



Audit
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UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF INSPECTOR GENERAL

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Control Number ED-OIG/A05-D0027

Mr. David Batchelder, Director
James Madison Preparatory School
5815 South McClintock Drive
Tempe, AZ 85283

NOV 21 2003

Dear Mr. Batchelder:

This **Final Audit Report** presents the results of our audit of the James Madison Preparatory School's (School) use of U.S. Department of Education (ED) funds for the period July 1, 2001, through June 30, 2002 (2001-2002 fiscal year). The objective of our audit was to determine if the School expended ED funds according to the law and applicable regulations.

Our audit disclosed that the School generally expended Public Charter Schools Program (PCSP) grant funds in accordance with the law. However, the School used \$5,601¹ of the \$150,000 in PCSP funds it received for the 2001-2002 fiscal year for costs that were unallowable. We recommend that the Chief Financial Officer, Office of the Chief Financial Officer, in conjunction with the Deputy Under Secretary for the Office of Innovation and Improvement, instruct the School to refund \$5,540 to ED and develop and implement policies and procedures to provide reasonable assurance that it uses federal funds for activities that are allowable under the law.

We provided the School with a draft of this report. The School concurred that it did not have policies and procedures in place to provide reasonable assurance that ED funds were expended for allowable activities during our audit period. However, the School generally did not concur with the finding and recommendation to refund PCSP funds to ED. The School provided a detailed explanation of why the costs should be considered allowable. Our review of the School's response caused us to change our finding and recommendation 1.1 in this report by eliminating some costs that we initially identified as being unallowable. The School's comments are summarized in the body of the report and included in their entirety as an attachment.

¹ The School charged \$150,739 to the PCSP grant, \$61 more than the \$150,678 it had available for the 2001-2002 fiscal year (\$150,000 received for the 2001-2002 fiscal year and \$678 the School carried over from the prior year).

AUDIT RESULTS

Finding No. 1 The School Charged \$5,601 in Unallowable Costs to the PCSP Grant

For the 2001-2002 fiscal year, the School used \$5,601 in PCSP funds for costs that were unallowable. We reviewed documentation for all 92 expenses totaling \$150,739 charged to the PCSP grant for the 2001-2002 fiscal year.² Seven expenses were for general operational costs. These costs included office supplies, finance charges, monthly fees for digital subscriber line service, and monthly copier lease payments.

The Elementary and Secondary Education Act of 1965, as amended by the Improving America's Schools Act of 1994, Title X, Part C, Section 10304(f)(3), and the Charter School Expansion Act of 1998,³ allows charter schools to spend funds for activities related to post award planning and design of the educational programs and initial implementation of the charter school. Activities related to initial implementation may include (a) informing the community about the school, (b) acquiring necessary equipment and educational materials and supplies, and (c) acquiring or developing curriculum materials. Charter schools are allowed to pay for other initial operational costs not met by other sources provided that those costs are directly related to the purpose of the PCSP grant. The intent of the PCSP grant is to pay for necessary items and services that would support the initial implementation and operations of the school while also allowing the school to become financially independent.

According to Office of Management and Budget (OMB) Circular A-122, *Cost Principles for Non-Profit Organizations*, a grantee must keep records that fully show how it used federal funds. Attachment A, Section A(2)(g), states that for a cost to be considered allowable, the specific cost must be adequately documented.

The School charged unallowable costs to the PCSP grant because it did not have written policies and procedures in place to provide reasonable assurance that the funds were expended on activities allowable under the law. Instead, School officials primarily relied upon the advice and guidance of a third party service provider. The School hired a third party service provider to help write the PCSP grant proposal and to provide financial services for the School. School officials relied on the advice from the third party service provider because School officials did not have knowledge of the applicable laws and regulations that was sufficient to properly execute the PCSP grant. Had School officials obtained sufficient knowledge by either reviewing their PCSP grant budget or contacting an ED charter school program official before charging these operational costs to the grant, the School may not have expended PCSP funds on unallowable costs.

