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UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF INSPECTOR GENERAL

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OCT 31 2003

Control Number ED-OIG/A05-D0029

Ms. Patricia Dalman, Administrator
Sonoran Desert School
4448 East Main Street, Suite 7
Mesa, AZ 85205-7916

Dear Ms. Dalman:

This **Final Audit Report** presents the results of our audit of the Sonoran Desert School's (School) use of U.S. Department of Education (ED) funds for the period September 1, 2001, through August 31, 2002 (project period). 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 did not expend Public Charter Schools Program (PCSP) grant funds in accordance with the law. The School used \$13,405 of the \$170,000¹ in PCSP funds it received for the project period for items and services that were unallowable. The School also charged \$24,121 to the PCSP grant for payment of salaries for curriculum development but was unable to provide documentation supporting the work the School's staff completed and when the work was completed.

In response to a draft of this report, the School did not concur with the two findings or recommendations 1.1 and 2.1. However, the School concurred with recommendations 1.2 and 2.2.

For Finding No. 1, the School stated that it believed that the unallowable costs identified in this report were allowable because the School used these items in conjunction with the School's mission to provide public education to students. For Finding No. 2, the School stated that it did not maintain documentation supporting its use of PCSP funds to supplement teacher's salary payments because it did not receive adequate guidance on how to document its use of PCSP funds for salary payments. After evaluating the School's response, we reclassified the unsupported costs to unallowable costs in Finding No. 2. Other than this reclassification, we found no basis for changing the findings or recommendations. The School's comments are summarized in the body of the report and included in their entirety as an attachment to this report.

¹ The School charged \$170,074 to the PCSP grant, \$74 more than the \$170,000 it had available for the project period.

AUDIT RESULTS

Finding No. 1 The School Charged \$13,405 in Unallowable Costs to the PCSP Grant

During our audit period, the School charged unallowable costs to the PCSP grant. We judgmentally selected 151 expenses totaling \$98,599 from the 262 expenses totaling \$170,074 charged to the PCSP grant for the project period. We reviewed written descriptions provided by the School for these 151 expenses and determined 36 expenses were unallowable and should not have been charged to the grant. The unallowable charges included non-educational supplies,² community college tuition costs for School students, student hearing tests, field trips, cell phones, and professional dues. These are general operational costs that should have been paid from other sources.

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.

The School did not have sufficient controls in place to provide reasonable assurance that PCSP funds were expended on activities allowable under the law. Instead, School officials relied on their own interpretation of the charter school law when purchasing items and services with PCSP funds. The costs we identified as unallowable were not included in the School's original PCSP grant budget. Had School officials reviewed their original PCSP grant budget or contacted an ED charter school program official before incurring these costs, the School may not have expended PCSP funds on unallowable items and services.

The School expended \$13,405 in PCSP funds to pay for items and services for ongoing school operations. Because School officials used PCSP grant funds to pay for general operational costs, the School was unable to use those funds to purchase items and services that would increase the chances of the School becoming financially independent.

² The non-educational supplies charged to the grant included office supplies for school administration, sweatshirts for students, a cordless telephone system for the School, student pay phone, graduation ceremony supplies, and award pins.

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

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 \$13,331 to ED⁴; and
- 1.2 develop and implement controls to provide reasonable assurance that ED funds are expended on items and services that are allowable under the law.

Auditee Comments

The School disagreed with the finding. The School's Administrator agreed that its officials relied on their own interpretation of the charter school law when purchasing items and services with PCSP funds but stated that the School was in regular communication with the grant coordinator in regard to expenditures. The School stated that, due to the lack of specificity in the law, it had to make decisions on how to expend PCSP funds. School officials believed that any purchases that supported the mission of the School would be allowable. These costs included such items as filling administrative needs for supplies, communications, student incentives, and other items it deemed critical to the implementation of the School.

OIG Response

We reviewed the School's comments and found no basis for changing the finding. The School admitted that they relied on their own interpretation of the charter school law when purchasing items with PCSP funds. In our opinion, the School official's interpretation of charter school law was incorrect because the items that they paid for with PCSP funds were not directly related to the initial implementation or operations of the School. The School's Administrator stated that she was in regular communication with the grant coordinator but has provided no evidence documenting that she discussed the allowability of certain PCSP expenses with the respective grant coordinator. The costs that we identified as unallowable were costs supporting ongoing school operations and should not have been paid with PCSP funds.

