



CSIS California School Information Services

April 16, 2007

Ms. Marta Reyes, Director
California Department of Education
1430 N Street
Sacramento, CA 95814

Re: Culture and Language Academy of Success (CLAS) Charter School

Dear Ms. Reyes:

This letter is provided by the Fiscal Crisis and Management Assistance Team (FCMAT) in response to the California Department of Education's (CDE) request to review the most recent financial information for the CLAS Charter School. The Charter Schools Division of the CDE completed a review of the CLAS Charter School as part of the process for consideration of an appeal to the State Board of Education (SBE) by the CLAS Charter School (Charter). FCMAT's review was requested to confirm and verify the information included in the CDE's most recent review of the Charter.

FCMAT reviewed the CDE's analysis of the CLAS Charter School and reviewed the supporting documentation provided by CLAS Charter School, which included a profit and loss report dated March 15, 2007; a balance sheet report dated March 15, 2007; and a combined budget and cash flow statement through January 31, 2007. FCMAT tested several aspects of the financial information provided to determine whether the data was reasonable based on the supporting information. The items requested for review included, but were not limited to, the following:

- 2005-06 Audit Report
- First and second interim reports for the 2005-06 fiscal year

Summary of Findings

FCMAT's review of the Charter's financial information was based on documents provided by the CDE, the Los Angeles Unified School District, and the CLAS Charter School. The Charter has experienced significant changes in its program over the past year, including an increase in enrollment, a change in location and the purchase of a facility. These changes can be challenging individually, but the charter has experienced all of these changes in a short period of time, requiring the continual monitoring of the budget, and revisions to the budget and the financial system as needed whenever such factors occur.

FCMAT

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The Charter has made strides in the area of academic success. However, a charter's academic success can be affected by its financial solvency in a short period of time. The budget of a local educational agency is a plan developed by its governing board to ensure fiscal solvency and provide educational services to current and future students.

The Charter began the 2006-07 fiscal year with a negative cash balance, as reflected in the audit report dated June 30, 2006. The original adopted budget showed a continued trend of deficit spending in 2006-07 in the amount of \$335,922. This deficit spending, combined with the "Going Concern" identified in the audit for 2005-06, indicates a trend that will continue unless the charter takes action to mitigate it. The Charter needs to correct the structural imbalance between revenues and expenses, as well as maintain a stated reserve level. The recommended reserve level for districts of similar size is 5% of annual expenses and transfers out based on its average daily attendance (ADA). The Charter would not currently be able to meet the 5% reserve requirement. Although there is an increase in ADA, the increase in expenses exceeds the growth in revenue.

The Charter submitted additional information as requested during the review of the financial data. The subsequent financial data received was not sufficient to appropriately assess the financial condition. Further supporting documentation is needed to assess the Charter's full financial status at this time. It is critical that the Charter have readily available monthly reports to enable the determination of its financial condition, so that the oversight agencies and the charter administration may make good management decisions. This should include a monthly profit and loss report, income statement, reconciled bank statements and updated debt schedules. It may also be necessary to review additional supplementary financial data.

The scope of FCMAT's work was to confirm and verify the current financial review completed by the CDE. FCMAT strongly concurs with the CDE's findings regarding the financial status of the CLAS Charter School. FCMAT has concerns that the Charter may not be able to complete the current year and meet its obligations unless immediate action is taken regarding revenues and expenses. It is unclear whether any steps have been taken during the current fiscal year to address the recommendations in the audit report. A detailed financial report from the Charter's financial system can provide a status check regarding the Charter's current cash flow situation. Creating this report would be a prudent step; the report should also be provided to the CDE. It is in the Charter's best interest to verify all financial information included in the current budget and reflected in the financial system. In addition, supporting documentation regarding the Charter's financial status should be provided to the CDE as part of the appeal to the SBE; this documentation might include, for example, bank reconciliations to back up payments made during the 2006-07 fiscal year. Ignoring the recommendations in the audit report regarding obligations could be devastating to the Charter and to the students it serves.

2005-06 Annual Audit Report

As of June 30, 2006, the Charter's annual audit report showed a negative ending fund balance of \$512,131. The Charter began the 2005-06 year with a negative cash balance of \$94,839. In addition, there was a negative cash balance in the amount of \$69,228 at the close of the 2005-06 fiscal year. The audit also included a "Going Concern" (Note Disclosure 12), indicating that the Charter will not be able to meet its obligations within a 12 month period. For the 2006-07 fiscal

year, the Charter is again projecting a negative cash balance of \$232,516 for the period ending June 30, 2007. This is a significant factor that requires immediate action regarding revenues and expenses. There is an inherent loss of purchasing power and the negative balances exacerbate the issue with an increase in operational costs in the short term, which may be detrimental to the entire program.

Additional findings in other areas include the following:

- **Internal Control**

Segregation of duties is lacking. This is an area that is often a challenge for smaller organizations, but is critical to safeguarding the assets of the Charter. Strong internal controls also protect employees from false accusations by setting up controls to ensure that no one person is receiving, recording, and posting to the general ledger. During the audit, it was noted that the Chief Educational Advocate was heavily involved in cash receipts, cash disbursements, and payroll functions of the operations. The Charter's response to rectify this issue was to seek professional assistance for the school operations and sign up for electronic filing for payroll tax filings.