² School personnel provided invoices and receipts for 21 PCSP cash draws from the Education Department's Central Automated Processing System, Grants Administration and Payment System. However, they did not provide us with accounting records that listed all the transactions charged to the grant.

³ The law was further amended by the No Child Left Behind Act of 2001, Title V, Part B.

Because School officials used PCSP grant funds to pay for \$5,601 in general operational costs, the School was unable to use those funds to purchase items that would increase the chances of the School becoming financially independent.

Recommendations

We recommend that the Chief Financial Officer, Office of the Chief Financial Officer, in conjunction with the Deputy Under Secretary for the Office of Innovation and Improvement, instruct the School to

- 1.1 refund \$5,540⁴ to ED; and
- 1.2 develop and implement policies and procedures that provide reasonable assurance that ED funds are expended on activities that are allowable under the law.

Auditee Comments

The School's Director agreed that the School needed to develop and implement policies and procedures to ensure that it expends ED funds on allowable activities. However, the School generally disagreed with the finding and recommendation 1.1. The School agreed that the finance charges were an unallowable cost but provided an explanation of why it considered the other costs to be allowable. The other costs included payments for magazine and newspaper subscriptions and office supplies, monthly fees for digital subscriber service, and monthly copier lease payments. The School commented that the teachers and students used the magazine and newspaper subscriptions in American history and government courses. The School explained that the office supplies, monthly digital subscriber service, and copier lease payments were used to develop and implement the School's curriculum and to market the school in the community.

OIG Response

Our review of the School's response caused us to change our finding and recommendation 1.1 in this report by eliminating some costs that we initially identified as being unallowable. However, we found no basis for changing our position that the office supply costs, finance charges, digital subscriber service fees, and copier lease payments charged to the PCSP grant were general operational costs and should not have been charged to the grant. We asked the School to provide additional documentation, such as accounting records, invoices, and receipts, to substantiate its claims that PCSP funds were used to pay for initial implementation costs of the School and not for general operational costs. The School was unable to provide documentary evidence supporting that these costs were incurred for the initial implementation of the School. The School's Director only provided us with signed affidavits from himself and the Administrator for the School, stating that the costs were related to curriculum development. Without

⁴ The School charged \$150,739 to the PCSP grant, \$61 more than the \$150,678 it had available for the 2001-2002 fiscal year. Therefore, we only recommend recovery of \$5,540 (\$5,601 in unallowable costs less \$61).

sufficient documentation showing how the School used PCSP funds, we do not have assurance that these costs were used for allowable purposes under the law and applicable regulations.

BACKGROUND

The purpose of the PCSP is to provide grants for the planning, design, and initial implementation of charter schools created by members of the local community. Grants may be made for a period of up to three years. Funds may be used to plan and design the education program of the charter school and evaluate the effects of charter schools.

Charter schools are governed by the charter school legislation enacted in the Elementary and Secondary Education Act of 1965, as amended by the Improving America's Schools Act of 1994, Title X, Part C, Section 10304(f)(3), and the Charter School Expansion Act of 1998.⁵ Charter schools that receive a grant directly from the federal government must also adhere to regulations listed in 34 C.F.R. Parts 75, 82, and 99.

The School received its charter from the Arizona State Board for Charter Schools and opened in August 2000. The School applied for a PCSP grant and received approval from ED on May 3, 2000. The grant provided the School with startup funding for a three-year period. For the 2001-2002 fiscal year, the second year of funding, the School received \$150,000.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of our audit was to determine if the School expended ED funds according to the law and applicable regulations. Our audit covered the award ED made on July 24, 2001, for \$150,000, PCSP funds of \$678 the School carried over from the prior year, and costs charged to the PCSP grant for the 2001-2002 fiscal year.

To accomplish our objectives, we

- interviewed School personnel;
- reviewed the School's records for 92 expenses totaling \$150,739 charged to the PCSP grant;
- selected a nonstatistical random sample of 5 of the 92 expenses (exclusive of 11 expenses we identified as unallowable) and asked for supporting documentation such as invoices and receipts. We then reviewed the invoices and receipts to determine whether the expenditures were allowable and supportable.