Finding No. 2 The School Cannot Support Its Use of \$24,121 in PCSP Funds

The School was unable to provide documentation supporting its use of \$24,121 in PCSP funds for payment of salaries for curriculum development. The School's accounting records show that it charged \$25,900 to the PCSP grant for curriculum development for the project period (the third year of the grant). The School's payroll records only supported \$1,779.

⁴ The School charged \$170,074 to the PCSP grant, \$74 more than the \$170,000 it had available for the project period. Therefore, we only recommend recovery of \$13,331 (\$13,405 in unallowable costs less \$74).

According to 34 C.F.R. § 75.702 and 75.730(b),⁵ a grantee shall use fiscal control and fund accounting procedures that insure proper disbursement of and accounting for federal funds. Pursuant 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. According to OMB Circular A-122, Attachment A, Section A(2)(g), for a cost to be considered allowable, the specific cost must be adequately documented. Attachment B, Paragraph 7(m)(1) and (2), states that the distribution of salaries and wages to a federal award must be supported by personnel activity reports that reflect the distribution of activity of each employee. These personnel activity reports must be maintained for all staff members (professionals and nonprofessionals) whose compensation is charged, in whole or in part, directly to the federal award.

During our audit period, the School did not have policies and procedures for the maintenance of records showing how it used federal funds. The School did not maintain time and effort reports or timesheets documenting the total amount of time employees worked on PCSP grant activities. The School also did not maintain records that showed what activities employees worked on and accomplished while being paid with PCSP funds. Additionally, the School was unable to provide support for all of the curriculum development work completed by employees paid with PCSP funds.

Without records to support how it used the funds, the School cannot demonstrate that it used the \$24,121 for the intended purposes of the PCSP grant.

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

- 2.1 refund \$24,121 to ED; and
- 2.2 develop and implement policies and procedures for maintaining necessary financial and personnel activity records documenting how the School expended PCSP funds.

Auditee Comments

The School commented that it did not maintain time and effort reports or timesheets documenting the total amount of time employees worked on PCSP grant activities. The School's Administrator commented that no guidelines were provided for specific documentation of stipend expenditures. The School also stated that the stipends were used to fund the development of additional curricula and to prevent overall salary reductions.

⁵ Unless otherwise specified, all regulatory citations are to the July 1, 2001, volume.

OIG Response

We reviewed the School's comments and found no basis for changing the finding. The School could not provide documentation of salary stipends paid with PCSP funds because it failed to maintain documentation of its supplementary salary costs paid with PCSP funds. Without sufficient documentation showing what School employees accomplished as a result of being paid with PCSP funds, we cannot be assured that PCSP funds were expended for allowable purposes.

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 1998.⁶ Charter schools that receive a grant directly from the federal government also must 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 1999. The School applied for a PCSP grant and received its authorization from ED on August 19, 1999. The grant provided the School with startup funding for a three-year period. For the project period, the third year of funding, the School received \$170,000 in PCSP grant funds.

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 \$170,000 authorization made on September 12, 2001, and costs charged to the PCSP grant for the project period.

To accomplish our objective, we

- interviewed the School's Administrator;
- reviewed accounting records and identified 262 expenditures totaling \$170,074 charged to the PCSP grant;
- judgmentally selected 147 expenses totaling \$89,241. We selected large dollar expenses and/or those with cost descriptions that, in our opinion, were inconsistent with the intent of the PCSP grant. We reviewed written descriptions for these expenses to determine if the expenditures were allowable;
- judgmentally selected four PCSP expenditures totaling \$9,358 and compared those expenses with the School's accounting records. We compared invoices and

⁶ The law was amended by the No Child Left Behind Act of 2001, Title V, Part B.

- cancelled checks provided by the School's Administrator supporting these four expenses; and
- compared payroll records with the School's accounting records to determine if all employee PCSP payroll expenditures were accurately recorded and supported.

We also relied, in part, on the School's computer-processed accounting data maintained using QuickBooks® software. We compared the School's data with information from ED's Central Automated Processing System. We also compared the School's supporting documentation for four transactions, consisting of invoices and canceled checks, with the School's computerized accounting records. Based on our tests, we concluded the data were sufficiently reliable to be used in meeting the audit's objective.

We performed our audit work between December 2002 and July 2003. We visited the School on December 11, 2002, and discussed the results of our audit with the School's Administrator on March 25, June 26, and July 17, 2003.

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 material weaknesses in the School's management controls over ED awards. The School did not have (1) sufficient controls in place to provide reasonable assurance that PCSP funds were expended on activities allowable under the law and (2) policies and procedures for maintaining records documenting how the School used ED funds. These weaknesses are 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
Washington, DC 20202

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', with a large, stylized flourish extending to the right.

