school to consume its financial reserves before providing additional funding to them. Don R. explained that this was likely a result of the recent charter school funding legislation (SB 740). In each case, Don R. proposed that the board contribute a portion of its reserves to Pathways in Education, another nonprofit organization that, according to the boards' minutes – he said – had the purpose of "... the promotion and accomplishment of educational pursuits." In fact, Don R. had submitted articles of incorporation to the California Secretary of State on behalf of Pathways in Education on January 28, 2002, just a few days before making his suggestion that OFY charter schools contribute funds to it. The board meeting minutes do not indicate that Don R. told the OFY boards that he had incorporated Pathways in Education. However, in each case, the boards authorized the charter schools' president and vice president, positions held by Mr. and Mrs. Hall, to contribute their respective school's reserve funds to Pathways in Education, keeping a 3 percent reserve floor.

On March 13, 2002, the OFY attorney described to OFY-Long Beach's board the procedures for dissolving a corporation and disposing of its assets. Two of the three members of OFY-Long Beach's board voted to dissolve OFY-Long Beach and contribute OFY-Long Beach's assets to OFY-Burbank, while reserving \$7,500 to complete OFY-Long Beach's dissolution. In April 2002, Mr. Hall signed the first round of checks totaling \$9.1 million from the OFY charter schools' corporate accounts to Pathways in Education, as shown in Exhibit 2-1 (see next page).¹⁶

In June 2002, OFY, Inc.'s attorney attended meetings of the boards for OFY-Burbank, OFY-San Gabriel, OFY-Upland, and OFY-Victor Valley. After the attorney gave the boards an update on SB 740 and continued to express concerns that the state may require charter schools to use excess reserves, the OFY staff indicated that with the exception of OFY-San Gabriel, anticipated reserves were again expected to be high enough to warrant transferring additional funds. Those boards voted to maintain their current policy of allowing the corporate officers to contribute excess reserves to Pathways in Education. In June and July, Mr. Hall signed checks transferring an additional \$1.7 million to Pathways in Education as shown in Exhibit 2-1.

¹⁶ The checks signed by Mr. Hall were made payable to an investment firm account owned by Pathways in Education.

Exhibit 2-1
Payments from Options for Youth Charter School
Corporations to Pathways in Education

Options for Youth	2002 Amounts		Totals
	April	June and July	
Burbank	\$2,450,000	\$300,000	\$2,750,000
Long Beach	430,000	0	430,000
San Gabriel	1,600,000	0	1,600,000
Upland	2,400,000	500,000	2,900,000
Victor Valley	2,200,000	900,000	3,100,000
Totals	\$9,080,000	\$1,700,000	\$10,780,000

Source: The OFY form 990s, vendor payment history, and checks.

Options for Youth/Pathways in Education Board Member Involvement

California Government Code and OFY-Victor Valley board policy prohibit OFY-Victor Valley board members, officers, and employees from participating in decisions and transactions that constitute a conflict-of-interest. A conflict-of-interest arises when a board member, officer, or employee is in a position to influence a decision in which he or she could benefit personally. As mentioned in Chapter 1, under the Charter Schools Act, a charter school that provides independent study is required to comply with the provisions of law that are otherwise applicable to the governing board of a school district or a county office of education that offers independent study. Government Code Section 1090 states that: “Members of the Legislature, state, county, district, judicial district, and city officers or employees shall not be financially interested in any contract made by them in their official capacity, or by any body or board of which they are members. **As used in this article, “district” means any agency of the state formed pursuant to general law or special act, for the local performance of governmental or proprietary functions within limited boundaries.**”

In addition, Government Code Section 87100 states that: “No public official at any level of state or local government shall make, participate in making or in any way attempt to use his official position to influence a governmental decision in which he knows or has reason to know he has a financial interest.”

On January 31, 2002, the OFY-Victor Valley board adopted a conflict-of-interest policy. That policy states, “[t]he Charter School shall ensure that its transactions are consistent with California law governing the operation of nonprofit corporations pertaining to conflicts of interest and shall ensure that its transactions are in the best interest of the charter school.” Although the policy appears to subject OFY-Victor Valley only to laws governing nonprofit organizations, as stated above state law and guidance specify that charter schools operated by nonprofit organizations are part of the public school system. In addition to unlawful conflicts of interest, there are also ethical conflicts of interest. An ethical conflict of interest can be defined as a situation in which a person has an interest sufficient to ap-

pear to influence the objective exercise of his or her duties. The test of an ethical conflict of interest is to determine whether the situation is likely to interfere or appear to interfere with the independent judgment one is supposed to show as a professional performing his or her duties.

Two OFY-Victor Valley board members appear to have had or developed legal and/or ethical conflicts of interest during their tenures on the OFY-Victor Valley board that could have influenced their decisions and the depth of their oversight. Specifically, Al An. and Ralph A. were members of the OFY-Victor Valley board on January 31, 2002, when that board (including them) voted to contribute reserve funds to Pathways in Education. Also at that meeting, Al An. and Ralph A. joined other members of the board that were present to address a number of issues before the board including the adoption of the OFY-Victor Valley conflict-of-interest policy discussed earlier. After voting on these various items, Al An. and Ralph A. resigned from the OFY-Victor Valley board of directors.

However, the audit team believes that Al An. and Ralph A. should not have participated in the decision to transfer funds to Pathways in Education. Specifically, two days earlier the board of OFY-CA voted to accept both Al An. and Ralph A.'s resignation from the OFY-Victor Valley board of directors effective February 4, 2002 and to appoint them to the board of directors of Pathways in Education. This indicates that OFY-CA was the sole member of Pathways in Education since its board had the authority to appoint members of the Pathways in Education board. On March 8, 2002, the CCSG board voted to adopt Pathways in Education's proposal to make CCSG Pathways in Education's sole member and to amend CCSG's articles of incorporation to broaden its purpose. The CCSG board submitted its amended articles of incorporation to the California Secretary of State on March 12, 2002, and on April 10, 2002, appointed Al An. and Ralph A. as the initial directors of Pathways in Education – reaffirming the earlier OFY-CA vote – and also elected Al An. as president of Pathways in Education and Ralph A. as secretary and chief financial officer/treasurer of Pathways in Education. The next day – April 11 – Mr. Hall signed an OFY-Victor Valley check to Pathways in Education's investment firm for \$2.2 million. The audit team was unable to determine how much, if anything, Pathways in Education paid to Al An. and Ralph A. In response to the audit team's request for their employment contracts with Pathways in Education, Pathways in Education's executive director, Ja. Hall, told the audit team, "...at no time have any current or past directors of the board received compensation from Pathways in Education."

Options for Youth-Long Beach Transfer of Funds to Pathways in Education

As stated earlier, two of the three members of OFY-Long Beach's board voted to dissolve OFY-Long Beach and contribute OFY-Long Beach's assets to OFY-Burbank, reserving \$7,500 to complete OFY-Long Beach's dissolution. Although the OFY-Long Beach board

did not approve contributing assets to Pathways in Education, Mr. Hall, as vice president of OFY-Long Beach, signed a check request form and an OFY-Long Beach check to Pathways in Education for \$430,000. This check reduced OFY-Long Beach's balance to \$6,523—less than the \$7,500 stipulated by the board. In addition, Mr. Hall's daughter – Ja. Hall – stood to potentially benefit from this transfer – through her employment with Pathways in Education.

The OFY chief financial officer told the audit team that the transfer of \$430,000 from OFY-Long Beach occurred “through an administrative error, which was identified and corrected.” He also said that, “... as with any clerical error in the world of finance and banking, the recipient is not entitled to the funds received and is under obligation to return them.” The audit team disagrees that the transfer was merely a clerical error; it was OFY-Long Beach's vice president, Mr. Hall, who signed the check request form and the check for \$430,000 that improperly transferred the funds to Pathways in Education. Further, OFY-Long Beach's tax return for the year reported the amount as a contribution to Pathways in Education.

Although it appears that one or more individuals ultimately recognized that the funds had been improperly transferred, the audit team does not believe that there was a credible attempt to return the funds to OFY-Long Beach. On June 27, 2002, (more than two months after the first check to Pathways in Education was written) Ralph A. and Ja. Hall signed a Pathways in Education check for \$434,618.25 made payable to OFY-Long Beach. Although this amount is \$4,618.25 more than the amount paid to Pathways in Education, according to the face of the check, it was a “Return to Long Beach.” On the same day Mr. Hall signed two OFY-Long Beach checks to OFY-Burbank – one for \$430,000 and the other for \$4,618.25. Although OFY-Long Beach's board had authorized contributing funds to OFY-Burbank, these transfers reduced OFY-Long Beach's balance to \$5,831.89; again less than the reserve stipulated by OFY-Long Beach's board.

Had OFY-Burbank retained the amounts transferred from OFY-Long Beach, the audit team would be less likely to question the original transfer. However, the very same day that he signed OFY-Long Beach's checks to OFY-Burbank, Mr. Hall also signed a check request and an OFY-Burbank check that sent the \$434,618.25 back to Pathways in Education. Because all of these checks were written on the same day, the audit team believes that \$430,000 of the \$434,618.25 paid to Pathways in Education did not, in fact, come from OFY-Burbank; it came from OFY-Long Beach, contrary to OFY-Long Beach's board direction.

The audit team attempted to determine the purpose of the \$4,618.25 portion of the \$434,618.25 that Pathways in Education paid to OFY-Long Beach. In response to the audit team's inquiry, OFY's chief financial officer told us he did not know what accounted for the difference in amounts. The audit team also asked Ja. Hall, executive director of Path-

ways in Education, why she would have written “Return to Long Beach” on the Pathways in Education check when the audit team could find no evidence that OFY-Long Beach had paid the \$4,618.25 to Pathways in Education. She responded that Pathways in Education is not subject to this audit and “is uninterested in participating in this audit.” Consequently, the audit team concludes that OFY-Long Beach returned the \$4,618.25 to Pathways in Education and that this amount was not an additional transfer of the charter schools’ funds to Pathways in Education.

The audit team was unable to determine conclusively whether Ja. Hall was a paid employee of Pathways in Education on the date Mr. Hall signed the checks transferring OFY charter school funds to Pathways in Education or when Ja. Hall signed the Pathways in Education check to OFY-Long Beach. The audit team specifically asked Ja. Hall for, among other things, a list of all Pathways in Education payments made to her, her mother, father, and her aunt in 2002 through 2005. Ja. Hall replied, “[Mrs.] Hall, [Mr.] Hall, and P. Hall have never received compensation or expense reimbursement from Pathways in Education.” She did not address whether or when Pathways in Education had made payments to her. However, according to Pathways in Education’s tax returns, Ja. Hall had possession of Pathways in Education’s books covering 2002, 2003, and 2004. In addition, according to Pathways in Education’s tax returns, Pathways in Education paid Ja. Hall \$30,334 in 2004.

Dissolution of Options for Youth-Long Beach

As stated earlier, two of the three members of OFY-Long Beach’s board voted to dissolve OFY-Long Beach in March 2002. However, as of April 2006 the documents required to dissolve it had not received by the California Secretary of State. The OFY, Inc.’s chief financial officer, told the audit team that there had never been any intent to dissolve OFY-Long Beach, Inc. and that, although the corporation is inactive, it continues to exist as an ongoing organization. The chief financial officer contended that because OFY-Long Beach has not operated a charter school during the time period of the audit, OFY-Long Beach’s corporate structure and activities do not fall within the audit’s scope.

Options for Youth External Reporting of Donations to Pathways in Education

The OFY has provided conflicting information regarding amounts OFY charter schools have transferred to Pathways in Education. On March 19, 2003, the Advisory Commission on Charter Schools sent a list of questions to Education Management Systems concerning OFY and OFL charter schools. One of these questions was, “What was the total contribution last year from Options for Youth and Opportunities for Learning schools to Pathways in Education?” In response to this question, Mrs. Hall reported that four OFY charter schools contributed a total of \$10,350,000 in FY 2001-02. However, this is not consistent with the \$10,834,822 total amount that five OFY charter schools reported on their tax returns (Form 990) submitted to the IRS. Moreover, it is not consistent with the OFY charter

schools' check registers. Exhibit 2-2 shows the amounts Mrs. Hall reported to the CDE, the amounts the charter schools reported to the IRS, and the amounts that the audit team compiled from the OFY charter schools' corporate check registers.

Exhibit 2-2
Discrepancies in Reported Amounts Transferred from
Options for Youth to Pathways in Education

Options for Youth	Reported to CDE ^a	Reported to IRS	Recorded in Charter School Corporate Check Registers
Burbank	\$2,750,000	\$2,765,000	\$2,750,000 ^b
Long Beach	Not listed	430,000	430,000
San Gabriel	1,600,000	1,639,822	1,600,000
Upland	2,900,000	2,900,000	2,900,000
Victor Valley	3,100,000	3,100,000	3,100,000
Totals	\$10,350,000	\$10,834,822	\$10,780,00

a California Department of Education.

b Adjusted to disregard the \$434,618.25 discussed below.

According to OFY, Inc.'s chief financial officer, Mrs. Hall did not report the transfer from OFY-Long Beach because the department was asking about the transfers when determining funding levels for 2002-03. Because OFY-Long Beach was no longer operating a charter and was not seeking state funds, it did not seem necessary to report OFY-Long Beach's transfer. However, the department's request for information was for the total contribution of OFY funds to Pathways in Education. Moreover, when responding to the questions Mrs. Hall did not include the amount of \$434,618.25 that OFY-Burbank ultimately transferred to Pathways in Education. According to OFY, Inc.'s chief financial officer, Mrs. Hall referred to OFY-Burbank's audited financial statements, which did not include the above amount. Regardless of OFY's interpretation of Pathways in Education's contribution, she should have disclosed the amounts that were transferred.

The OFY's chief financial officer stated that the additional \$15,000 OFY-Burbank reported (to the IRS) it had donated to Pathways in Education appears to have been a write-off of uncollectible receivables that was incorrectly posted to the contributions account. He said the \$15,000 was not related to the Pathways in Education contribution. The chief financial officer also told the audit team that the \$39,822 difference in the amount that OFY-San Gabriel reported it had donated to Pathways in Education as opposed to the amount that Mrs. Hall reported to CDE was the result of a keying error and actually represents oversight fees related to OFY-Mount Shasta.

Pathways in Education Use of Funds

Although Don R., then chief operating officer of OFY, told four of the five charter schools' boards that Pathways in Education's purpose was "the promotion and accomplishment of

educational pursuits,” that was not Pathways in Education’s purpose according to its articles of incorporation that Don R. submitted to the California Secretary of State on January 28, 2002. These articles specify that the purpose of Pathways in Education was “to engage in charitable and educational purposes,” and they go on to say that those purposes include “the making of distributions to organizations that qualify as exempt [non-profit] organizations.” According to Mr. Hall, Don R. suggested that OFY reserves be used to create a new educational nonprofit that would provide new avenues for servicing California’s at-risk youth and to assist those students failed by the traditional educational model in California.

Pathways in Education and Options for Youth’s Curriculum Division

Despite receiving \$10.8 million from the five charter school corporations, Pathways in Education has not spent much of this amount on programs for California youth. According to federal tax returns filed by Pathways in Education, it spent nothing for program services in 2002.

Nevertheless, Pathways in Education spent \$56,476 on legal and accounting fees and \$46,748 on planning and development. Pathways in Education’s only source of income in 2002 was the \$10.8 million it received from the OFY charter school corporations and the investment income it generated. On October 1, 2002, Pathways in Education created a for-profit organization: R3 Learning Solutions, LLC. The same law firm – Freeman, Freeman & Smiley, LLP – that is discussed in the last section of this chapter, filed the LLC’s articles of organization with the California Secretary of State.

The audit team asked Ja. Hall for any general public information on the products and/or services offered by R3 Learning Solutions, LLC. The audit team wanted to determine whether there were business or financial relations between the two companies. She responded that since neither Pathways in Education nor R3 Learning Solutions, LLC are included in the scope of the audit, she could see no basis for this request. She went on to say that R3 Learning Solutions, LLC has no connection to OFY or OFL and has never been funded by the State of California.

However, the audit team learned that as early as October 7, 2002, there was discussion of R3 Learning Solutions, LLC purchasing OFY, Inc.’s curricula assets. In fact, by that time Freeman, Freeman & Smiley, LLP, had already prepared an operating agreement between Pathways in Education and R3 Learning Solutions, LLC. Consequently, the audit team believes that Pathways in Education specifically created R3 Learning Solutions, LLC so that it could use the money it had received from the OFY charter school corporations to purchase OFY, Inc.’s curricula assets. In turn, R3 Learning Solutions, LLC planned to sell OFY, Inc.’s curricula to schools and educators nationwide.

Shortly after R3 Learning Solutions, LLC was created, an appraiser prepared a draft appraisal of OFY, Inc.’s curricula, concluding its value was \$243,000 as of December 9, 2002.

In 2003, Pathways in Education spent \$6,059 on program services, \$62,376 on legal and accounting fees, and \$17,559 on planning and development. The audit team found no evidence that Pathways in Education transferred money to R3 Learning Solutions, LLC or that R3 Learning Solutions, LLC purchased OFY, Inc.'s curricula. However, Pathways in Education once again had no other source of income during 2003 other than the investment income it generated from the money it received from the OFY charter school corporations in the prior year.

The activities conducted by Pathways in Education and R3 Learning Solutions, LLC raise questions about the intended use of OFY funds. The audit team believes all of these arrangements were designed to divert the flow of funds away from state scrutiny, as supported by Ja. Hall's statement to the audit team that R3 Learning Solutions, LLC has never been funded by the State of California and her refusal to provide information regarding R3 Learning Solutions, LLC.

By establishing additional entities, the individuals described in Chapter 1 were able to use state funds for various purposes without being subjected to oversight under state laws.

Pathways in Education in Illinois

Pathways in Education reported that it spent \$202,016 for program services in 2004, and \$261,024 for management and general expenses, including \$30,334 in salary to Ja. Hall. Pathways in Education also reported that its 2004 management and general expenses included \$44,094 for legal and accounting fees and \$25,000 for a donation. Once again, Pathways in Education did not have any income besides the investment income it generated from the \$10.8 million contribution from the OFY charter school corporations in 2002. The audit team was unable to identify the entity that was the recipient of the \$25,000 donation.

Although Mr. Hall told the audit team that Pathways in Education was created to help California at-risk students, it appears that Pathways in Education has been spending at least some of its funds on trying to establish an independent study school in Illinois. Since as early as November 2004, Mr. Hall, Ja. Hall, and Pathway in Education leadership pact supervisor have been involved in applying for a contract with Chicago Public Schools for an independent study contract school. In order to be eligible for such a contract in Illinois, Pathways in Education had to establish a corporation in Illinois. Although Pathways in Education-Illinois was ostensibly the corporation applying for the Illinois contract, Pathways in Education employees were involved in preparing the proposal, conducting mock interviews, and traveling to Chicago for interviews. In addition, Pathways in Education-Illinois' proposal designated Pathway in Education leadership pact supervisor as the principal of the proposed Pathways in Education contract school, and Ja. Hall as the executive director. Employees of OFY, Inc. and Education Management Systems were also involved in Pathways in Education's attempt to obtain a contract with Chicago Public Schools. Further, it appears that Pathways in

Education paid the expenses of those who went to Chicago to participate in the interviews. Because Pathways in Education has denied the audit team access to its records, the audit team was unable to determine how much Pathways in Education has spent on efforts to expand into Illinois or other states. Nevertheless, an application submitted to the Chicago Public Schools states that Pathways in Education would loan Pathways in Education-Illinois \$750,000, and would provide financial support to pay for the cost of Pathways in Education-Illinois' director of education in the first two years of the contract. The director of education's salary alone was budgeted at \$125,000 per year.

Options For Youth's and Pathways in Education's Other Business Dealings

As previously mentioned in Chapter 1 of this report, OFY purchased books on behalf of the OFL charter schools under an agreement with Education Management Systems. The OFY also purchased books on behalf of Pathways in Education from February through May 2004. However, OFY did not bill Pathways in Education for these books until March 2006—more than two years after incurring expenses on Pathways in Education's behalf. Moreover, OFY did not bill Pathways in Education until the audit team brought this omission to its attention.

Specifically, the audit team identified a bill sent to Education Management Systems showing shipments of \$554 worth of curriculum that had a separate line item outside the normal course of Education Management Systems billing. The billing showed it as a shipment made to Education Management Systems on behalf of Pathways in Education. When asked the significance of the bill, OFY management determined that, in addition to the \$554 identified on the invoice, three additional Pathways in Education shipments totaling \$14,695 were outstanding. Once this mistake was identified, OFY billed the total amount of \$15,249 to Pathways in Education in March 2006, and payment in full was received and deposited in April 2006. Nevertheless, the failure to promptly bill Pathways in Education represents an interest-free loan to a related organization. The audit team could find no evidence that a loan was approved by the OFY board.

Options for Youth Attorney's Potential Adverse Interests

The California State Bar Association issues Rules of Professional Conduct for its members who are licensed to practice law. Rule 3-310, "Avoiding the Representation of Adverse Interests," specifies that "A member shall not accept or continue representation of a client without providing written disclosure to the client where: (1) The member has a legal, business, financial, professional, or personal relationship with a party or witness in the same matter..." In addition, Rule 3-310 also requires a member attorney to obtain the written consent of his clients before accepting representation in matters in which the interests of the clients potentially conflict.

The attorney who represented OFY-Burbank, OFY-San Gabriel, OFY-Upland, and OFY-Victor Valley attended the board meetings when those boards approved transferring reserve funds to Pathways in Education. The minutes of those meetings do not indicate that the attorney notified the board members that he also represented Pathways in Education, as apparently required by the rules. In fact, the attorney's law firm prepared the articles of incorporation for Pathways in Education just before the OFY charter school boards approved the transfer of reserve funds. The OFY's chief financial officer told the audit team that, to the best of his knowledge, OFY board members were aware that the firm of Freeman, Freeman & Smiley, LLP was legal counsel to both OFY and Pathways in Education. He said that no written disclosure or waivers were obtained, because there was and is no adverse relationship between OFY entities and Pathways in Education. In addition, the attorney told the audit team that written disclosures and waivers were not necessary because no adverse interests existed. However, as stated, the State Bar Rules of Professional Conduct appear more comprehensive and address what an attorney must do to avoid any adverse relationship.

Recommendations

To better protect itself against the potential for adverse representation, OFY should:

- Obtain written disclosure from its attorney and grant or withhold informed written consent to dual representation by that attorney when OFY engages in a transaction with another party or entity that is represented by the same attorney who represents OFY, as required by Rule 3-310 of the California Rules of Professional Conduct.

To ensure that the OFY charter schools have used state funds appropriately and in accordance with all applicable state laws, CDE should:

- Consider a referral to the appropriate authorities, such as the Attorney General or the Fair Political Practices Commission, to investigate the nature and legality of the transfer of funds between the OFY charter schools and Pathways in Education.
- Consider seeking reimbursement or withholding funding in the amount of \$10.8 million related to the OFY transfers to Pathways in Education—if it is determined there is a legal basis for doing so.

Chapter 3: Charter School Funding and Financial Analysis

Similar to public schools, OFY, OFL, and CCSG charter schools receive funding from CDE based on the program sites' ADA. Schools claim ADA based on the aggregate attendance of students during each reporting period. For example, one student who attends school each day for the entire reporting period is eligible for 1.0 ADA. The amount of ADA claimed by program sites correlates directly into dollars – the higher the ADA for a program, the greater the amount of funds that the program will receive from the state. The ADA funding rates vary by school year and grade level. On a per-student basis, schools receive more funding for students from higher grade levels than from lower grade levels. For example, in the 2003-04 school year, ADA rates ranged from \$4,540 at the kindergarten through 3rd grade level to \$5,506 at the 9th through 12th grade level.

School districts and charter schools calculate ADA and report it to CDE three times per year. After the charter schools report their ADA to CDE, the State Superintendent of Public Instruction apportions state school funds to the charter schools.¹⁷ The source of the ADA data that the audit team used to determine the appropriateness of the charter school funding was from the charters' annual audited financial statements.

Senate Bill 740 (Chapter 892, Statutes of 2001) amended the Charter School Act of 1992, which established criteria for funding determinations for charter schools offering non-classroom-based instruction. Education Code Section 47634.2 authorized the State Board of Education to establish criteria to evaluate funding requests as well as to determine the total amount of funding each nonclassroom-based charter school should receive. The State Board of Education made its latest revision to the regulations in July 2005 to clarify changes on pupil-to-teacher ratios and full-time certificated employee definitions.

When applying for funding, independent study charter schools such as those operated by OFY, OFL, and CCSG must also submit a Nonclassroom-Based SB 740 Funding Determination form (SB 740 form). Charter schools may be eligible for partial or full funding depending on the ratio of expenditures to revenues for selected items. Charter schools report revenue and expenditure data from the previous school year. The State Board of Education uses this data as a basis for making its determination of the percentage of funding that the school is eligible to receive in the upcoming year. For instance, the SB 740 form used to determine funding levels for 2005-06 is based on actual financial data from the 2004-05 school year.

¹⁷ For charter schools that offer nonclassroom instruction, final funding determinations are based upon both ADA and additional considerations, per SB 740, passed in 2001. These considerations which are discussed further on the following pages include the percentage of revenue a charter school spends on instruction-related activities and certificated teacher salaries.

As shown in Exhibits 3-1 and 3-2, the state has established unique requirements for determining funding levels for nonclassroom-based instruction provided by charter schools. To receive 100 percent of available funding, a charter school must ensure that its ratios of certain expenses to revenues meet specific thresholds. If a charter school's ratios do not meet these levels, it can still receive partial funding, usually determined as a reduced percentage of the total available funding. For example, all of the OFY, OFL, and CCSG charter schools received 70 percent of available funding for the 2003-04 school year; however, OFY and OFL maintain that they qualified for 100 percent funding.

Exhibit 3-1
Criteria Used to Determine Charter School Funding Levels
School Years 2003-04 and 2004-05

Ratio of Certificated Staff Compensation to Total Public Revenues^a	and/or	Ratio of Expenditures for Instruction and Related Services to Total Revenues^a	Funding Eligibility
Equals or exceeds 50%	and	Equals or exceeds 80%	100% ^b
Equals or exceeds 50%	and	Equals or exceeds 70%, but less than 80%	85%
Equals or exceeds 40%, but less than 50%	and	Equals or exceeds 60%, but less than 70%	70%
Less than 40%	or	Less than 60%	No funding

Source: California Code of Regulations, Title 5, Division 1, Chapter 11, Subchapter 19, Section 11963.4.

a Prior year's revenues and expenses are used in these calculations.

b A charter school must meet an additional requirement to receive 100 percent funding by ensuring that its ratio of ADA for independent study pupils to full-time certificated employees responsible for independent study does not exceed the equivalent ratio of pupils to full-time certificated employees for all other educational programs operated by the largest unified school district in the county or counties in which the charter operates.

The funding determination requirements changed for the 2005-06 school year for which funding determinations are made based on 2004-05 data.

Exhibit 3-2
Criteria Used to Determine Charter School Funding Levels
School Year 2005-06

Ratio of Certificated Teachers Compensation (Instructional Staff only) to Total Public Revenues^a	and/or	Ratio of Expenditures for Instruction and Related Services to Total Revenues^a	Funding Eligibility
Equals or exceeds 40%	and	Equals or exceeds 80%	100% ^b
Equals or exceeds 40%	and	Equals or exceeds 70%, but less than 80%	85%
Equals or exceeds 35%, but less than 40%	and	Equals or exceeds 60%, but less than 70%	70%
Less than 35%	or	Less than 60%	No funding

Source: California Code of Regulations, Title 5, Division 1, Chapter 11, Subchapter 19, Section 11963.4.

a Prior year's revenues and expenses are used in these calculations.

b A charter school must meet an additional requirement to receive 100 percent funding by ensuring that its ratio of ADA for independent study pupils to full-time certificated employees responsible for independent study does not exceed a pupil-teacher ratio of 25 to 1 or the equivalent ratio of pupils to full-time certificated employees for all other educational programs operated by the largest unified school district in the county or counties in which the charter operates.

As illustrated above, charters are ineligible for funding if they do not spend at least 35 percent of their total public revenues on certificated teachers (40 percent on certificated teachers and staff for school years prior to the 2005-06 funding determination) or 60 percent of total revenues on instruction and related services. Furthermore, as discussed in Chapter 4, a charter that does not meet the minimum threshold for its pupil-to-teacher ratios is ineligible to receive funding for that portion of ADA that causes it to exceed the baseline pupil-to-teacher ratios.

Because the funding determination depends to a large extent on the amounts that the charter schools report spending for certificated staff and instructional materials on their funding determination forms, the accuracy of the amounts reported as expended in the various categories is very important.¹⁸ The following sections describe the issues identified in the audit team's review of financial data pertaining to the OFY, OFL, and CCSG charters.

Financial Data Used in Funding Determination for the Options for Youth Charters

The audit team identified some issues concerning the accuracy and reliability of data reported on the SB 740 forms submitted by the OFY charters. The issues include discrepancies in the data reported on the SB 740 forms, minor differences in financial data between the forms and the charters' accounting records, recording of expenses to incorrect accounting codes, and questionable accruals and expenses.

Expense Percentage Calculations

In its review of the 2003-04 SB 740 forms based on 2002-03 data, the audit team identified several instances in which OFY charters reported percentages for certificated salaries or instructional expenses that differed from the audit team's calculations. Exhibits 3-3 and 3-4 (see next page) illustrate the differences between the percentages reported on the SB 740 forms and the percentages determined by the audit team based on the revenue and expense data reported by the charters. In each case, if the charter reported the percentages correctly using the supporting financial data, it would not have impacted the funding level for which the charter was eligible. Therefore, the audit team found it puzzling that the charters would report incorrect percentages particularly since the financial data used in the calculations was also included on the SB 740 forms.

¹⁸ Certificated instructional staff are defined as those who hold a valid certificate, permit, or other document equivalent to that which a teacher in other public schools would be required to hold from the California Commission on Teacher Credentialing, and who work in a position that provides direct instruction or direct instructional support to students.

Exhibit 3-3
Differences in the Percentage of Instructional Expenses
to Total Revenues Reported by Options for Youth on the
2003-04 SB 740 Forms

Charter	Percentage Reported by OFY on the SB 740 Forms	Percentage Calculated by Auditors Using Financial Data Included in the SB 740 Forms
Mount Shasta	82.2	83.9
San Gabriel	71.9	73.2
Upland	64.1	72.5
Victor Valley	71.5	71.8

Source: Options for Youth 2003-04 SB 740 Funding Determination forms.

Exhibit 3-4
Differences in the Percentage of Certificated Staff Expenses
to Total Public Revenues Reported by Options for Youth on the
2003-04 SB 740 Forms

Charter	Percentage Reported by OFY on the SB 740 Forms	Percentage Calculated by Auditors Using Financial Data Included in the SB 740 Forms
Burbank	43.9	44.4
Mount Shasta	54.4	54.5
San Gabriel	44.1	44.5
San Juan	50.9	53.6
Upland	48.4	49.2
Victor Valley	48.1	48.7

Source: Options for Youth 2003-04 SB 740 Funding Determination forms.

Upon further review of the financial data, the audit team concluded that the differences in percentages of certificated staff expenses on Exhibit 3-4 are due to the charters using the incorrect revenue amount in the calculation. When reporting the percentage on the SB 740 form, the charters appear to be using total revenue, rather than total public revenue. According to the SB 740 instructions, total public revenue is comprised of all federal and state revenues and local revenues in lieu of property taxes, less other financing sources and the portion of local revenues in excess of the amount in lieu of property taxes. By incorrectly using total revenue in the calculation, the charters are understating the certificated staff expense percentage.

