

FCMAT

FISCAL CRISIS & MANAGEMENT ASSISTANCE TEAM



Administrative Agent
Larry E. Reider
Office of Kern County
Superintendent of Schools

Chief Executive Officer
Joel D. Montero

1300 17th Street – CITY CENTRE
Bakersfield, CA 93301-4533
Telephone.....661-636-4611
Fax.....661-636-4647
Web site.....www.fcmat.org

422 Petaluma Blvd. North, Suite C
Petaluma, CA 94952
Telephone.....707-775-2850
Fax.....707-775-2854

June 26, 2006

Walter Ferguson, Executive Director
Cypress Grove Charter High School for Arts and Sciences
225 Normandy Road
Seaside, California 93955

Dear Mr. Ferguson:

The purpose of this management letter is to report the findings and recommendations of the Fiscal Crisis and Management Assistance Team (FCMAT) identified through its management assistance review of the Cypress Grove Charter High School for the Arts and Sciences (Cypress Grove). This review was requested by the charter to help assess the ongoing viability of the program. While this management letter may be used to support the appeal for a charter petition to the California State Board of Education (SBE), FCMAT takes no position with respect to that process. Specifically, the charter has asked FCMAT to consider factual information and to:

1. Perform a fiscal analysis related to the eight issues contained in the May 31, 2006 letter from Mr. Walter Ferguson, Executive Director, related to the fiscal solvency of the charter.
2. Reconcile, to the extent possible, outstanding issues with respect to either supposed overcharges and/or underreported revenues totaling \$171,000.
3. Examine district records to determine the fiscal viability of the charter to include a review of prior year actuals and future year projections.

Beginning approximately June 2, 2006, FCMAT requested and received documentation from Cypress Grove and the Monterey Peninsula Unified School District (MPUSD). Follow-up conversations were held with Garry Bousum, Assistant Superintendent Business Services, Monterey County Office of Education; Tom Woodruff, Chief Business Officer, Monterey Peninsula Unified School District; Paul Minney, charter school counsel;

Cathi Vogel, charter school consultant; Steve Westcoatt, auditor, Perry-Smith LLP; and Marta Reyes, Director, Charter Schools Division, California Department of Education (CDE).

On June 19-20, 2006, the FCMAT team, consisting of Joel Montero, CEO and Linda Grundhoffer, FCMAT consultant, visited Cypress Grove and the MPUSD. The team interviewed and consulted with a variety of staff from both the district and the charter school. This management letter summarizes FCMAT's analysis of the provided documentation, information contained in the MPUSD financial system, review of other charter records provided by Cypress Grove and the CDE, interviews with district and charter school staff, and consultation with district and charter school external auditors.

With reference to assumptions made in the Cypress Grove May 31, 2006 letter, the team found the fiscal records and the financial system of the MPUSD to be easily accessible, up to date and in keeping with the Standardized Account Code Structure (SACS). Except where otherwise noted, the district follows the directives of the California School Accounting Manual (CSAM). The MPUSD is currently the authorizing authority for three charter schools. Of these, one is directly funded by the state and two, including Cypress Grove, are not. The Monterey County Office of Education receives apportionment for all three charter schools. In the case of Cypress Grove and one other school, those apportionments are posted to the MPUSD Fund (09). There is a concern on the part of the Cypress Grove administration that charter school funds within fund (09) are commingled and the external auditor makes reference to this in a letter dated January 23, 2006. The team found that documentation at the district level was fully adequate to both assess and track revenues and expenditures for the various charter schools. In the team's analysis, all amounts were able to be tied back to the total official apportionment numbers and expenditures then tracked appropriately.

None of the three charter schools has direct or remote access to the district's financial system. According to the MPUSD staff, this issue will be remedied in 2006-07. Also, there appears to be no routine budget reporting sequence directly to the charter schools from the district. The district system is capable of producing financial reports at least quarterly, but it appears that those reports often do not make their way to the charter school offices unless the charter staff specifically requests them. Cypress Grove maintains that the absence of the availability of detailed transaction reports and budget reconciliations has hindered its ability to monitor and manage its finances.

Cypress Grove opened in 2001-02. Final audit reports for all fiscal years between 2001-02 and 2003-04 are complete. The 2004-05 audit has not been finalized because issues with respect to that budget year have not been resolved to the satisfaction of the Cypress Grove administration. Some of those issues are the focus of this management review. In any event, the completion of the 2004-05 audit is not being interrupted because the district's financial system is not accessible or functionally complete. The financial audit for the 2005-06 fiscal year should commence very soon and will be dependent upon a collaborative resolution of the issues outstanding in 2004-05.