Richard J. Dowd
Regional Inspector General
for Audit

Attachment

Attachment

Mr. Richard J. Dowd
U.S. Department of Education
Office of Inspector General
111 N. Canal Street, Suite 940
Chicago, IL 60606-7204

Date: 10/6/03
RE: Draft Audit Report ED-OIG/A05-D0029

Dear Mr. Dowd:

I am writing in response to the Draft Audit Report dated September 18, 2003. Thank you for the opportunity to review audit findings in advance and to provide commentary on the findings and recommendations currently being considered. In the following sections I will provide a summary of the two Draft Audit Report's Findings and Recommendations, followed by the School response to each of the two Findings and Recommendations. The final section will include alternative recommendations for your consideration.

Summary of Finding No. 1 and Recommendations

Finding No. 1 of the Audit Report states that "The School Charged \$13,405 in Unallowable Costs to the PCSP Grant," and includes the following recommendations:

- 1.1 The School should refund \$13,331 to ED.
- 1.2 The School should develop and implement controls to provide reasonable assurance that federal funds are expended on items and services that are allowable under law.

School Response to Finding No. 1 and Recommendations 1.1 and 1.2

The Draft Audit Report states, "The School did not have sufficient controls in place to provide reasonable assurances that PCSP funds were expended on activities allowable under the law." While the Public Charter Schools Program is definitely a progressive and positive source of charter school funding, the entire Public Charter Schools Program seemed itself to lack sufficient controls over expenditures, including a lack of specific regulatory guidelines regarding expenditures. Any instructions in regard to expenditures were scattered and anecdotal in nature. The recommendation to develop and implement controls is an excellent one—so good that it should have been required as a formal part of the application process and periodically reviewed during the grant period. Is the school to blame if it didn't receive specific guidance while participating in the grant? If a federal program lacked these controls, is it fair for a small, newly formed school to be penalized for not having them?

The Draft Audit Report states, "School officials relied on their own interpretation of the charter school law when purchasing items and services with PCSP funds." To an extent this is true, although the School administrator was in regular communication with the grant coordinator in regard to expenditures. The lack of specificity mentioned above in regard to what was allowable seems to be a key issue because it does leave decisions open to

interpretation. In particular, this seems to apply to the interpretation of the phrase “educational materials and supplies.” The interpretation presented in this Finding seems to limit purchases to those used directly in a classroom. The School’s interpretation included any purchases that supported the mission of the school to provide a free and appropriate public education; in this interpretation, filling administrative needs for supplies, communications, student incentives, and other items is critical to the implementation of the school. To our understanding, there is no reason why these expenditures aren’t allowed since “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... 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.”

Likewise, the Draft Audit Report describes these as unallowable expenditures because they are “items and services for ongoing school operations” and “general operational costs.” But isn’t it true that any program that is implemented by definition becomes an ongoing cost? The only questions are a) what constitutes implementation? and b) what constitutes an ongoing cost? The parameters of the PCSP grant defined this because it was a time-limited grant; it follows that the grant period itself must be the implementation period because the grant purpose is implementation. The distinction between implementation expenditures and ongoing expenditures is too indistinct to permit classification on that basis alone; for example, the purchase of computer equipment is clearly allowable, yet computers also represent an ongoing expense. It does not seem fair to penalize the School on the basis of criteria that is indistinct and debatable.

Summary of Finding No. 2 and Recommendations

Finding No. 2 of the Audit Report states that “The School Cannot Support Its Use of \$24,121 in PCSP Funds,” and includes the following recommendations:

- 2.1 The School should provide documentation supporting the School expended \$24,121 for curriculum development or refund this amount to ED.
- 2.2 The School should develop and implement policies and procedures for maintaining necessary financial and personnel activity records documenting how the School expended PCSP funds.

School Response to Finding No. 2 and Recommendations 2.1 and 2.2

The Draft Audit Report states, “The School did not maintain time and effort reports or timesheets documenting the total amount of time employees worked on PCSP grant activities.” This criticism does not take into account the fact that the employees in question are professional educators who are paid by salary. It is not standard practice at this School or any other school we are aware of for any salaried employee to maintain time and effort reports or timesheets. Professional educators are responsible for the execution of various school duties, including curriculum development, under the supervision of the Administrator; satisfactory performance of these duties is a basis for continued employment. In effect, the documentation called for in this audit represents an exception from standard practice in regard to salaried employees; given the special nature of these requirements,

specific guidelines should have been disseminated to all schools participating in the grant to avoid confusion.