The audit team also noted minor differences (aside from the differences that would be expected) between the revenue and expense data included on the charters' 2003-04 SB 740 forms and the amounts reported in the charters' accounting records. The charters may have had valid reasons for adjusting revenues and expenses recorded in the general ledger for SB 740 reporting purposes, but the audit team did not attempt to identify these reasons because the immaterial differences had no effect on the charters' funding determinations.

The audit team did not identify any material differences between the financial data and the reported expense percentages on the SB 740 forms that would have affected funding for 2004-05 and 2005-06. The CDE provided an Excel form on its Web site for charters to use in completing the forms for these years to assist in reducing reporting inaccuracies. In addition, the charters' financial auditors prepared additional schedules to help facilitate the reporting of financial data on the SB 740 forms.

Pupil-to-Teacher Ratio Data

The audit team found eight instances among the three years reviewed in which an OFY charter reported a pupil-to-teacher ratio that did not match the ratio it had calculated based on its supporting documentation elsewhere. Most of these instances involved small discrepancies. For example, OFY-Mount Shasta's SB 740 form for 2003-04 reported the pupil-to-teacher ratios as 17-to-1, while the supporting documentation maintained by OFY identified the ratio as 19-to-1.

The audit team also found ten instances where OFY rounded up the pupil-to-teacher ratios contained in their supporting documentation to a number greater than the closest integer. For example, the supporting documentation for OFY-Burbank's 2002-03 pupil-to-teacher ratios identifies the ratio as 17.2-to-1. However, in its SB 740 form reporting to CDE, OFY rounded up the ratio to 19 to 1. The SB 740 instructions require independent study charter schools to round the pupil-to-teacher ratios down.

Further, the audit team noted three instances where the charters reported a pupil-to-teacher ratio that was lower than it could support. For example, in 2004-05, OFY-Upland reported a pupil-to-teacher ratio of 21-to-1 on its internal tracking worksheet, but reported a pupil-to-teacher ratio of 18-to-1 on its funding determination worksheet. As discussed later in Chapter 4, this incorrect rounding down caused one charter – Mount Shasta – to appear to be in compliance with pupil-to-teacher ratio funding requirements when in fact, it was not. Consequently, the audit team recommended that the state consider reducing Mount Shasta's funding by the \$164,000 it appears to have been overpaid in FYs 2002-03 and 2003-04.

Classification of Expenses

The audit team also found that the OFY charters had reported some of their expenses incorrectly by coding them to the wrong accounting categories on the funding determination

forms. The audit team traced 88 transactions from the general ledger to source documents and also vouched several dozen transactions per year at each charter from source documents to the general ledger. The audit team found in its testing that the charters had incorrectly recorded five items on the funding determination forms. In some cases, the erroneous coding resulted in OFY overstating its instructional expenses and the related funding determination form percentages.

Exhibit 3-5 summarizes the identified errors and their effect on the charters' instructional expenses. These errors did not individually impact the determination of funding levels for the charters. However, because the audit team only reviewed a sample of expense items, it could not determine whether other misclassified items exist in the larger population of expenses—which could have potentially affected the accuracy of the funding determination in previous years.

Exhibit 3-5
Options for Youth Expenses Incorrectly Recorded
on the Funding Determination Forms

Year	Charter	Date of Transaction	Total Dollar Value of Transaction	Amount in Dispute	Description	Affects Certificated Percentage?	Affects Instructional Percentage?
2003-04	Mount Shasta	06/25/04	\$2,263.89	\$2,263.89	Charges for administrative staff charged to instruction and related services—salaries and benefits.	No	Yes
2003-04	Victor Valley	07/31/03	\$154.44	\$154.44	Health insurance for students charged to books and instructional materials.	No	Yes
2004-05	OFY, Inc. ^a	07/16/04	\$1,140.00	\$1,140.00	Professional administrative consulting costs charged to instruction and related services—contract costs.	No	Yes
2004-05	OFY, Inc. ^a	05/04/05	\$1,000.00	\$400.00	Raffle prizes improperly charged to books and instructional materials and \$100 was not specified as to how it would be used.	No	Yes
2004-05	OFY, Inc. ^a	05/06/05	\$1,000.00	\$400.00	Raffle prizes improperly charged to books and instructional materials and \$100 was not specified as to how it would be used.	No	Yes
Totals			\$5,558.33	\$4,358.33			

Source: Auditor-generated exhibit summarizing the results of items selected for testing that were incorrectly coded on the SB 740 form.

a These expenses were allocated by OFY, Inc. to all six charters.

Additionally, the audit team identified several expenses that were correctly recorded on the SB 740 funding determination forms, but did not directly relate to school operations. For example, during the three years covered by the audit, OFY paid more than \$32,000 for employee parties at Disneyland. This includes more than \$18,000 for food, parking, and admission, that OFY paid for 666 attendees in December 2003. Further, the audit team noted what appeared to be excessive charges for educational advisory board meetings, such as \$4,500 spent at the Ritz-Carlton in 2004-05 for a meeting of 23 board members and OFY staff. This total included food costs of \$1,932 and alcohol purchases of \$963.

Finally, the audit team also noted that OFY included some educational expenses in their calculation of certificated teacher salaries and benefits. The OFY's chief financial officer told the audit team that he believes OFY properly classified these expenses related to a scholarship program that specifically benefits employees. He also described these payments as fringe benefit payments, and while not directly paid to employees, stated that he believes they were part of the cost of salaries and benefits. Although exclusion of these expenses would not impact OFY's funding determination, OFY's categorization of these expenses appears inconsistent with requirements in the California School Accounting Manual and the SB 740 instructions.

Options for Youth/Opportunities for Learning Related-Party Billings

The audit team found one instance where OFY paid the entire cost of a luncheon and presentation that OFL employees also attended. The OFY's failure to bill OFL for its portion of the luncheon and presentation is more evidence of lax internal controls and evidence of potential inurement—a nonprofit providing benefit to a shareholder or individual (in this case a for-profit entity)—which is expressly prohibited by the IRS and could result in the revocation of tax exempt status.

Sound internal control practices would normally provide mechanisms for an entity to collect all amounts owed and Article 16, Section 6 of the California State Constitution prohibits gifts of public funds. Further, Internal Revenue Code Section 501(c)(3) expressly forbids the inurement of net earnings to the benefit of a private shareholder or individual. This code further states that an otherwise qualifying organization will be disqualified for exemption if it excessively benefits private interests, either through inurement of its net earnings to certain “insiders” or by primarily benefiting the interests of persons who, though not “insiders,” do not comprise a charitable class.

The OFY's payment of OFL expenses and failure to seek reimbursement could be considered violations of all these provisions. Specifically, OFY paid the entire costs of \$5,243 for a May 2005 training presentation, breakfast, and lunch at Descanso Gardens. However, OFY did not seek payment—until the audit team brought the issue to their attention in January 2006—for the \$2,464 in expenses incurred on behalf of the 21 OFL staff who attended the meeting. This error is similar to other errors the audit team found involving

OFY related-party entities. Specifically, Chapter 2 addresses a similar mistake in which OFY failed to invoice over \$15,000 for books it sent to Pathways in Education. In addition, as discussed in Chapter 1, OFY may be violating the inurement principles by not collecting timely payments for hundreds of thousands of dollars sold in books to the OFL charters and by paying for the leases of the Halls' automobiles, which are presumably used to conduct OFL business. These transactions are evidence of poor internal controls and, if left uncorrected, could result in gifts of public funds.

Credit Card Usage and Controls

The audit team found numerous problems related to the executive staff usage of OFY company credit cards including incomplete or missing receipts to support the charges, incomplete or missing purchase requisition forms, and incomplete or missing coding to identify the accounting categories that OFY charged the purchases to, as reported on its SB 740 forms. As a result, the audit team could not determine the appropriateness or validity of many of the expenditures, or where the expenses were charged on the SB 740 forms.

Some OFY executive staff, primarily Mr. and Mrs. Hall, utilize various credit cards to purchase items such as airline tickets, hotel rooms, meals, gasoline, car washes, and other retail or online items. While examining various purchases to determine their validity, reasonableness, and effect on the OFY SB 740 funding determination forms, the audit team discovered numerous issues that indicate there was a lack of internal controls by OFY regarding use of credit cards. This lack of internal control is significant considering that OFY paid several bills for six credit cards totaling \$156,435 in 2002-03 and \$221,361 in 2003-04. Exhibit 3-6 (see next page) highlights examples of the many specific issues found.

Exhibit 3-6 highlights a small number of the many examples identified by the audit team and does not include items such as a \$1,908 expenditure at the Kern Lodge or a \$404 expenditure at Caribe Royale Resort in Florida for which receipts existed, but the receipts and files lacked information regarding the purpose of the expenditures. Many of the items also lacked other supporting documentation such as purchase requisition forms or coding on the receipts indicating where OFY charged the expenses on its SB 740 forms.

Exhibit 3-6
Examples of Options for Youth, Inc. Credit Card Charges
Lacking Supporting Receipts or Adequate Indications of
Where the Amounts Were Charged

Date	Vendor/Description, Location	Amount
11/1/2003	The Melrose Hotel – Lodging, DC	\$890.75
11/1/2003	The Melrose Hotel – Lodging, DC	859.80
11/12/2003	Disneyland – Group Ticketing, Anaheim, CA	144.00
12/17/2003	The Ritz Carlton – Lodging, Pasadena, CA	1,616.78
2/13/2004	Trilogy at Redmond – Food/Bev, WA	195.85
3/31/2004	Marriott – Lodging, DC	721.17
3/31/2004	Marriott – Lodging, DC	728.51
4/1/2004	Hyatt Regency – Lodging, Sacramento, CA	801.72
6/22/2004	Star Car Wash, Sunland, CA	61.99
7/7/2004	Descanso Gardens – Goods/Services, Pasadena, CA	300.00
7/11/2004	Starbucks – Food/Beverages, Malibu, CA	103.48
10/17/2004	Hilton Sedona Resort, Sedona, AZ	672.95
10/17/2004	Hilton Sedona Resort, Sedona, AZ	772.06
11/9/2004	Divina Cucina – Food/Beverages, Montrose, CA	98.49
12/6/2004	La Canada Camera, La Canada, CA	120.00
12/17/2004	The Ritz Carlton – Lodging, Pasadena, CA	1,839.00
12/29/2004	The Ritz Carlton – Lodging, Pasadena, CA	517.59
2/2/2005	Postal Store – US Postal Service-Internet, MO	3,701.00
2/3/2005	Hyatt Regency, Sacramento, CA	262.91
2/22/2005	Crystal Coach Limousines, WA	132.00
3/3/2005	Crowne Plaza Hotel, DC	775.40
3/3/2005	Crowne Plaza Hotel, DC	801.02
3/16/2005	The Sharper Image – Assorted Merchandise, San Francisco, CA	1,082.38
4/12/2005	Brookside Golf Course, Pasadena, CA	2,169.63
4/27/2005	Jacob Marse Florist, Pasadena, CA	205.13
5/8/2005	La Playa Hotel – Lodging, Carmel, CA	470.22
Total		\$20,043.83

Source: The OFY, Inc. invoice files for American Express Cards.

It is clear from reviewing the credit card expenditure history that the Halls spent considerable amounts of OFY's funds on lodging, airfare, gas, car washes, and meals. For example, the American Express statement for February 15 to March 15, 2005 revealed a total of 14 meals charged by Mr. and Mrs. Hall, totaling \$2,963. It is not uncommon for the Halls to expense dinners amounting to several hundred dollars per week and sometimes in a day to OFY. Although the Halls' employment contracts with OFY provide for payment of their expenditures related to OFY administration, the audit team could not verify the reasonableness or necessity of many of the charges due to the lack of supporting documents.

Due to the time and effort involved, the audit team did not ask OFY to attempt to gather support for all of the missing and incomplete credit card receipts. However, for two items that the audit team did pursue, OFY was able to provide only partial documentation that was inconclusive in supporting the appropriateness of the expenses. The OFY's chief financial officer and controller agreed that the controls over the credit cards were lacking and, to their credit, developed a policy in April 2006 that should help improve practices in the future, if implemented properly. In addition, the OFY, Inc. chief financial officer told the audit team that OFY has begun an investigation into the credit card charges.

Certificated Teacher Bonus Accruals

Based on a review of OFY board minutes, funding calculation worksheets, and the general ledger, the audit team found that OFY used teacher bonuses in part, to increase funding in subsequent years. Although OFY awarded and paid numerous bonuses to its teachers during the FYs reviewed, OFY also accrued large amounts at year-end to the bonuses payable account—amounts that were mostly reversed when it failed to obtain higher funding levels. Using teacher bonus accruals as a means to increase funding does not appear to comply with generally accepted accounting principles. Additionally, OFY increased its credentialed teacher expenses by reporting noncredentialed teacher and administrative staff bonus expenses as credentialed teacher bonus expenses. However, the SB 740 forms require schools to report expenses for credentialed teachers, credentialed administrators, and noncredentialed staff separately. The OFY's failure to follow this state requirement is evidence of poor internal controls and could result in overclaimed funding apportionment.

In July 2004, the then chief financial officer of Educational Management Systems stated to the CCSG Board that OFY and OFL charters both planned to accrue certain expenses for FY 2003-04, including teacher bonuses, for purposes of receiving 100 percent public funding. Additionally, he stated that in the event that the charters did not receive this funding level, they would reverse the accrued expenses. In August 2004, OFY's accounting staff prepared a funding determination worksheet in which they noted that by spending \$5,000 more per teacher, including bonuses, the OFY charters expected a "\$12.2 million increased funding return on its investment."

Based on its worksheet, at FY 2003-04 year-end, and as shown in Exhibit 3-7 (see next page), OFY accrued \$1.6 million in teacher incentives for its six charters. The OFY subsequently failed to secure its 100 percent funding goal and it reversed \$1.2 million of the accrued amounts. In 2004-05, OFY paid the remainder of the accrued bonus amounts to its teachers for each of the charters except OFY San Gabriel. The OFY-San Gabriel teacher bonus accrual was later found to be incorrect due to a key punch error that resulted in an overaccrual of more than \$55,000. As a result, OFY-San Gabriel overstated its 2003-04 credentialed teacher expenses by this amount.

Exhibit 3-7
Options for Youth Overaccrued \$1.2 Million of
Teacher Bonuses in Fiscal Year 2003-04

Charter	Accrued Teacher Bonuses June 30, 2004	Reversed Bonuses	Net Year-End Accrual Amount June 30, 2004
Burbank	\$540,837	(\$437,167)	\$103,670
Mount Shasta	\$17,411	\$0	\$17,411
San Gabriel	\$125,921	(\$28,261)	\$97,660
San Juan	\$83,422	(\$40,653)	\$42,769
Upland	\$585,871	(\$519,679)	\$66,192
Victor Valley	\$280,608	(\$217,728)	\$62,880
Totals	\$1,634,070	(\$1,243,488)	\$390,582

Source: Auditor-generated exhibit using OFY's payroll registers, general ledger, and bonus accrual journal entries.

Generally accepted accounting principles require that financial reports provide accurate information about the economic resources of an organization and the effects of changes in these resources. In order for expenditures to be formally recognized, the information presented must be reliable—that is, the information must be sufficiently faithful in its representation of the underlying obligation and sufficiently free of error and bias to be useful to decision-makers. Further, expenditures are to be recognized in the period in which the liability was incurred. The OFY's efforts to accrue bonus expenses to increase future funding does not appear to comply with generally accepted accounting principles. The OFY's chief financial officer informed the audit team that OFY only used this practice of accruing bonuses and teacher benefits during FY 2003-04.

Additionally, contrary to funding requirements, OFY included noncredentialed teachers in its calculation of credentialed teacher salaries and bonuses. Specifically, the audit team found that in FY 2003-04, OFY overstated its credentialed teacher salaries and benefits line item by including bonuses totaling \$53,976 for noncredentialed staff—staff that included center coordinators and administrators. In FY 2004-05, OFY also included \$66,000 in bonuses for noncredentialed staff. Although these errors did not have a material adverse effect on OFY's funding determination percentages, the practice of lumping together both groups of staff into the same category is more evidence of poor internal controls and does not comply with state funding requirements.

Financial Data Used in Funding Determination for the Opportunities for Learning Charters

The audit team identified issues with the financial data OFL charters reported on their SB 740 forms. Many of these issues are similar to the issues identified at the OFY charters. In addition, the OFL charters inflated the amount of certificated salaries and benefits reported on their SB 740 forms by double-counting the salaries of certain certificated administrators and recording other expenses incorrectly to this expense category.

Expense Percentage Calculations

The audit team identified several instances in which OFL charters reported percentages for certificated salaries on their 2003-04 SB 740 forms that differed from the percentages calculated by the audit team using numbers the charters reported on the SB 740 forms or in their general ledgers. For example, OFL-Capistrano reported certificated salaries as 70.8 percent of its total public revenues, even though the audit team's calculation using financial data the charter reported in its SB 740 form indicates a percentage of 72.2. However, this difference would not have impacted the funding level for which the charter was eligible. Similar to the OFY charters, it appears that this OFL charter erroneously reported this percentage because it used the amount of total revenues in the calculation, rather than total public revenues.

The audit team also noted some minor differences between the data charters reported on their SB 740 forms and the amounts they reported in their accounting records. There are instances in which it is appropriate to adjust expenses in the general ledger to conform to the SB 740 reporting format. However, the audit team found other unexpected differences, that were likely related to timing, that it did not attempt to reconcile because the relatively small dollar amounts of the differences did not affect the level of funding for which the charters were eligible.

Pupil-to-Teacher Ratio Data

The audit team identified discrepancies with the pupil-to-teacher ratios the OFL charters reported on their 2003-04 SB 740 forms. In response to queries about the discrepancies, OFL provided additional support on four different occasions; however, the OFL support included different numbers each time. The subsequent versions also contained ratios that did not match the amounts reported on the SB 740 forms. Ultimately, even though OFL could not support the number of FTEs or pupil-to-teacher ratios for one charter or pupil-to-teacher ratios for the other two charters, the discrepancies did not affect the charters' funding. Nevertheless, the fact that OFL continued to provide multiple versions of its calculations raised concerns about the charters' internal controls and ability to report accurate and reliable data. In Chapter 4, the audit team addresses this issue in further detail.

Classification of Expenses

The audit team determined that the OFL charters coded some of their expenses in incorrect categories on their funding determination forms. The audit team traced 90 transactions from the general ledger to source documents and also vouched several dozen transactions per year and charter from source documents to the general ledger. The audit team's tests identified 16 items the charters had reported incorrectly on their funding determination forms. For these items, the erroneous coding resulted in OFL overstating its certificated staff or instructional expenses and the related funding determination form percentages.

For example, the audit team found that charters had recorded gift certificate expenditures for teachers under the category of either certificated staff salaries and benefits or books, supplies, and equipment on at least three occasions. However, gifts do not appear to meet the definition of employee benefits or instructional materials as described in the California School Accounting Manual. Based on these criteria, it appears that OFL misclassified a total of \$5,207 pertaining to teacher gift certificates for all three charters from the sample of expense items reviewed. The audit team believes these amounts should have been recorded under the category of other instructional and related benefits.

Exhibit 3-8 (see next page) summarizes the errors that the audit team identified and their effect on the charters' certificated staff or instructional expenses. Although these errors did not individually impact the determination of funding levels for the charters, there may be other unidentified expenses that were misclassified, which could have potentially affected the accuracy of the funding determination in previous years. The director of finance for Education Management Systems agreed that it needs to improve its accounting procedures; however, he stated that it is difficult to do because they have limited resources. The audit team found this statement disconcerting due to the potentially excessive salaries drawn by the Halls, as described in Chapter 1.

Exhibit 3-8
Opportunities for Learning Invoices That Appear to Be Incorrectly Recorded on Their Funding Determination Forms

Year	Charter	Date of Transaction	Total Dollar Value of Transaction	Amount in Dispute	Description	Affects Certificated Percentage?	Affects Instructional Percentage?
2002-03	Baldwin Park	07/15/02	\$1,350.00	\$1,350.00	Contract for dance lessons improperly charged to credentialed teacher salaries.	Yes	No
2002-03	Baldwin Park	09/09/02	\$1,312.50	\$1,312.50	Contract for dance lessons improperly charged to credentialed teacher salaries.	Yes	No
2002-03	Baldwin Park	10/14/02	\$520.00	\$520.00	Executive counseling services improperly charged to credentialed teacher salaries.	Yes	Yes
2002-03	Baldwin Park	11/01/02	\$900.00	\$900.00	Contract for dance lessons improperly charged to credentialed teacher salaries.	Yes	No
2002-03	Wm. S. Hart	10/14/02	\$520.00	\$520.00	Executive counseling services improperly charged to credentialed teacher salaries.	Yes	Yes
2002-03	Wm. S. Hart	04/07/03	\$800.00	\$800.00	Recruiting event improperly charged to credentialed teacher salaries.	Yes	No
2003-04	Baldwin Park	11/19/03	\$2,750.00	\$2,750.00	Gift certificates for teachers improperly charged to credentialed teacher salaries.	Yes	No
2003-04	Capistrano	08/18/03	\$422.11	\$422.11	Administrative charges improperly charged to credentialed teacher salaries.	Yes	Yes
2003-04	Capistrano	09/29/03	\$398.02	\$398.02	Administrative charges improperly charged to credentialed teacher salaries.	Yes	Yes
2003-04	Capistrano	10/27/03	\$484.38	\$484.38	Administrative charges improperly charged to credentialed teacher salaries.	Yes	Yes
2003-04	Capistrano	11/19/03	\$150.00	\$150.00	Gift certificates for teachers improperly charged to credentialed teacher salaries.	Yes	No
2003-04	Capistrano	12/08/03	\$421.20	\$421.20	Administrative charges improperly charged to credentialed teacher salaries.	Yes	Yes
2003-04	Capistrano	03/29/04	\$1,800.00	\$1,800.00	Executive consulting services improperly charged to credentialed teacher salaries.	Yes	No
2004-05	Baldwin Park	12/13/04	\$576.24	\$576.24	Administrative charges improperly charged to credentialed teacher salaries.	Yes	No
2004-05	Baldwin Park	01/31/05	\$1,900.00	\$1,900.00	Teacher scholarships improperly charged to credentialed teacher salaries.	Yes	No
2004-05	Wm. S Hart	11/02/04	\$2,307.80	\$2,307.80	Gift certificates for teachers improperly charged to credentialed teacher salaries.	Yes	No
Totals			\$16,612.25	\$16,612.25			

Source: Auditor-generated exhibit summarizing the results of items selected for testing that were incorrectly reported on the SB 740 form.

Certificated Administrator Salary Calculations

In preparing the SB 740 forms for the OFL-William S. Hart and OFL-Baldwin Park charters, Education Management Systems erred in making adjustments related to its certificated staff. As a result, OFL double-counted the salaries for some of these staff, thereby inflating its SB 740 certificated staff percentages.

At the time the 2004-05 SB 740 forms were prepared, the independent auditor for the OFL charters did not prepare financial statements that were presented in accordance with the SB 740 forms. As a result, Education Management Systems staff had to assign revenues and expenses as reported in the audited financial statements, into the categories used on the SB

740 forms. In reviewing the adjustments for two charters on their 2004-05 SB 740 forms, the audit team found that Education Management Systems erroneously included certificated administrators, including Mr. and Mrs. Hall in the certificated teacher salaries and benefits category.

The Education Management Systems' accounting system tracks expenses for certificated teachers and administrators collectively in one account. The SB 740 form breaks these expenditures out into two categories, both of which flow into the credentialed salaries ratio, but only one of which flows into the instructional materials ratio. Therefore, the charters must separate out these expenditures for SB 740 reporting purposes. However, when Education Management Systems separated these expenses, it deducted the amounts for the certificated administrator expenses from the "Books, Supplies, and Equipment" line item rather than from the "Certificated Teachers" line. Consequently, Education Management Systems included \$325,861 of expenses for OFL-William S. Hart and \$316,507 of expenses for OFL-Baldwin Park in both the certificated administrator and certificated teacher line items.

The Education Management Systems director of finance informed the audit team that Education Management Systems makes these adjustments to be more conservative in preparing its ratio for instructional-related expenses. However, this rationale is questionable because the adjustment only impacted the certificated staff ratio and not the instructional expense ratio. After the audit team brought the issue to its attention, Education Management Systems adjusted its SB 740 forms and resubmitted them to CDE. Although these errors did not adversely affect the certificated staff ratios by themselves—reducing the OFL-William S. Hart ratio from 47.6 percent to 42.8 percent and the OFL-Baldwin Park ratio from 44.7 percent to 40 percent—combining these errors with the errors discussed in the next section can have a significant impact on the funding determination.

Reimbursements and Professional Development Expenses

Of greater concern was that OFL improperly included selected expenditures in the certificated employee salaries and benefits category. As a result, the state paid two OFL charter schools nearly \$7 million that they were not entitled to receive during the 2004-05 school year.

In reviewing the documents used to compile expenses reported on the SB 740 forms for 2003-04 through 2005-06, the audit team found that OFL incorrectly included teacher automobile expenses, reimbursements, and education costs in the certificated salaries and benefits category. According to the instructions for completing the Nonclassroom-Based Funding Determination for all three years reviewed, these types of expenses should have been reported under the category of "All Other Instruction and Related Services and Other Operating Costs." That category specifically includes travel, conference, and professional development costs for instructional or related personnel. This apparent misallocation of

expenses appears to have resulted in OFL incorrectly calculating and reporting the certificated staff expense percentages for all three charters for each of the three years, and may have resulted in overpaid revenues for two charters in one year.

For the most part, the improper categorization of these expenses would not have affected the charters' funding determinations because the amounts did not reduce the percentage of public revenues spent on certificated salaries and benefits below minimum required levels. However, in accordance with funding determination rules, neither OFL-Baldwin Park nor OFL-Capistrano would have been eligible for funding for the 2004-05 school year had OFL correctly categorized the expenses on that year's SB 740 forms. Instead, the State paid \$6,317,319 to OFL-Baldwin Park and \$409,998 to OFL-Capistrano during that year based on OFL's improper claims, as shown in Exhibit 3-9.

Exhibit 3-9
Comparison of Opportunities for Learning Certificated Staff
Percentages and Impact on Funding for 2004-05 School Year

Charter	Percentage		Potential Amount of Funding to be Disallowed for 2004-05 School Year
	Reported by OFL on the SB 740 Form	Calculated by Audit Team After Adjusting for Erroneous Recording of Expenses	
Baldwin Park	44.66	39.05	\$6,317,319
Capistrano	40.04	37.15	\$409,998

Sources: Opportunities for Learning SB 740 Funding Determination Forms, audited financial statements, and general ledgers.

The Education Management Systems director of finance told the audit team that teacher automobile expenses, reimbursements, and education costs are benefits and therefore, are correctly reported by OFL under the category of certificated salaries and benefits. However, the California School Accounting Manual's description of the types of expenses that constitute employee benefits does not appear to support OFL's inclusion of those expenses as salaries and benefits.

Certificated Teacher Bonus Accruals

Although there is indication that OFL, similar to OFY, attempted to use bonuses as a means of gaining additional funding, the audit team did not identify the magnitude because OFL did not always book into its accounting system the bonuses it included in its funding determination forms, and its bonus accrual entry methodology is structured in such a way that the audit team could not easily identify the amounts.

The Education Management Systems director of finance stated that OFL uses a rolling accrual methodology, only booking the net difference to the accruals periodically such as at the end of the year to adjust them to what OFL believes it still owes teachers at the end

of the year. This methodology does not provide a clear trail to track whether incentives are properly calculated and recorded in the books because it only shows the net change for the year. Therefore, the audit team would not be able to easily identify the accruals and subsequent reversals in the same way as it could for the OFY transactions. As a result, the audit team did not attempt to determine whether OFL had made large accruals and subsequent reversals as found at OFY because the accounting records reflect only the net amount of these entries.

Furthermore, the audit team found that the net amounts accrued were eventually paid, meaning that OFL was not overstating its net bonus accruals in its accounting system. However, like OFY, OFL apparently did file a SB 740 funding determination form that included excess bonus accruals. In July 2004, Education Management Systems former chief financial officer stated during a board meeting that both OFL and OFY planned to book certain expenses, including teacher bonuses, as being accrued for purposes of receiving 100 percent public funding, amounts that would be subsequently reversed if the funding was not achieved. The current Education Management Systems director of finance confirmed that OFL did file a draft SB 740 funding determination form that included bonus accruals; however, he told us that OFL later revised the forms (because it did not receive 100 percent funding) to eliminate the bonus accruals and that the amounts were never booked in the accounting system. He also stated that OFL only used this practice one time for the 2004-05 funding determination requests.

Finally, the audit team noted that OFL, like OFY, recorded some noncredentialed teacher bonuses into the credential teacher salary line item. However, the amounts of these bonuses were immaterial. Therefore, the audit team did not pursue this further.

Financial Data Used in Funding Determination for the California Charter School Group Charter

The audit team also identified various financial reporting issues with the CCSG charter, OFL-Hacienda-La Puente. The audit team identified issues concerning the accuracy and reliability of data the charter reported on its SB 740 forms. The issues include discrepancies between the data reported on the SB 740 forms and the charter's general ledger, and recording of expenses to incorrect categories on the SB 740 form. In addition, the charter's overstatement of its certificated staff expenses resulted in it receiving state funding when it failed to meet minimum required spending thresholds.

Expense Percentage Calculations

The audit team determined that the percentages reported for certificated salaries and instructional expenses on OFL-Hacienda-La Puente's 2003-04 SB 740 form differed from the percentages calculated based on the financial data provided on the form and from the charter's general ledger. The CCSG charter reported that OFL-Hacienda-La Puente spent

44.7 percent on certificated staff and 68 percent on instruction. However, using data reported by CCSG on the SB 740 form, the audit team calculated the percentages as 43.5 percent for certificated staff and 66.2 percent for instruction. Moreover, the audit team found in its comparison of SB 740 amounts to the general ledger that the charter overstated Books, Supplies, and Equipment expenses by \$28,035. This caused the percentage for instructional expenses to be overstated as well. However, the audit team found that adjusting for these differences ultimately did not cause the charter to drop below minimum required spending thresholds.

Pupil-to-Teacher Ratio Data

The OFL-Hacienda-La Puente charter reported a pupil-to-teacher ratio on its 2003-04 SB 740 form that did not agree with supporting documentation. After being unable to determine the reason for the difference, the audit team questioned Education Management Systems regarding the basis for the ratio. Similar to the OFL charters, Education Management Systems responded by providing different versions of data to support its pupil-to-teacher ratio calculations. However, each subsequent version continued to contain ratios that did not match the amounts reported on the SB 740 form. For example, one document showed a pupil-to-teacher ratio of 27.23-to-1, while a subsequent document reported the ratio as 19.7-to-1. Ultimately, the differences did not affect the charter's funding level. Nevertheless, the fact that Education Management Systems continued to provide multiple versions of its calculations raised concerns about its ability to report accurate and reliable data. In Chapter 4, the audit team addresses this issue in further detail.

Classification of Expenses

The audit team also found that the charter reported some items in the wrong accounting categories on its SB 740 form. The audit team traced 22 transactions from the general ledger to source documents and also vouched several dozen transactions per year from source documents to the general ledger. The audit team's review found three items the charter reported incorrectly on its funding determination forms. For these items, the erroneous coding resulted in certificated staff expenses being overstated, thus resulting in the related percentages reported being higher than they should have been.