There are eight issues related to either overcharges or underreported revenues that Cypress Grove has asked the team to assess. In all, these disputed items total \$171,000 as computed by the charter school staff. The following list constitutes the disputed items and the dollar amount associated with each from the perspective of the Cypress Grove administration.

Overcharges (by the district to the charter school)

1. Facilities Rent	\$ 6,400
2. Business Services	\$44,071
3. Fiscal Oversight Fees	\$16,318

Underreported Revenues (by the district to the charter school)

4. Prior Year Apportionments	\$23,101
5. Implementation Grant Funds	\$20,000
6. Staff Development Buyback Days	\$15,592
7. Federal Military Impact Aid	\$22,351
8. "Smith Journal Entry Error"	\$23,717

Given that these disputed amounts could affect the ending fund balance for 2004-05 and therefore the beginning fund balance for 2005-06, FCMAT's goal is to offer an external, independent opinion as to their reconciliation. The conclusions stated in this management letter are the opinion of the team and, as such, are not binding on either the MPUSD or Cypress Grove.

Facilities Rent

It appears from district records that the charter school has been charged different amounts for allowable charges for facilities costs in different years. In 2002-03 the district charged Cypress Grove \$4.28/sq. ft. In 2003-04 the amount was reduced to \$3.95/sq. ft. The team did not verify the calculation methodology for rent; however, the concern is that the district's other charter schools are charged a different amount and therefore the handling of Cypress Grove should be consistent. The team did verify that all charter schools were charged the same rate in fiscal year 2003-04. The team could find no language either in the Charter Petition or the memorandum of understanding between the district and the charter to support the contention that Cypress Grove's rent is tied to other charter schools for which MPUSD is the authorizing entity. The team is not aware of any statutory language that would create such a requirement. That being said, MPUSD and Cypress Grove should endeavor to assure that the district is in compliance with Proposition 39 regulations on the calculation of allowable charges for facilities costs, as these rules could apply in some situations. It should also be noted that the charter school's use of district facilities is subject to annual application as referenced in Education Code Section 47614. Notwithstanding further review as is indicated above, there is no basis on which to judge that the MPUSD owes Cypress Grove for facilities rent overcharges.

Business Services

The original agreement between the district and the charter school established a business relationship between the two parties for fiscal services provided to Cypress Grove by the MPUSD. Among the services provided are assistance with budget development, payroll, accounts payable, etc. The agreement establishes the use of the district's indirect cost rate (ICR) as the calculation rate for business services provided on an annual basis. The ICR fluctuates each year. Initially, the ICR was 4.97% and that rate was utilized to bill Cypress Grove for services. The team could find no amendment to the original agreement that would have changed the basis of the billing arrangement for business services. In fact,

in fiscal year 2003-04, the rate for computing the cost for business services to the charter was 5.8%, or the district's ICR for that year. In 2004-05 the district's ICR was reduced to 4.26%, but the rate for computing the cost for business services to Cypress Grove was increased to 10%. Therefore, in 2004-05 MPUSD charged Cypress Grove \$70,509.27. Based on the ICR of 4.26%, and the language in the initial agreement, the costs for business services applied to Cypress Grove should have been \$26,437.72. Given these assumptions, the MPUSD owes Cypress Grove \$44,071.55.

Oversight Fees

Per the California Education Code, the authorizing district of a charter school may assess a charge for the actual costs only up to 1% or 3% for administrative services depending upon certain provisions in the code related to how the district provides for facilities. Education Code Sections 47613, 47632, and 47633 establish how and what is involved in the computation of the 1% or 3% administrative services charge. The oversight fee charged by MPUSD to Cypress Grove should be 1%. The district has computed all fees based on all revenue sources, at a higher rate than is allowable, when, in fact, the Education Code, in the sections highlighted above, establishes a more limited calculation methodology. The revenues utilized for the calculation by the district in 2004-05 equaled \$788,048 when the amount should have been \$747,261. The numbers utilized to come to the aforementioned conclusions are confirmed both in the district's financial system and at the CDE.

