OFFICE OF THE NEW YORK STATE COMPTROLLER

DIVISION OF LOCAL GOVERNMENT
& SCHOOL ACCOUNTABILITY

Buffalo United Charter School

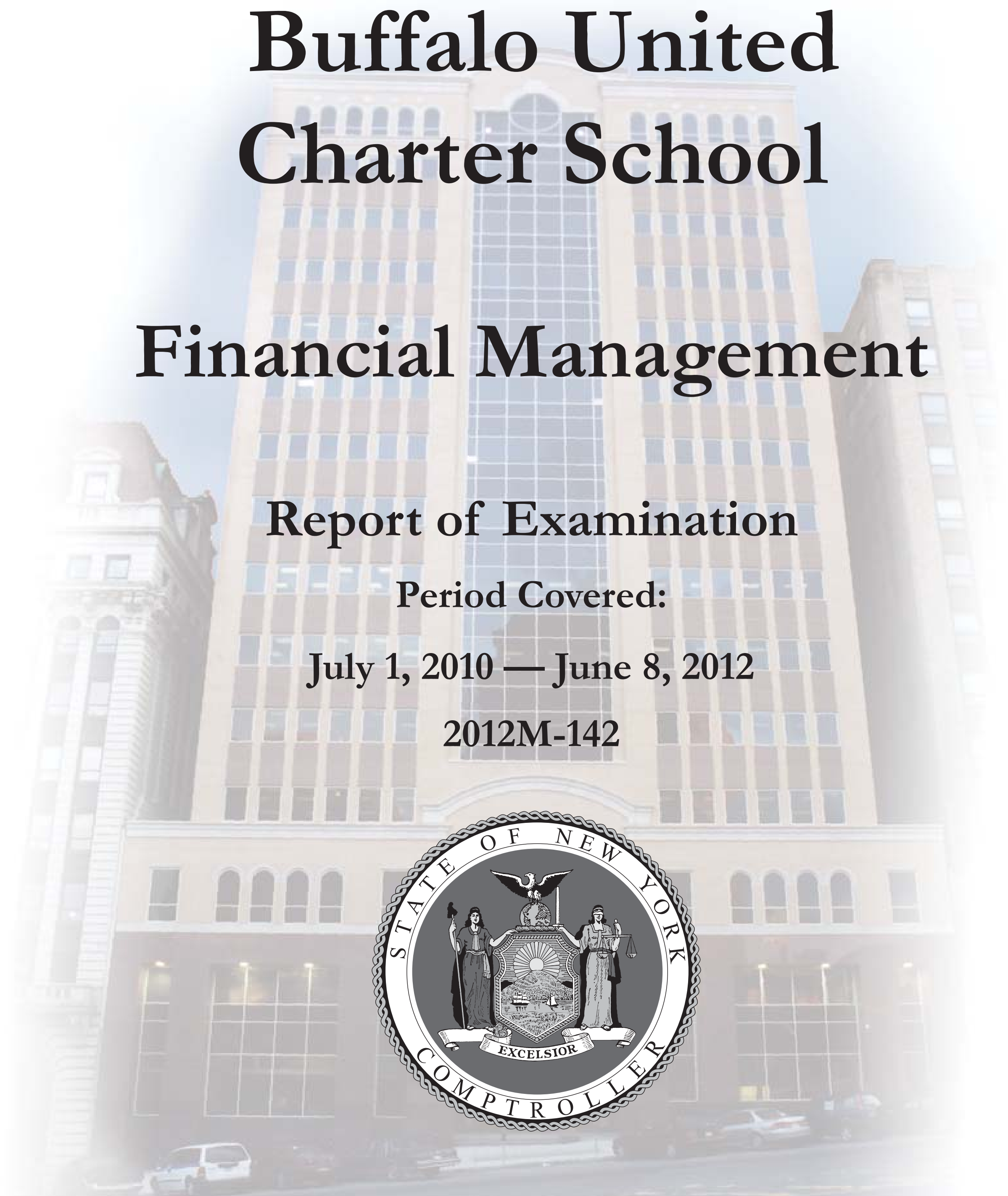
Financial Management

Report of Examination

Period Covered:

July 1, 2010 — June 8, 2012

2012M-142



Thomas P. DiNapoli

Table of Contents

State of New York
Office of the State Comptroller

Division of Local Government
and School Accountability

December 2012

Dear School Officials:

A top priority of the Office of the State Comptroller is to help School officials manage government resources efficiently and effectively and, by so doing, provide accountability for tax dollars spent to support School operations. The Comptroller oversees the fiscal affairs of public schools statewide, as well as compliance with relevant statutes and observance of good business practices. This fiscal oversight is accomplished, in part, through our audits, which identify opportunities for improving operations and School board governance. Audits also can identify strategies to reduce costs and to strengthen controls intended to safeguard School assets.