Exhibit 3-10 summarizes the errors identified by the audit team and their effect on the charter's certificated staff or instructional expenses. Although these errors did not individually impact the determination of funding levels for the charter, there may be other unidentified expenses that were misclassified, which could have potentially affected the accuracy of the funding determination in previous years.

Exhibit 3-10
California Charter School Group Expenses That Were
Incorrectly Recorded on Their Funding Determination Forms

Year	Charter	Date of Transaction	Total Dollar Value of Transaction	Amount in Dispute	Description	Affects Certificated Percentage?	Affects Instructional Percentage?
2002-03	Hacienda-La Puente	11/19/03	\$2,250.00	\$2,250.00	Gift certificates for teachers improperly charged to books.	Yes	No
2004-05	Hacienda-La Puente	11/08/04	\$2,412.70	\$2,412.70	Gift certificates for teachers improperly charged to direct salaries.	Yes	No
2004-05	Hacienda-La Puente	02/22/05	\$180.00	\$180.00	Teacher reimbursement improperly charged to books.	Yes	No
Totals			\$4,842.70	\$4,842.70			

Source: Auditor-generated exhibit summarizing the results of items selected for testing that were incorrectly coded on the SB 740 form.

The audit team found that, similar to the other OFL charters, CCSG improperly reported the amount that OFL-Hacienda-La Puente spent on certificated employee salaries and benefits by including teacher automobile expenses, reimbursements, and education costs in this total. When the audit team recalculated the certificated staff percentage by removing the expenses of these three categories, it determined that the charter's percentage fell below the minimum threshold required for receiving any funding during the 2004-05 school year. As a result, OFL-Hacienda-La Puente should not have been eligible for any of the \$5,543,196 provided by the state that year, as summarized in Exhibit 3-11.

Exhibit 3-11
Comparison of California Charter School Group Certificated Staff Percentages and
Impact on Funding For 2004-05 School Year

Charter	Percentage		Potential Amount of Funding to be Disallowed for 2004-05 School Year
	Reported by Education Management Systems on the SB 740 Form	Calculated by Audit Team After Adjusting for Erroneous Recording of Expenses	
Hacienda La Puente	41.50	35.00	\$5,543,196

Sources: Opportunities for Learning/CCSG SB 740 Funding Determination Forms, audited financial statements, and general ledgers.

Recommendations

To ensure that OFL and CCSG have received an appropriate amount of funding, and are using a proper methodology to calculate funding determination ratios, the CDE should:

- Make a determination regarding whether to seek reimbursement or withhold funds for any overpaid funds related to the potentially inaccurate or unsupported financial data on the SB 740 forms identified in this chapter. In particular, the CDE should determine whether the Education Management Systems/OFL charters and the CCSG/OFL Hacienda-La Puente charter schools should reimburse the state for the \$6.7 million and \$5.5 million, respectively, which appear to have been improperly claimed during the 2004-05 school year.

To establish compliance with state requirements for funding determination, OFY and Education Management Systems/OFL should do the following:

- Maintain accurate and reliable documentation to support the expense percentages and pupil-to-teacher ratios used in the SB 740 forms.
- Establish procedures to ensure that staff properly record expenses to the correct accounting categories and perform periodic reviews to verify their accuracy.
- Develop procedures to prevent potential instances of inurement, such as establishing requirements for ensuring that OFY properly invoices OFL for goods and services provided, and that OFL pays the invoices promptly.
- Implement the new credit card policy at OFY to improve controls over the use of credit cards and the documentation of expenses resulting from those transactions. Consider adopting a similar policy at Education Management Systems to ensure consistency among the charters' procedures.
- Investigate all of the OFY credit card charges incurred during the three-year period of the audit to determine whether the charges were reasonable, appropriate for school business, and recorded appropriately in the financial statements.
- Discontinue the practice of accruing bonuses at year-end simply as a means to increase the charters' opportunities for additional funding. The charters should ensure that they document and have a justifiable basis for paying bonuses during the upcoming year before accruing the related expenses.

Chapter 4: Charter School Pupil-to-Teacher Ratios

The audit team found questionable practices and methods of calculating the number of FTE certificated teachers for inclusion in the pupil-to-teacher ratios at all three entities (OFY, OFL, and CCSG). Specifically, the CDE attorneys deemed the method used by these entities to determine the FTE rate for certificated teachers as invalid. Moreover, some charters could not support the FTE claimed, made errors in their calculations of pupil-to-teacher ratios, double-counted teachers, and included unallowable staff as FTE. Because of these issues, all three entities may have received excess funding from the state.

State Laws and Regulations Related to Nonclassroom-Based Charter Schools

As mentioned in Chapter 3, the final rule for receiving 100 percent funding generally requires independent study schools to maintain a pupil-to-teacher ratios that is equal to or lower than that of the largest unified school district in the county(ies) served by the charter school. The State Board of Education expanded this requirement in December 2005 to include an option for the charter schools to use a 25-to-1 ratio instead of the district comparison. Calculating the pupil-to-teacher ratios involves dividing the total ADA as of the second principal funding apportionment date by the total number of FTE teachers in a charter. The ADA apportionment will not be funded to the extent that it causes a charter to exceed the comparison ratio.

California Education Code and CDE instructions specify that charters must only include certificated teachers who provide direct instruction to the ADA-generating students as FTE and exclude certificated staff, such as counselors, special education specialists, and administrators, who exclusively provide administrative or supplementary services. If these staff do provide direct instruction, charters may include the fractional amount of time the employee spent providing direct instruction. Because OFY and OFL FTE calculations include all certificated teachers employed on the second principal apportionment date and the calculations are predicated on the assumption that each FTE teacher worked and provided direct instruction each day of the school year (that is, they already count each student's regular supervising teacher), it is not appropriate for the charters to claim FTE for substitute teachers that fill in during teacher absences. Although the audit team found the ADA used in funding calculations is materially accurate, several issues exist related to the FTE and pupil-to-teacher ratio calculations.

Methodology for Determining Full-Time Equivalent Certificated Teachers

As shown in the textbox, the three charter-holding entities all utilize a formula whereby a full-time teaching assignment at their schools results in a 1.92 FTE for the purpose of calculating the pupil-to-teacher ratios for funding apportionment. The OFY and OFL

management contended that the teachers of the three charter-holding entities work more days and hours than a “typical” teacher due to their year-round calendar and longer school day. They also asserted that numerous other schools throughout California claim teachers at a rate of greater than 1.0 FTE. To determine whether the 1.92 methodology is permissible under existing laws and regulations, the audit team sought a legal opinion from CDE’s attorneys.

The CDE’s attorney opined that the 1.92 methodology does not comply with existing laws and regulations and that the charters should claim their teachers on a 1.0 FTE scale.¹⁹

OFY, OFL, and CCSG Method for Calculating Full-Time Equivalent Teachers

OFY, OFL, and CCSG calculate their teachers as 1.92 FTEs by comparing the number of hours and days worked by their teachers to those worked by teachers in other traditional schools.

	Hours of Student Contact Per Day	Instruction Per Year	
		Days	Total Hours
Traditional schools	5 X	175	= 875
OFY, OFL, and CCSG schools	7 X	240	= 1,680

Note: Because $1,680 \div 875 = 1.92$, OFY, OFL, and CCSG count each full-time teacher as 1.92 FTEs.

In response to this finding, OFY and OFL sought their own legal opinion. The OFY and OFL attorney opined that the method used by the schools to calculate FTE teacher counts for the purpose of determining pupil-to-teacher ratios is consistent with current law.²⁰

As a result of these differences in opinion, on February 15, 2006, OFY and OFL filed a lawsuit in the Superior Court of California in Los Angeles County against the State Board of Education, FCMAT, the State Controller, and the five county superintendents who requested the audit. The parties had not resolved this lawsuit by the end of the audit team’s fieldwork in May 2006.

Potential Liability in Legal Challenge Based on Differences in Methodology for Calculating a Full-Time Equivalent Certificated Teacher

As shown in the following exhibits, if the state prevails in the legal challenge regarding the FTE calculation method, the three entities could be liable to the state for overpaid funding.

¹⁹ Please see Appendix C for the complete text of CDE’s legal opinion.

²⁰ Please see Appendix D for the complete text of this legal opinion.

Also shown in the exhibits for reference are the audit team’s recalculations of the charters’ FTE counts using two different methodologies.²¹ The audit team made these recalculations to provide comparison data and to test the reasonableness of each charter’s FTE calculations. The first of the audit team’s methods, the “days worked” methodology, utilized iSIS-trac (student information system) data provided by three entities and compared the total possible days and hours a teacher could have worked during the year to the hours teachers are required to work to achieve full-time work status at the charter schools and at a traditional school. Secondly, the audit team used teacher employment records, with hire and termination dates, to recalculate total FTE for each charter. As the exhibits reveal, the audit team’s recalculations seemed to correlate to the FTE counts, with about the same amount of FTEs being higher and lower in each of the three years.

As shown in Exhibit 4-1 (below and on the following page), if the state prevails in the legal challenge, the OFY charter may have been overpaid almost \$21.9 million from the state during FYs 2002-03 through 2004-05. The comparison methods revealed lower FTEs in all cases except one for 2002-03—indicating that OFY’s reported FTE counts may have been overstated. The comparison method FTE’s were about equal in the number of cases that were higher and lower for 2003-04 and 2004-05.

**Exhibit 4-1
Options for Youth: Revised Full-Time Equivalents and Potential Excess Funds Claimed
Fiscal Years 2002-03 Through 2004-05^a**

	FTE Reported on SB 740 (Based on 1.92 FTE)	CDE Approved FTE Methodology (Based on 1.0 FTE)	Audit Team Reasonableness Test—Using Start and End Dates		Audit Team Reasonableness Test—Using Days Worked	
			Based on 1.92	Based on 1.0	Based on 1.92	Based on 1.0
Fiscal Year 2002-03						
Individual Charter FTE Detail:						
Burbank	73	38	67	35	71	37
Mount Shasta	10	5	10	5	11	6
San Gabriel	31	16	25	13	28	14
San Juan	28	15	22	12	24	12
Upland	62	33	59	31	61	32
Victor Valley	54	28	48	25	47	25
Total FTE	258	135	231	120	242	126
Funds Received Fiscal Year 2002-03	Potential Excess Funds Received Using 1.0 Methodology, Fiscal Year 2002-03					
\$15,617,005	\$6,245,156^b					

Continued

²¹ We describe more fully the audit team methodologies for calculating the FTE teachers in Appendix A.

	FTE Reported on SB 740 (Based on 1.92 FTE)	CDE Approved FTE Methodology (Based on 1.0 FTE)	Audit Team Reasonableness Test			
			Using Start and End Dates		Using Days Worked	
			Based on 1.92	Based on 1.0	Based on 1.92	Based on 1.0
Fiscal Year 2003-04						
Individual Charter FTE Detail:						
Burbank	86	45	76	40	78	41
Mount Shasta	10	5	12	6	13	7
San Gabriel	38	20	30	16	30	16
San Juan	42	22	38	20	40	21
Upland	72	38	80	42	80	42
Victor Valley	54	28	54	28	59	31
Total FTE	303	158	290	151	300	156
Funds Received Fiscal Year 2003-04	Potential Excess Funds Received Using 1.0 Methodology, Fiscal Year 2003-04					
\$21,619,377	\$7,546,766^b					
Fiscal Year 2004-05						
Individual Charter FTE Detail:						
Burbank	72	37	73	38	82	43
Mount Shasta	Not applicable	—	—	—	—	—
San Gabriel	34	18	25	13	26	14
San Juan	40	21	39	20	47	24
Upland	78	40	72	38	79	41
Victor Valley	74	39	60	31	64	33
Total FTE	298	155	271	141	297	155
Funds Received Fiscal Year 2004-05	Potential Excess Funds Received Using 1.0 Methodology, Fiscal Year 2004-05					
\$26,095,926	\$6,514,891^b					
Funds Received Fiscal Years 2002-03 to 2004-05	Potential Excess Funds Received Using 1.0 Methodology Fiscal Years 2002-03 to 2004-05					
\$63,332,308	\$21,870,346^b					

Sources: Auditor calculations based on comparison of OFY's Nonclassroom Funding Determination reports (SB 740 forms), iSISTrac records for FYs 2002-03 to 2004-05, and OFY's roster of employees, including start and termination dates. All funding levels have been adjusted to reflect the 60 percent funding level for FY 2002-03 and the 70 percent funding levels for FYs 2003-04 and 2004-05. Differences are due to rounding.

a The FTEs are rounded to the nearest integer.

b The estimates of potential excess funds received are conservative because they are based on the information claimed by OFY and not the lower numbers verified by the audit team for FTE and the pupil-to-teacher ratio of the largest district.

Should the state prevail in the lawsuit filed by the Hall entities, Exhibit 4-2 reveals a potential liability of nearly \$14 million to OFL for FYs 2002-03 through 2004-05. The alternative comparison methods again were both higher and lower than the normalized rate with the comparison FTE. The rates were equally higher and lower in the first two years and predominantly higher in FY 2004-05.

**Exhibit 4-2
Opportunities for Learning: Revised Full-Time Equivalents and Potential Excess
Funds Claimed, Fiscal Years 2002-03 Through 2004-05^a**

	FTE Reported on SB 740 (Based on 1.92 FTE)	CDE Approved FTE Methodology (Based on 1.0 FTE)	Audit Team Reasonableness Test			
			Using Start and End dates		Using Days Worked	
			Based on 1.92	Based on 1.0	Based on 1.92	Based on 1.0
Fiscal Year 2002-03						
Individual Charter FTE Detail:						
Baldwin Park	63	33	76 ^b	39 ^b	74 ^b	38 ^b
Capistrano	4	2	4	2	4	2
William S. Hart	77	40	64	33	71	37
Total FTE	144	73	144	75	149	77
Funds Received Fiscal Year 2002-03		Potential Excess Funds Received Using 1.0 Methodology, Fiscal Year 2002-03				
\$9,881,194		\$3,556,215^c				
Fiscal Year 2003-04						
Individual Charter FTE Detail:						
Baldwin Park	72	38	74	39	62	32
Capistrano	4	2	6	3	6	3
William S. Hart	84	44	81	42	78	41
Total FTE	160	83	161	84	146	76
Funds Received Fiscal Year 2003-04		Potential Excess Funds Received Using 1.0 Methodology, Fiscal Year 2003-04				
\$13,167,787		\$4,899,514^c				
Fiscal Year 2004-05						
Individual Charter FTE Detail:						
Baldwin Park	84	44	72	38	88	46
Capistrano	6	3	7	4	8	4
William S. Hart	49	26	54	28	62	32
Total FTE	139	73	133	70	158	82
Funds Received Fiscal Year 2004-05		Potential Excess Funds Received Using 1.0 Methodology, Fiscal Year 2004-05				
\$12,954,898		\$5,513,873^c				
Funds Received Fiscal Years 2002-03 to 2004-05		Potential Excess Funds Received Using 1.0 Methodology, Fiscal Years 2002-03 to 2004-05				
\$36,003,879		\$13,969,602^c				

Sources: Auditor calculations based on comparison of OFL's Nonclassroom Funding Determination reports (SB 740 forms), iSIStrac records for FYs 2002-03 to 2004-05, and OFL's roster of employees, including start and termination dates. All funding levels have been adjusted to reflect the 60 percent funding level for FY 2002-03 and the 70 percent funding levels for FYs 2003-04 and 2004-05. Differences are due to rounding.

- a The FTEs are rounded to the nearest integer.
- b The comparison method FTE's are overstated due to the effects of including 25 part-time teachers on a full-time basis and because it includes at least four FTE's for teachers that OFL-Baldwin Park claimed as FTE in other OFL charters.
- c The estimates of potential excess funds received are conservative because they are based on the information claimed by OFL and not the lower numbers verified by the audit team for FTE and the pupil-to-teacher ratio of the largest district.

The CCSG may have been overpaid more than \$4 million for the two FYs 2002-03 and 2003-04, as shown in Exhibit 4-3, if the state prescribed method is determined to be accurate by the courts. The comparison methods resulted in a lower FTE in 2002-03 and a higher FTE in 2003-04.

Exhibit 4-3
California Charter School Group: Revised Full-Time
Equivalents and Potential Excess Funds Claimed
Fiscal Years 2002-03 through 2003-04

	FTE Reported on SB 740 (Based on 1.92 FTE)	CDE Approved FTE Methodology (Based on 1.0 FTE)	Audit Team Reasonableness Test			
			Using Start and End dates		Using Days Worked	
			Based on 1.92	Based on 1.0	Based on 1.92	Based on 1.0
Fiscal Year 2002-03						
Individual Charter FTE Detail:						
California Charter School Group	60	31	54	28	55	28
Funds Received Fiscal Year 2002-03		Potential Excess Funds Received Using 1.0 Methodology, Fiscal Year 2002-03				
\$4,138,039		\$1,424,485				
Fiscal Year 2003-04						
Individual Charter FTE Detail:						
California Charter School Group	55	29	58	30	58	30
Funds Received Fiscal Year 2003-04		Potential Excess Funds Received Using 1.0 Methodology, Fiscal Year 2003-04				
\$5,543,196		\$2,598,912				
Fiscal Year 2004-05						
Individual Charter FTE Detail:						
California Charter School Group	No Data Available For Fiscal Year 2004-05					
Funds Received Fiscal Years 2002-03 to 2003-04		Potential Excess Funds Received Using 1.0 Methodology, Fiscal Years 2002-03 to 2003-04				
\$9,681,235		\$4,023,397				

Sources: Auditor calculations based on comparison of CCSG’s Nonclassroom Funding Determination reports (SB 740 forms), iSIStrac records for FYs 2002-03 to 2003-04, and CCSG’s roster of employees, including start and termination dates. All funding levels have been adjusted to reflect the 60 percent funding level for FY 2002-03 and the 70 percent funding levels for FY 2003-04. Differences are due to rounding.

- a The FTEs are rounded to the nearest integer.
- b The estimates of potential excess funds received are conservative because they are based on the information claimed by CCSG and not the lower numbers verified by the audit team for FTE and the pupil-to-teacher ratio of the largest district.

The estimates generated using the two audit team comparison methodologies are affected by the audit team's conservative estimates of teachers' days worked and the exclusion of teachers not included in iSISTrac. Specifically, the audit team's estimates made the assumption that teachers worked on all possible school days in a given time period for which they appear in iSISTrac, and for a full seven hours on each day. To the extent that teachers, such as part-time teachers, did not work seven full hours every day or were only available for selected days out of a particular period, the FTE comparison shown in the exhibits would decrease. However, these overstatements are offset to the extent that a charter had teachers who provided direct instruction but were not the primary teachers claiming the ADA in iSISTrac.

Overall Reasonableness Tests Performed on Full-Time Equivalent Certificated Teacher Calculations

In an attempt to determine the reasonableness of the 1.92 rate for FTE teachers used by the charters, the audit team calculated the FTE rate and number of FTE needed based upon the ADA claimed by each of the charters. However, these recalculations rarely supported either the 1.0 or the 1.92 rate, or the FTEs claimed by the charters.

Because one ADA in the OFY and OFL independent study programs is typically generated by a student completing the required coursework and attending class for two hours per week for an average of 35 weeks, each ADA would require 70 hours of teacher time/direct instruction. Thus, multiplying the ADA claimed by 70 gives the total number of hours of direct instruction needed to generate the ADA claimed. Dividing this total of ADA hours by the number of FTE claimed gives the average hours per FTE. Then, dividing the hours per FTE by 875 hours (which is the number of hours used by the charters as a base for a standard teacher in calculating the 1.92 rate) provides an FTE factor. The audit team's calculations of the average FTE factor for each of the charters are shown in Exhibits 4-4 through 4-6 (pages 90 through 93).

Moreover, the 1.92 rate assumes that OFY, OFL, and CCSG teachers are providing 1,680 hours of direct instruction per year. At an estimated 70 hours of instruction per year per ADA, teachers working 1,680 hours in a year should be able to generate approximately 24 ADA per year. Therefore, the audit team tested (for reasonableness) the charters' FTE calculations by dividing total ADA claimed by 24 to determine the number of FTE (at the 1.92 rate) needed to generate the claimed ADA. To the extent that these calculations were lower than the FTEs claimed by the charters, the audit team observed that the FTE claimed may be overstated. These calculations for each of the charters are also shown in Exhibits 4-4 through 4-6.

The auditor comparison calculations of the FTE rate and FTE needed based upon a charter's ADA does not consider all factors and is presented merely as a test of reasonableness.

Specifically, it does not include any direct instruction provided by teachers that does not result in ADA — which would increase the FTE calculations. Offsetting this, the calculations also do not account for cases where a teacher provides direct instruction to more than one student during one hour — which would decrease the FTE calculations. Because the effect of these offsetting scenarios cannot be accurately determined, the FTE calculations are merely estimates — estimates that only support the 1.92 FTE rate claimed by the charters in a few cases.

The calculated FTE for the OFY charters, as shown in Exhibit 4-4 (see below and next page), ranged between 1.26 and 1.68 — well below the 1.92 rate claimed by OFY. The weighted average calculation of the FTE teachers for each of the three years — which ranges from 1.46 to 1.47 — also does not support the 1.92 rate. Moreover, none of the calculated total FTEs needed to generate the claimed ADA was close to the number of FTEs claimed by OFY. As shown later in this chapter in Exhibit 4-7 (see page 95), the audit team found that OFY included some unallowable staff and double-counted other staff in its claimed FTE totals. While removing these staff from the calculations in Exhibit 4-4 would cause the calculated FTE rates to increase, applying the lower calculated FTE rates from Exhibit 4-4 to OFY claimed FTE would cause the calculated FTE to decrease significantly.

Exhibit 4-4
Options for Youth Average Full-Time Equivalent Teachers
Based on Average Daily Attendance Ranged From 1.26 to 1.68

Charter	ADA Claimed	Total FTE Claimed Per SB 740	Calculated Hours Worked		Average FTE of Teachers Claimed Based on 875 Hours per Year (1.0 FTE)	Calculated FTE Needed to Achieve ADA Based on 1,680 Hours per Year (1.92 FTE)
			Based on ADA	Per FTE		
2002-03						
Burbank	1,414.22	73.40	98,995.40	1,348.71	1.54	58.93
Mount Shasta	183.04	9.60	12,812.80	1,334.67	1.53	7.63
San Gabriel	561.70	31.20	39,319.00	1,260.22	1.44	23.40
San Juan	455.09	27.84	31,856.30	1,144.26	1.31	18.96
Upland	1,104.65	62.40	77,325.50	1,239.19	1.42	46.03
Victor Valley	985.03	53.76	68,952.10	1,282.59	1.47	41.04
Total Weighted Average	4,703.73	258.20	329,261.10	1,275.22	1.46	195.99
2003-04						
Burbank	1,500.10	86.40	105,007.00	1,215.36	1.39	62.50
Mount Shasta	186.02	9.60	13,021.40	1,356.40	1.55	7.75
San Gabriel	612.46	38.40	42,872.20	1,116.46	1.28	25.52
San Juan	666.30	42.24	46,641.00	1,104.19	1.26	27.76
Upland	1,522.00	72.27	106,540.00	1,474.19	1.68	63.42
Victor Valley	1,075.54	53.76	75,287.80	1,400.44	1.60	44.81
Total Weighted Average	5,562.42	302.67	389,369.40	1,286.45	1.47	231.77

Charter	ADA Claimed	Total FTE Claimed Per SB 740	Calculated Hours Worked		Average FTE of Teachers Claimed Based on 875 Hours per Year (1.0 FTE)	Calculated FTE Needed to Achieve ADA Based on 1,680 Hours per Year (1.92 FTE)
			Based on ADA	Per FTE		
2004-05						
Burbank	1,392.38	71.88	97,466.60	1,355.96	1.55	58.02
Mount Shasta	Not Applicable					
San Gabriel	584.17	33.96	40,891.90	1,204.12	1.38	24.34
San Juan	701.23	40.32	49,086.10	1,217.41	1.39	29.22
Upland	1,606.00	77.60	112,420.00	1,448.71	1.66	66.92
Victor Valley	1,168.34	73.92	81,783.80	1,106.38	1.26	48.68
Total Weighted Average	5,452.12	297.68	381,648.40	1,282.08	1.47	227.17

Source: Audit team generated using information from the SB 740 funding determination request forms.

At the 1.92 rate, the calculated FTE needed to generate the ADA claimed is much lower than the actual FTE claimed.

The calculated FTE per teacher for the OFL charters, as shown in Exhibit 4-5 (see next page), ranged between 0.94 and 2.06 but was well below the 1.92 rate claimed by OFL in all but three cases. The weighted average calculation of FTE per teacher for each of the three years—from 1.69 to 1.81—also does not support the 1.92 rate. Moreover, the calculated number of FTEs needed to generate the ADA claimed was only close to the number of FTEs claimed by OFL for one of the three schools each year. As shown in Exhibit 4-9 (see page 97), the audit team found that OFL included a number of questionable staff in its claimed FTE. While removing these staff from the calculations in Exhibit 4-5 would cause the calculated FTE rates to increase, applying the lower calculated FTE rates from Exhibit 4-5 to OFL's claimed FTE would cause the FTE to decrease.

**Exhibit 4-5
Opportunities for Learning Average Full-Time Equivalent Teachers
Based on Average Daily Attendance Ranged From 0.94 to 2.06**

Charter	ADA Claimed	Total FTE Claimed Per SB 740	Calculated Hours Worked		Average FTE of Teachers Claimed Based on 875 Hours per Year (1.0 FTE)	Calculated FTE Needed to Achieve ADA Based on 1,680 Hours per Year (1.92 FTE)
			Based on ADA	Per FTE		
2002-03						
Baldwin Park	1,511.04	63.16	105,772.80	1,674.68	1.91	62.96
Capistrano	45.22	3.84	3,165.40	824.32	0.94	1.88
Wm. S. Hart	1,496.22	77.36	104,735.40	1,353.87	1.55	62.34
Total Weighted Average	3,052.48	144.36	213,673.60	1,480.14	1.69	127.19
2003-04						
Baldwin Park	1,715.02	72.15	120,051.40	1,663.91	1.90	71.46
Capistrano	103.75	7.68	7,262.50	945.64	1.08	4.32
Wm. S. Hart	1,649.86	84.00	115,490.20	1,374.88	1.57	68.74
Total Weighted Average	3,468.63	163.83	242,804.10	1,482.05	1.69	144.53
2004-05						
Baldwin Park	1,784.49	84.25	124,914.30	1,482.66	1.69	74.35
Capistrano	103.23	5.75	7,226.10	1,256.71	1.44	4.30
Wm. S. Hart	1,272.19	49.44	89,053.30	1,801.24	2.06	53.01
Total Weighted Average	3,159.91	139.44	221,193.70	1,586.30	1.81	131.66

Source: Audit team generated using information from the SB 740 funding determination request forms.

The total calculated FTE needed (at the 1.92 rate) to generate the ADA claimed is lower than the actual FTE claimed in most cases; however, three charters were close to the 1.92. rate.

As shown in Exhibit 4-6 (see next page), the calculated FTE per teacher for the CCSG charter ranged between 1.65 and 2.04 for the two years reviewed. Moreover, the calculated FTE needed to generate the claimed ADA exceeded the number of FTEs claimed by CCSG in 2003-04—but was significantly lower in 2002-03. The audit team found that CCSG only included one questionable staff in its claimed FTE—as shown Exhibit 4-11 (see page 100).

Exhibit 4-6
The California Charter School Group’s Use of the 1.92 Rate for Full-Time Equivalent Teachers Appears Reasonable in 2003-04 but Not in 2002-03

Charter	ADA Claimed	Total FTE Claimed Per SB 740	Calculated Hours Worked		Average FTE of Teachers Claimed Based on 875 Hours per Year (1.0 FTE)	Calculated FTE Needed to Achieve ADA Based on 1,680 Hours per Year (1.92 FTE)
			Based on ADA	Per FTE		
2002-03						
Hacienda La Puente	1,228.19	59.52	85,973.30	1,444.44	1.65	51.17
2003-04						
Hacienda La Puente	1,404.96	55.20	98,347.20	1,781.65	2.04	58.54
Total Weighted Average	2,633.15	114.72	184,320.50	1,606.70	1.84	109.71

Source: Audit team generated using information from the SB 740 funding determination request forms.

FTE needed at 1.92 rate is much lower than claimed for 2002-03; however, calculated FTE needed was higher for 2003-04.

Full-Time Equivalent Certificated Teacher and Pupil-to-Teacher Ratio Calculation Tests

The last methods used to test the reasonableness of the entities’ calculations of FTE teachers included a test to ensure each of the teachers included in the FTE calculation held a valid teaching credential as required; a comparison to teachers listed in the student information system (iSISTrac) in an effort to identify, for further investigation, any staff claimed as FTE who may not have provided direct instruction; and a test of the position or title of teachers claimed as FTE to ensure they were not in an unallowable class. Additionally, the audit team recalculated the FTE and pupil-to-teacher ratios claimed and verified the comparison pupil-to-teacher ratios used by the entities (for the 2002-03 and 2003-04 comparison to the largest unified school district). The audit tests revealed discrepancies in the charters’ FTE that are not included in Exhibits 4-1 through 4-6 shown above and discrepancies in the pupil-to-teacher ratio calculations that could potentially increase the amount of overpaid state funds.

Each of the entities uses what it calls a “norming day” — one day during the year, usually April 15, when each of the charters count the number of FTE teachers on the payroll — to determine the number of FTE for inclusion in the annual pupil-to-teacher ratios.²² The

²²The California School Accounting Manual refers to the use of a method similar to the OFY and OFL “norming day” for cost allocation purposes.

audit team reviewed a sample of more than 50 of these FTE teachers from OFL and OFY and found that each teacher held a valid teaching credential during the time the teacher provided instruction.

However, in comparing the lists of all teachers claimed as FTE on the SB 740 form to the support provided by the entities, the audit team found miscalculations in the FTE and the inclusion of several staff that are questionable. Additionally, some of the pupil-to-teacher ratio calculations were wrong because of improper rounding, and the entities overstated in several cases the comparison pupil-to-teacher ratios for the largest unified school district. As a result, the charters may have been overpaid by the state.

Options for Youth

The audit team's investigation of the staff claimed as FTE by OFY and review of the FTE teacher lists and other documents revealed that OFY claimed nearly 43 questionable FTEs during the three years reviewed. Specifically, as shown in Exhibit 4-7 (see next page), OFY erroneously claimed FTE for several counselors and double-claimed six staff at up to 1.92 FTE each at two different charters. Moreover, the support OFY provided for its FTE claims did not always agree with the amount of FTE that OFY claimed in its SB 740 forms. Specifically, the support revealed lower FTEs in three cases and a higher FTE in one. The OFY also did not always round properly in its calculations.