Another issue concerns a prior year revenue adjustment identified by the external auditor. This adjustment has been applied to 2004-05 when, in the judgment of the team, it should be applied in the current year (2005-06). The net result will be that the charter school's revenue will eventually increase. The amount of the oversight fee charged by the district in 2004-05 was \$22,199.21 based on the revenue adjustments from prior years added to the total revenues. It is the team's opinion that the oversight fee for 2004-05 should have been based on revenues of \$747,261, and therefore the calculation would yield a \$7,472.61 charge, or a difference of \$14,726.60. This methodology that moves the prior year adjustments into the current year could inflate the calculation of the oversight fee in fiscal year 2005-06, based on the application of the appropriate Education Code sections, which would somewhat offset the lower rate charged in 2004-05.

Prior Year Principal Apportionments

All charter schools receive apportionments based partially on a calculation performed by the CDE. Charter schools receive state aid based on a formula specific to whether they contain certain grade levels, and their in-lieu taxes (local property taxes) are added to this amount. In this case, the state does not "backfill" charter schools to make up the difference in the revenue limit. The in-lieu tax amount that is provided to charter schools is estimated by the state at P-2, and the apportionment is calculated and made. In approximately February of each year, in-lieu taxes are recertified based on the actual amount of property tax collected by the counties. If the amount of tax collected is more than the P-2 estimate, as it normally is, a recalculation of in-lieu taxes is necessary. This recertification and recalculation of taxes has little effect on regular K-12 districts because their revenue limit remains unchanged. However, because charter schools receive all the in-lieu taxes due to them over and above their state aid, their revenue can be impacted. This is the case with Cypress Grove. The team found that the recertification of in-lieu tax amounts was never recalculated for Cypress Grove. Therefore, it is due revenue for past years of \$10,364.

Implementation Grant Funds

Cypress Grove is due implementation grant funds in the amount of \$20,000 for fiscal year 2004-05. In effect, the check from the state is “lost in the mail.” The team’s understanding is that the district staff are awaiting the arrival of the check and will post this amount to the charter school when it arrives. This amount will increase the Cypress Grove fund balance by \$20,000.

Staff Development Buyback Days

There was initial discussion and communication between the district and charter school regarding the number of valid employees that could be claimed for staff development buyback days. Initially, a receivable of \$3,292 is recorded in the 2005-06 books for this purpose. Final reconciliation of the number of valid employees (31) for this calculation is complete for a total claimable amount of \$9,287. The balance of \$5,995 has not been posted to the charter school. It is the opinion of the team that the district owes the charter \$5,995.

Federal Impact Aid

Some local educational agencies (LEAs) may receive money from the federal government if they educate children who are dependents of federal employees living in the district attendance area and are residents of other states. This funding is referred to as Impact Aid or PL874 money. Districts must conduct an annual census of their students to assess the number of federal employee dependents. Based on this count, districts are funded in the subsequent year. There may be a question with respect to whether or not charter schools that are not directly funded by the state are due their pro rata share of Impact Aid from the sponsoring district that collects it. Two Education Code Sections might apply. EC 47634.4 provides the option for directly funded charter schools to apply to the federal government to receive impact aid. In this case, the charter school would follow the same census gathering and application process as if it were a school district. Another code section, EC 47636, establishes that a charter school may negotiate with its sponsor to receive other funds, such as Forest Reserve funds. In this latter statute, Impact Aid is not specifically mentioned, although one might conclude that it would be included in a broad definition of other funds.

The MPUSD has calculated the amount of Impact Aid funding based on its 2003-04 census for dollars that would be received in 2004-05. As a routine part of that calculation, the district has also determined that the pro rata share of that revenue would be \$18,186.97 for Cypress Grove should the district decide to apportion it. While it is clear that the subject of impact aid payments was often discussed between the charter school and the district, and some references are made to the conversations in documentation, the team could find no written agreement between the district and the charter related to the payment of impact aid to the charter school. Cypress Grove is currently not directly funded and is therefore unable to apply on its own behalf for Impact Aid funds per EC 47634.4. FCMAT is unable and unwilling to interpret current law or Education Code to resolve this issue and is not aware of any federal statute or guideline that would provide guidance. FCMAT can say that Impact Aid is routinely passed along to charter schools in California but is also aware of instances where it is not. In the absence of a written agreement that would establish a process for Cypress Grove, it is the team’s opinion that MPUSD has discretion with respect to this issue.