Following is a report of our audit of the Buffalo United Charter School, entitled Financial Management. This audit was conducted pursuant to Article V, Section 1 of the State Constitution and the State Comptroller's authority as set forth in Section 2854 of the Education Law.

This audit's results and recommendations are resources for School officials to use in effectively managing operations and in meeting the expectations of taxpayers, students and their parents. If you have questions about this report, please feel free to contact the local regional office for your county, as listed at the end of this report.

Respectfully submitted,

Office of the State Comptroller
Division of Local Government
and School Accountability

Introduction

Background

A charter school is a public school financed by local, State and Federal resources that is not under the control of the local school board and is governed under Education Law Article 56. Buffalo United Charter School (School) is governed by a Board of Trustees (Board) that has eight members. The Board has entered into a management agreement with National Heritage Academies, Inc. (NHA), a privately held for-profit corporation located in Grand Rapids, Michigan. The Board has been using NHA to operate the School since its inception in the 2003-04 fiscal year. The management agreement assigns virtually all revenue[1] the School receives to NHA, which is responsible for the general management and control of the School's finances. The Board also has a lease agreement with an NHA subsidiary for the building where the School operates.

The School's revenues for the 2010-11 fiscal year were approximately $8.6 million. These revenues were derived from billing area school districts for resident pupils and from certain State and Federal aid attributable to these pupils. Since virtually all revenue was assigned to NHA for its management of School operations, the School reported net assets of approximately $8,000 as of June 30, 2011.

Objective

The objective of our audit was to examine the School's relationship with NHA to address the following related question:

- Did the Board properly monitor the management corporation operating the School and ensure School funds are effectively and efficiently used?

Scope and Methodology

Our overall goal was to assess the School's financial operations. Since financial operations were handled by the management corporation, we evaluated that relationship for the period July 1, 2010 to June 8, 2012. We extended our scope back to 2003 for information related to the building lease.

We conducted our audit in accordance with generally accepted government auditing standards (GAGAS). More information on such

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[1] All revenue is assigned to NHA except 2 percent or $35,000, whichever is less, which is designated as the Board's discretionary fund. With revenues for the 2010-11 fiscal year of $8.6 million, 2 percent is approximately $172,000. Therefore, the discretionary fund was limited by the terms of the agreement to the $35,000 cap, which represents less than 0.5 percent of total revenue for the 2010-11 fiscal year. For all eight fiscal years that NHA has operated the School (2003-04 through 2010-11) the 2 percent amount exceeded the $35,000 cap which the Board received.

standards and the methodology used in performing this audit are included in Appendix C of this report.

Comments of School Officials and Corrective Action

The results of our audit and recommendations have been discussed with School officials and their comments, which appear in Appendix A, have been considered in preparing this report. School officials generally disagreed with our findings but indicated they would consider and address the recommendations in the School's corrective action plan. Appendix B contains our comments on issues raised in the School's response.

The Board has the responsibility to initiate corrective action. We encourage the Board to prepare a plan of action that addresses the recommendations in this report, and to forward the plan to our office within 90 days. For more information on preparing and filing your Corrective Action Plan (CAP), please refer to our brochure, *Responding to an OSC Audit Report*, which you received with the draft audit report. We encourage the Board to make this plan available for public review in the Secretary's office.

Financial Management

The Board is ultimately responsible for safeguarding public funds intended for educational purposes, even when it contracts with a management corporation to operate the School. The Board should fulfill this responsibility by providing adequate oversight of the corporation to ensure that all transactions are accounted for and that public funds are used effectively and efficiently for educational purposes.

The School's by-laws state that the Board Treasurer (Treasurer) shall keep or cause to be kept adequate and correct accounts of the School's properties, receipts, and disbursements. The Treasurer also shall render or cause to be rendered to the Board, as requested, but no less frequently than once every fiscal year, an account of the School's financial transactions and financial condition. NHA performs most of the Treasurer's key duties.[2] The management agreement states that NHA will provide the School with a projected budget that contains reasonable detail as requested by the Board and includes all projected expenses and costs reasonably associated with operating the School and the NHA school program.[3] The management agreement also indicates that both NHA and the School would consider requests to amend the budget in good faith. It further states that NHA expenses are not to deviate materially from the provisions of the budget without Board approval and that NHA is to make all its financial and other records related to the School available to the Board.