**Exhibit 4-7
Options for Youth Claimed 43 Unallowable Full-Time Equivalent Teachers During
the Three Years Reviewed**

	FTE Claimed on SB 740	FTE Per Support Provided to Audit Team	Questionable FTE Recommended to be Disallowed	Auditor Calculated FTE (at 1.92 rate) Rounded Properly (Down)	Reason for Recommending Disallowance of FTE
2002-03					
Burbank	73.4	72.96	1.92	71	Claimed one teacher twice (1.92).
Mount Shasta	31.2	9.6	0	9	
San Gabriel	31.2	31.2	2.40	28	Claimed unallowable counselor (1.92) and claimed another teacher twice (0.48).
San Juan	27.84	27.8	1.92	25	Claimed unallowable counselor (1.92).
Upland	62.4	62.4	3.84	58	Claimed two unallowable counselors (1.92 each).
Victor Valley	53.76	53.8	1.92	51	Claimed unallowable counselor (1.92).
2003-04					
Burbank	86.4	82.4	6.46	75	Claimed unallowable counselor (1.92), claimed two teachers twice (1.92 each), and claimed one teacher at full-time who is half-time (0.7).
Mount Shasta	9.6	9.6	0.48	9	Claimed one teacher at full-time who was three-quarter time (0.48).
San Gabriel	38.4	37.8	4.80	33	Claimed unallowable counselor (1.92) and claimed two teachers twice (1.92 and 0.96).
San Juan	42.24	42.2	1.92	40	Claimed unallowable counselor (1.92).
Upland	72.27	77.6	3.84	73	Claimed two unallowable counselors (1.92 each).
Victor Valley	53.76	53.8	1.92	51	Claimed unallowable counselor (1.92).
2004-05					
Burbank	71.88	71.9	1.92	70	Claimed unallowable counselor (1.92).
Mount Shasta	Not applicable				
San Gabriel	33.96	34.0	3.84	30	Claimed unallowable counselor (1.92) and an unallowable special education teacher.
San Juan	40.32	40.3	0	40	Claimed unallowable counselor (1.92) and missed claiming one teacher when adding (+1.92).
Upland	77.6	77.6	3.84	73	Claimed two unallowable counselors (1.92 each).
Victor Valley	73.92	73.9	1.92	72	Claimed unallowable counselor (1.92).
Total			42.94		

Source: Auditor generated utilizing data from OFY and the SB 740 forms.

While claiming FTE for the questionable staff listed in Exhibit 4-7 had no effect on OFY’s funding determination, OFY’s miscalculation of its pupil-to-teacher ratios does have an effect. As Exhibit 4-8 shows, correcting OFY’s rounding error and using verified pupil-to-teacher ratio numbers from the largest unified school district for OFY-Mount Shasta in 2002-03 and 2003-04 causes its actual pupil-to-teacher ratios to exceed that of the largest district. As a result, OFY-Mount Shasta appears to have been overpaid \$164,068 from the state.

**Exhibit 4-8
Options for Youth May Have been Overpaid More Than \$164,000
Due to Its Pupil-to-Teacher Ratio Calculations**

	Pupil-to-Teacher Ratios					Amount of Recommended Apportionment Disallowance
	Claimed on SB 740	Actual Based on Support Provided and Proper Rounding	Auditor Calculated After Removing Disallowed FTE (Must Round Down)	Largest Unified School District		
				OFY Claimed	Auditor Verified	
2002-03						
Burbank	19	17	17	21	21	
Mount Shasta	17	19	19	21	18	\$70,281
San Gabriel	18	17	18	21	21	
San Juan	16	16	17	21	23	
Upland	18	16	18	21	22	
Victor Valley	19	16	17	21	22	
2003-04						
Burbank	18	18	20	26	22	
Mount Shasta	19	20	20	19	18	\$93,787
San Gabriel	16	16	18	26	22	
San Juan	16	15	16	21	23	
Upland	21	19	20	21	22	
Victor Valley	20	20	21	21	22	
2004-05						
Burbank	20	19	19	25	25	
Mount Shasta	Not applicable	—	—	—	—	—
San Gabriel	18	17	19	25	25	
San Juan	18	17	17	25	25	
Upland	18	20	22	25	25	
Victor Valley	18	16	16	25	25	
Total						\$164,068

Sources: Auditor generated using data from OFY, the SB 740 forms, and the comparison districts.

Exhibit 4-9
Opportunities for Learning Lacked Support for 21 Full-Time Equivalent Teachers It Claimed in Fiscal Year 2002-03 and Claimed 25 Questionable Full-Time Equivalent Teachers During the Three Years Reviewed

	FTE Claimed on SB 740	FTE Per Support Provided to Audit Team	Questionable FTE Recommended to Be Disallowed	Auditor Calculated FTE (at 1.92 rate) Rounded Properly (Down)	Reason for Recommending Disallowance of FTE
2002-03					
Baldwin Park	63.16	56.2	2.0	54	Claimed administrators, Mr. and Mrs. Hall, as 1 FTE each for preparing curriculum—not valid, no direct instruction. Also could not support its claim of 63.16 FTEs.
Capistrano	3.84	3.84	0	3	
Wm. S. Hart	77.36	63.48	2.0	61	Claimed administrators, Mr. and Mrs. Hall, as 1 FTE each for preparing curriculum—not valid, no direct instruction. OFL also added up FTEs incorrectly—should be 63.5 instead of 71.2.
2003-04					
Baldwin Park	72.15	72.69	13.44	59	Claimed six substitutes hired on March 29, 2004 (1.92 each) and told us later they were teachers. However, files for five of them showed they were temporary, on-call, substitutes who were all dismissed due to lack of need/work. Claimed floater who does not appear in iSIStrac (1.92).
Capistrano	7.68	7.68	0.00	7	
Wm. S. Hart	84	84	1.92	82	OFL was unable to explain a floater (1.92) who does not appear in iSIStrac and was listed as hired on February 4, 2004.
2004-05					
Baldwin Park	84.25	84.27	5.4	78	Claimed four substitutes (0.78, 0.78, 1.92, & 1.92—having no records in iSIStrac).
Capistrano	5.75	5.76	0	5	
Wm. S. Hart	49.44	49.44	0.48	49	Claimed area supervisor with no iSIStrac records (0.48)
Total			25.24		

Source: Auditor generated utilizing data from OFL and the SB 740 forms.

The OFY's chief financial officer acknowledged the mistake in including the counselors in the FTE ratios and offered to recalculate and resubmit the SB 740 forms. However, the inclusion of the counselors did not have a material effect on OFY's pupil-to-teacher ratios and had no effect on OFY's final funding amounts – unlike the rounding errors and inaccurate comparison district pupil-to-teacher ratios.

Opportunities for Learning

The issues found at OFL were more significant. As detailed in Exhibit 4-9, (see previous page) OFL lacked support for 21 FTEs it claimed in 2002-03 and also claimed 25 questionable FTEs for teachers. Specifically, OFL claimed administrators as FTE in 2002-03 and claimed several substitutes and floater teachers in the following two years. Among some of the OFL staff charged to FTE included two FTEs each (for a total of four) for Mr. and Mrs. Hall in FY 2002-03. The Education Management Systems controller told us that OFL made this claim because the Halls spent the entire year developing curriculum for the schools. However, state law provides that teachers must provide direct instruction to students to be claimed as a FTE for the pupil-to-teacher ratios.

Moreover, OFL included three auditors as FTEs (ranging from 1.78 to 1.92) in their calculation for the three years reviewed. The rationale was that these auditors also provided direct instruction to students. Although the audit team did not make an adjustment for these auditors because OFL also listed them as teachers, the audit team could find no records for some of these auditors claiming ADA for any students they may have had assigned to them, so it is possible that any direct instruction may have been as a substitute teacher. In fact, two of the three OFL charters included substitute and “floater” teachers in their FTE calculations. According to OFL's director of finance, the position, rather than the teacher, should be the measure of FTE status. However, the audit team reviewed the employment files for five of the six substitute teachers hired on March 29, 2004 — only 17 days before OFL took its “norming day” count — and found that all five teachers were substitutes hired on a temporary, “on call” basis, from the OFY charter schools, and who were subsequently dismissed between three and ten months later due to “the lack of work.” The OFL claimed all of these teachers at a 1.92 rate; however, in these cases, it seems irrelevant whether a position or a person is counted—neither supports the inclusion of a 1.92 rate. Furthermore, this is contrary to the CDE's Instructions for Ratio Calculations, which requires charters to calculate FTE using the total number of certificated teachers and FTE — certificated teachers who directly provided instruction to all pupils whose ADA was reported to the CDE.

Exhibit 4-10 (see next page) shows the impact on the pupil-to-teacher ratios of removing these questionable staff from FTE. The exhibit also shows that OFL overstated the pupil-to-teacher ratios for the largest unified school district comparisons in both 2002-03 and 2003-04. Finally, OFL appears to have rounded incorrectly in its FTE/pupil-to-teacher ratio calculations. The result of these errors indicates that OFL may have been overpaid more than \$3.6 million from the state for the three years reviewed.

Exhibit 4-10
Opportunities for Learning May Have Been Overpaid More Than
\$3.6 Million Due to its Pupil-to-Teacher Ratio Calculations

	Pupil-to-Teacher Ratios					Amount of Recommended Apportionment Disallowance
	Claimed on SB 740	Actual Based on Support Provided and Proper Rounding	Auditor Calculated After Receiving Disallowed FTE (Must Round Down)	Largest Unified School District		
				OFL Claimed	Auditor Verified Ratios	
2002-03						
Baldwin Park	23	26	27	26	21	\$1,183,641
Capistrano	12	15	15	29	N/A	
Wm. S. Hart	18	22	23	26	21	718,441
2003-04						
Baldwin Park	24	23	29	26	22	\$1,539,720
Capistrano	14	14	14	29	N/A	
Wm. S. Hart	20	19	20	26	22	
2004-05						
Baldwin Park	21	21	22	25	25	
Capistrano	18	20	20	25	25	
Wm. S. Hart	25	26	26	25	25	\$194,935
Total						\$3,636,737

Source: Auditor-generated exhibit using data from OFL, the SB 740 forms, and the comparison districts.

California Charter School Group

The CCSG may have been overpaid nearly \$1.1 million in state funding because of rounding errors, inclusion of one unallowable teacher in its FTE, and comparisons to incorrect pupil-to-teacher ratios for the largest unified district. Exhibit 4-11 and Exhibit 4-12 (see next page) detail the findings for CCSG for 2002-03 and 2003-04, the last year of operation for CCSG.

**Exhibit 4-11
California Charter School Group Claimed Only
One Questionable Teacher from Fiscal Year 2002-03 Through 2003-04**

	FTE Claimed on SB 740	FTE Per Support Provided to Audit Team	Questionable FTE Recommended to be Disallowed	Auditor Calculated FTE (at 1.92 rate) Rounded Properly (Down)	Reason for Recommending Disallowance of FTE
2002-03					
Hacienda La Puente	59.52	54.9	1	53	Claimed floater teacher with no iSIStrac records (1.0).
2003-04					
Hacienda La Puente	55.2	55.2	0	55	
2004-05					
Hacienda La Puente	Not Applicable				
Total			1		

Source: Auditor-generated exhibit utilizing data from CCSG and the SB 740 forms.

**Exhibit 4-12
The California Charter School Group May Have Received \$1.1 Million More Than It Was Entitled to Due to Its Pupil-to-Teacher Ratio Calculations**

	Pupil-to-Teacher Ratios					Amount of Recommended Apportionment Disallowance
	Claimed on SB 740	Actual Based on Support Provided and Proper Rounding	Auditor Calculated After Receiving Disallowed FTE (Must Round Down)	Largest Unified School District		
				CCSG Claimed	Auditor Verified	
2002-03						
Hacienda La Puente	20	21	22	26	21	\$388,189
2003-04						
Hacienda La Puente	25	25	25	26	22	\$770,669
2004-05						
Hacienda La Puente	Not Applicable					
Total						\$1,158,858

Source: Auditor-generated exhibit utilizing data from CCSG and the SB 740 forms and the comparison districts.

Recommendations

To determine the proper methodology for calculating FTE, OFY and OFL should either:

- Seek a swift resolution of their FTE-related lawsuit against the state.
- Attempt to establish a common understanding with the state regarding the rules for calculating FTE.

To improve their controls and practices over the calculations of FTE and pupil-to-teacher ratios, OFY and OFL should establish appropriate monitoring and review of funding determination worksheets to ensure that they:

- Calculate FTE in accordance with established rules utilizing proper rounding techniques.
- Maintain adequate support for FTEs claimed.
- Claim only allowable FTE staff.
- Do not include substitutes in FTE.
- Do not report FTE staff multiple times for a given year.
- Obtain accurate reports of the pupil-to-teacher ratios for the largest unified school districts (if applicable).

To ensure that OFY and OFL have received an appropriate amount of funding, and are using a proper methodology for calculating FTE, CDE should:

- Seek a swift resolution to the FTE-related legal action by OFY and OFL.
- Attempt to establish a common understanding with OFY and OFL regarding the rules for calculating FTE.
- Consider seeking reimbursement or withholding funds for any FTE-related overpaid revenue as determined by the court's ruling.
- Make a determination regarding whether to seek reimbursement or withhold funds for the potentially overpaid funds related to the unallowable teachers included in the FTE counts and the improper FTE and pupil-to-teacher ratio calculations identified in this chapter.

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Chapter 5: Student Attendance Records

In its review of student attendance records at the OFY, OFL and CCSG charter schools, the audit team found that OFY overclaimed 32, OFL overclaimed 529, and CCSG overclaimed 438 attendance days pertaining to the 2003-04 school year. The audit team found that these attendance days were inappropriately claimed for various reasons, such as for coursework not included in the student agreements, attendance that took place prior to the agreement date, and the lack of sample work products in the student files. As summarized on Exhibit 5-1, the state overpaid OFY by \$703, OFL by \$11,665, and CCSG by \$9,934.

Exhibit 5-1
Summary of Student Attendance Days Overclaimed
by Charter Schools for the 2003-04 School Year

Charter School	Number of			Dollar Amount Resulting from Overclaimed Student Attendance Days
	Files Tested	Student Files with Errors	Overclaimed Student Attendance Days	
OFY-Burbank	75	4	18	\$385.62
OFY-Mount Shasta	18	1	6	136.08
OFY-San Gabriel	21	2	8	181.44
OFY-San Juan	15	0	0	0.00
OFY-Upland	21	1 ^a	0	0.00
OFY-Victor Valley	18	0	0	0.00
OFY Subtotals	168	8	32	\$703.14
OFL-Baldwin Park	47	9	186	\$4,218.48
OFL-William S. Hart	38	11	323	6,992.74
OFL-Capistrano	8	1	20	453.60
OFL Subtotals	93	21	529	\$11,664.82
OFL-Hacienda-La Puente	74	12	438	9,933.84
CCSG Subtotals	74	12	438	\$9,933.84
Totals	335	41	999	\$22,301.80

^a See footnote on next page for explanation regarding this error.

Note: The audit team also tested up to ten OFL and OFY student files for the 2002-03 and 2004-05 school years. The audit team did not find any student attendance days that were inappropriately claimed for these two years.

Exhibit 5-1 also shows that 967 out of 999 overclaimed attendance days pertain to OFL schools (including CCSG's OFL-Hacienda-La Puente). In addition, based on the files reviewed, the audit team did not identify any student file errors and inappropriately claimed days for two OFY charters.

Under California State law, charter schools calculate ADA based on the number of instruction days and actual attendance days, and report the amounts to the CDE at three specific intervals during the school year. The State Superintendent of Public Instruction apportions

state and local school funds to each school based on the data reported. Charter schools like OFY and OFL that have programs involving independent study or nonclassroom instruction, undergo an additional assessment to determine whether the charter schools are funding instructional and certificated staff at minimally accepted levels. Charter schools that do not meet the acceptable levels of staffing receive reduced funding.

To receive ADA apportionments, an independent study program must comply with attendance reporting, student file maintenance requirements, and student-teacher ratios outlined in the California Education Code and California Code of Regulations. For example, Section 51747 of the California Education Code requires that a school district have policies in place for creating independent study contracts (student agreements) that describe the work students will perform and the criteria for earning course credits for that work. Section 11703 of Title 5 in the California Code of Regulations requires that student records also contain a daily or hourly attendance register. Charter schools claim attendance days for students based on the work credits completed and attendance earned. The charter schools must maintain sufficient records of completed student work to justify the attendance claims made for apportionments. The state can disallow ADA apportionments for attendance days claimed that do not comply with these laws and regulations. To ensure compliance with attendance reporting and student file maintenance requirements, OFL and OFY perform annual internal audits of their student files. At the end of the school year, the teachers at each charter devote several days to reviewing the students' files. Although these audits help identify errors in the student files, the audit team still found numerous errors in the files that caused the charters to claim inappropriate ADA apportionment.

Student Agreements and Course Listings

The OFL charter schools (including CCSG's OFL-Hacienda La Puente) inappropriately claimed 938 attendance days in the 2003-04 school year pertaining to 31 students who completed courses that were not included in their agreements. Similarly, OFY charter schools inappropriately claimed eight days for two students during the same year.²³ Section 51747(c)(6) of the California Education Code requires that a student agreement include "A statement of the number of course credits or, for the elementary grades, other measures of academic accomplishment appropriate to the agreement, to be earned by the pupil upon completion." Although there is a specific area on the student agreement designated for such information, the student agreements for 33 students above did not list the specific courses for which the charter school claimed attendance days.

According to some charter school teachers, it is not unusual for teachers to add course names to the student agreements after the student completed a course or after a semester

²³ The OFY-Upland also claimed attendance days for a student whose coursework was not included in the student agreement. However, since the student was in a home study program and because attendance was not recorded by work product, the team was unable to determine exactly how many days the charter school inappropriately reported.

has already started, rather than at the time the agreement is signed. The audit team was unable to determine the prevalence of this practice at the schools, because teachers do not include the date of each course entry written into the student agreements.

Student Work Product

The OFL-Hacienda La Puente claimed 24 attendance days for a student and OFY-Burbank claimed eight attendance days for another student even though the files for these students did not contain samples of work products pertaining to the attendance claimed. Title 5 of the California Code of Regulations, Sections 11703(b)(3) and 16026, require that representative samples of each pupil's work be maintained for a minimum of three years. Moreover, the lack of a work sample raises questions about the validity of the student's actual participation in the subject lacking the work sample.

Attendance Records

The audit team also found that OFL-Hacienda La Puente overclaimed five attendance days for a student and OFY-Burbank overclaimed a total of ten attendance days for four other students because the organizations overreported these amounts in their attendance reporting systems. In each case, the handwritten attendance records identified fewer days of attendance than the number of days recorded in the Regular Work Assignment document used to generate attendance figures in the attendance reporting system. According to Section 47612.5(a)(2) of the California Education Code and Section 11703(b)(4) of Title 5 of the California Code of Regulations, school sites must maintain contemporaneous records that document all pupil attendance. The organizations are not justified in claiming attendance days for dates that are not specified in their attendance records.

Student Agreement and Student Start Dates

The OFY-Mount Shasta inappropriately claimed six attendance days for a student because these days preceded the starting date of the student's agreement. According to Sections 46300.7 and 51747(c)(8) of the California Education Code, students' written agreements for independent study must be signed by the student, the student's parents, and responsible charter school employees before a school is able to claim credit for student attendance. Any days outside of the agreement dates are not eligible for state funding.

While reviewing the student files at the schools, audit team members observed some student agreements that contained handwritten dates accompanying the signatures that were written in different handwriting styles and in different colors of ink from those of the actual signatures. Based on these inconsistencies, it appears that the dates may have been added to the agreements subsequent to the signatures, which raises concerns about the timing and authenticity of the signatures. The signing of a student agreement is intended to represent an up-front agreement by the student, parent, and school to adhere to the school's policies for completion of work assignments and earning of attendance credit. The integrity of the independent study process is in question when there are instances in which agreements do not appear to be signed in advance.

Options for Youth External Auditor Findings

The OFY hired a public accounting firm to conduct external audits of the OFY attendance accounting procedures at two charter schools for FY 2001-02. The accounting firm tested a random sample of 33 students at an OFY-Upland charter school site, and 25 students at an OFY-Victor Valley charter school site. Findings from these audits, both issued October 8, 2003, were similar to the audit team's findings described in this chapter. Some of the similarities included the following:

- Five OFY-Upland contracts tested were missing a statement regarding the minimum number of credits earned.
- One OFY-Upland homework sample tested was not signed by the teacher. Instead, a credit label is affixed to the student agreement at the end of the contract period. For OFY-Upland and OFY-Victor Valley, there are no courses listed on the student agreement at the beginning of the agreement period. However, to their credit, OFY schools subsequently discontinued the practice of using the credit labels. Starting in January 2004, the schools have been hand writing the course names in the student agreements prior to the agreements being signed.

Recommendations

To ensure compliance with state requirements for independent study and charter school apportionments, OFL, OFY, and CCSG should do the following:

- Reimburse the state for funds received as a result of the overclaimed attendance days identified in this chapter.
- Establish processes at the schools to ensure that staff include all courses in the student agreement before the beginning of each semester, rather than during the semester or after a student completes a course.
- Ensure that the student agreements are signed and dated prior to the first day that students are enrolled and that attendance days are not claimed outside of the agreement dates.
- Ensure that attendance records are maintained in the student files and properly support the number of attendance days claimed.
- Include samples of work products in all student files to justify the independent study attendance days claimed for state funding.
- Strengthen the practice of conducting annual internal audits of student files.

Finally, OFY and OFL should report their progress in addressing this report's recommendations to the each of the charter-authorizing entities, the appropriate county offices of education, and the CDE every six months until all recommendations have been fully addressed.

Appendix A

Summary

In March 2005, at the request of the State Superintendent of Public Instruction, the California Department of Education and the county offices of education in Los Angeles, Orange, Sacramento, San Bernardino, and Siskiyou counties, initiated an audit of the fiscal and administrative conditions of the OFY and OFL charter schools. The FCMAT contracted with MGT to perform this audit of the charters. The audit request required that the audit team perform tests to ensure that the charters were complying with independent study requirements and to determine whether the charters had engaged in related-party transactions with vendors or contractors. To accomplish these goals, the audit team agreed to perform tasks such as investigating the charters' administrative expenses, certificated staff and instructional expenses, and calculations of pupil-to-teacher ratios to ensure that amounts were accurate, compliant with state laws and regulations, and did not result in overclaimed revenues. The audit team's multi-faceted approach to completing the tasks outlined in the audit work plan is documented in this appendix, with a detailed description of the tasks completed by the audit team in meeting the audit's objectives.

Audit Limitations

The audit team's scope was restricted to the OFY, OFL, and CCSG schools, limiting the audit team's ability to access documentation and information held by other entities such as OFY, Inc., OFY-CA, Inc., Pathways in Education, Inc., Education Dynamics, Inc., Partners in Special Education, Inc., and R3 Learning Solutions, LLC. Given the prominent roles sometimes played by these organizations in the charter schools' operations and finances, the audit team was unable to determine the full effects of selected transactions.

Impairment of Auditors' Independence

One of the most important audit standards is that of independence. In all matters relating to the audit work, the audit organization and the individual auditor should be free from external impairments to independence. External impairments to independence occur when auditors are deterred from acting objectively and exercising professional skepticism by pressures, actual or perceived, from management and employees of the audited entity. In such cases, the auditors may not have complete freedom to make an independent and objective judgment and the audit may be adversely affected.

On more than one occasion, an officer from OFL directly and indirectly threatened litigation due to disagreements related to the audit. The threat of litigation constitutes grounds for reporting a potential impairment to the independence of the audit imposed by the management of the audited entity. However, despite the attempts by the officer to influence the audit team, the independence of the audit team and the audit report was not compromised in this case. While the audit team took into consideration issues and concerns raised by

officers of OFL and OFY, the audit team did not allow the threats of litigation to affect its professional judgment or unduly affect the findings included in the audit report. In addition, as indicated by the responses from OFY and OFL, the entities withheld information from the audit team. As such, the audit team has concerns that the entities were not entirely forthcoming with information. This audit report represents the audit team's findings uncovered during a thorough review of available information, including all information provided by the entities during the course of the audit.

Audit Standards

The audit was conducted in accordance with generally accepted government auditing standards promulgated by the Comptroller General of the United States. These standards pertain to the auditor's professional qualifications, the quality of the audit effort, and the characteristics of professional and meaningful audit reports. Specifically, the audit followed the general standards pertaining to qualifications, independence, and due professional care. The standards pertaining to conducting the audit fieldwork and preparing the audit report were also followed. By following these standards, the audit team ensured the independence and objectivity of the audit team, the analysis, and the resulting findings and recommendations offered in this report.

Information Gathering

In general, MGT utilized a number of approaches to obtain the necessary information to accomplish audit objectives. To develop an in-depth understanding of the issues and potential outcomes pertaining to each task, the audit team interviewed current and former employees and board members. To identify concerns among the local community regarding the charter schools' business operations, the audit team developed a Web site to solicit information from the public regarding current and past concerns related to the charter schools. The audit team conducted further investigation of those allegations falling within the audit's scope.

Detailed Scope and Methodology

Investigate Compliance with Independent Study Requirements

The counties and the CDE asked the audit team to determine whether the OFY, OFL, and CCSG charter schools comply with independent study requirements. To the extent that the charters did not comply, the audit team attempted to quantify the amount of attendance revenues that the charters may have inappropriately claimed from the state.

To determine whether the charters complied with independent study requirements, the audit team conducted on-site reviews at 16 of the 31 OFL school sites and 17 of the 29 OFY school sites. The audit team's selection of school sites was designed to include at least one site from each of the ten charter schools. The audit team randomly selected between 8 to 16 student files for testing at each school site. In total, the audit team tested 168 student files at OFY schools and 167 student files at OFL schools.

The audit team selected 298 of the 328 files tested from the 2003-04 school year because the audit team's scope was initially limited to transactions occurring for this year. Subsequently, when the requestors expanded the audit team's scope to include school years 2002-03 and 2004-05, the audit team performed tests of an additional 13 student files from 2004-05 and 17 from 2002-03. The audit team's tests on the 2004-05 files focused on students 19 years of age or older and determining whether issues identified in the initial tests were mirrored in the subsequent year's files.

The audit team's purpose in reviewing student files was to do the following:

- Determine the number of school days in which the students engaged in required educational activities that met the state criteria for a qualified attendance day.
- Verify that the student files contained signed written agreements with all of the required elements.
- Verify that the charters were not reporting days of attendance for dates occurring prior to the date that all parties signed the independent study agreement or for dates that occurred after the last day covered by the agreement.
- Verify that a certificated employee of the charter school coordinated, evaluated and provided general supervision of the students' independent study.
- Verify that the work completed was consistent with the assignments outlined in the independent study agreement.
- Verify that evaluated samples of pupil work were included in the file, related to specific assignments, and that the supervising teacher had signed or initialed and dated their review.
- Verify that students who were more than 19 years of age had been continuously enrolled.
- Verify that the charters were not claiming more than one day of attendance per day for any pupil.

To determine whether the charter schools had appropriately claimed daily attendance for students whose files it reviewed, the audit team compared the student agreements, regular work assignments, and work product samples with attendance records and records of credits earned. For those days that the audit team determined that charters had inappropriately included in their ADA totals, the audit team calculated the effect these overstated days had on the charters' funding and the dollar amount of overclaimed revenues.

Investigate Related-Party Transactions

The requestors asked the audit team to determine whether the charter schools had engaged in related-party transactions, either between the charter school entities or with other related

entities, including businesses that provided goods and services to the schools, either directly or indirectly. To the extent that such transactions had occurred, the requestor asked the audit team to quantify the effects, and specifically the extent to which the charter schools or other entities had used state funds to illegally or improperly benefit principals, officers, or other key personnel. The requestors also asked the audit team to review transactions with Pathways in Education, regardless of the year.

To determine whether related-party transactions existed, the audit team first identified the location and availability of source documents, especially those pertaining to contracts and agreements between the charter schools and contractors or vendors providing goods and services. The audit team obtained documentation for transactions occurring between and within the OFY, OFL, and CCSG organizations. However, because the audit team's scope limited it to the OFY, OFL, and CCSG schools, it was unable to always access documentation held by other related entities such as OFY, Inc., Education Management Systems management companies, OFY-California, Education Dynamics, Inc., Partners in Special Education, Inc., and other organizations of interest, such as Pathways in Education, Inc. and R3 Learning Solutions, LLC.

In selecting transactions for testing, the audit team first identified the charters' major vendors; specifically, vendors who had transactions totaling \$50,000 or more with the OFY, OFL, or CCSG charter schools between 2002-03 and 2004-05. The audit team focused on vendor payments and check requests made on behalf of the school and on behalf of the OFY, OFL, and CCSG organizations as a whole. The audit team identified 64 major vendors for OFY, 23 for OFL, and 8 for CCSG. The audit team included transfers made between OFY, OFL, or CCSG schools or charters in its testing of major vendors. The audit team verified the information charters reported in their check registers by comparing the registers to the schools' SB 740 funding determination forms and invoices.

For each major vendor identified, the audit team performed research to identify the vendor's owners, board members, executive management, and majority stakeholders. The audit team conducted this research using several sources, including Secretary of State Corporation filings for several states, Lexis-Nexis, invoices reviews, interviews with staff, on-site visits, and Internet searches.

The audit team obtained lists of past and present officers, board members, and key stakeholders for the OFY, OFL, and CCSG organizations. The audit team verified the information the charters provided by reviewing correspondence attached to school funding determination forms and board minutes. Similar to the research performed of major vendors, the audit team conducted research to determine these individuals' other business relationships and potential conflicts of interest. The audit team obtained and documented OFY, OFL, and CCSG bylaws and operating agreements to better understand the board selection process and the authority held by the positions investigated.

The audit team compared the lists of major vendors, interested parties, and charter officers and directors to identify possible related parties, vendors for whom one or more representatives or key stakeholders appeared to have had pre-existing relationships with one or more of the charter school representatives. To the extent possible, the audit team also identified connections via spouses, family members, other relatives, and friends. The audit team reviewed charter school employee rosters and other personnel documents and attempted to identify situations where Hall family members were employed by or had an ownership stake in the major vendors doing business with the charter schools.

For the possible related-party vendors or employees it identified, the audit team next determined each individual's roles and responsibilities to evaluate the extent of the influence they may have had over contracting, purchasing, and hiring decisions. Further, to gain an understanding of the nature of the transactions between the charter schools and these individuals, the audit team categorized selected transactions for major vendors by the types and categories of goods and services provided. To the extent available, the audit team also obtained and reviewed contracts, written agreements, and correspondence. Additionally, the audit team tested a nonstatistical sample of invoices for these vendors. The audit team reviewed employee job descriptions, compensation rates, and employment agreements. The audit team tested transactions to determine whether they were properly initiated and approved by the board, sufficiently documented, and that the expenditures for goods or services were reasonable and necessary for the charters' operations. The audit team sought clarification from the charter schools when the information was either unavailable or unclear, requesting that the charters provide an explanation and/or source documents.

For each vendor and employee contract it reviewed, the audit team determined if the charters had followed established procurement guidelines and whether these guidelines were proper and had sufficient internal controls governing the transactions. Specifically, the audit team did the following:

- Reviewed board minutes and decisions to determine whether the board had approved the contract.
- Determined whether the charters had documented evidence that it had received the goods or services.
- Reviewed invoices and other source documents to verify whether the vendors had provided these items in accordance with contract terms.
- Assessed whether expenditures for goods and services and compensation levels appeared reasonable and necessary for the operations of the charter school.
- Evaluated whether the charters had properly disclosed related-party transactions by reviewing charter school governing board decisions and evaluating the extent of the disclosures for appropriateness within state law.
- Reviewed the methodology and approach used by the boards in establishing the criteria for fair market value.

In addition to reviewing state laws regarding conflicts of interest, the audit team also reviewed the appropriateness of OFY, OFL, and CCSG conflict-of-interest policies and procedures. For each charter school, the audit team tested whether the school's governing board implemented and adhered to established procedures by reviewing the procedures followed in awarding contracts to vendors and in hiring Hall family members.