“Smith Journal Entry Error”

The “Smith Journal Entry Error” is simply that: an error that has no positive or negative bearing on Cypress Grove’s finances. It was originally a change in posting from one object code to another that required a journal entry to correct. Because the person’s name in the district that actually made the error was Smith, the correction is referred to in the district’s books as the “Smith error.” The team tracked this error, and although it took several postings to correct, it has no effect on fund balance in any fiscal year.

Summation Regarding General Solvency

Based on the analysis of the team with respect to fiscal year 2004-05, all overcharges and under-reported revenues equal \$95,157.15 in favor of Cypress Grove’s fund balance. This number is notwithstanding the issue related to federal Impact Aid. If the district chose to apportion federal Impact Aid to the charter, the total of all items in question, in the judgment of the team, would be a positive \$113,344.12 to the ending fund balance for 2004-05. These numbers are opposed to the \$171,000 identified by the Cypress Grove administration in the May 31, 2006 letter.

A review of the unaudited actuals for 2004-05 currently shows a negative fund balance of \$192,398. The net impact of the analysis of the team on the charter budget would change this fund balance number to a negative \$97,241, not including the issue related to federal Impact Aid. If federal Impact Aid dollars were applied, the net result would be a negative ending fund balance of \$79,054 in 2004-05 for the charter school.

As of June 20, 2006, Cypress Grove had a total of \$95,579.94 in an outside checking account. Money in this account represents one-time cash and could be utilized to cancel the negative fund balance for fiscal year 2004-05 via a direct payment to the district. However, there are other fiscal issues to consider.

Looking at the fiscal history of Cypress Grove from inception to current year, FCMAT can assume and has verified that the audited actual amounts related to the budget in the years 2001-02 through 2003-04 are materially accurate. There may be some prior year adjustments to revenue as indicated above, but the amount is less than enough to significantly impact the overall financial picture of the school. With the exception of year one, 2001-02, Cypress Grove has a history of deficit spending. A review of this trend indicates that in the subsequent years, deficit spending increases annually. This would indicate a structural deficit running through the budget that has yet to be mitigated even in the current year, 2005-06. Therefore, regardless of the school’s position with respect to fund balance in any year, there is an ongoing structural problem that can only be addressed in one of two ways: increase revenue or decrease spending. The team believes, based on a review of revenues and expenditures, that the deficit spending trend continues in the currently unaudited fiscal years 2004-05 and 2005-06. This analysis would further indicate that should the beginning balance of 2005-06 be positive, notwithstanding any other adjustment or change to revenues or expenditures, the ending fund balance in that year will again be negative.

Cypress Grove does not maintain positive cash flow during the year, given the charter’s current fiscal model. As a result, MPUSD has to support the cash flow of the charter to make payroll.

When this happens, the County Treasurer charges the district interest. This is reflected in Cypress Grove's revenue from other local sources as a negative number. As deficit spending increases and fund balances decline, cash is affected, potentially worsening the problem. Should Cypress Grove become a direct-funded charter, cash flow problems of this type will more negatively impact the school.

Currently and in prior years, Cypress Grove does not reflect a reserve in its budget. Although it may maintain cash in a separate account that does not show on the district's books, budgeting for a reserve would be prudent. Reserves of this type are generally agreed upon between the charter authorizer and charter school. All of the assumptions made by the team in this management letter consider a zero reserve position.

Consultants employed by the charter have created a multiyear projection indicating the potential position of Cypress Grove through fiscal year 2008-09. The team finds that the projections are accurate based on the assumptions used to create them. The primary assumptions are that the charter will have a positive fund balance in 2005-06, that ADA at P-2 will increase from 157 to 267 in 2007-08, and that other local revenues will be maintained above the \$50,000 level in the budget. Given the revenue and enrollment trends from inception to the current year, Cypress Grove would have to grow and fiscally evolve at a rate that is significantly eclipsed by its history in order to make the projections a reality.

Recommendations

Should Cypress Grove continue to operate:

1. The administration and board of the charter school must commit to the development and implementation of a fiscal recovery plan. The recovery plan must, at a minimum, address the structural deficit, establish and maintain a reserve, and address the cash flow needs of the school.
2. The school should request and obtain direct funding status from the state.
3. The school should apply directly to the federal government to receive federal Impact Aid.

This concludes FCMAT's work for the charter school. Should you have questions or need further clarification, please contact me at (707) 775-2852. Thank you for allowing FCMAT to be of service in this matter.

Sincerely,



Joel D. Montero
Chief Executive Officer