The Board relies almost exclusively on NHA to handle the School's finances. We therefore question whether the Board can sufficiently monitor NHA. With almost all financial duties and responsibilities assigned to NHA, the Treasurer cannot adequately fulfill certain duties as prescribed in the by-laws. Further, NHA's failure to fully disclose detailed information about its internal costs and how they are allocated to the School limits the Board's ability to verify that these charges are accurate and appropriate.

While the Board technically approves the annual budget prepared by NHA, the management agreement provides for virtually all of the

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[2] Through its contract with the management corporation, the School has, in effect, assigned most of the financial duties to NHA including approving bills, signing checks, recording financial activity, and providing financial reports to the Board. Many of these duties would typically be the responsibility of a Treasurer.

[3] The management agreement, amended in May 2011, includes the following additional language relating to the budget: "…including but not limited to an itemized break down of revenues and amounts paid to NHA relating to: (a) regular education; (b) special education; and (c) management and general functions."

School's revenues to go to NHA. As such, approving the budget, and any subsequent amendments, is essentially meaningless. We found that, as NHA's estimates of School revenue increased or decreased, NHA simply adjusted various cost allocations to the School to equal 100 percent of available revenue with no indication of increased or decreased service level. For example, the 2010-11 fiscal year budget, which initially totaled approximately $7.6 million, was amended twice. The first amendment reduced total expenses to approximately $7.3 million, in November 2010. The second amendment, in May 2011, increased total expenses to more than $8.7 million. These significant changes were the result of NHA adjusting revenue estimates during the year and balancing the budget with corresponding decreases or increases in budgeted expenses presented to the Board.

We found a similar pattern during the 2011-12 fiscal year. Revenues in the initial 2011-12 budget totaled approximately $8.2 million and increased in November 2011 to $9.2 million. The budget for indirect costs was then simply increased to account for this additional revenue.

Further, NHA's descriptions of costs related to the School budget (provided in an accompanying memo) do not fully identify the purpose of certain direct and indirect costs, and the School does not have access to supporting documentation for more than $3 million in indirect costs[4] allocated at NHA's discretion. An NHA official stated that the corporation does not provide a breakdown of site-based [direct] and allocated [indirect] costs because it was unclear why the Board needs the information to approve the budget or provide adequate oversight.

The significant budgetary fluctuations, along with the lack of transaction-level detail for indirect costs, suggest that the Board did not have adequate information on which to base decisions regarding the School's finances. The School Board's Chairman told us that the Board was satisfied with the budget information provided and that NHA is responsive to Board members' questions and requests for information. However, he also said that, as part of an overall reassessment of the agreement, the Board negotiated changes, effective May 2011, which included clarifying the language regarding NHA's responsibilities for providing budget detail information. As of the end of our audit

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[4] According to NHA, it treats some costs as direct to the School and some as indirect costs, allocated among the various schools that it manages, and that because its business model is highly centralized there is a large number of indirect costs allocated among the schools it manages. The audited financial statements for the 2010-11 fiscal year report $5,576,000 in actual direct expenses, and $3,002,000 (35 percent of total expenses) in indirect costs allocated to the School.

fieldwork on June 8, 2012, however, the Board still lacks detailed information regarding the School's financial operations. Therefore, the Board is not sufficiently informed to ensure that School funds are used for educational purposes or to determine whether assigning all the School's revenue to NHA is reasonable and appropriate.

There are options that could provide the School with improved financial control and allow for the Treasurer to comply with the accounting provisions of the by-laws while continuing to contract with NHA. For example, NHA could provide specified services at a fixed price per year or at a set price per student, enabling the School to avoid the loss of financial control that occurs when the Board simply agrees to provide virtually all revenues received to NHA.

Lease Agreement – The Board entered into a lease agreement with an NHA subsidiary in 2003 for a school building. According to NHA, its subsidiary purchased the building in 2003 for $230,000 and has incurred equipment acquisition, building renovation, and land improvement costs totaling $5.6 million as of the end of the 2010-11 fiscal year. From July 2003 through the 2010-11 fiscal year, lease payments charged to the School totaled $6.7 million. In effect, the NHA subsidiary recovered its investment in less than seven years of operation (i.e., at the end of the 2009-10 fiscal year).[5] Consequently, School officials have not demonstrated the arrangement was in the best interests of the School, particularly since NHA controls virtually all of the School's revenues through the management agreement.