Investigate Charter School Administrative Expenses Paid

To determine whether disparities exist in the administrative personnel and operating resources assigned to each school and the costs associated with these resources, the audit team calculated the amount of administrative expenses charged to each school. Because Education Management Systems' administrative expenses are included in its contracts with the OFL charters, the audit team reviewed general ledger entries and check history reports to determine if these expenses matched amounts in the contracts. The OFY, Inc. lacks contracts with OFY schools and does not calculate a set amount per month, per school. Therefore, the audit team had to estimate the costs of administrative services for OFY schools. In doing so, the audit team first requested that OFY, Inc.'s chief financial officer provide an estimate of these costs. The audit team tested this estimate by analyzing revenues reported on tax returns, amounts received from Education Management Systems and other non-OFY entities reported in the general ledger, and then dividing the remainder of the revenue by the number of OFY centers in operation. The audit team found that this estimate generally compared with that provided by the OFY, Inc.'s chief financial officer. The audit team could not evaluate the operating resources assigned to each charter because it did not have complete access to OFY, Inc.'s and Education Management Systems' information.

To compare OFY, Inc.'s and Education Management Systems' administrative costs, the audit team calculated a monthly amount attributable to each OFY learning center. The audit team determined the services provided by both OFY, Inc. and Education Management Systems to their respective schools to ensure that the comparison between the two would be on the same basis. The audit team included in the OFY average monthly rates that amount of fees charged for Education Dynamics, Inc. services. The audit team evaluated OFY, OFL, and CCSG cost allocation methodologies by comparing services and costs within and between the charter systems to determine their reasonableness and to test for disparities. The audit team requested explanations for any discrepancies.

Investigate Certificated Staff and Instructional Expenses

The audit team performed work to test the accuracy of OFY, OFL, and CCSG reported amounts of certificated staff compensation and instructional costs compared to the amount of total public revenues and total revenues for the 2002-03 through 2004-05 school years. The audit team used each charter school's SB 740 funding determination forms to identify the ratio of certificated staff compensation to the amount of total public revenues for each school year that the charters reported to the state and the ratio of instructional costs to total revenues. The audit team traced amounts reported by the charters to supporting financial

records to determine whether the charters had accurately reported and classified these amounts. The audit team also summarized the charters' general ledgers to verify the numbers reported by the OFY, OFL, and CCSG schools on the SB 740 funding determination forms.

To test whether charters were in compliance with credentialed teacher salary and instructional cost requirements, the audit team tested expenditures reported in these categories. For each of the fiscal years reviewed, the audit team selected between two to 18 transactions from each charter's general ledger and verified that these entries were adequately supported by source documents and had been accurately recorded and categorized. In total, the audit team selected 88 transactions for OFY, 90 for OFL, and 22 for CCSG from 2002-03 to 2004-05 school year. The audit team also randomly selected dozens of invoices from vendor files for each charter and year and tested to ensure these had been reported accurately in the general ledger and correctly categorized in the charters' SB 740 funding determination forms.

The audit team compared amounts reported in the charters' funding determination forms (SB 740s), audited financial statements, and general ledgers or supplemental information to ensure that the reported amounts matched the amounts in the internal documentation. Using verified amounts, the audit team recalculated certificated staff and total instructional cost percentages using the state-approved methodology and formulas. To the extent that the audit team found that these ratios fell below the state threshold for funding, the audit team calculated the amounts of revenues that the charters overclaimed from the state. As part of its review, the audit team investigated bonus accruals by the charters. To determine whether the OFL methodology for awarding and paying bonuses and incentives to its teachers was reasonable, the audit team reviewed the OFL's bonus calculation criteria. The audit team held discussions with OFL fiscal staff to determine how OFL awards discretionary bonuses to its employees. The audit team also reviewed OFL's general ledger for a three-year period to gain an understanding of total bonuses paid and accrued during FYs 2002-03 to 2004-05.

To determine whether the OFY methodology for awarding and paying bonuses and incentives to its teachers was reasonable, the audit team reviewed OFY's general ledger for FYs 2003-04 and 2004-05 to gain an understanding of total bonuses paid and accrued during these years. The audit team held discussions with OFY fiscal staff and reviewed selected journal entries and bonus calculation worksheets to determine how OFY awards bonuses and incentives. Finally, the audit team compared total bonuses paid to OFY staff to salaries to determine the reasonableness of the amounts that were paid.

Investigate Pupil-to-Teacher Ratios

The requestors asked the audit team to verify the OFY/OFL calculations of the ratio of independent study teachers to ADA generated through full-time independent study pursu-

ant to *Education Code* Section 51745.6, Title 5, California Code of Regulations, Section 11704, and the Instructions for Ratio Calculations published by the Independent Study Office at the CDE. Moreover, the requestors asked the audit team to perform alternate procedures to validate the accuracy of the calculations. For example, the audit team was asked to recalculate charter FTEs by testing the start and end dates for teachers to determine the amount of time worked by all teachers during a school year.

The audit team tested the accuracy of the OFY, OFL, and CCSG calculations of the ratio of independent study teachers to average daily student attendance generated through full-time independent study pursuant to state law. The audit team first identified each charter's P-2 classroom-based ADA, FTEs, and pupil-teacher ratios reported in audited financial statements, SB 740 funding determination forms, and in internally generated tracking documents, as applicable. The audit team verified the pupil-to-teacher ratios of the largest unified school district in the counties in which the charters operated in FYs 2002-03 and 2003-04 by contacting staff at these districts to obtain their information. For one district that did not respond to the audit team's request for information, the audit team calculated the pupil-to-teacher ratio using the ADA and FTE information this district provided to CDE. For FY 2004-05, the audit team did not verify pupil-to-teacher ratios since the charters were using the maximum ratio of 25-to-1.

To determine whether the charters were reporting only credentialed teachers as FTEs, the audit team reviewed a sample of teachers' files and verified credential and employment start and end dates. The audit team's initial tests were limited to a sample of 100 teachers the OFY, OFL, and CCSG charters had listed on their school year 2003-04 employee rosters. Upon the expansion of the scope to include school years 2002-03 and 2004-05, the audit team tested additional teacher files to the extent that the audit team had not already reviewed these teachers' records in the initial sample. The audit team also focused on teachers the charters had reported as FTEs but who had no student records in the iSIStrac system, and those teachers whose employment hire date fell close to the charters' "norming" date, suggesting potential FTE inflation. When the audit team noted discrepancies, it requested additional information from the OFY, OFL, and CCSG charters. To the extent that the charters could not provide adequate explanations and support, the audit team excluded these teachers and recalculated the FTE counts and pupil-to-teacher ratios.

Average Daily Attendance Testing

To verify the accuracy of ADA reported by the charters, the audit team summarized student data reported in iSIStrac records for FYs 2002-03 to 2004-05 and compared this to ADA the charters reported in audited financial statements and on funding determination worksheets, and subsequently, reported to the state. The audit team was able to reconcile its calculation of ADA from iSIStrac records to reported amounts, thereby establishing that the iSIStrac records were complete.

The audit team summarized iSIStrac data to determine whether OFY, OFL, or CCSG had claimed ADA for students who were age 23 or older during fiscal year 2004-05. The audit team also used the iSIStrac records to determine whether the charters had claimed ADA for students age 20 or older and who had not been continuously enrolled since they were age 19. To the extent that these students had not been continuously enrolled, the audit team calculated the amount of overclaimed ADA OFL or OFY had submitted on behalf of these students. The audit team found that the charters had claimed ADA for some of these students. However, because the amount claimed was immaterial, the audit team did not pursue this further. The audit team also summarized the iSIStrac records to determine whether OFL or OFY had claimed more than 175 days of work for any students and to ensure that ADA claimed was the lesser of days attended or documented days of work product produced. The audit team did not have any material findings from this work.

Full-Time Equivalent Testing

To determine the reasonableness of the 1.92 rate for FTEs used by the charters, the audit team calculated the FTEs and number of FTEs needed based upon the ADA claimed by each of the charters. Because one ADA in the independent study program is typically generated by a student attending class for two hours per week for an average of 35 weeks, each ADA would require 70 hours of teacher time/direct instruction. Thus, multiplying the ADA claimed by 70 gives the total number of hours of direct instruction needed to generate the ADA claimed. Dividing this total of ADA hours by the number of FTEs claimed gives the hours per FTE. Then, dividing the hours per FTE by 875 hours (which is the number of hours used by the OFY and OFL charters as a base for a standard teacher in calculating the 1.92 rate) provides a FTE factor to test the reasonableness of reported FTEs by the charters.

Moreover, the 1.92 rate assumes that OFY, OFL, and CCSG teachers are providing 1,680 hours of direct instruction per year. At 70 hours of instruction per year per ADA, teachers working 1,680 hours in a year should thus be able to generate 24 ADA per year. The audit team therefore tested the charters' FTE calculations by dividing total ADA claimed by 24 to determine the number of FTEs (at the 1.92 rate) needed to generate the claimed ADA. To the extent that this was lower than the FTEs claimed by the charters, the audit team observed that the FTEs claimed may be inaccurate.

The audit team also evaluated the reasonableness of OFY, OFL, and CCSG FTEs claimed by recalculating FTEs using several methods. First, for each charter school, the audit team used data reported in the iSIStrac records to create FTEs based on "days worked." The audit team matched school tracks and months covering the same time periods. For example, in FY 2002-03, the time period of December 16, 2002

Tracks and months corresponding to the period of December 16, 2002 through January 10, 2003

- Track A, Month 7
- Track B, Month 5
- Track C, Month 4
- Track D, Month 5
- Track E, Month 3

Source: OFL and OFY school calendars.

through January 10, 2003 covered five track months (see insert). Therefore, when looking at teachers' work history, the audit team collapsed all the student records found for a particular teacher in those tracks and months into one number. For each of the unique time frames identified through the comparison of the school calendar, the audit team also noted the total possible school days during that time period. The period of December 16, 2002 to January 10, 2003 had 12 school days (after weekends and holidays were excluded), so 12 would be the most days that a teacher could have worked during that time frame.

The audit team summarized iSIStrac records by teacher and time period worked, calculating the maximum possible days that a teacher could have worked based on the student records and time frames associated with each teacher in the iSIStrac system. The audit team considered this a conservative methodology because teachers received credit under this methodology for working every day for the periods in which they had student records, and credit for every hour of each day worked. This was done because iSIStrac records provided information on the number of students seen and attendance for those students, but contained no data on total days worked by teachers. Consequently, under this methodology, even if a teacher worked only one day during a particular time period with 12 possible days in it, the teacher was given credit for having worked all 12 days rather than just the one. This methodology represents the upper boundary of the maximum days a teacher could have worked.

The OFY, OFL, and CCSG charters require teachers to work 240 days per year, 7 hours per day (1,680 hours per year). To calculate the FTE associated with each teacher, the audit team used the maximum possible days worked (based on the summary of iSIStrac data) and multiplied this by 7 (the number of hours per day the schools require teachers to work). Dividing calculated hours worked by the total required hours per year (1,680 hours per year) gives the FTE attributable to each teacher. For example, if the iSIStrac summary showed that a teacher could have worked 160 possible days during the year, the teacher's FTE count would be 0.67.

160 days X 7 hours per day = 1,120 total possible hours worked
 1,120 possible hours ÷ 1,680 required hours = 0.67 FTEs

The audit team's second methodology used teacher employment data as verified by iSIS-trac records to calculate FTEs under the "start and end dates" methodology. The audit team tested teacher hire and termination dates against records in the iSIStrac system. To the extent that the records indicated that a teacher had not worked for the entire year, the audit team reduced the FTE attributable to that teacher by the percentage of time that the teacher had no student records. The audit team did not assign FTEs to teachers the charters had reported as FTEs but for whom no student records were found. Conversely, for teachers who the charters had not claimed as FTEs, but who did have student records, the audit team assigned a proportional amount to that teacher based on the amount of time he or she had worked. The audit team then summarized total FTEs by charter and year.

Because CDE attorneys opined that the 1.92 FTE rate the charters claim for full-time teachers is not reasonable, the audit team calculated the amount of overclaimed revenues by converting the FTEs claimed by the charters to a 1.0 scale. The calculation of funding for each charter is dependent on three primary factors: the pupil-to-teacher ratio of the charter, ADA, and FTEs. The audit team recalculated the amount of funding that each charter would have received using the state's method by determining each charters' allowable ADA using revised pupil-to-teacher ratios calculated from the adjusted FTEs. Next, using allowable ADA counts, the audit team calculated allowable funding by multiplying ADA, grade-level percentages, and categorical block or general purpose grant funding rates for each year. The audit team used grade level percentages reported by each charter in their iSISTrac records because categorical block grant and general purpose grant amounts vary based on the student grade levels.

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Appendix B

Major Vendors (>=\$50,000)			Summary
64	23	8	OFY, OFL, and CCSG Major Vendors 2002-03 through 2004-05
OFY	OFL	CCSG	Vendor Name
x			Academic Book Services, Inc.
x			Amazon.Com Corporate Credit
x			American Express
x			American Guidance Srv., Inc.
	x		AP - Palmdale III, LLC
x			Apple One
	x		Baldwin Park Unified School District
		x	Bank of the West
	x		Bar Triple R
x			Birtcher Anderson Properties
	x		BP, LLC
x			Burbank Unified School
x			Business Computing, Inc
	x		Business Properties Partnership (#18 & #19)
x			California Office Sys Inc.
x			Calvert School
	x		Capistrano LLC
x	x		CDW Government, Inc.
		x	Centers Business Management
x			Datalinknetworks
x			David Buchan Business Consulting
x			Del Rey Properties
x	x		Dell Marketing L.P.
x			Education Dynamics Inc.
x	x	x	Education Management Systems
x			Fidelity Investments
x			Follett Education Services
x			Freeman, Freeman & Smiley, LLP
x			Goodheart-Wilcox Publisher
x			Guardian
		x	Hacienda La Puente / EMS
		x	Hacienda La Puente School District
x			Harcourt Brace
x			Houghton Mifflin
x			Inwindale Investors, LP
x			James S. Catterall
x			JorgensenHR
		x	KRM Risk Management & Insurance Services
	x		Lancaster Commerce Center, LLC
x			Laney & Associates
x			Master Clean
x			McGraw-Hill Companies
x			Nasco- Modesto
x	x	x	National University Institute
x	x		Office & Ergonomic Solutions
x	x		Office Depot
x			Options for Youth- Burbank
x			Options for Youth- Mt. Shasta
x			Options for Youth- San Gabriel
x			Options for Youth- San Juan
x			Options for Youth- Upland
x			Options for Youth- Victor Valley
x	x		Options for Youth, Inc.
	x		Pan Pacific Retail Properties
x	x	x	Partners in Special Education
x	x		Pearson Education
x			Pro Printing, Inc.
x			Qwest Business Services
x			Ritz Center Inc.
x	x		Rosenow Copies
x	x		SBC
x			Scantron Corporation
x			Shervan Plaza
x			Silver and Freedman
x			Southern California Edison
x			Sprague and Associates
	x		SRF PICO, LLC
x			The Hartford
x			Thomas Winery (Summit Team)
x			TMT-Pasadena LLC
x	x		Total Education Solutions
x			Trinity Reprographics
x			United Parcel Service
	x		University Plaza, LLC
x			Upland Unified School District
x			US Bank Card
x			Vavrinek, Trine, Day & Co., LLP
x			Verizon California
x			Victor Valley High School Dist
	x		William S Hart Union HS District
64	23	8	

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Appendix C

California Department of Education

MEMORANDUM

Date: September 27, 2005

To: Marta Reyes, Director
Charter Schools Division

via:

From: Eileen Gray
Deputy General Counsel

Subject: INDEPENDENT STUDY CHARTER SCHOOLS' STUDENT-TEACHER RATIO

Background: An audit is being conducted related to a funding determination for a charter school, and one of the issues being investigated is the charter school's calculation of its student-teacher ratio for the purpose of its entitlement to apportionment. The charter school has provided its rationale for its calculation in response to CDE's inquiries. We have been provided with a copy of the contract between Los Angeles Unified School District and United Teachers of Los Angeles which is apparently part of the basis for the charter school's calculation of its student-teacher ratio.

The Charter School's Methodology: The charter school states: "According to the employment contract, a full time teaching assignment at the charter school shall require 1,680 hours of instructional time on an annual basis **and shall be considered to be 1.92 full-time equivalent for the sole purpose of calculating the student-teacher ratio pursuant to Education Code 51745.6 and the prescribed formula and definitions set forth in Title V regulations.**"

The charter school explains that their teachers have student contact for 7 hours per day while the largest districts' teachers have student contact for 5 hours. The charter school teachers have student contact time on 240 days while the district teachers have student

contact on only 175 days. This results in a total hours of instruction by the charter school of 1680 hours and by the district of 875 hours. By using the district's figures to measure full-time equivalent (FTE), the charter school concludes that each of its teachers is a 1.92 FTE. In one example, this enables the charter school to calculate that its 24 certificated employees are the FTE of 40.32 certificated employees, thus enabling the charter school to serve more students without exceeding the ratio of the largest district.

Issue Presented: Is the charter school's calculation of its student-teacher ratio authorized by law?

Relevant Statutes and Regulations:

Education Code section 47612.5(b) provides that a charter school that provides independent study shall comply with Article 5.5 (commencing with Section 51745) of Chapter 5 of Part 28 and implementing regulations.

Section 51745 describes independent study that may be offered by districts and county offices of education. Section 51745.6(a) provides in part: The ratio of average daily attendance for independent study pupils 18 years of age or less to school district full-time equivalent certificated employees responsible for independent study, calculated as specified by the State Department of Education, shall not exceed the equivalent ratio of pupils to full-time certificated employees for all other education programs operated by the school district. The computation of these ratios shall be performed annually by the reporting agency at the time of, and in connection with, the second principal apportionment report to the Superintendent of Public Instruction."

Subdivision (b) of Section 51745.6 further provides: Only those units of average daily attendance for independent study that reflect a pupil-teacher ratio that does not exceed the ratio described in subdivision (a) shall be eligible for apportionment pursuant to Section 42238.5, for school districts, and Section 2558, for county offices of education. Nothing in this section shall prevent a school district or county office from serving additional units of average daily attendance greater than the ratio described in subdivision (a), except that those additional units shall not be funded pursuant to Section 42238.5 or Section 2558.

Regulations are found at Title 5 of the California Code of Regulations. Section 17000 states: "Full-time equivalent certificated employees" means any combination of full-time certificated employees and part-time certificated employee assignments and aggregate to the amount of instructional time specified in the contract of a full-time certificated classroom teacher of the district or county office of education.

Section 11700.1(c) provides: "School district" or "district" for the purposes of this subchapter and of Article 5.5 (commencing with Section 51745) of Chapter 5 of Part 28 of

the Education Code, means a school district or a charter school, unless the context clearly indicates otherwise.

Section 11704 provides: In a charter school, for the purposes of Education Code section 51745.6, the ratio of average daily attendance for independent study pupils 18 years of age or less to full-time certificated employees responsible for independent study shall not exceed the equivalent ratio of pupils to full-time certificated employees for all other educational programs operated by the largest unified school district, as measured by average daily attendance, in the county or counties in which the charter school operates. Units of average daily attendance for independent study that are ineligible for apportionment as provided in subdivision (b) of Education Code section 51745.6 shall also be ineligible for funding pursuant to Chapter 6 (commencing with section 47630) of Part 26.8 of the Education Code.

Analysis:

The charter school has chosen a methodology that does not comply with the regulations.

Section 11700 provides that the definition of FTE is as specified in the contract of a full-time certificated classroom teacher of the district or county office of education. Pursuant to section 11700.1, “charter school” can be substituted in lieu of “district or county office” in the regulations and statutes because the context of section 11700 does not clearly indicate otherwise.

Thus, the FTE for the charter school is defined by its contract with its teachers which calls for employees to work 7 hours per day for 240 days of instruction. That then is the measure of an FTE for the charter school. There is no basis in the statutes or regulations that would instruct a charter school to define its FTEs by reference to anything other than the school’s contract with its teachers. The charter school’s statement that for the sole purpose of student-teacher ratios, the FTE shall be considered to be a 1.92 FTE is without legal support.

Moreover, even if such a reference were permissible, there is no basis upon which the charter school could choose 5 hours (periods) to compare to its 7 hours of student contact. The applicable contract states as a general matter that the general workday requires no fewer than eight hours of on-site and off-site work. (2004-2006 Agreement, Article IX, p. 29). The charter school’s statement that a full-time teaching assignment shall be considered to be a 1.92 full-time equivalent for the sole purpose of the student-teacher ratio has no basis in law and must be disregarded.

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MEMORANDUM

CLIENT-MATTER NUMBER
 xxx-0100

TO: John Hall, Joan Hall
 Options for Youth/Opportunities for Learning

FROM: Gregory V. Moser, Special Counsel

DATE: November 2, 2005

RE: Whether the method used by the schools for calculation of the student-teacher ratio complies with California law

You have asked whether the method used by Options for Youth, Inc. and Opportunities for Learning, Inc. to calculate the pupil-teacher ratios described in Education Code section 47612.5 is consistent with current California laws and regulations, and whether there is any legal basis for the State Board of Education or California Department of Education to reduce funding levels for these schools based solely on the schools' measure of teacher FTEs used.

In our opinion, the method used by these schools to calculate teacher FTEs for the purpose of determining the pupil-teacher ratio for independent study students is consistent with current law and may be relied upon by the schools. Indeed, recently-approved regulatory changes only strengthen that conclusion. The law allows a wide range of methods to be used to calculate these ratios. Consequently, we believe the State Board of Education has no legal basis for reducing funding levels to your schools based solely upon the FTE calculation used by your school, as described herein.

ANALYSIS

Options for Youth, Inc. and Opportunities for Learning, Inc. operate charter schools in California which provide education to students through independent study in accordance with Education Code section 47612.5. Under that section, charter schools operating independent study programs must, as a condition of receiving any apportionment, comply with the rules applicable to school districts operating independent study programs. (Education Code section 51745 et seq.)



In addition, these charter school programs are subject to potential reductions in funding based upon the provisions of Education Code section 47634.2, as well as the supplemental regulations adopted by the State Board of Education (5 Cal. Code Regs. §11963-11963.6), based on the provisions of SB 740.

Your schools have consistently complied with these requirements, as tested by your auditors over the past several years. However, the California Department of Education has recently questioned a portion of the methodology used by your schools to demonstrate compliance with the pupil-teacher ratios required by Education Code section 51745.6. As applied to charter schools, the ratio of pupils to “full-time certificated employees responsible for independent study shall not exceed the equivalent ratio of pupils to full-time certificated employees for all other educational programs operated by the largest unified school district ... in the county or counties in which the charter school operates.” (5 Cal. Code Regs. §11704.)

Limited guidance is provided under these statutes or regulations as to how these pupil-teacher ratios are to be computed by charter schools. Although Education Code section 51745.6 directs school districts to exclude special day classes and teachers and “necessary small schools” from the calculation, little other guidance is provided.

The “Independent Study Operational Manual” published by the California Department of Education (Rev. 2-00) references and appends a 1999 memorandum issued by then-Superintendent of Public Instruction Delaine Eastin describes a methodology to be used by school districts. This directive requires districts to use P-2 ADA to determine the number of students. For the number of teachers, it advises districts to count “the total number of certificated teachers and full-time equivalent (FTE) certificated teachers who directly provided instruction to all pupils.” Teachers who provide “supplemental or administrative services” can be counted only for the “fractional amount of time that employee provided direct instruction.” It also indicates that “Fractional numbers *in the total* are to be rounded down, unless the total is less than one” (Emphasis added.) The memorandum goes on to describe various options which school districts have to calculate ratios for various grade levels.

Under this same directive, County Offices of Education are told to “Follow the instructions for school districts using as the base ratio the ratio for the high school or unified school district with the greatest ADA in that county.”

But it is clear that, despite this guidance, the CDE advises in the Independent Study Operational Manual, “There is no uniform practice statewide in the hiring of part-time teachers. Master contracts for regular full-time teachers also have different formal time obligations from one district to another. For this reason, it is difficult to specify a precise method for equating part-time teachers’ time on a fractional basis to that of regular teachers’ time to arrive at full-time equivalent. Because the purpose of the teacher-pupil ratio provision in the 1989 statutory revisions was to prevent gross abuse, any reasonable means of arriving at full-time equivalent in a given district should suffice for audit purposes.” (p. 4-3.) You have advised us that your independent outside auditors, with substantial experience in school finance, have routinely accepted and endorsed your methodology, as described below.

Rather than hiring part-time teachers, or “full-time” teachers on a traditional school calendar of 175 or 180 days, you have advised us that your schools operate 240 days per year, and that your teachers provide 7 hours of *direct instruction* per day, as opposed to 5 hours per school day in a traditional school district (such as Los Angeles Unified School District). As a result, a “full-time” teacher at one of your schools actually provides the equivalent of 1.92 teachers on a traditional school district calendar meeting minimum instructional minutes requirements. It is on this basis that you calculate your pupil-teacher ratios.

As to students, however, no student generates more than 1 unit of ADA—even if they progress through the curriculum far faster than the average student, and even if the “time value” of the work performed exceeds the average student’s quantity of work, or the number of days on which instruction is available exceeds the minimum number of days. This is in keeping with the provisions of 5 Cal. Code Regs. §11960 which provides expressly that “no charter school pupil may generate more than one day of attendance in a calendar day.”

We understand that the California Department of Education has considered, and rejected the inclusion of a similar limitation on whether a single teacher can be counted as more than one FTE for the purposes of Education Code section 51745.6. In February 2005, the CDE proposed to modify section 11704 to expressly state that “For purposes of determining a charter school’s pupil-teacher ratio, one person may not generate more than one “full-time equivalent certificated position. For purposes of this section, a “full-time certificated position means a position where the teacher is required to work a minimum six-hour day and 175 days per fiscal year. Part-time positions shall generate a partial FTE on a proportional basis.”

However, in May 2005, the CDE proposed instead to modify section 11704 to state: “For purposes of this section, a “full-time certificated employee” means an employee who is required to work a minimum six-hour day and 175 days per fiscal year. Part-time positions shall generate a partial FTE on a proportional basis.” In other words, the CDE dropped language that would have prohibited the recognition of teachers working more than “full time” as generating more than one FTE. The CDE staff report explaining this change recognizes that this is possible, stating that “The proposed amendment would also ensure that the pupil-teacher ratio in nonclassroom-based charter schools does not greatly exceed that typically reported by the school districts [by] . . . counting each person in a full-time certificated position only once, *unless the teacher works in excess of a standard work day and number of annual work days.*”

The State Board of Education approved this regulation in May, and it is currently proceeding through the formal rulemaking process, which is ongoing. (The public comment period ended in July and the regulation was forwarded to the Department of Finance and Office of Administrative Law in July 2005.) This is significant for two reasons. First, it shows that the State Board and CDE believe that it is possible for a single teacher to account for more than one FTE in an independent study context. Second, there is no current regulation which squarely addresses this question. Consequently, a determination by FCMAT or another state agency to



disallow this method of calculating the pupil-teacher ratio would potentially amount to an underground regulation and be invalid.¹

The staff report on these regulations is also instructive for another reason. It points out that “the factors included in the [pupil-teacher] ratio vary from district to district, and many school districts do not complete their calculations until late spring, near the end of the charter school’s fiscal year.” Thus, the CDE recognizes that there are significant disparities in the methods used by school districts to calculate the ratio.

We understand that your auditor has reviewed LAUSD method of calculating its ratio, and concluded that, rather than the reported ratio of 22-1, the actual ratio, calculated properly, is close to the statewide average of over 26-1. Based on the considerations described above, we believe your schools would therefore be justified in taking reasonable steps to predict and calculate the pupil-teacher ratio in the largest district within your county (Los Angeles), using any permissible method.

¹ The recently issued Education Audit Regulations for Charter Schools are not to the contrary. For example, 5 Cal. Code Regs. §19851 requires adherence to current laws and regulations, but provides no further detail on calculation of FTEs.



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RESPONSE TO AUDIT OF OPTIONS FOR YOUTH

I. INTRODUCTION

FCMAT and MGT of America, Inc. (the “Auditors”) were engaged to perform a Limited Scope Review of the operations of the Options for Youth Charter Schools during the 2002-2003, 2003-2004 and 2004-2005 fiscal years. This review has occurred over the past 14 months culminating in a report setting forth the Auditors’ findings and recommendations (the “Audit Report”). The Audit Report contains a great deal of narrative and economic data to which OFY has been afforded 5 days to respond. OFY submits the following response (the “Response”) in order to address, as comprehensively as possible, the information, conclusions and recommendations contained in the Audit Report.

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The Audit Report contains numerous factual inaccuracies, erroneous assumptions, improper conclusions (including legal conclusions falling entirely outside the Auditors’ areas of expertise), and recommendations that are, therefore, misguided. While the Auditors have made a number of useful observations and suggestions that will be considered and, in some cases, implemented by OFY to improve the quality of its administration, many of the Auditors’ conclusions and recommendations must be rejected because they are factually untenable or lack a sound legal and regulatory basis.

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In 2002-2003, 2003-2004 and 2004-2005 OFY served approximately 30,000 students, consisting almost entirely of at-risk youth, failed or under-served by the traditional public school system, many of whom would have never completed high school or attempted to do so but for OFY’s programs. Since those years, and indeed throughout its history, OFY has strived to continuously improve itself in all respects. OFY charters have earned accreditation from the Western Association of Schools and Colleges (WASC). OFY believes these efforts have shown tangible and substantial results in the most important of areas - student achievement. API scores of OFY Charter Schools are an average of 105 points higher than alternative schools in the districts in which OFY operates. In comparison to peer schools located in the districts in which OFY operates, OFY’s CAHSEE passage rates are an average of 36% higher in English-Language Arts and 17% higher in Mathematics. In comparison to the state average, OFY’s Hispanic students’ CAHSEE passage rates are 16% higher in English-Language Arts. OFY students

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Communications Director,
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Dr. Charles S. Terrell, Jr.
Former Superintendent
of Schools San Bernardino
County and City

who are socio-economically disadvantaged have an 18% higher CAHSEE passage rate in English-Language Arts than the State average for students in this same group.

OFY participated in the Audit willingly and in all reasonable respects. At appropriate times, OFY attempted to point out to the Auditors those areas where the Auditors' assumptions and conclusions are erroneous. In some instances, the Auditors responded by making appropriate corrections. In other instances, the Auditors failed to consider empirical data and other contextual information material to their analysis that, upon full and reasonable consideration, would likely have altered the Auditors' conclusions and recommendations.

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The most glaring example of improper conclusions reached as a result of the Auditors' failure to consider pertinent information pertains to the recommendation that the California Department of Education ("CDE") consider reclaiming tens of millions of dollars in funding due to OFY's alleged incorrect calculation of FTE. The Auditors contend that OFY's incorrect FTE calculation renders the pupil-to-teacher ratios of the OFY charter schools greater than the ratios of the largest unified school districts in the counties in which the charter schools operate. OFY repeatedly requested that the Auditors consider documentation from the CDE itself that directly contradicts the Auditors' conclusions. As discussed more fully below, OFY provides herewith CDE communications confirming that the pupil-to-teacher ratio requirement cited by the Audit Report was a requirement only for receipt of 100% funding. **OFY charter schools did not receive 100% funding in any of the audited years.** Thus, the Audit Report's analysis, discussions, conclusions and recommendations regarding OFY's FTE and pupil-to-teacher ratios is entirely irrelevant and should be stricken in their entirety from the final Audit Report.