We performed our audit work between December 2002 and July 2003. We visited the School on December 5, 2002, and discussed the results of our audit with School officials on March 24, 2003.

⁵ The law was amended by the No Child Left Behind Act of 2001, Title V, Part B.

Our audit was performed in accordance with generally accepted government auditing standards appropriate to the scope of audit described above.

STATEMENT ON MANAGEMENT CONTROLS

As part of our audit, we did not assess the adequacy of the School's management control structure applicable to all ED awards because this step was not necessary to achieve our audit objective. Instead, we relied on testing of the School's compliance with the PCSP law and applicable regulations. Our testing disclosed a material weakness in the School's management controls over ED awards. The School did not have policies and procedures in place to provide reasonable assurance that PCSP funds were expended according to the law. This weakness is discussed in the **AUDIT RESULTS** section of this report.

ADMINISTRATIVE MATTERS

Statements that managerial practices need improvements, as well as other conclusions and recommendations in this report, represent the opinions of the Office of Inspector General. Determinations of corrective action to be taken will be made by the appropriate ED officials.

If you have additional comments or information that you believe may have a bearing on the resolution of this audit, you should send them directly to the following ED officials, who will consider them before taking final Departmental action on this audit.

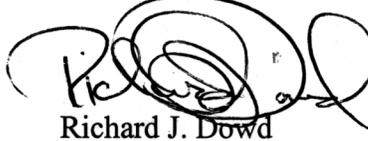
Jack Martin, Chief Financial Officer
Office of the Chief Financial Officer
U.S. Department of Education
400 Maryland Avenue, SW, Room 4E313
Washington, DC 20202

Nina Shokraii Rees, Deputy Under Secretary
Office of Innovation and Improvement
U.S. Department of Education
400 Maryland Avenue, SW, Room 4W317
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It is ED's policy to expedite the resolution of audits by initiating timely action on the findings and recommendations contained therein. Therefore, receipt of your comments within 30 days would be greatly appreciated.

In accordance with the Freedom of Information Act (5 U.S.C. §552), reports issued by the Office of Inspector General are available to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act.

Sincerely,

A handwritten signature in black ink, appearing to read "Richard J. Dowd", written in a cursive style with several loops and flourishes.

Richard J. Dowd
Regional Inspector General
for Audit

Attachment



James Madison Preparatory School

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8 October 2003

Mr. Richard J. Dowd
Regional Inspector General for Audit
United States Department of Education
Office of Inspector General
Region V
111 N. Canal, Suite 940
Chicago, IL 60606

Mr. Dowd,

We are in receipt of your Draft Audit Report of 12 September 2003. Please consider this letter submitted on behalf of the school in response to the Draft Audit Report. We appreciate the opportunity to comment. It is our understanding that the draft is not final and is subject to revision before the completed report is released.

Finding No. 1

The auditors found eleven unallowable expenditures totaling \$5710. These costs are identified as including newspaper and magazine subscriptions, office supplies, finance charges, monthly fee for DSL service, and monthly copier lease payments.

As identified in the findings, allowable expenses relate to those "Activities related to initial implementation may include (a) informing the community about the school, (b) acquiring necessary equipment and educational materials and supplies, and (c) acquiring or developing curricular materials. Charter schools are allowed to pay for other initial operational costs not met by other sources provided that those costs are directly related to the purpose of the PCSP grant. The intent of the PCSP grant is to pay for necessary items and services that would support the initial implementation and operations of the school while also allowing the school to become financially independent." In our comments we will refer to these allowable expenditures as part a, part b, or part c.