Recommendations

1. The Board should negotiate changes in the terms of the management agreement with NHA in order to gain more control of the School's finances.

2. The Board should periodically assess the terms and conditions of any management agreements to ensure that they are reasonable and in the best interests of the School.

[5] In the 2010-11 fiscal year, the annual lease payment totaled $957,444 ($858,720 for the building and $98,724 for equipment). The School's cumulative payments of $6.7 million through 2010-11, less $957,444, equals a total of approximately $5.75 million paid as of the 2009-10 fiscal year end.

APPENDIX A

RESPONSE FROM SCHOOL OFFICIALS

The School's officials' response to this audit can be found on the following pages.

November 27, 2012

Office of the State Comptroller
Division of Local Government and School Accountability
Buffalo Regional Office
Attn: Robert Meller, Chief Examiner
295 Main Street, Suite 1032
Buffalo, NY 14203-2510

Via Federal Express

Dear Mr. Meller:

On behalf of the entire Board of Buffalo United Charter School (BUCS), I send this letter as a formal response to the draft audit report by the Office of the State Comptroller (OSC) (Audit Report #2012M-142), dated October 31, 2012. We respect the OSC's priority to help school officials manage government resources efficiently and effectively. For this reason, we view this audit report as a valuable tool to assist us in evaluating whether school funds were put to their highest and best use. We take our responsibility for safeguarding public funds very seriously, and we use all the tools available to do so.

We have noted two recommendations in the audit report: that the Board should negotiate changes in the terms of the management agreement with [National Heritage Academies, Inc. ("NHA")] in order to gain more control of the School's finances; and that the Board should periodically assess the terms and conditions of any management agreements to ensure that they are reasonable and in the best interests of the School. We respectfully submit that we have exercised due diligence and caution in our oversight of NHA's provision of services to the school.

In response to the first recommendation, we respectfully disagree with the suggestion that the Board does not have control of the School's finances. As described in the report, the Board has contracted with National Heritage Academies (NHA) to provide the educational program, management services, and financial services to BUCS. We have ultimate control over the School's finances, and we have delegated the day-to-day financial decisions to NHA. All financial decisions made by NHA with regard to the School are required to be made within the framework of the Board-approved budget.

See Note 1 Page 12

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The audit report describes our budget process in detail. As the audit indicates, the budget process has three stages: the preliminary spring budget approval (prior to the start of the fiscal year); the fall budget approval (after the school year begins and student count can be more reasonably estimated); and the final amended budget (at the end of the school year). The management agreement requires NHA not to expend revenues in any way that deviates from the budget provisions without Board approval. We recognize, however, that it is our responsibility to review and approve the budget and subsequent amendments. Evidence of the care we take in the budget process (including the Board's discussion and analysis of the budget) can be found in all Board meeting minutes[1].

See Note 2 Page 12

The audit report also mentions that the Board lacked detailed information regarding the school's financial operations. It should be noted that beginning in the 2010-11 budget cycle, NHA has provided the Board with greater detail on the budget. The quarterly financial reports also include this increased level of detail to better help the Board in its oversight of fiscal operations.

See Note 3 Page 12

With regard to the second recommendation, we would like to highlight the process that we implemented in our most recent negotiation with NHA on the management agreement. Several years ago[2], we created a Management Contract Review Committee consisting of three Board members to conduct a comprehensive review of the Board's contract with NHA. This committee reports to the full Board on NHA's performance against the contract, addressing such factors as successes, challenges, and suggested changes, if any, to the current contract and management relationship. The Committee worked with counsel to renegotiate the management agreement and is scheduled to do another review and negotiation when the current agreement comes due. Based on the recommendation in the audit report, the Committee will annually review the management agreement and report to the full board.

See Note 4 Page 12

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[1] At the January 5, 2010 meeting, the Board discussed NHA's method for allocating costs to the school and how the funds for the school are managed, including the expenses allocated to each school managed by NHA. At the same meeting, the Finance Subcommittee Report was discussed. During the report, it was mentioned that NHA had responded to the Committee's earlier questions and had modified the format provided. The Committee also requested additional explanation on certain line items, which NHA provided and which were discussed at the March 9, 2010 meeting.