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While OFY respects the Auditors' right to report those factual circumstances they believe to have been observed during the Audit, OFY, beginning with this Response, will pursue all available opportunities to ensure that the record is accurate, fair and balanced.

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II. RESPONSE TO AUDIT REPORT

A. The Auditors Failed to Issue Separate Reports for the Separate Entities.

Despite numerous requests that the Auditors report findings for OFY in a report pertaining to OFY only, the Auditors chose to produce a consolidated Audit Report including numerous other entities founded by, or in some other fashion related to, Joan and John Hall, the founders of OFY. Thus, it is important to emphasize at the outset of this Response that OFY is a collection of not-for-profit charter schools. Opportunities for Learning ("OFL"), also the subject of the Audit Report, is another group of charter schools for at-risk youth founded and operated by the Halls. However, the OFL schools are for-profit entities and as such are operated differently and are subject to many different financial procedures, standards, and modes of administration than are the OFY schools. It appears that this fact has not been taken into account by the Auditors calling

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into question many of the over-generalized comments and conclusions regarding OFY's and OFL's operations.

B. Chapter One – Related Party Transactions.

The Audit Report makes several suggestions regarding ways in which OFY can better ensure that related party transactions are appropriate in all respects. While none of the referenced transactions were substantively or procedurally improper, a number of the Auditors' recommendations are useful and are likely to be implemented when considered by the OFY Boards of Directors. 8

However, the Audit Report lacks a discussion of the contexts in which the referenced transactions occurred. The Auditors also fail to report that these transactions have long been known to, and even reviewed by, OFY sponsoring school districts and the CDE. In addition, many of the Auditors' specific findings regarding related party transactions are inaccurate and misleading. 3

Context of Related Party Transactions

Over the years, OFY discovered that there were few services available in the marketplace appropriately tailored to independent study charter school programs. As a result, OFY was frequently required to accommodate services and products ranging from special education to student attendance accounting software designed for non-independent study programs. The costs, loss of efficiency and burden on teachers associated with these adaptations was substantial. Over the years, Joan and John Hall have developed products or services specifically designed to meet the needs of independent study programs. Many of these products are consumed not only by the OFY and OFL charter schools, but also by public school districts. 9

In any instance in which OFY engaged in transactions with businesses in which the Halls held an interest, the Halls' interests were disclosed and board approvals were obtained, and OFY charters have always been charged less than they would have paid to an unrelated third party vendor. 10

The CDE Was Fully Aware of the Referenced Transactions

The transactions referenced in the Audit Report were never hidden in any manner. Sponsoring districts have made inquiries into the background, purpose and nature of the transactions, in each instance finding satisfaction in the responses provided by OFY. In addition, due the disclosure requirements established by SB 740, the CDE was aware of many of the referenced transactions before recommending funding levels for OFY. 11

OFY's Conflict of Interest Policies Are Adequate

While OFY believes that its conflict of interest policies have always met all applicable legal requirements, OFY has no objection to considering the Auditors'

suggestion that OFY’s written policy be expanded and set forth in greater detail. OFY emphasizes, as noted in the Audit Report, that all transactions with any related party were fully disclosed to each of the OFY Boards and all legal requirements for approval of the transactions, particularly those set forth in the California Corporations Code, were met.

The Audit Report Inaccurately Describes the Relationship Between OFY, Inc. and the OFY Charter Schools

The Auditors misconstrue the nature of the relationship between OFY, Inc. and the individual OFY charter schools. The Auditors attempt to portray OFY, Inc. as a “Hall entity” charging fees to the other OFY entities. The Auditors’ description is inappropriately misleading. OFY, Inc. is a non-profit entity which is primarily used to collectively and, therefore, efficiently administer certain aspects of the six (6) OFY charters. These charters save money and operate more cost-effectively by having administrative operations such as payroll, human resources, purchasing and technology services handled by one administrative entity. The individual OFY charters then each assume a proportionate share of OFY, Inc.’s overhead. OFY, Inc. collects only enough to pay for its costs of operation. Joan and John Hall take no salary from OFY, Inc. and there is no personal benefit received by them as a result of this administrative structure. When the function of OFY, Inc. is correctly portrayed and understood, it becomes clear that the Auditors’ reference to “\$27.8 million in fees” is misleading and misrepresentative of the actual relationship between OFY, Inc. and the OFY charter schools.

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No Agreement Between OFY, Inc. and the OFY Charter Schools Is Necessary

The Auditors point out that there is no agreement for management services between OFY, Inc. and the OFY charter schools. No such agreement is required or necessary. This comment is an example of the faulty conclusions reached when the relationships of the entities are incorrectly portrayed. OFY, Inc. is *not* a management company. As described above it is essentially a cooperative through which the individual OFY entities collectively administer many aspects of their operations. OFY, Inc. does not earn any profit but simply allocates its costs of operation among the participating OFY entities. Therefore, no written agreement is necessary.

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All Necessary Board Approvals Were Obtained

All of the transactions discussed in the Audit Report received board approval. While clerical errors in minutes or misplaced minutes may have occurred in isolated instances, each board reviewed all transactions in which its entity participated. The Auditors were provided the names and contact information for all board members. The Auditors chose only to contact two board members from the same board. Had the Auditors contacted the members of each board, the Auditors could have confirmed that all transactions have in fact received proper board approval.

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Billing Practices

OFY acknowledges that in some instances OFY, Inc's billings were delayed or marred by inadequate record keeping. Most of the instances described in the Audit Report occurred two or more years ago. Since then, OFY has implemented additional practices and procedures to minimize any errors in its billing and payment practices. The Audit Report acknowledges these efforts, including the engagement of an outside auditing firm to ensure that all charges are properly billed and properly documented.

OFY objects to the characterization of clerical billing errors as interest free loans. This is an example of misleading and inaccurate representations that undermine the usefulness of the Audit Report and calls into question the Auditors' impartiality. Any delays in collections by OFY, Inc. were inadvertent. They were neither intended to be nor resulted in "interest free loans" and were not attempts by OFL to unduly benefit from the use of OFY resources.

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The Comparison of OFY, Inc. and EMS, Inc. "Charges" Is Immaterial and Irrelevant

The Audit Report contains an irrelevant and misguided comparison of amounts paid by the individual OFY charter schools to OFY, Inc. and the fees charged by Education Management Systems, Inc. ("EMS") for management services provided to the Opportunities for Learning charter schools. As discussed, OFY, Inc. is not a management company. It is primarily an administrative cooperative. EMS is a for-profit management company. Thus, any comparison of amounts paid to these entities is inapposite. The amounts of OFY, Inc.'s overhead costs allocated to individual OFY charter schools are based on each entity's pro rata share of ADA (or direct payment of costs exclusively attributable to a particular entity). It is therefore irrelevant how this objectively determined amount compares to charges by EMS to OFL charters.

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All Officers and Directors Acted Freely and Independently

All officers and directors of OFY entities acted freely and independently and continue to do so currently. Any suggestion that any officer or director (other than the Halls themselves) acted at the behest of the Halls or sacrificed his or her own independence for the will of the Halls is entirely unsupportable. OFY charters permit district representation on each of the boards and in most cases districts have in fact designated representatives to act as liaisons with the boards or even to serve as board members. The name and contact information of every board member was supplied to the Auditors who for unknown reasons chose not to speak with the members of each board. Each board member should have been provided an opportunity to address any concerns the Auditors might have regarding board member independence. It is notable that the Auditors' comments in this regard lack any concrete examples of board members subjugating their independent judgment for that of the Halls. The Audit Report merely speculates that compromised judgment is a possibility. A management structure that

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ensures maintenance of the organization's vision is not at all unusual to the charter school movement and is by no means a reflection of any board member's lack of independence.

The Audit Report's Discussion of OFY, Inc.'s E-Plus Group, Inc. Contract Is Inaccurate

The Audit Report claims that OFY, Inc. improperly engaged in a business transaction with a company employing Karen N., a board member and officer of OFY-CA, Inc. In fact, this individual was not an officer or director of OFY-CA, Inc. (or any other OFY entity) until after the subject transaction occurred and she had no involvement in OFY Inc.'s decision to engage in the transaction. In 1998, OFY purchased computer equipment from ePlus Group, Inc. ("ePlus"). The contract provided for payments over time. Ms. N. was not an officer or director of OFY-CA, Inc. when OFY, Inc. approved the contract. She joined OFY-CA, Inc. later and the payments made by OFY, Inc. to ePlus after Ms. N. joined OFY-CA, Inc. were merely payments due on the previously approved and executed purchase contract. Ms. N. was not a board member of OFY-CA, Inc. at anytime that the OFY, Inc. board exercised any discretion whatsoever regarding the ePlus contract. There was absolutely no impropriety associated with this transaction.

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Joan and John Halls' Salaries Are Appropriate

The Auditors assert that the Halls' salaries "appear questionable." Joan and John Hall serve the OFY entities pursuant to employment contracts reviewed and approved by the OFY Boards on a regular basis. The Halls' compensation is based upon a comparison of salaries paid to officers of other similar-sized non-profit entities. The non-cash compensation received by the Halls is commensurate with benefits received by officers of other entities with similar sized budgets. All reimbursements received by the Halls relate to company business ranging from attendance at conferences to other travel and meals *directly* related to OFY operations. There is no finding in the Audit Report of any financial impropriety by the Halls.

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The Auditors' discussion regarding the amount of time devoted by the Halls to their positions is over-generalized and based on a selective and incomplete use of documents. While marketplace and entity comparisons play an important role in determining compensation, the analysis is not and should not be entirely objective. Joan and John Hall are career educators who developed, and on a daily basis sustain, an extraordinarily successful educational model. There is nothing contained in the Audit Report or elsewhere to suggest that the OFY entities did not receive the full benefit of the compensation paid to the Halls.

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C. Chapter 2 – Pathways in Education.

The Contribution of Funds to Pathways Was Expressly Permissible Under the Law

California law permits any non-profit organization to contribute funds to another non-profit entity so long as the receiving entity has a similar charitable purpose. Since 2002 when the boards of OFY elected to contribute funds to a similar non-profit organization known as Pathways in Education, the CDE has inquired about and analyzed the transaction. In each instance, OFY has fully explained the nature and purpose of the contribution. The CDE has been aware of the contribution of funds by OFY to Pathways in Education prior to every funding determination it has made for OFY since 2002 and because the contribution was legal in all respects, there is no basis for a recommendation regarding further inquiry by any governmental agency.

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The funds contributed by the OFY charters were their funds to transfer. Accordingly, the Auditors' comments regarding usage of the funds are entirely undermined by a faulty factual predicate – that the funds received and spent by Pathways in Education are State funds. They are not. The OFY charters elected to contribute some of their reserved funds to another educational non-profit. The contributions were entirely permissible under Federal and State law.

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No OFY Board Members Were Conflicted

The notion that two members of the OFY-Victor Valley, Inc. Board of Directors had a conflict of interest when voting to contribute funds from OFY-Victor Valley, Inc. to Pathways in Education is based on a legal conclusion that is both erroneous and outside the Auditors' area of expertise. It is correct that two members of the OFY-Victor Valley, Inc. Board of Directors resigned from the board after voting for the contribution and subsequently assumed positions as members of the Pathways in Education Board of Directors. However, doing so did not constitute a conflict of interest because they had no personal interest in the transaction and derived no personal benefit therefrom. Neither was paid to serve as an OFY Director and neither was paid to subsequently serve as a Pathways in Education Director. Absent a personal benefit derived by the Directors in connection with the transfer, no conflict of interest existed.

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The Transfer of OFY-Long Beach Funds Was Proper

The Auditors' observations regarding the transfer of OFY-Long Beach, Inc. funds to Pathways in Education is an exercise in form over substance having no practical or material significance. The Auditors correctly point out that the OFY-Long Beach, Inc. Board of Directors voted to dissolve the entity and transfer its assets to OFY-Burbank, Inc. While it is also correct that the OFY-Long Beach, Inc. Board did not approve the transfer of its funds to Pathways in Education, it did approve the release of its funds to OFY-Burbank, Inc. whose Board approved the contribution of its reserve funds to Pathways in Education.

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OFY agrees that from an accounting standpoint it would have been more accurate for the funds to have been first transferred to OFY-Burbank, Inc. and thereafter contributed to Pathways in Education. However, ultimately, the result would have been the same. In any event, as noted in the Audit Report, the transfers were reversed and the funds were transferred back to OFY-Long Beach, Inc. so that they could be transferred to OFY-Burbank, Inc. in accordance with the Board's direction. Once OFY-Long Beach, Inc. elected to release its funds to OFY-Burbank, Inc. it had no control over how OFY-Burbank, Inc. chose to dispose of the funds. Hence, once again, the practical result is the same and there is nothing improper about the fact that the OFY-Long Beach, Inc. funds were ultimately contributed to Pathways in Education.

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Pathways Use of Its Funds Is Outside the Scope of This Audit, But Is Nonetheless Proper

Pathways in Education is not a recipient of California State funds and as such is not properly a subject of this audit. The Auditors scrutinized the activities of Pathways in Education based upon an apparent belief that Pathways in Education holds State funds and that various obligations are therefore attached to disposition of the funds. This is an erroneous assumption. Pathways in Education is a non-profit entity dedicated to educational purposes. This is not inconsistent with the understanding of the OFY Boards that the entity was formed for the accomplishment of educational pursuits. Pathways in Education was and is free to dispose of its funds in any manner consistent with its charitable purpose.

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Attorney Disclosures

OFY elects to respond to the Auditors' comments regarding its legal representation only for the purposes of pointing out that the Auditors have again engaged in the pursuit of errant legal conclusions. There was no adverse relationship between the OFY entities and Pathways in Education. One was merely the recipient of a charitable contribution from the other. Absent any adversity in the relationship between the entities, Rule of Professional Conduct 3-310 has no application as a matter of law.

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D. Chapter 3 – Charter School Funding and Financial Analysis.

This chapter of the Audit Report contains a review of OFY's submissions to the CDE for annual funding determinations pursuant to SB 740. The chapter is punctuated by a number of largely insignificant and immaterial alleged inconsistencies in entries on OFY's funding determination applications. However, the Auditors acknowledge that these alleged errors had no impact upon the amount of funding received by OFY. With respect to those instances in which the Auditors claim that OFY was, or may have been, overpaid, OFY disputes the conclusions and recommendations of the Auditors.

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While All Credit Card Charges Were Proper, OFY Agrees to Strengthen Its Controls

OFY acknowledges that with respect to a number of credit charges OFY was unable to provide receipts for the charges. Thus, OFY agrees with the Auditors that its credit card record keeping controls can and should be strengthened. To this end, OFY has instituted a new Travel and Expense Report Policy and engaged an outside accounting firm to review charges to ensure appropriate expense verification.

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Certain charges referenced in the report are mentioned out of context potentially leading to inaccurate conclusions. For example, the sums spent on Disneyland events were spent in connection with annual employee and staff appreciation events which hundreds of employees attended. The cost of the events, per employee, were extremely reasonable and appropriate. Staff appreciation events such as these are not at all unusual in the educational arena or any industry.

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OFY disputes that a receipt is the only viable basis for ascertaining the proper purpose of a particular expenditure. Of the \$20,043.00 in credit card charges that the Auditors identify as “at risk” for being improper expenditures, OFY has been able to confirm the proper purpose of 99% of the referenced amounts. The charges fall within four basic categories: (1) Educational meetings and conferences related to “Dropout Recovery” (54.8% or \$10,933.00); (2) Educational Program Funding and Sponsoring District Interaction (5.3% or \$1,065.00); (3) Personnel Training and Development (12.3% or \$2,470.00); and, (4) General Operating Expenses expenses (27.5% or \$5,516.00).

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The only travel expenses charged to OFY by the Halls or other employees consist of charges for attending conferences and other business related events. None of the charges were for the personal benefit of the Halls.

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While OFY acknowledges that receipts are helpful in appropriately documenting expenses, in and of themselves, they do little to establish the actual purpose of a particular expense. Because OFY can confirm through other sources the business related purposes of the charges referenced in the Audit Report, the fact that the funds were appropriately spent has been confirmed.

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Teacher Bonus Accruals Were Consistent With the Provisions of SB 740

As the Audit Report points out, an independent study charter school is funded for a particular year based upon the amount of money the entity spent in its prior year of operation. In the audited years, OFY incurred liabilities for teacher performance bonuses. OFY properly included these liabilities as expenses of the prior year on its funding applications. Based upon the entities’ expenditures and liabilities, including accrued bonuses, OFY met the requirements for and was entitled to 100% funding for the 2003-2004 fiscal year. Had the CDE adhered to the funding regulations, OFY would have received the increase in funds attributable to 100%. In discussions with the CDE, OFY was informed that the CDE chose not to adhere to the funding regulations in its

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recommendations for funding. OFY then determined that at the reduced funding level proposed by the CDE, OFY did not have the cash flow to pay both the bonuses and its other operating expenses.

When 100% funding was not awarded in 2003-2004, OFY reversed a portion of the accrued bonuses and paid bonuses only in the amounts that could be afforded in light of the actual funding amount of less than 100% was received. As noted in Exhibit 3-7 of the Audit Report, regarding teacher bonuses for year 2003-2004, OFY sought to pay teacher bonuses of \$1,634,070 but was only able to pay \$390,582 in bonuses. In Exhibit 3-8 entitled, "Options for Youth Overaccrued Almost \$640,000 of Teacher Bonuses in Fiscal Year 2004-05," the Audit Report inaccurately reports the bonus information. The Audit Report represents that OFY accrued \$648,531 and then reversed without payment \$639,852 in an attempt to obtain 100% funding. OFY's intent and its financial records show that it actually accrued \$381,590 and paid bonuses to teachers in the amount of \$381,590.

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The accrual of teacher bonuses is consistent with common, accepted accounting principles and is consistent with the funding guidelines of SB 740. Therefore, the CDE should have approved funding at the levels stipulated by SB 740 in each year. This would have allowed the charter schools the ability to predict their funding levels and effectively forecast available funds. The assertion that accrued bonuses were merely a means of manipulating the funding process to obtain a higher funding level is untrue and needlessly inflammatory. This is evidenced by, among other things, the fact that OFY paid hundreds of thousands of dollars of the accrued bonuses based upon the amount of funding actually obtained. In any event, the accruals had no impact upon the funding determinations and did not result in OFY receiving any overpayment of State funds.

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E. Chapter 4 – Charter School Pupil-To-Teacher Ratios.

The Entire Section of the Audit Report Regarding FTE and Pupil-To-Teacher Ratios Should be Stricken or Disregarded As Inapplicable and Irrelevant

As pointed out in the Introduction to this Response, the Auditors consistently refused to consider probative data offered by OFY to support its positions regarding a variety of the Auditors' conclusions and recommendations. By failing to consider all relevant data, the Auditors compromised their impartiality and reached conclusions totally unsupportable under applicable law. There is no portion of the Audit Report more flawed as a result of incomplete analysis than the discussion pertaining to FTE calculations and pupil-to-teacher ratios.

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As the Audit Report points out, in order for an independent study charter school to have received 100% funding, the school was "generally" required to maintain a pupil-to-teacher ratio that is equal to or lower than that of the largest unified school district in the counties served by the charter school. The pupil-to-teacher ratio is calculated by dividing Average Daily Attendance by the number of full time equivalent teachers. The Audit Report claims that OFY "may" have been overpaid during the audit years as a

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result of its use of an improperly high FTE number. OFY's FTE during the audited years was 1.92. The Auditors assert that the CDE claims that FTE may not exceed 1.0.

When OFY was informed of the CDE's claim, OFY requested that the Auditors consider the applicable regulations and the CDE's historical (and contrary) position on the issue. As the Audit Report indicates, the Auditors failed to do so. As only one example of CDE communications contradicting its current position, OFY attaches hereto a Memorandum prepared by Janet Sterling (School Services Fiscal Services Director) to the State Board of Education in May 2002 setting forth and explaining the recommendations of the Advisory Commission on Charter Schools for funding regulations to be adopted pursuant to SB 740. These proposed regulations were ultimately adopted. In Attachment 1 of the Memorandum, Ms. Sterling clearly indicated that for the 2002-2003 fiscal year, the requirement that a charter school's pupil-to-teacher ratio be equal to or lower than the largest unified school district in the counties in which the charter school is located, is a requirement *only for 100% funding*. The pupil-to-teacher ratio threshold is not a requirement for the lesser levels of funding. As the proposed regulations were adopted, the same funding standards applied in each of the years that are the subject of the Audit Report.

None of the OFY charter schools received 100% funding in the audited years. Accordingly, they were not required to maintain pupil teacher ratios at the levels required for 100% funding. **The pupil-to-teacher ratio analysis upon which this entire chapter of the Audit Report and the recommendations therein are based has absolutely no application whatsoever to OFY during the audited years.** Thus, the entirety of Chapter 4 of the Audit Report should be excluded from the final Audit Report.

The Audit Report states that the pupil-to-teacher ratio is a requirement applicable to 100% funding. Therefore, it is entirely unclear why the Auditors would proceed to apply the requirement to OFY. It can only be presumed that had the Auditors fully and completely analyzed the issue, including the data offered by OFY to substantiate its position, the Auditors could have avoided this erroneous analysis.

The Audit Report Lacks Any Reliable Basis for Adopting the CDE's Position

Assuming, for argument sake only, that the pupil-to-teacher ratio requirement did apply to OFY in the audited years, the Auditors' analysis of OFY's funding as it relates to FTEs is erroneous or otherwise unsupportable for the following additional reasons:

1. The Auditors accepted the CDE's claim that FTE may not exceed 1.0 without having undertaken *any* analysis of whether the use of 1.0 is consistent with applicable laws and regulations and further did so without considering established CDE's practice contrary to its recent 1.0 interpretation;

2. The Auditors ignored data provided to them by OFY demonstrating that the CDE has repeatedly and even frequently approved funding for numerous charter schools using FTE amounts in excess of 1.0 up to and including 2.0;

3. The Auditors failed to take into account the fact that the CDE was aware of OFY's use of 1.92 FTE in each of the audited years and made no adjustment to funding based on a claim of improper FTE;

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4. The Auditors failed to consider the fact that the CDE has publicly acknowledged that a charter school's teachers may teach amounts in excess of the public school district's full time teaching position. The California Basic Educational Data System, maintained by the CDE, allows for annual reporting of teacher FTEs greater than 1.0 (or 100%);

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5. The Auditors neglect to mention that the California Legislature considered amending Title 5 of the California Code of Regulations to limit FTE to 1.0 as a matter of law. The amendment was expressly rejected; and,

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6. The Auditors do not consider the State Teachers Retirement System regulations which clearly acknowledge that teachers can and do work in excess of a district full time teaching position and receive credit towards retirement benefits based upon the excess work-time in addition to immediate salary increases.

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While ignoring all of the evidence to the contrary, the Auditors provide no independent or external support whatsoever for the assertion that FTE **cannot** exceed 1.0.

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OFY's FTE amount is not a fictional number. OFY teachers work substantially more hours and days than traditional public school full time teaching positions. As a result, OFY's FTE was and is legitimately greater than 1.0 and there is no basis upon which to deny OFY funding based upon its actual and legal FTE calculation.

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The Audit Report concedes that resolution of this issue requires a legal determination (which would be inappropriate for the Auditors to make themselves). Much of the discussion contained in Chapter 4 of the Audit Report is also immaterial as it is merely a one-sided presentation of the amount of funding OFY should return if the CDE's contradictory position on FTE is upheld. Since applicable law and the CDE's historical conduct thoroughly undermine the notion that FTE may not exceed 1.0, such an outcome appears highly unlikely.

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OFY-Mt. Shasta, Inc's Pupil-to-Teacher Ratio Did Not Exceed the District's

The Audit Report claims that OFY-Mt. Shasta Inc.'s Pupil-To-Teacher Ratio was higher than Yreka Unified High School District's ("YUHSD's") ratio in the 2002-2003 and 2003-2004 school years. Interestingly, the Auditors claim that they rely upon verified Pupil Teacher Ratios from YUHSD. In fact, the YUHSD ratio used by the Auditors improperly includes 3.0 special education FTE teachers in 2002-2003 and 2.6 special education FTE teachers in 2003-2004 – FTE that is expressly prohibited by the CDE's "Instructions for Ratio Calculations." When calculated in accordance with the CDE's instructions, YUHSD's ratio was higher than the ratio told to the Auditors when they verified it "*by phone.*"

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OFY Agrees That the Dispute Regarding FTE Should Be Resolved

Ultimately, notwithstanding the foregoing, OFY agrees with several of the Auditors' recommendations with respect to the issue of FTE. For example, OFY agrees that all parties would benefit from a swift resolution of the pending lawsuit between OFY and the CDE regarding proper FTE calculation so that future disputes can be avoided. OFY also agrees that FTE should be calculated in accordance with established rules.

F. Chapter 5 – Student Attendance Records.

In 2003-2004 OFY served thousands of students. The Auditors concluded that in the course of educating these thousands of students, OFY overstated 32 attendance days. OFY acknowledges that the minimal overstated amount is the result of clerical errors that are bound to occur when so many students are being served. While perfection is likely an unattainable goal, OFY accepts the recommendations of the Auditors concerning student attendance record-keeping to ensure that the records and related reporting are as accurate as possible.

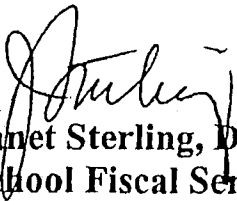
III. CONCLUSION

As noted at the outset of this Response, OFY has cooperated in all reasonable respects with the Audit. While OFY believes that many of the recommendations contained in the Audit Report are based upon faulty factual premises and improper or erroneous legal conclusions, OFY is committed to improving its programs in all respects. It is in that spirit that OFY, through its Directors and Officers, will continue to consider the recommendations contained in the Audit Report and, where consistent with regulatory guidelines, implement those recommendations that will help OFY to continue its successful commitment to serving California's at-risk and educationally under-served youth.

Last Minute Memorandum

To: STATE BOARD MEMBERS

Date: May 29, 2002

From:  Janet Sterling, Director
School Fiscal Services Division

Re: ITEM #36

Subject PERMANENT REGULATIONS REGARDING CLASSROOM AND
NONCLASSROOM BASED INSTRUCTION IN CHARTER SCHOOLS:
IMPLEMENTATION OF THE PROVISIONS OF SENATE BILL 740

Attached for consideration is a package of amendments to the proposed regulations regarding classroom and nonclassroom-based instruction in charter schools, which implement (in part) the provisions of Senate Bill 740 (Chapter 892, Statutes of 2001). These proposed amendments reflect the recommendations of the Advisory Commission on Charter Schools (ACCS) on the permanent regulations, which were developed by ACCS over the past three months and after considerable public testimony by interested parties. The first attachment is a summary of the ACCS's recommendations on the standards that charter schools offering nonclassroom-based instruction would be required to meet to receive a specific funding level. The second attachment is the text of the amended regulations, which reflects the ACCS recommendations.

California Department of Education staff recommend that the State Board of Education direct that this package of amendments be circulated for a 15-day public review period in accordance with the Administrative Procedures Act.

Attachments to Agenda Item:

Attachment 1: Summary of ACCS's Recommendations (Page 1)

Attachment 2: Title 5, California Code of Regulations (Page 1-14)

SUMMARY OF ACCS'S RECOMMENDATIONS

FOR THE 2002-03 FISCAL YEAR

- I. **80 percent** – a charter school must demonstrate **BOTH** of the following:
1. The charter school's total expenditures on certificated employee salaries and benefits are at least **35 percent** of the charter school's total public revenues; **AND**
 2. The charter school's total expenditures on instruction and instruction-related activities are at least **55 percent** of the charter school's total revenues.
- II. **100 percent (i.e. full funding)** – a charter school must demonstrate that its total expenditures on certificated employee salaries and benefits are at least **50 percent** of the charter school's total public revenues.
- III. **Less than 80 percent** – if a charter school does not meet **BOTH** of the minimum requirements to receive 80 percent funding, then the funding level is **70 percent**.

FOR 2003-04 AND EACH FISCAL YEAR THEREAFTER

- I. **70 percent** – a charter school must demonstrate **BOTH** of the following:
1. The charter school's total expenditures on certificated employee salaries and benefits are at least **40 percent** of the charter school's total public revenues; **AND**
 2. The charter school's total expenditures on instruction and instruction-related activities are at least **60 percent** of the charter school's total revenues.
- II. **85 percent** – a charter school must demonstrate **BOTH** of the following:
1. The charter school's total expenditures on certificated employee salaries and benefits are at least **50 percent** of the charter school's total public revenues; **AND**
 2. The charter school's total expenditures on instruction and instruction-related activities are at least **70 percent** of the charter school's total revenues.
- III. **100 percent (i.e. full funding)** – a charter school must demonstrate **ALL** of the following:
1. The charter school's total expenditures on certificated employee salaries and benefits are at least **50 percent** of the charter school's total public revenues; **AND**
 2. The charter school's total expenditures on instruction and instruction-related activities are at least **80 percent** of the charter school's total revenues; **AND**
 3. The charter school's pupil-teacher ratio as calculated pursuant to *Education Code* Section 51745.6 is no greater than the pupil-teacher ratio of the largest unified school district in the county or counties in which the charter school operates.
- IV. **Less than 70 percent** – if a charter school does not meet **ALL** of the minimum requirements to receive 70 percent, then the funding level is **zero**.

-
- All expenditure and revenue data will be prior year data, except for new charter schools, which will use estimated current year data.
 - Mitigating factors and individual circumstances may be considered by the ACCS and SBE in making determinations different from the standards above.



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RESPONSE TO AUDIT OF OPPORTUNITIES FOR LEARNING

I. INTRODUCTION

FCMAT and MGT of America, Inc. (the “Auditors”) were engaged to perform a Limited Scope Review of the operations of the Opportunities for Learning Charter Schools during the 2002-2003, 2003-2004 and 2004-2005 fiscal years. This review has occurred over the past 14 months culminating in a report setting forth the Auditors’ findings and recommendations (the “Audit Report”). The Audit Report contains a great deal of narrative and economic data to which OFL has been afforded 5 days to respond. OFL submits the following response (the “Response”) in order to address, as comprehensively as possible, the information, conclusions and recommendations contained in the Audit Report.

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The Audit Report contains numerous factual inaccuracies, erroneous assumptions, improper conclusions (including legal conclusions falling entirely outside the Auditors’ areas of expertise), and recommendations that are, therefore, misguided. While the Auditors have made a number of useful observations and suggestions that will be considered and, when appropriate, implemented by OFL to improve the quality of its administration, many of the Auditors’ conclusions and recommendations must be rejected because they are factually untenable or lack a sound legal and regulatory basis.

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In 2002-2003, 2003-2004 and 2004-2005 OFL served approximately 20,000 students, consisting almost entirely of at-risk youth, failed or under-served by the traditional public school system, many of whom would have never completed high school or attempted to do so but for OFL programs. OFL charter schools are owned and operated by Education Management Systems, Inc. (“EMS”), which is owned by Joan and John Hall.