School Comments on Expenditures

Newspaper and magazine subscriptions

Madison Prep is a college prep school focused on American History and Government. All of our courses include historical issues, and in many of our classes current events are also studied in comparison to historical precedents. The newspaper subscription (AZ Capitol Times) was ordered and utilized as a part of the Arizona history and American Government courses, as it is the best local paper reporting on state and federal government issues. Magazines that were ordered include the Smithsonian, American Enterprise, and US News and World Report. The teachers developed the curriculum to include such periodical materials, and include current and recent articles in their course planning and implementation.

Part of the development of a new school includes the development of a new library within the school, and a school library means books and periodicals and computers that students can use for research and study. Madison Prep's school library consists of some donated books and reference materials, Internet access, and some donated periodicals, many of which are quite dated.

The school used the PCSP funds for these subscriptions because the use of these publications is an integral part of our curriculum (per part c; acquiring or developing curricular materials), for both in-class and library reference purposes. It should be noted that there were no subscriptions for publications unrelated to Madison Prep's curricular emphases, and we respectfully request that these expenditures be considered as allowed under part c.

HISTORIA EST MAGISTRA VITAE
"History is the Teacher of Life"



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Office Supplies

Office supplies charges submitted as PCSP expenditures include items needed to implement the Madison Prep curriculum during our first couple of years. Some of these supplies, while consumable, are still integral to our courses. Some of these were publishing supplies (covers, bindings, etc.) and printing for individual course materials. Some of these supplies were used for marketing the school in the community. The office supplies expenditures do not reflect the school's entire office supply consumption for the year, nor do they reflect office supplies for administrative use to a significant degree. We respectfully request that these expenditures be considered as allowed under parts a, b, and c.

Finance charges

The finance charges from Alliance Book Company were included on an invoice for textbooks that the school paid in full from PCSP funds. We concur with the finding that these finance charges are unallowable.

Monthly fees for DSL service

For 2-3 months during the year, Madison Prep teachers are actively engaged in the building and re-tooling of curriculum. Much of this happens during the summer months, and some of it happens during the school-year breaks. During our first three years the time and effort invested in the development, evaluation, revision and integration of the curriculum has been great. The use of PCSP funds for these DSL payments reflects the critical importance of the Internet to acquiring and developing of curriculum materials. During summer and breaks the only use of the DSL service has been for curriculum research and development. The DSL fees submitted for PCSP funds do not reflect the use of DSL through the majority of the year, but rather reflects the use of DSL as a vital tool for teachers. We respectfully request that these expenditures be considered as allowed under part c.

Monthly copier lease payments

In developing and preparing curricular materials for classes, at times it makes more sense to use our own copier rather than a commercial copying/binding service. This makes the most sense when our copier use is lower than the contracted amount, during the summer and in months where fewer copies are made. The copier lease payment that was charged to the grant helps cover the cost for a portion of the copies made for curricular materials in-house during the year. We respectfully request that these expenditures be considered as allowed under part c.

Management Controls

The other issue raised in your letter is regarding the material weakness of management controls. We are in the process of reworking our financial system. The impact of the problems with the third party business services firm has been substantial. As to corrective action on this issue, we will be working with our accounting firm on management controls and developing an expenditure review process internally. Any request for grant expenditures will be reviewed by the Administrator and the Director and compared directly to the actual grant description of allowable expenses. If there are any questions about the appropriateness of a given request then USDofEd staff will be contacted and their ruling will be documented in writing.

School Response to Recommendations

- 1.1 As stated above, the school believed that the use of grant funds in order to accomplish curricular and organizational goals in the early days of the school was important and allowable. The school respectfully requests that the Inspector General will take into account the actual use of these expenditures and consider them to be qualified expenses in light of parts a, b, and c. As to the

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- specific expenditures, the school concurs with the auditors that the finance charges of \$772.03 should not be allowed and this amount should be remanded to the USDofEd.
- 1.2 The school concurs with this recommendation and will commence the development and implementation of policies and procedures to address this recommendation. These policies and procedures will be drafted with the assistance of our accountant and implemented within our systems by 31 December 2003.

Thank you for the opportunity to respond to this draft audit report, and thank you in advance for your consideration.

Sincerely,

David M. Batchelder
Director

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