At the November 1, 2011 meeting, a board member asked NHA to provide more information on the line items that saw substantial changes. At the February 7, 2012 meeting, it was reported that the Finance Committee spoke with the NHA Director of School Accounting to clarify questions on the amended budget. Additionally, NHA provided a memo to the board with explanations on fluctuations in the 11-12 budget.

[2] The Committee was established at the October 30, 2009 Board meeting.

Beyond the recommendations, we would also like to respond to certain points raised in the audit report. Specifically, there is a comment in the audit report that we feel is misleading and requires clarification. While noting the alleged comment by an NHA representative ("that the corporation does not provide a breakdown of site-based (direct) and allocated (indirect) costs because it was unclear why the Board needed the information to approve the budget or provide adequate oversight"), it is important to point out that the budgets are documented with a significant amount of detail (more than 90 separate expense line items). Although the budget document does not distinguish between site-based costs and costs that are centralized and allocated, there is a significant amount of detail on the type of cost.

See Note 3 Page 12

Additionally, the comment about the lease agreement in the audit report is not an accurate representation of the facts. While the investment amounts are accurate, the report neglects to note that the lease was carefully negotiated by the Board. The Board, with assistance from its independent counsel, reviewed the lease agreement and rate prior to signing. A member of the Board, who is also an attorney in Buffalo, was actively involved in the lease negotiation. We are confident that his professional experience in real property litigation, commercial landlord-tenant disputes, and construction litigation added value to this negotiation.

See Note 5 Page 12

Thank you for the opportunity to respond to the audit report. We will review the recommendations included in the audit report and a separate Corrective Action Plan will be filed to directly address the recommendations.

Sincerely,

Art Traver
Board President
Buffalo United Charter School

Electronic cc: [redacted]
John Kelepurovski
Laura Kaleefey

APPENDIX B

OSC COMMENTS ON THE SCHOOL'S RESPONSE

Note 1

All financial decisions made by NHA may be within the framework of the budget; however, when the Board enters into a management agreement that assigns NHA virtually all of the School's revenue, the budget provides little control.

Note 2

Had initial budget estimates been more accurate, the School may have been in a better position to plan for the effective use of funds in the interest of its students. The significant budget fluctuations, referenced in our report, do not provide such an opportunity. The amendments to both the 2010-11 and 2011-12 budgets provided for significant increases months after the school year had begun: an increase of $1.4 million (from $7.3 million to $8.7 million) for the 2010-11 fiscal year was approved in May 2011; and an increase of $1 million (from $8.2 million to $9.2 million) for the 2011-12 fiscal year was approved in November 2011.

Note 3

While the Board is provided greater financial detail than before, the information does not differentiate between direct (site-based) costs and indirect (centralized) costs.

Note 4

While we commend School officials for taking action to obtain further information from NHA, the Board still does not have adequate information to ensure that the indirect costs charged to the School are reasonable or equitable. We encourage the School's contract review committee to continue pursuing appropriate contractual provisions for obtaining a detailed breakdown of indirect costs.

Note 5

We acknowledge the negotiation efforts cited in the School's response. However, the lease agreement must be considered in the context of the overall management agreement, which allows NHA to control virtually all the School's money. As long as the management agreement continues to provide such control, NHA will have the ability to adjust budget lines to compensate for any reductions in the School's lease payments.

APPENDIX C

AUDIT METHODOLOGY AND STANDARDS

The objective of our examination was to assess the financial operations of the School. Since financial operations were handled by a management corporation (NHA), we evaluated the School's relationship with NHA.

We examined the School's management agreement for the period July 1, 2010 to June 8, 2012. We extended our scope back to 2003 for information related to the School building lease. Our audit included various procedures to gather relevant evidence concerning our stated objective, as follows:

- We reviewed the management agreement, lease agreement, School Charter, by-laws, annual report, and Board meeting minutes to understand the School's operations.
- We reviewed Board members' annual disclosure of financial interest forms for the 2010-11 fiscal year to determine whether these forms were properly completed.
- We reviewed the School's audited financial statements for the 2010-11 fiscal year.
- We interviewed NHA personnel and the School Board Chairman.[6]
- We evaluated the School's annual budgeting and financial audit processes.

We conducted this performance audit in accordance with generally accepted government auditing standards (GAGAS). Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

[6] Referred to in the by-laws as President

APPENDIX D

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