- **Payroll Tax Liability**

The Charter is delinquent in this area. Not filing payroll taxes in a timely manner increases the cost of payroll taxes in the form of penalties. In addition, the shortage of cash at the end of the fiscal year may not allow the Charter to meet obligations as they become due. The taxes owed were more than 100% of the liability for the period ending June 30, 2006.

- **Notes Payable**

- *Low Income Investment Fund* — A mortgage loan for the purchase of a building during the 2005-06 fiscal year in the amount of \$5.9 million.
- *Related Party Transaction* — The Charter's Chief Educational Advocate has loaned the Charter funds with terms as a non-interest-bearing note with an outstanding balance of \$344,372 as of June 30, 2006. As of March 14, 2007, the note holder has indicated that the loan, as indicated in the audit, is now a grant and all future debt is cancelled, which was identified in a letter from the Chief Educational Advocate. This amount is reflected as a grant in the cash flow statement for February 2007, and is shown as an increase in the accounts payable for February 2007, indicating that a balance is still owed.
- *Charter School Loan, Charter Schools Association* — There is an outstanding balance of \$76,097 as of June 30, 2006.

The supporting documents for these loans were not provided as part of this review. It is difficult to determine what was included in the budget for the current year regarding payments on these loans. Even without the debt schedule, it is apparent that the Charter has extended itself financially with regard to loans and the ability to meet its current obligations. The cash flow statement should be isolated from the budget document, and assumptions should be clear regarding accounts receivable and accounts payable transactions.

- **Note Disclosure 13, Management Plans**

The audit report lists objectives to be met immediately for the Charter to meet its academic and financial goals. These objectives include the following:

- Repay past due amount to the IRS and EDD no later than June 30, 2007.
- Readjust the 2006-07 budget to match actual attendance numbers.
- Look at proposed cuts in operations and staffing.
- Commit to raising additional revenue to cover the full cost of school operations.
- Reorganize its board of directors.
- Refinance the loan.

FCMAT was not able to determine if any of the above referenced objectives have been completed or included in the budget for the remaining portion of the 2006-07 fiscal year.

2006-07 Budget

The budget document provided to FCMAT did not include clear assumptions, nor did it indicate what changes were reflected in the current cash flow. The cash flow statement also doubled as the budget document. The format could be improved if accompanied by a clear narrative regarding the changes in the budget from the original adopted budget to first interim and to second interim. There were several notations from CDE staff regarding necessary adjustments to the budget. The most significant budget adjustment noted is to decrease state funding by \$765,000 because of one grant that has not been awarded and another grant that was awarded to a different charter school in a previous fiscal year.

Significant adjustments to the budget are needed in the area of salaries and benefits. Although Note Disclosure 13 identified the reductions to be made in operational costs, there do not appear to be reductions in the current document. The increase in classified salaries is more than \$450,000 over the adopted budget, and the projected budget for salaries and benefits exceeds prior year actuals.

Although charter schools are not required to maintain the same level of reserve as a district is under Title 5, California Code of Regulations Section 15443, doing so a prudent business practice and the following items should be taken into consideration:

1. **Size.**

A smaller charter needs a larger percentage in reserve. A typical short-term reason for a reserve, such as replacement of a blown boiler, cannot be accomplished with 5% of a small school's budget.

2. **Source of revenues.**

A charter school may require a larger reserve, since its dependence on funds other than state revenue leaves it more vulnerable to budget fluctuations. A charter school that uses foundation funding to support ongoing costs, or a charter school operating on one-time allocations, such as prior year reserves, needs a higher net ending balance.

3. Revenue trends.

A charter that is deficit spending needs a larger reserve because the eventual turnaround may require a special safety valve. A declining-enrollment charter school needs more reserve because of fixed-cost issues. And a fast-growth charter school needs a higher reserve amount to cover the unfunded infrastructure costs, unless other non-general fund resources are both plentiful and reliable.

4. ADA projections.

ADA projection accuracy is another factor to consider. If the charter school is unable to accurately project future growth or decline in ADA, the district will need the cushion of a higher reserve. An error rate of 2% to 3% in ADA projections could result in a 2% to 3% change in revenues, which could lead to a dramatic drain on educational resources, unless it is offset by expenditure changes. Further, there is no safety net for charter schools that miss the mark regarding ADA because charters are funded based on current year ADA and thus cannot use the greater of current year or prior year ADA. Higher reserves are an important protection mechanism for any charter school that has the potential for a significant change in ADA.

5. Unfunded debt.

A charter school that has issued debt for general fund purposes might need more reserve to ensure repayment of the debt.

As part of determining an appropriate reserve, review the reserve percentage of the monthly payroll cost compared to the ending fund balance. In addition, the reserve is one-time money: once established, it need not be replaced if left undisturbed; however, if it is spent, replacement is essential and often difficult.

2006-07 Cash Flow Statement

The cash flow statement included budget information but did not reconcile the budget indicated on the left side of the document with that indicated on the right side of the document. Any budget adjustments made should be identified by a narrative indicating the changes made in the budget. In addition, the budget document should be updated to reflect the changes so that reports can be used to make management decisions. The cash flow statement should be presented separately from the budget document to provide a clear financial picture of the projected ending cash balance.

FCMAT is pleased to have provided this service. If there are any questions about the information contained in this letter, please feel free to contact me at (661) 636-4611.

Sincerely,

Michele Huntoon, CPA
Chief Management Analyst