Unfortunately, no guidelines were provided within the PCSP for any specific documentation of stipend expenditures. The School administrator communicated with the grant coordinator to verify the permissibility of stipend expenditures. No guidelines for documenting these expenditures were given at that time despite the fact that such expenditures were given permission by the coordinator and would clearly be occurring.

The stipend funds in question were used to fund the development of additional curricula and to prevent overall salary reductions during a serious budget shortfall caused by a drop in enrollment (this drop in enrollment was due to the adoption of a school uniform policy that increased course promotions and student achievement, but unfortunately caused a significant number of students to leave the school; school enrollment has almost doubled since the discontinuation of the uniform policy). Charter schools face significant facilities costs since facilities are paid for out of the general fund; on top of this, a fluctuation of as few as ten students can cause significant budget problems. The need for additional curricula was related to the underlying reasons for the budget shortfall. The School was originally conceived as a college preparatory school, but the nature of our student population has required us to become an alternative school serving at-risk students. This has meant changes in policy to address falling enrollment as well as the development of appropriate curriculum materials. Issuing stipends for the development of additional curricula was necessary to meet the needs of our clientele as well as to offset the reduction in salaries caused by the enrollment drop.

According to the stated PCSP purpose, "charter schools are allowed to pay for other initial operational costs not met by other sources." Because of the drop in enrollment, expenses during this period exceeded State Equalization Assistance income by \$45,453.00¹; salaries for essential curricular work could not have been maintained without supplementation by grant stipends. This is documented in the Annual Financial Report² and is clear evidence that grant monies were used to pay for "other initial operational costs not met by other sources."

Concurrences and Alternative Recommendations

Because of the absence of clear and specific guidelines during the implementation of the PCSP grant, the School cannot concur with either finding presented in the Draft Audit Report. While these findings are clearly the result of a conscientious and professional review process, the lack of specific and consistent criteria for allowing or disallowing expenditures during the grant implementation itself undermines the validity of any *ex post facto* finding. The admissibility of these expenditures depends on an interpretation of the general grant guidelines cited in the Draft Audit Report; given the absence of specific guidelines for expenditures and the documentation of expenditures, the School made reasonable judgments regarding the disposition of funds based on School needs.

¹ State and Federal incomes are separated in the budget.

² Please refer to the attached document *FY 2001-02 State of Arizona Charter School Annual Financial Report*

The School concurs with Recommendations 1.2 and 2.2 regarding the development and implementation of expenditure controls and financial activity records for special sources of funding. If grant audits are based on these criteria, the development and implementation of expenditure controls and financial activity records should be required as part of the application process; moreover, grant recipients should receive specific training in these areas upon successfully obtaining grant funds.

The school does not concur with Recommendations 1.1 and 2.1. Requiring the school to refund \$37,452.00 represents a significant monetary hardship which undermines the very point of awarding PCSP funds in the first place. Because this money has already been spent in support of the school, any money refunded would be taken directly from the classroom. This Recommendation constitutes a harsh penalty that runs directly counter to the grant's stated purpose to "increase the chances of the School becoming financially independent."

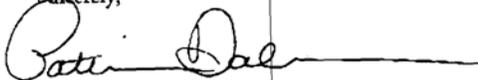
The School suggests an alternative recommendation regarding the use of these funds. If the findings are upheld, it would be much more fair and more appropriate to require the School to apply the amount of these funds to future School expenditures that would satisfy the guidelines for expenditures and record-keeping presented in the Draft Audit Report. This would satisfy any concerns raised during the audit process while assuring that students were not unfairly penalized. This would also provide the opportunity to formulate and apply a controls and record-keeping process for grant expenditures as recommended in the Draft Audit Report. If this recommendation is approved, the School will formulate the necessary policies and procedures within one week of receiving approval and will complete expenditures using these guidelines over the next six to twelve months.

In addition, during the PCSP funding period a total of \$24,079.69 was spent on marketing the school.³ Although the grant funds include "informing the community about the school," grant funds were not used to cover these marketing expenses. May any of the funds questioned in this Draft Audit Report be applied to these clearly allowable expenditures, thereby resolving any concerns while assuring that students were not unfairly penalized?

Conclusion

Thank you once again for the opportunity to share the School's perspective on the Draft Audit Report. Please don't hesitate to contact me by phone at (480) 396-5463 or by email at pdalman@sdschool.org if you have any questions.

Sincerely,



Patricia Dalman
Administrator, Sonoran Desert School

³ Please refer to attached document *PCSP Grant Unclaimed Marketing Expenses*