What began many years ago as an experiment in the efficiencies and effectiveness of the for-profit educational model has evolved into an extraordinarily successful program that has captured tens of thousands of youth lost or forgotten in the traditional public school system. Today, the Western Association of Schools and Colleges (“WASC”) accredited OFL charter schools enjoy API scores that are 130 points higher than alternative schools in the counties in which OFL operates. In comparison to peer schools, OFL CAHSEE passage rates are an average of 10%-20% higher in English-Language Arts and 5%-10% higher in mathematics. In

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Joan Hall

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LAUSD Board of
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Educator; Author

Dr. Ted Kimbrough
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Senior Minister, First AME Church,
Retired

Mr. William Rivera
Communications Director,
Retired, LAUSD

Dr. Charles S. Terrell, Jr.
Former Superintendent
of Schools San Bernardino
County and City

comparison to the State average, OFL’s Hispanic students boast CAHSEE passage rates that are 20% higher in English-Language Arts. OFL students who are socio-economically disadvantaged have a 15% higher CAHSEE passage rate in English-Language Arts than the State average for students in the same group.

OFL participated in the Audit willingly and in all reasonable respects. OFL attempted to provide the Auditors with corrections and additional information with respect to those areas where the Auditors’ assumptions and conclusions are erroneous. In some instances, the Auditors responded by making appropriate corrections. In other instances, the Auditors failed to consider empirical data and other contextual information material to their analysis that, upon full and reasonable consideration, would likely have altered their conclusions and recommendations.

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The most glaring examples of improper conclusions reached as a result of the Auditors’ failure to consider pertinent information pertains to the recommendations regarding allegedly “incorrect FTE calculation” and OFL’s inclusion of teacher continuing education expenses and reimbursements as part of the schools’ expenses for certificated teacher salaries and benefits in the SB 740 funding determination process. With respect to the FTE calculations, the Auditors contend that OFL’s allegedly “incorrect FTE calculation” renders the pupil-to-teacher ratios of the OFL charter schools greater than the ratios of the largest unified school districts in the counties in which the charter schools operate. OFL has repeatedly requested that the Auditors consider documentation from the California Department of Education (“CDE”) itself that directly contradicts the Auditors’ conclusions. As discussed more fully below, OFL provides herewith CDE communications confirming that the pupil-to-teacher ratio requirement cited by the Audit Report was a requirement only for receipt of 100% funding. OFL charter schools did *not* receive 100% funding in any of the audited years. Thus, the Audit Report’s analysis, discussions, conclusions and recommendations regarding OFL’s FTE and pupil-to-teacher ratios are entirely irrelevant and should be stricken in their entirety from the final Audit Report.

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With regard to the inclusion of teacher continuing education as part of certificated salary and benefits expenses, the Auditors’ analysis is inconsistent with the regulations adopted pursuant to SB 740. The Auditors rely on the contents of a CDE SB 740 instruction form which itself is inconsistent with the regulations. The Auditors also ignore the fact that the CDE was well aware of the manner in which OFL accounted for teacher continuing education and reimbursement expenses *before* making funding determinations in the audited years.

6

To the extent that the Audit Report contains factual errors and faulty legal conclusions and recommendations, OFL responds herein and will continue to respond through all available procedures in order to ensure that the record regarding the operations of OFL charter schools is accurate and impartial.

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II. RESPONSE TO AUDIT REPORT

A. The Auditors Failed to Issue Separate Reports for Separate Entities.

Despite numerous requests by OFL that the Auditors report findings for OFL in a report pertaining to OFL only, the Auditors produced a consolidated Audit Report including numerous other entities founded by, or in some other fashion related to, Joan and John Hall, the founders and owners of EMS and its OFL charter schools. There are entities discussed in the Audit Report that are neither owned nor controlled by the Halls and inclusion of all such entities in the Audit Report is a violation of accounting standards. It is important to emphasize at the outset of this Response that OFL is a group of for-profit charter schools. Options for Youth (“OFY”), also the subject of the Audit Report, is another group of charter schools for at risk youth founded and operated by the Halls. However, the OFY schools are not-for-profit entities and as such are operated differently and are subject to many different financial procedures, standards, and modes of administration than are the OFL schools. It appears that this fact has not been taken into account by the Auditors, calling into question the appropriateness of many of the over-generalized comments and conclusions regarding OFL’s and OFY’s operations.

8

B. Chapter One – Related Party Transactions.

The Audit Report makes several suggestions regarding ways in which OFL can better ensure that transactions between related entities are appropriate in all respects. A number of these recommendations are likely to be implemented when considered by the OFL Governing Boards. However, the Audit Report lacks a discussion of the contexts in which related party transactions occurred. Moreover, the Auditors fail to report that these transactions were known to and even reviewed by OFL sponsoring school districts and the CDE. In addition, many of the Auditors’ specific findings regarding related party transactions are inaccurate and misleading.

3

Context of Related Party Transactions

Over the years since OFL was formed, it discovered that there were few services available in the marketplace appropriately tailored to independent study charter school programs. As a result, OFL was frequently required to accommodate services and products ranging from special education to student attendance accounting software designed for non-independent study programs. The costs, loss of efficiency and burden on teachers associated with these adaptations was substantial. Joan and John Hall have, over the years, developed products and services specifically designed to meet the particular needs of independent study programs. Many of these products are consumed not only by the OFL and OFY charter schools, but also by public school districts.

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In any instance in which OFL engaged in transactions with businesses in which the Halls held interests, full disclosures of the Halls' interests were made and governing board approvals were obtained. The Audit Report contains no examples of any transactions between OFL and any related entity that were not entered into in accordance with California law.

10

The CDE Was Aware of the Referenced Transactions When Making Funding Determinations in the Audited Years

The related party transactions referenced in the Audit Report were never hidden. From time to time, sponsoring districts have made inquiries into the background, purpose and nature of the transactions, in each instance finding satisfaction in the responses provided by OFL. In addition, due to the disclosure requirements associated with the SB 740 funding determination process, the CDE was aware of many of the referenced transactions before making its funding recommendations.

11

OFL's Conflict of Interest Policy Is Adequate

OFL's conflict of interest policy meets all applicable legal requirements, a fact implicitly acknowledged in the Audit Report. Nonetheless, OFL has no objection to considering the Auditors' suggestion that OFL's written policy be expanded and set forth in greater detail.

OFL's Relationship With OFY, Inc.

OFY, Inc. is a non-profit entity formed for the primary purpose of collectively administering certain operations of the OFY charter schools. One aspect of this collective administration relates to the purchasing of school supplies (textbooks, study aids, etc.) The ability to combine each of the OFY charter schools' purchasing power allows OFY, Inc. to, among other things, obtain favorable pricing. In order to expand and enjoy the benefits of this cooperative approach to school administration, the OFL charter schools also purchase supplies through OFY, Inc. The OFL schools pay a reasonably allocated share of the operating overhead of OFY, Inc. In doing so, the for-profit OFL schools have ensured that they have not received any undue benefit from the non-profit organization. As noted in the Audit Report, an outside auditing firm was engaged by OFY, Inc. to review the cost allocation charges assessed to OFL by OFY, Inc. to establish a reasonable overhead allocation and to develop systems for prompt billing and payment.

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OFL acknowledges that there were instances in which its payment of billings from OFY, Inc. were delayed. At no time were the delays intended to unduly benefit OFL. OFL is aware that OFY has agreed with the Auditors' recommendations that its billing procedures be strengthened and OFL intends to cooperate fully in that process and to take its own internal steps to ensure prompt payment for all OFY, Inc. purchases.

The Comparison of OFY, Inc. and EMS, Inc. "Charges" Is Immaterial and Irrelevant

The Audit Report contains a largely irrelevant and misguided comparison of payments by the individual OFY charter schools to OFY, Inc. and the fees charged by EMS for management services provided to the Opportunities for Learning charter schools. This portion of the Audit Report reflects a fundamental misunderstanding concerning the corporate structure of OFL. As noted above, EMS, which operates the OFL charter schools, is a for-profit subchapter S corporation. Each OFL charter school is operated by a limited liability company of which EMS is the sole member. Any excess revenue generated by the OFL limited liability companies ultimately ends up in EMS. Thus, it is irrelevant what amount the OFL schools paid to EMS for management services. Any amount not paid for such services would simply have flowed through to EMS.

13

All Governing Board Members Act Freely and Independently

All governing board members of OFL acted freely and independently during the audited periods and continue to do so. Any suggestion that any board member acted at the behest of the Halls or sacrificed his or her own independence for the will of the Halls is unsupported. The name and contact information of every governing board member was supplied to the Auditors who for unknown reasons chose not to speak with the board members. Each board member should have been provided an opportunity to address any concerns the Auditors might have regarding board member independence. The Auditors' comments in this regard lack any concrete examples of board members subjugating their independent judgment for that of the Halls. The Auditors merely speculate that compromised judgment is a possibility. A management structure that ensures maintenance of the organization's vision is not at all unusual to the charter school movement and is by no means a reflection of any board member's lack of independence. Moreover, inasmuch as EMS is a for-profit entity, it is neither unusual nor inappropriate for the company's shareholders to exercise control over the management of the company.

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Joan and John Halls' Salaries Are Appropriate

The Auditors assert that the Halls' salaries "appear questionable." Joan and John Hall serve the OFL entities pursuant to employment contracts reviewed and approved by the OFL governing boards on a regular basis. The Halls' compensation was and is commensurate with that of salaries paid to officers of other entities of similar sizes and natures. In any event, in the case of OFL, the salaries paid to Joan and John Hall are entirely immaterial. The Halls are the sole shareholders of EMS. Thus, any funds earned by the OFL companies and not paid out to the Halls in salary would have been distributed in the form of dividends.

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The non-cash compensation received by the Halls is also commensurate with benefits received by officers of other entities with similar sized budgets, and is also irrelevant for the reason stated above. All reimbursements received by the Halls relate to

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company business ranging from attendance at conferences to other travel and meals *directly* related to OFL operations. There is no indication in the Audit Report of any financial abuse by the Halls.

The Audit Report acknowledges that because of the for-profit nature of EMS-OFL, the Halls compensation is “less relevant” in profitable years, but potentially problematic in less profitable years because the OFL entities remain obligated to pay the Halls’ salaries. However, there is no basis to suggest that if the OFL companies were unable to pay the Halls’ salaries they would sacrifice other aspects of the companies’ operations in order to sustain their salaries.

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Joan and John Hall are career educators who developed, and on a daily basis sustain, an extraordinarily successful educational model. There is nothing contained in the Audit Report or elsewhere to suggest that the OFL entities did not receive the full benefit of the compensation received by the Halls.

C. Chapter 3 – Charter School Funding and Financial Analysis.

This chapter of the Audit Report contains a review of OFL’s submissions to the CDE for annual funding determinations pursuant to SB 740. The chapter mentions only isolated and “minor” inconsistencies in OFL’s financial data submitted to the CDE. While OFL is mindful of the largely insignificant errors, they are nonetheless immaterial as the Auditors acknowledge that they had no impact upon OFL’s funding determinations. With respect to those instances in which the Auditors claim that OFL was or may have been overpaid, OFL disputes the conclusions and recommendations of the Auditors.

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Reporting of Certificated Administrator Salaries

The Audit Report correctly points out that in 2004-2005, on its SB 740 funding determination submission, OFL inadvertently included certificated administrators in the certificated teachers category. The error arose due to the fact that the salaries of certificated employees are accumulated in the same general ledger account. In completing the SB 740 funding determination forms, the accumulated salary data needed to be separated between certificated teachers who are directly instructional and certificated teachers who are administrative. The SB 740 form used for the 2004-2005 funding determination was a new format and the accounting personnel who completed the form inadvertently erred with respect to the classification of certificated salary teachers by including the salaries of the administrative certificated employees.

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While OFL acknowledges the error, it objects to the Auditors’ characterization of the clerical misclassification as “double counting.” When the error was discovered OFL reduced the amount of other expenses so that the total amount of expenses claimed as a basis for the requested funding was accurate. As noted by the Audit Report, the error had no impact upon OFL’s funding determination for that year.

20

Professional Development Expenses Were Properly Categorized

The Audit Report's conclusion that OFL may have been over-paid because it included continuing teacher education as a benefit for its certificated teachers constitutes a substantial auditing error. In reaching their conclusion and recommendations, the Auditors have ignored the applicable regulation, have misapplied the definition of "teacher benefits" and have failed to exercise common sense.

21

In order to qualify for State funding during the fiscal years audited, independent study charter schools, including OFL, were required to expend their funds according to State mandated requirements. In the audited years, in order to obtain a minimal funding level of 70%, OFL was required to spend 60% of its total revenue on instruction and related services. In addition, of that 60% spent on instruction and related services, 40% of OFL's total revenue was required to be spent on certificated salaries and benefits. (See, California Code of Regulations, Title 5, Sec. 11963.3(c)(1).) According to the Regulations, therefore, teacher benefits are a subset of instruction and related expenses.

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In its SB 740 submission, OFL included payments for continuing teacher education (including National University scholarships) and teacher expense reimbursements in the 40% percent certificated salaries and benefits category. The Auditors concluded that this entry was erroneous because the CDE's instructions apparently indicate that such expenses should be included in the 60% category for instruction and related services but *not* within the 40% certificated teacher benefit category.

The lethal flaw in the Auditors' conclusion is that, regardless of what the instruction form provided, funding was to be determined only in accordance with properly adopted regulations. The regulations clearly indicated that all expenditures for certificated teacher benefits were to be included in the 40% category. There is nothing contained in the regulations stating that teacher benefit expenses should be counted toward instruction and related services but not toward the certificated salaries and benefits category. It defies common sense to suggest that continuing teacher education is not a benefit of employment. Teachers carry their degrees and the benefits of continuing education with them wherever they work. Moreover, teacher compensation in both charter schools and traditional public schools is directly tied to the teacher's level of education.

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In order to reach their misguided conclusion, the Auditors rely on the definitions of "Instruction Costs" and "Employee Benefits" found in the glossary section of the California School Accounting Manual ("CSAM"). However, these definitions wholly support OFL's position on this issue. The CSAM glossary states that "Instruction Costs" include salaries and benefits of teachers. It further states that "employee benefits" include a variety of benefits, not paid directly to the employee. It should be noted that the SB 740 instructions for completing the funding determination process provide a definition for "Salaries and Benefits" that expressly includes personnel costs associated with activities "designed to provide motivation . . . and improvement of skills or personal

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development.” By including the continuing teacher education benefit in the 40% certificated salary and benefits category of its SB 740 form as well as part of its 60% spent on instruction and related services category, OFL acted consistently with the applicable regulations and CSAM. To the extent the SB 740 instruction form requested OFL to allocate its expenses differently, it is the instruction form that was at odds with the applicable regulations and CSAM standards.

25

After improperly adjusting the OFL charter’s certificated teacher benefit expense reporting for the 2004-2005 fiscal year, the Auditors note that, by disqualifying teacher education programs from certificated expenses, the total percentage claimed by OFL-Baldwin Park in its certificated salary and benefit category fell to *less than 1%* below the required 40% threshold. For OFL-Capistrano, the total percentage claimed by the school in its certificated salary and benefit category dropped to only *2.85%* below the required 40% threshold. In response, the Audit Report suggests that the schools should be required to forfeit the entire amount of their funding for the 2004-2005 fiscal year. In light of the foregoing discussion, this is an unjustifiable conclusion that does nothing to promote the purposes and policies behind the SB 740 funding determination process.

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Finally, it is significant that in 2004-2005, the CDE was expressly aware of the fact that OFL included continuing teacher education and teacher expense reimbursements in the 40% certificated teacher salary and benefits category. Unfortunately, the Auditors refused to review numerous forms of correspondence between OFL and the CDE regarding this issue. With full knowledge of the manner in which OFL reported its teacher benefits expenses, the State Board of Education, on the recommendation of CDE staff, approved OFL’s funding. This is, therefore, no longer a pertinent issue.

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D. Chapter 4 – Charter School Pupil-to-Teacher Ratios.

The Entire Section of the Audit Report Regarding FTE and Pupil-To-Teacher Ratios Should be Stricken or Disregarded As Inapplicable and Irrelevant

As pointed out in the Introduction to this Response, the Auditors repeatedly declined to consider probative data offered by OFL to support its positions regarding a variety of the Auditors’ conclusions and recommendations. By failing to consider all relevant data, the Auditors compromised their impartiality and reached conclusions unsupported under applicable law. There is no portion of the Audit Report more flawed as a result of incomplete analysis than the discussion pertaining to FTE calculations and pupil-to-teacher ratios.

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As the Audit Report points out, in order for an independent study charter school to have received 100% funding, the school was “generally” required to maintain a pupil-to-teacher ratio that is equal to or lower than that of the largest unified school district in the counties served by the charter school. The pupil-to-teacher ratio is calculated by dividing Average Daily Attendance by the number of full time equivalent teachers. The Audit Report claims that OFL “*may*” have been overpaid during the audit years as a

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result of its use of an improperly high FTE number. OFL's FTE during the audited years was 1.92. The Auditors assert that the CDE claims that FTE may not exceed 1.0.

When OFL was informed of the CDE's claim, OFL requested that the Auditors consider the applicable regulations and the CDE's historical (and contrary) position on the issue. As the Audit Report indicates, the Auditors failed to do so. As only one example of CDE communications contradicting its current position, OFL attaches hereto a Memorandum prepared by Ms. Janet Sterling (School Services Fiscal Services Director) to the State Board of Education in May 2002 setting forth and explaining the recommendations of the Advisory Commission on Charter Schools for funding regulations to be adopted pursuant to SB 740. These proposed regulations were ultimately adopted. In Attachment 1 of the Memorandum, Ms. Sterling clearly indicated that for the 2002-2003 fiscal year, the requirement that a charter school's pupil-to-teacher ratio be equal to or lower than the largest unified school district in the counties in which the charter school is located, is a requirement *only for 100% funding*. The pupil-to-teacher ratio threshold is not a requirement for the lesser levels of funding. As the proposed regulations were adopted, the same funding standards applied in each of the years that are the subject of the Audit Report.

None of the OFL charter schools received 100% funding in the audited years. Accordingly, they were not required to maintain pupil teacher ratios at the levels required for 100% funding. **The pupil-to-teacher ratio analysis upon which this entire chapter of the Audit Report and the recommendations therein are based has absolutely no application whatsoever to OFL during the audited years.** Thus, the entirety of Chapter 4 of the Audit Report should be excluded from the final Audit Report.

The Audit Report acknowledges that the pupil-to-teacher ratio requirement is an additional requirement for 100% funding (as opposed to the lesser potential funding amounts). Therefore, it is entirely unclear why the Auditors would proceed to apply the requirement to OFL and they may not have erroneously done so if the information proffered by OFL during the Audit had been considered.

The Audit Report Lacks Any Reliable Basis for Adopting the CDE's Position

Assuming, for argument sake only, that the pupil-to-teacher ratio requirement did apply to OFL in the audited years, the Auditors' analysis of OFL's funding as it relates to FTEs is erroneous or otherwise unsupported for the following additional reasons:

1. The Auditors accepted the CDE's claim that FTE may not exceed 1.0 without having undertaken *any* analysis of whether the use of 1.0 is consistent with applicable laws and regulations and further did so without considering established CDE's practice contrary to its recent 1.0 interpretation;

2. The Auditors ignored data provided to them by OFL demonstrating that the CDE has repeatedly and even frequently approved funding for numerous charter schools using FTE amounts in excess of 1.0 up to and including 2.0;

3. The Auditors failed to take into account the fact that the CDE was aware of OFL's use of 1.92 FTE in each of the audited years and made no adjustment to funding based on a claim of improper FTE;

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4. The Auditors failed to consider the fact that the CDE has publicly acknowledged that a charter school's teachers may teach amounts in excess of the public school district's full time teaching position. The California Basic Educational Data System, maintained by the CDE, allows for annual reporting of teacher FTE's greater than 1.0 (or 100%);

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5. The Auditors neglect to mention that the California Legislature considered amending Title 5 of the California Code of Regulations to limit FTE to 1.0 as a matter of law. The amendment was expressly rejected; and,

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6. The Auditors do not consider the State Teachers Retirement System regulations which clearly acknowledge that teachers can and do work in excess of a district full time teaching position and receive credit towards retirement benefits based upon the excess work-time in addition to immediate salary increases.

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While ignoring all of the evidence to the contrary, the Auditors provide no independent or external support whatsoever for the assertion that FTE **cannot** exceed 1.0.

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OFL's FTE amount is not a fictional number. OFL teachers work substantially more hours and days than traditional public school full time teaching positions. As a result, OFL's FTE was and is legitimately greater than 1.0 and there is no basis upon which to deny OFL funding based upon its actual and legal FTE calculation.

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The Audit Report concedes that resolution of this issue requires a legal determination (that would be inappropriate for the Auditors to make themselves). Much of the discussion contained in Chapter 4 of the Audit Report is also immaterial as it is merely a one-sided presentation of the amount of funding OFL should return if the CDE's erroneous and contradictory position on FTE is upheld. Since applicable law and the CDE's historical conduct thoroughly undermine the notion that FTE may not exceed 1.0, such an outcome appears highly unlikely.

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OFL Agrees That the Dispute Regarding FTE Should Be Resolved

Ultimately, notwithstanding the foregoing, OFL agrees with several of the Auditors' recommendations with respect to the issue of FTE. For example, OFL agrees that all parties would benefit from a swift resolution of the pending lawsuit between OFL and the CDE regarding proper FTE calculation so that future disputes can be avoided. OFL also agrees that FTE should be calculated in accordance with established rules.

E. Chapter 5 – Student Attendance Records.

OFL concedes that record-keeping errors associated with student files led to a relatively incidental amount of over-paid attendance days. However, OFL also notes that during this period, thousands of students were served and that some amount of record-keeping errors are virtually impossible to avoid. Nonetheless, OFL finds the Auditors' recommendations with respect to this issue to be reasonable and intends to review its record-keeping practices and implement policies intended to reduce the risk of errors.

III. CONCLUSION

As noted at the outset of this Response, OFL has cooperated in all reasonable respects with the Audit. While OFL believes that many of the recommendations contained in the Audit Report are based upon faulty factual premises and improper or erroneous legal conclusions, OFL is committed to improving its programs in all respects. It is in that spirit that OFL, through its Managers and Officers, will continue to consider the recommendations contained in the Audit Report and, where appropriate, implement those recommendations that will help OFL to continue its successful commitment to California's at risk and educationally under-served youth.

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Last Minute Memorandum

To: STATE BOARD MEMBERS

Date: May 29, 2002

From:  Janet Sterling, Director
School Fiscal Services Division

Re: ITEM #36

Subject PERMANENT REGULATIONS REGARDING CLASSROOM AND
NONCLASSROOM BASED INSTRUCTION IN CHARTER SCHOOLS:
IMPLEMENTATION OF THE PROVISIONS OF SENATE BILL 740

Attached for consideration is a package of amendments to the proposed regulations regarding classroom and nonclassroom-based instruction in charter schools, which implement (in part) the provisions of Senate Bill 740 (Chapter 892, Statutes of 2001). These proposed amendments reflect the recommendations of the Advisory Commission on Charter Schools (ACCS) on the permanent regulations, which were developed by ACCS over the past three months and after considerable public testimony by interested parties. The first attachment is a summary of the ACCS's recommendations on the standards that charter schools offering nonclassroom-based instruction would be required to meet to receive a specific funding level. The second attachment is the text of the amended regulations, which reflects the ACCS recommendations.

California Department of Education staff recommend that the State Board of Education direct that this package of amendments be circulated for a 15-day public review period in accordance with the Administrative Procedures Act.

Attachments to Agenda Item:

Attachment 1: Summary of ACCS's Recommendations (Page 1)

Attachment 2: Title 5, California Code of Regulations (Page 1-14)

SUMMARY OF ACCS'S RECOMMENDATIONS

FOR THE 2002-03 FISCAL YEAR

- I. **80 percent** – a charter school must demonstrate **BOTH** of the following:
1. The charter school's total expenditures on certificated employee salaries and benefits are at least **35 percent** of the charter school's total public revenues; **AND**
 2. The charter school's total expenditures on instruction and instruction-related activities are at least **55 percent** of the charter school's total revenues.
- II. **100 percent (i.e. full funding)** – a charter school must demonstrate that its total expenditures on certificated employee salaries and benefits are at least **50 percent** of the charter school's total public revenues.
- III. **Less than 80 percent** – if a charter school **does not meet BOTH** of the minimum requirements to receive 80 percent funding, then the funding level is **70 percent**.

FOR 2003-04 AND EACH FISCAL YEAR THEREAFTER

- I. **70 percent** – a charter school must demonstrate **BOTH** of the following:
1. The charter school's total expenditures on certificated employee salaries and benefits are at least **40 percent** of the charter school's total public revenues; **AND**
 2. The charter school's total expenditures on instruction and instruction-related activities are at least **60 percent** of the charter school's total revenues.
- II. **85 percent** – a charter school must demonstrate **BOTH** of the following:
1. The charter school's total expenditures on certificated employee salaries and benefits are at least **50 percent** of the charter school's total public revenues; **AND**
 2. The charter school's total expenditures on instruction and instruction-related activities are at least **70 percent** of the charter school's total revenues.
- III. **100 percent (i.e. full funding)** – a charter school must demonstrate **ALL** of the following:
1. The charter school's total expenditures on certificated employee salaries and benefits are at least **50 percent** of the charter school's total public revenues; **AND**
 2. The charter school's total expenditures on instruction and instruction-related activities are at least **80 percent** of the charter school's total revenues; **AND**
 3. The charter school's pupil-teacher ratio as calculated pursuant to *Education Code* Section 51745.6 is no greater than the pupil-teacher ratio of the largest unified school district in the county or counties in which the charter school operates.
- IV. **Less than 70 percent** – if a charter school **does not meet ALL** of the minimum requirements to receive 70 percent, then the funding level is **zero**.

-
- All expenditure and revenue data will be prior year data, except for new charter schools, which will use estimated current year data.
 - Mitigating factors and individual circumstances may be considered by the ACCS and SBE in making determinations different from the standards above.

CALIFORNIA CHARTER SCHOOL GROUP
P.O. Box 1028
Pasadena, California 91102

July 28, 2006

Mr. Tyler Covey
MGT of America, Inc.
455 Capitol Mall, Suite 600
Sacramento, CA 95814

Dear Mr. Covey:

This letter is in response to the draft report titled "Extraordinary Audit of the Options For Youth, Inc. and Opportunities For Learning, Inc., Charter Schools," which California Charter School Group ("CCSG") received from MGT of America, Inc. on July 24, 2006. The comments below are in addition to comments CCSG has provided to the audit team orally.

The draft provided to CCSG is a redacted version of the audit report. Thus, CCSG has not had an opportunity to review the entire report before its public release. In addition, certain of the redactions make it difficult in some instances to determine the full meaning of the unredacted text. The report also contains numerous dates, dollar amounts and other data which CCSG does not have the time or the resources to confirm or verify prior to the July 29, 2006 deadline CCSG was given for this written response. Nonetheless, CCSG offers the following general response to the redacted draft audit report:

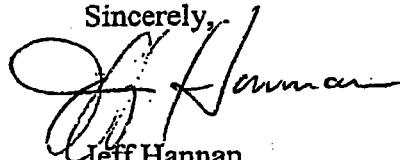
The current board of directors and management of CCSG have been with CCSG only since the fall of 2004. Accordingly, our understanding of what occurred with respect to the OFL - Hacienda La Puente Charter School (the "OFL-HLP School") prior to our involvement is not based on direct experience. As CCSG's counsel explained to the audit team during the course of the audit, however, it is our understanding that Education Management Systems ("EMS") had exclusive responsibility for and control over CCSG's student records and practically every other aspect of the operations of the OFL-HLP School since inception.

Pursuant to the terms of the Services and Property Agreement between CCSG and EMS, EMS's responsibilities included, without limitation, all functions that relate to educational services, facilities management, human resources management, administration and operation of the OFL-HLP School. Pursuant to the agreement, EMS had the sole responsibility and authority to determine staffing levels. It is our

understanding that EMS's responsibilities also included the preparation of all reports relating to funding determinations for the OFL-HLP School. In any event, the current board of directors and management of CCSG had no hand in preparing any of the materials characterized in the report as inaccurate, inconsistent, incorrect, unsupported, or otherwise erroneous.

Soon after I became President of CCSG in September 2004, we terminated the Services and Property Agreement with EMS effective June 30, 2005, and as a result of that termination CCSG closed the OFL-HLP School on June 30, 2005. CCSG has attempted to cooperate fully with the audit team's requests for information since the audit of the OFL and OFY charter schools was announced, including after the OFL-HLP School closed. CCSG looks forward to working with the California Department of Education to try to resolve any issues pertaining to the OFL-HLP School.

Sincerely,

A handwritten signature in cursive script, appearing to read "Jeff Hannan". The signature is written in black ink and is positioned to the left of the typed name.

Jeff Hannan

President

California Charter School Group, Inc.

The Audit Team's Comments on the Response from Options for Youth

To provide clarity and perspective, the audit team is commenting on Options for Youth's (OFY) response to the audit. The numbers correspond to the numbers the team has placed in OFY's response.

1. The OFY's statement is misleading. Although the culmination of the investigative audit is occurring more than a year after it began, OFY and Opportunities for Learning (OFL) delayed the audit for several months by its failure to provide timely information. Furthermore, formal approval of an audit expansion also added another month to the process. Therefore, the audit team conducted the actual "review" in much less time than 14 months.
2. This statement by OFY is misleading. Throughout the audit, the audit team shared information regarding its findings, including most of the Exhibits in the audit report. The audit team also briefed OFY regarding all of its findings and the report layout on June 8, 2006, shared the Introduction section on June 7, 2006, and shared the body of the draft report with OFY at the exit conference on July 13, 2006. While it is true that OFY had five days to respond to the official draft report it received on July 24, 2006, it had much more time to consider its responses to the major issues.
3. The OFY's statements are overly broad and inaccurate—as evidenced by the audit team's remaining responses below.
4. This is another overly broad statement by OFY that is misleading and mostly inaccurate. As illustrated by the audit team's responses below, the audit team believes it considered all relevant information to reach its conclusions and that, in some cases, OFY failed to completely respond to our findings until it provided its response to the audit report.
5. This response is the first time OFY has revealed its belief that the pupil-to-teacher ratio requirement is only a requirement to receive 100 percent funding. The audit team sent OFY, on June 20, 2006, all of the data used in its calculations for determining the overclaimed apportionment. The OFY focused its responses to this data on some information contained on the California Department of Education (CDE) Website that was irrelevant to the calculations. Specifically, OFY contended the audit team calculations were wrong by using comparison district information on *student enrollment*, not pupil-to-teacher ratios, to support its assertions. The OFY has based its response to the audit report on an inaccurate interpretation of a May 2002 memo from CDE—without consulting the appropriate statute, California Education Code Section 51745.6, which states that charter school funding shall be reduced to the extent that its units of average daily attendance (ADA) result in a pupil-to-teacher ratio that exceeds that of the comparison district (please see audit team response number 39 for the complete text of this law). While meeting this provision *is* a requirement for receiving 100 percent funding, not meeting this requirement is still a basis for reductions in funding—*regardless* of the funding percentage received as determined by the SB 740 funding process. Under OFY's interpretation, it could have *any* pupil-to-teacher ratio if it does not receive 100 percent funding.

6. The audit team considered and responded to three rounds of informal written feedback from OFY regarding this audit report. Several of the objections raised in OFY's official written response, while sometimes raised during the audit process, were not raised by OFY during the three rounds of informal feedback. The OFY/OFL entities, primarily OFL, repeatedly threatened lawsuits when the audit team uncovered information that was not supportive of the entities. The audit team conducted a thorough review based on available information, including all information provided by the entities during the course of the audit. The new information presented in the OFY official response indicates that the auditees withheld information from the audit team. As such, the audit team has added information to the scope and methodology regarding the audit team's concerns that the auditees were not always forthcoming.
7. This comment is not relevant to the audit report. For the issues reviewed by the audit team (such as related party transactions, SB 740 funding percentages, full-time equivalent (FTE), and ADA, the laws, regulations, and policies are the same—regardless of the entity's legal structure. Furthermore, the audit team found that OFY and OFL operated very similarly in all these areas. Moreover, it is acceptable, when conducting multiple audits with the same scope, to include multiple programs and entities within one report. Generally Accepted Government Auditing Standards sections 1.15 and 2.13f clearly address this type of reporting.
8. This is a mischaracterization of the audit report contents. As referred to in Chapters 1 and 2, the audit team found two related party transactions—one with Pathways in Education (Pathways) and one with ePlus group—to be questionable.
9. This is another overly broad statement. The audit team found that during the three years reviewed, Educational Dynamics, Inc. and Partners in Special Education each contracted with three public school districts; however, all of the contracts reviewed by the audit team have expired.
10. This assertion is questionable, since OFY was unable to provide evidence that they had looked to outside, unrelated, vendors to provide the same management services as OFY, Inc. Furthermore, as stated in the audit report, the OFY schools do not have the ability to choose another vendor. The audit report also reveals that several of the OFY boards did not consider all relevant cost factors related to Educational Dynamic, Inc.
11. Neither the CDE nor the county offices of education found "satisfaction in the responses provided by OFY" as evidenced by CDE and county offices of education requests to conduct an investigation into the related party transactions. Moreover, in some cases, OFY provided the referenced entities with incomplete or inaccurate information as evidenced by the Pathways and FTE disclosures.
12. As described in the report on page 4, the audit team defines Hall entities as an entity that any of the Hall family founded, owns, or works in as an officer or director. As also described in the report, the audit team believes that the Halls are able to exert some measure of control over the OFY entities due to the sole member set-up of the organization.
13. As OFY, Inc. refused to provide information to the audit team, the team cannot validate the assertion that the Halls receive no additional salary from OFY, Inc.

- The audit team did verify that OFY, Inc. paid for many of the Halls' automobile, travel, and entertainment expenses. However, because OFY, Inc. allocates all its costs to the charters, the charters are, in effect, making the payments.
14. This statement is incorrect. The report does not refer to the OFY schools paying OFY, Inc. "\$27.8 million in fees." Rather, the report states that the schools paid \$27.8 million to OFY, Inc. for operating costs and "management services."
 15. There is no relevance as to whether OFY is a "management company," as the OFY chief financial officer called it in a June 6, 2006 email to the audit team, or an organization that "provides management services for public charter schools" as it describes itself on the California Office of the Attorney General's Website, or a "cooperative," as they now call it. The schools should have an agreement in place to protect their interests and to ensure proper operation and control over the "cooperative."
 16. It is incorrect for OFY to assert that "all of the transactions discussed in the Audit Report received board approval." Rather, the report reveals that the OFY school boards did not approve the related party relationships with OFY, Inc. or ePlus. Moreover, the audit team did query the two board members about the validity of the meeting minutes in question. One of the board members chose to meet with the team in the presence of the current OFY chief financial officer. Neither board member had much recollection about the board meetings in question, which had occurred nearly four years earlier, but confirmed to the best of their recollection that the minutes sounded accurate. Therefore, the audit team concluded that the value of contacting other board members was limited, especially since a member of the Hall family signed and attested to all of the minutes in question—not the other board members.
 17. Characterizing these transactions (in which the nonprofit OFY extends interest-free credit for several months to OFL, a related for-profit entity) as an interest-free loan has nothing to do with the audit team's impartiality. The audit team could not determine, and made no comment on, the intent of the transactions, reporting only on the results.
 18. The audit team disagrees. The audit team concedes that the comparison is not perfect; however, because each of the entities, OFY, Inc. and Education Management Systems, provide similar services and much of the same management to schools that operate very similarly, the team believes the comparison is relevant. As highlighted in the report, the audit team finds it noteworthy that the for-profit management company appears to charge nearly \$40,000 less per school than does the nonprofit "cooperative."
 19. The audit report reveals two instances, the OFY-Victor Valley transfer to Pathways in Education, and the purchases from ePlus in which the independence of certain OFY board members is questionable. Moreover, during the three years reviewed by the audit team, only three board members, one of whom was non-voting, were from the district.
 20. This is the first time OFY has presented this information to the audit team. The audit team made OFY aware of its concerns related to this transaction on several occasions. Because this information was not made known, the audit team cannot verify the veracity of OFY's new assertions. When queried about the ePlus

transactions during May 2006, OFY's chief financial officer provided the following statements: "*The Board of Directors for the OFY entities have delegated day-to-day operational activities such as this to management, so voting or approving a transaction or vendor is not something that would be addressed in a BOD meeting or its minutes.*" "*We found no disclosure or discussion relating to this relationship or transaction in the board minutes.*" Moreover, OFY did not provide the audit team with the "approved and executed purchase contract" as mentioned in the response and the invoices reviewed by the audit team were itemized—indicating that OFY and ePlus may not have previously agreed upon the items or the purchase price. The team was also unable to verify, as claimed in the OFY response, whether Karen N. was an officer or director of any OFY entities in 1998 because OFY did not provide this information to the audit team. The audit team was able to determine that Karen N. was an incorporator of OFY-CA (the entity that selects the board for the other OFY entities) in October 1999, served as president in May 2001, and was a director in January 2002. Karen N. was also the president of OFY, Inc. (the entity that made the payments to ePlus) at the same time that it made payment to ePlus in September 2002.

21. The audit team disagrees. As pointed out in the report, the Hall's OFY salaries do not compare favorably with the salaries of other school superintendents. Moreover, as discussed in the report, the audit team could not verify the appropriateness of many of the "non-cash compensation" benefits received by the Halls because the transactions lacked adequate supporting documentation.
22. These statements are overly broad. The audit team made OFY aware of its concerns regarding the Halls' salaries and the related board analysis of these salaries. At no time did OFY offer additional documents to refute these concerns. The audit team is also unclear and concerned about OFY's statement that the compensation analysis "should not be entirely objective."
23. OFY's comments regarding CDE's prior reviews of this transaction are not relevant. In fact, it was CDE and the five county offices of education that asked the audit team to investigate "all transactions with Pathways in Education, regardless of the year." Because the audit team did not have full access to Pathways' records, it could not make a complete assessment about the appropriateness of the transfers. The questionable relationships and circumstances surrounding the transactions warrant the recommendation for a referral to conduct a more detailed inquiry.
24. These statements are contrary to assertions made by OFY's former chief operating officer and the fact that the State ordered the investigation into the transfer of the funds. Specifically, as described in the audit report, in recommending the transfers to Pathways the OFY chief operating officer told the board of the OFY charters "*it was very possible that the state would require the charter school to consume its financial reserves before providing additional funding to them.*" The funds may no longer be state funds; however, the funds were initially received from the State, were subject to appropriate state laws, were transferred under unusual circumstances and rationales, and are therefore worthy of investigation.

25. As stated in the report, the two board members held the positions *concurrently*—authorizing the transfer of funds from OFY-Victor Valley while on the board of the receiving entity, Pathways. Moreover, the audit team could not confirm the assertions regarding the lack of personal benefits from the two board members because OFY, Inc. would rarely provide information and Pathways would not provide information to the audit team. However, the audit team did learn that the two board members in question were, at times, involved in paid positions with the OFY entities with one member working as the assistant to the president and the other working as the director of community relations. Therefore, without further investigation and increased access to records, it cannot be verified that no personal benefit was received.
26. The audit team disagrees that its observations are “an exercise in form over substance.” As OFY described in its response, “the OFY-Long Beach Funds were ultimately contributed to Pathways” and “the OFY-Long Beach board did not approve the transfer to Pathways.” This is the substance or end result of the transaction that the audit team found questionable. Moreover, the failure to report this transfer to the State is another cause for concern.
27. Again, OFY has missed the substance of the transaction and has erred in its assumptions. OFY should be well versed in the scope of the audit that was requested by the CDE and five county offices. In the scope, the audit team was asked to look at “all transactions with Pathways, regardless of the year” and to investigate “related party transactions.” Pathways became relevant to the audit, beyond the business transactions, when it was learned that several of Pathways directors and officers are either current or former OFY or OFL directors or officers or are related to the Halls. Additionally, the transfer of funds to Pathways was made, according to OFY’s former chief operating officer, to avoid state sanctions—as discussed further in audit team response number 24.
28. The audit team has not made “an errant legal conclusion.” Rather the audit team has made an observation and recommendation that it believes could be useful to OFY. Given the fact that OFY transferred nearly \$11 million to Pathways, the audit team has concerns that OFY’s legal counsel also represented Pathways without formal disclosure or consent.
29. This is an overly broad statement by OFY without specific information as to what it disagrees with. OFY makes no mention of the specific detailed items in the report for which it contends it was not overpaid. Again, this is the first time OFY has revealed its concerns to the audit team. Moreover, the audit team agrees that many of the items discussed in the chapter are insignificant in terms of dollar amount; however, the errors found, if uncorrected, could lead to larger issues.
30. OFY’s header in this section is news to the audit team. It is unclear how OFY was able to determine that “all credit card charges were proper” without supporting documentation and receipts. Again, OFY did not provide any of this information for the credit card charges, spanning three years, reviewed by the audit team.
31. The source of this information is unknown to the audit team. The OFY did not provide the audit team with any evidence related to other schools that spend \$18,000 on a staff holiday party.

32. OFY's premise is false and it did not previously share any of this information with the audit team. Generally accepted government auditing standards require auditors to obtain sufficient, competent, and relevant evidence to afford a reasonable basis for the auditor's findings and conclusions. OFY's assertion that receipts "do little to establish the actual purpose of a particular expense" is incorrect. Receipts document the nature, type, and detail of the transaction, and allow auditors, as well as those responsible for maintaining OFY's books, to verify the appropriateness of the charges. Without this evidence, neither the audit team nor OFY has a basis for concluding the charges were accurate or appropriate, and that they did not personally benefit the Halls.
33. As described in the audit report, OFY filed statements with CDE indicating it had met expenditure requirements for credentialed teacher salaries. However, OFY only met the requirements by artificially increasing teacher bonus accruals to obtain the additional funding. Please see the audit team response number 35.
34. This is one instance where OFY did provide additional information in support of its assertions. Specifically, OFY was able to provide clarifying data for the 2004-05 bonus accruals. The audit team subsequently removed this exhibit from the audit report. Because the audit team advised OFY staff of the exhibit's removal prior to the OFY issuing its response, it is unclear why it is mentioned here.
35. The audit team disagrees. The audit team never stated that OFY cannot accrue bonuses. As discussed in the report, accruing expenses to reach an additional funding level is inconsistent with the provisions of SB 740, the California School Accounting Manual (CSAM), and Generally Accepted Accounting Principles (GAAP). Specifically, the SB 740 instructions state that unless otherwise indicated, all financial information shall be presented using the definitions in CSAM. CSAM requires nonprofit charter schools to use GAAP. As the audit report points out, accruing expenses to achieve a greater level of funding is inconsistent with GAAP. Further, as stated in the report, OFY did *not* pay out more than \$1.2 million of the bonuses it accrued in 2003-04. In fact, it subsequently reversed these entries in its accounting records.
36. The audit team considered all relevant data and reached supported, impartial conclusions. In fact, this was perhaps the only area in which a member of the Hall entities' exit conference team complimented the audit team on its balance and fairness. Therefore, it is surprising that OFY now states that the audit team has compromised its impartiality. Please see the audit team response numbers 5, 39, and 43. The information presented by the Hall entities supported that other schools had claimed FTE rates greater than 1.0 FTE. However, this information did not contradict the legal opinion presented by CDE in as much as all the schools that did use the 1.0 FTE did not contradict the OFY/OFL legal opinion.
37. The audit team used the term "generally" due to the 2005 change in law that now allows the additional option for schools to use a 25 to 1 comparison ratio. The report states that OFY "may" have been overpaid during the audit years because the issue is currently before the courts to decide. Moreover, for questionable FTE issues, the audit team states that OFY "may" have been overpaid by more than \$164,000 because the final determination will need to be made by CDE and there are numerous factors and calculations involved.

38. This is incorrect. Nowhere in the report does the audit team state it failed to consider CDE's position. Please see audit team response number 36.
39. As noted in audit team response number 5, OFY is incorrect regarding its interpretation of the "memo" prepared by CDE and should have consulted the actual code section (referenced in the memo) for additional information. The audit team presents California Education Code Section 51745.6 below to provide the full context of the requirements, which are separate from the funding determination percentage rules. Moreover, the audit team did not ignore any of the information provided by OFY.

The ratio of average daily attendance for independent study pupils 18 years of age or less to school district full-time equivalent certificated employees responsible for independent study, calculated as specified by the State Department of **Education**, shall not exceed the equivalent ratio of pupils to full-time certificated employees for all other educational programs operated by the school district. The ratio of average daily attendance for independent study pupils 18 years of age or less to county office of **education** full-time equivalent certificated employees responsible for independent study, to be calculated in a manner prescribed by the State Department of **Education**, shall not exceed the equivalent ratio of pupils to full-time certificated employees for all other educational programs operated by the high school or unified school district with the largest average daily attendance of pupils in that county. The computation of those ratios shall be performed annually by the reporting agency at the time of, and in connection with, the second principal apportionment report to the Superintendent of Public Instruction.

(b) Only those units of average daily attendance for independent study that reflect a pupil-teacher ratio that does not exceed the ratio described in subdivision (a) shall be eligible for apportionment pursuant to Section 42238.5, for school districts, and Section 2558, for county offices of **education**. Nothing in this section shall prevent a school district or county office of **education** from serving additional units of average daily attendance greater than the ratio described in subdivision (a), except that those additional units shall not be funded pursuant to Section 42238.5 or Section 2558.

40. The audit team did not fail to consider that CDE was aware of OFY's use of a 1.92 FTE factor. Because the issue of whether an FTE factor of 1.92, 1.0, or something in between, is now a legal matter before the courts, the audit team attempted to present the disputed facts. More importantly, the audit team considered the fact that CDE was one of the six entities that had concerns regarding OFY's calculation of FTE and, as a result, requested an audit to investigate OFY's FTE calculations.
41. OFY is mistaken. The audit team did not ignore any of the information provided by OFY. Please see the audit team response numbers 36 and 40.

42. The fact that other schools can and have claimed greater than 1.0 FTE is not in dispute, rather it is OFY's method for doing so that is.
43. The report states that OFY's teachers do work more than a "typical" teacher. However, California State Teachers' Retirement System regulations are neither referenced in nor applicable to the SB 740 funding process. Please see audit team response numbers 41 and 42.
44. The audit report does not state that FTE cannot exceed 1.0. Rather, the report presents CDE legal counsel's opinion that the OFY 1.92 methodology does not comply with existing laws and regulations.
45. The assertion that OFY teachers work more than a typical teacher is acknowledged in the audit report. The courts will determine the validity of the 1.92 calculation.
46. The audit team finds it surprising that OFY now asserts that the audit team response is biased when this notion was not addressed during the exit conference with the Hall entities. Rather, as mentioned earlier, this was perhaps the only area in which a member of the Hall entities' exit conference team complimented the audit team on its balance and fairness. Please see audit team response number 40.
47. This statement is inaccurate and it is unclear where the OFY received its information that the audit team obtained the data "by phone." Although the audit team provided its findings and supporting data to OFY in June 2006, OFY did not share this response with the audit team until it sent its official response to the audit report. The audit team verified all of its supporting pupil-to-teacher ratios in writing with the exception of Yreka Unified High School District, which the audit team verified via the Internet. Please see audit team response number 5 for a more detailed response to this issue. The OFY is correct that the verified pupil-to-teacher ratio for Yreka Unified High School District included special education FTEs. However, OFY fails to mention that the ratio also included special education ADA. The audit team backed out both the special education ADA and FTE, and the pupil-to-teacher ratio for Yreka Unified High School District did not change from the 18 to 1 ratio — as reported in Chapter 4.
48. The audit team responses 1 through 47 reveal that OFY's allusions to "faulty factual premises and improper or erroneous legal conclusions" are false.

The Audit Team's Comments on the Response from Opportunities for Learning

To provide clarity and perspective, the audit team is commenting on Opportunities for Learning's (OFL) response to the audit. The numbers correspond to the numbers the team has placed in OFL's response.

1. The OFL's statement is misleading. Although the culmination of the investigative audit is occurring more than a year after it began, OFL and Options for Youth (OFY) delayed the audit for several months by failing to provide timely information. Furthermore, formal approval of an audit expansion also added another month to the process. Therefore, the audit team conducted the actual "review" in much less time than 14 months.
2. This statement by OFL is misleading. Throughout the audit, the audit team shared information regarding its findings, including most of the exhibits in the audit report. The audit team also briefed OFL regarding all of its findings and the report layout on June 14, 2006, shared the Introduction section on June 7, 2006, and shared the body of the draft report with OFL at the exit conference on July 13, 2006. While it is true that OFL had five days to respond to the official draft report it received on July 24, 2006, as indicated above, OFL had much more time to consider its responses to the major issues.
3. The OFL's statements are overly broad and inaccurate—as evidenced by the audit team responses below.
4. This is an overly broad statement by OFL that is misleading and mostly inaccurate. As illustrated by the audit team's responses below, the audit team believes it considered all relevant information to reach its conclusions and that, in some cases, OFL failed to completely respond to our findings until it provided its formal response to the audit report.
5. This response is the first time OFL has revealed its belief that the pupil-to-teacher ratio requirement is only a requirement to receive 100 percent funding. In May and June of 2006, the audit team sent OFL all of the data used in its calculations for determining the overclaimed apportionment. The OFL focused its responses to our findings on the allowability of the teacher "position" rather than the "person." However, the laws seem clear, by requiring the positions to be filled with credentialed persons that it is the person that counts. The OFL has based its formal response on a new argument that is an inaccurate interpretation of a May 2002 memo from the California Department of Education (CDE) — without consulting the appropriate statute. Specifically, California Education Code Section 51745.6 states that charter school funding shall be reduced to the extent that its units of average daily attendance (ADA) result in a pupil-to-teacher ratio that exceeds that of the comparison district (please see audit team response number 31 for the complete text of this law). While meeting this provision *is* a requirement for receiving 100 percent funding, not meeting this requirement is still a basis for reductions in funding — *regardless* of the funding percentage received as determined by the SB 740 funding process. Under OFL's

- interpretation, it could have *any* pupil-to-teacher ratio if it does not receive 100 percent funding.
6. The audit team disagrees with OFL's characterizations; please see the audit team response numbers 21 through 26 for a more detailed explanation. Further, the audit team did not fail to consider whether CDE was aware of the calculations, noting the CDE was part of the group that requested the investigation into OFL's certificated teacher calculations.
 7. The audit team considered and responded to three rounds of informal written feedback from OFL/OFY regarding this audit report. Several of the objections raised in OFL's official written response, while sometimes raised during the audit process, were not raised by OFL during the three rounds of informal feedback. The OFL/OFY entities, primarily OFL, repeatedly threatened lawsuits when the audit team uncovered information that was not supportive of the entities. The audit team conducted a thorough review based on available information, including all information provided by the entities during the course of the audit. The new information presented in the OFL official response indicates that the auditees withheld information from the audit team. As such, the audit team has added information to the scope and methodology regarding the audit team's concerns that the auditees were not always forthcoming.
 8. This comment is not relevant to the audit report. For the issues reviewed by the audit team (such as related party transactions, SB 740 funding percentages, full-time equivalent teachers (FTE), and ADA, the laws, regulations, and policies are the same—regardless of the entity's legal structure. Furthermore, the audit team found that OFY and OFL operated very similarly in all these areas. Moreover, it is acceptable, when conducting multiple audits with the same scope, to include multiple programs and entities within one report. Generally Accepted Government Auditing Standards sections 1.15 and 2.13f clearly address this type of reporting.
 9. This is an overly broad statement. The audit team found that during the three years reviewed, Educational Dynamics and Partners in Special Education each contracted with three public school districts; however, all of the contracts reviewed by the audit team have expired.
 10. While it may be that the audit team did not uncover any improper related-party transactions related to OFL, the audit team was unable to examine all of the records for Education Management Systems.
 11. Neither the CDE nor the county offices of education found "satisfaction in the responses provided by OFL" as evidenced by the requests to conduct an investigation. Moreover, in some cases, OFL provided the referenced entities with incomplete or inaccurate information as evidenced by the FTE disclosures.
 12. As described in the audit report, because of the delayed payments, OFL has received the benefit of interest-free financing from OFY.
 13. The audit team agrees that the OFL structure makes the comparison less relevant during years with excess revenues. However, if it were completely irrelevant, then the audit team questions why OFL and Education Management Systems include a fee at all in their approved contract. Moreover, the fee would become relevant should the OFL charters experience periods without "excess revenue."

14. The audit team did query two OFY board members about the validity of some meeting minutes. Both board members told the audit team that they had little recollection about the board meetings, which had occurred nearly four years earlier, but confirmed to the best of their recollection that the minutes sounded accurate. Therefore, the audit team concluded that the value of contacting other board members was limited. Moreover, OFL's last sentence supports our assertion that the OFL's shareholders, John and Joan Hall, exercise control over the "management" of the company.
15. The OFL's argument is circular and inaccurate. Specifically, OFL states that its governing boards take the time to "review and approve the Halls' employment contracts on a regular basis" but that the "salaries paid are entirely immaterial." Moreover, as discussed in the report, the audit team has concerns about the decisions reached by the OFL boards because they did not consider all relevant compensation factors and because, as OFL acknowledged above, John and Joan Hall exercise control over the entities. Again, the audit team agrees that the OFL structure makes the salaries paid to the Halls less relevant during years with excess revenues. However, the salaries would become relevant should the OFL charters experience periods without excess revenue.
16. The audit team is concerned that OFL believes the non-cash compensation paid to the Halls is irrelevant. Because Education Management Systems would not open its financial records to the audit team, the audit team could not review the nature, purpose, or support for any non-cash compensation received or to determine if its credit card policies were as lax as OFY's.
17. The audit team is unaware of any basis for suggesting that the Halls would sacrifice their salaries that are authorized by the approved employment contracts.
18. This is an overly broad statement by OFL without specific information as to what it disputes. The OFL makes no mention of the specific detailed items in the report for which it contends it was not overpaid. Again, this is the first time OFL has revealed its concerns to the audit team. Moreover, the audit team agrees that many of the items discussed in the chapter are insignificant in terms of dollar amount; however, the errors found, if uncorrected, could lead to larger issues.
19. The last of several responses from OFL to the audit team (related to its double-counting of certificated administrators' salaries), which is presented below, indicated that OFL's calculations were deliberate. The response below contains other factual inaccuracies concerning the ultimate effect the correct presentation would have on the OFL SB 740 funding determination percentages. Specifically, the response from the OFL director of finance in September 2005 is as follows:

The certificated teachers that are included in the \$325,861 total are actual certificated teachers and, in accordance with the law (SB740), these certificated teachers belong on line B.1.a. (i). That's where these certificated teachers belong. The certificated percentage will remain at 42.8%. We do not have to do the reclass. We were just being conservative reclassing them out of instructional because they are not directly instructional. But, they are actual certificated teachers. As I have said previously, we can refile an amended SB740 and exclude the reclass which would

show the certificated and instructional total percentage at 65.4% instead of the more conservative 60.6% which was filed in December 2004.

What I meant by “there is no line item in the instructional section of the form for salaries” is that on lines B.1.b., B.1.c.(i), B.1.c.(ii), and B.1.c.(iii), there is no line item for instructional “salaries”. These lines make up the “instructional” section (color coded in peach/orange on the attached EXCEL spreadsheet). Once again, we do not have to be conservative and do the reclass entry.

This reclass entry was done in both WSH and BP. In both of these charters, some or all of the same certificated teachers earned salaries. So, a consistent reclass was done in both charters.

The issue isn’t whether these employees are certificated or not. They are, in fact, certificated teachers and they belong on line B.1.a.(i). This is in accordance with the existing law.

The issue is that you don’t like the way the reclass was made. That’s fine. Once again, we do not have to do this reclass. We can take it out.

20. Although these errors of more than \$600,000 did not by themselves adversely impact OFL’s funding determination percentages, combining these errors with other audit team findings did — as discussed in the report.
21. The audit team disagrees with OFL and its response in this section. The audit team notes that OFL has not addressed the teacher reimbursements or teacher mileage payments that the audit team found to be incorrectly categorized. The OFL had originally argued that these items should be included as a teacher “benefit.”
22. The OFL has misunderstood the funding requirement. To achieve the 70 percent funding level, OFL is correct that it had to spend 60 percent of its total revenue on instruction and related services. However, OFL must also spend at least 40 percent of total *public* revenues on certificated salaries and benefits. The OFL’s statement that 40 percent of the 60 percent spent on instruction and related services had to be spent on certificated teacher salaries reflects a flawed understanding of the funding requirements.
23. Because the regulations are *silent* on the definition of benefits, the audit team looked to the SB 740 form and its instructions (CDE developed the regulation, the SB 740 form, and its instructions). The instructions clearly include travel, conference, and professional development costs for instructional or related personnel in the *60 percent category*. The SB 740 instructions also state that unless otherwise indicated, all financial information shall be presented using the definitions in the California School Accounting Manual (CSAM). CSAM clearly draws a distinction between “salaries and benefits” and “instructional supplies/travel and conference expenses.” Moreover, the definition of benefits in CSAM does not include scholarships/education, mileage, teacher reimbursements, or anything similar in its list of examples. Specifically, CSAM defines benefits as:

Employee benefits. Amounts paid by the [local education agency] on behalf of employees. These amounts are not included in the gross salary but are over and above. They are fringe-benefit payments; and while not paid directly to employees, they are nevertheless part of the cost of salaries and benefits. Examples are (1) group health or life insurance payments; (2) contributions to employee retirement; (3) OASDI (Social Security) taxes; (4) Workers' Compensation payments; and (5) payments made to personnel on sabbatical leave.

24. The audit team disagrees and notes that OFL has selectively provided information to its benefits as noted in the audit team response number 23 and below. Specifically, the personnel costs that OFL notes as being related to activities “designed to provide motivation...and improvement of skills or personal development” is not related to *teacher education* as OFL infers. Rather, OFL does not include the last part of the referenced sentence, which clearly refers to including the salaries of teachers who provide things such as athletics, band, or choir to the *students*.
25. The audit team disagrees for the reasons listed above. Stated more clearly, the regulations are silent on the definition of benefits; however, the SB 740 instructions and CSAM appear to be coordinated. It is noteworthy that after much disagreement during the audit, that OFL now does not address its inclusion of teacher reimbursements and mileage expenses in the 40 percent category (certificated salaries and benefits).
26. The audit team refers OFL to item IV in the “Summary of ACCS Recommendations” that OFL included with its response. Specifically, the memo (and the regulations) states, “if a charter does not meet all of the minimum requirements to receive 70 percent, *then the funding level is zero.*”
27. The audit team did not refuse to review any relevant information during the audit. Moreover, neither CDE nor the county offices of education found satisfaction in the information provided by OFL, as evidenced by the audit request to conduct an investigation into OFL’s certificated teacher expenses. In some instances, as discussed in the report, OFL provided the referenced entities with incomplete or inaccurate information as evidenced by the FTE disclosures.
28. The audit team considered all relevant data and reached supported, impartial conclusions. In fact, this was perhaps the only area in which a member of the Hall entities’ exit conference team complimented the audit team on its balance and fairness. Therefore, it is surprising that OFL now states that the audit team has compromised its impartiality. Please see the audit team response numbers 5 and 30. The information presented by the Hall entities supported that other schools had claimed FTE rates greater than 1.0 FTE. However, this information did not contradict the legal opinion presented by CDE in as much as all the schools that did use the 1.0 FTE did not contradict the OFY/OFL legal opinion.
29. The audit team used the term “generally” due to the 2005 change in law that now allows the additional option for schools to use a 25-to-1 comparison ratio. The report states that OFL “may” have been overpaid during the audit years because the issue is currently before the courts to decide. Moreover, for questionable FTE issues, the audit team states that OFL “may” have been overpaid by more than \$3.6 million because the final determination will need to be made by CDE and there are numerous factors and calculations involved.

30. This is incorrect. Nowhere in the report does the audit team state it failed to consider CDE's position. Please see audit team response number 28.
31. As noted in audit team response number 5, the OFL has misinterpreted the "memo" prepared by CDE and should have consulted the actual code section (referenced in the memo) for additional information. The audit team presents California Education Code Section 51745.6 below to provide the full context of the requirements, which are separate from the funding determination percentage rules. Moreover, the audit team did not ignore any of the information provided by OFL.

The ratio of average daily attendance for independent study pupils 18 years of age or less to school district full-time equivalent certificated employees responsible for independent study, calculated as specified by the State Department of **Education**, shall not exceed the equivalent ratio of pupils to full-time certificated employees for all other educational programs operated by the school district. The ratio of average daily attendance for independent study pupils 18 years of age or less to county office of **education** full-time equivalent certificated employees responsible for independent study, to be calculated in a manner prescribed by the State Department of **Education**, shall not exceed the equivalent ratio of pupils to full-time certificated employees for all other educational programs operated by the high school or unified school district with the largest average daily attendance of pupils in that county. The computation of those ratios shall be performed annually by the reporting agency at the time of, and in connection with, the second principal apportionment report to the Superintendent of Public Instruction.

(b) Only those units of average daily attendance for independent study that reflect a pupil-teacher ratio that does not exceed the ratio described in subdivision (a) shall be eligible for apportionment pursuant to Section 42238.5, for school districts, and Section 2558, for county offices of **education**. Nothing in this section shall prevent a school district or county office of **education** from serving additional units of average daily attendance greater than the ratio described in subdivision (a), except that those additional units shall not be funded pursuant to Section 42238.5 or Section 2558.

32. The audit team did not fail to consider that CDE was aware of OFL's use of a 1.92 FTE factor. Because the issue of whether an FTE factor of 1.92, 1.0, or something in between, is now a legal matter before the courts, the audit team attempted to present the disputed facts. More importantly, the audit team considered the fact that CDE was one of the six entities that had concerns regarding OFL's calculation of FTE and, as a result, requested an audit to investigate OFL's FTE calculations.
33. OFL is mistaken. The audit team did not ignore any of the information provided by OFL. Please see the audit team response numbers 28 and 32.
34. The fact that other schools can and have claimed greater than 1.0 FTE is not in dispute, rather it is OFL's method for doing so that is in dispute.

35. The report states that OFY's teachers do work more than a "typical" teacher. However, California State Teachers' Retirement System regulations are neither referenced in nor applicable to the SB 740 funding process. Please see the audit team response numbers 33 and 34.
36. The audit report does not state that FTE cannot exceed 1.0. Rather, the report presents CDE legal counsel's opinion that the OFL 1.92 methodology does not comply with existing laws and regulations.
37. The assertion that OFL teachers work more than a typical teacher is acknowledged in the report. The courts will determine the validity of the 1.92 calculation.
38. The audit team finds it surprising that OFL now asserts bias in the report when OFL did not address this notion during our exit conference with the Hall entities. Rather, as mentioned earlier, this was perhaps the only area in which a member of the Hall entities' exit conference team complimented the audit team on its balance and fairness.
39. The audit team responses numbers 1 through 38 reveal that OFL's opinions related to "faulty factual premises and improper or erroneous legal conclusions" are false.