Office of the New York State Comptroller

Division of Local Government
& School Accountability

# Buffalo Academy of Science Charter School

## School Building Lease

### Report of Examination

**Period Covered:**

**July 1, 2006 — April 22, 2013**

**2013M-138**

Thomas P. DiNapoli

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# State of New York
# Office of the State Comptroller

**Division of Local Government**
**and School Accountability**

July 2013

Dear School Officials:

A top priority of the Office of the State Comptroller is to help school officials manage their schools efficiently and effectively and, by so doing, provide accountability for tax dollars spent to support school operations. The Comptroller oversees the fiscal affairs of charter 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 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 Academy of Science Charter School, entitled School Building Lease. 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. The Buffalo Academy of Science Charter School (School) is governed by a Board of Trustees (Board) which comprises five members. Charter school trustees are voted in by sitting members. The Board is responsible for the general management and control of the School's financial and educational affairs.

Charter schools have less legal operational requirements than traditional public schools. Most of the charter school's requirements are contained in its by-laws, charter agreement, and the fiscal/financial management plans, which are part of the charter school application and renewal processes.

The School, located in the City of Buffalo, was established in 2004 and operated from a leased building until 2006. It then moved to its current location, another leased building, which is owned by a New York-New Jersey metropolitan area-based nonprofit educational services corporation (Corporation). The School currently offers classes for Grades 7 through 12.

The School's 2012-13 fiscal year budgeted operating expenses totaled approximately $5 million. These expenses were funded primarily with revenues derived from billing school districts for resident pupils (91 percent) and from State and Federal aid attributable to these pupils (9 percent). The School had approximately 375 enrolled students and 65 employees as of March 2013.

**Objective**

The objective of our audit was to examine the School's process for selecting and negotiating the related financial terms to obtain building space for School operations. Our audit addressed the following related question:

- Did the Board use an adequate process to acquire a building in the most cost-beneficial manner that also met the School's needs?

**Scope and Methodology**

While our audit was for the period July 1, 2006, to April 22, 2013, we reviewed information related to the School's search for a new building that dated back to January 2004 to achieve our audit objective.

We conducted our audit in accordance with generally accepted government auditing standards (GAGAS). More information on such 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 the findings but indicated that they would consider the recommendations to improve operations. Appendix B includes 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 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 School Board Secretary's office.

# School Building Lease

The Board is entrusted with the responsibility of safeguarding School resources. The Board fulfills this responsibility, in part, by fully evaluating existing options before committing these resources. When selecting a suitable site on which to construct a school building, or locating an existing building for acquisition or lease, the Board should establish a process to properly identify the needs of the School (including location, building size, suitability for intended use, and future expansion) and to determine if related costs are appropriate to help ensure the School's long-term financial viability. The Board should analyze all cost aspects for each site to assist in evaluating all of the proposals, in light of current market conditions. This would provide assurance that the option chosen is the most economic and meets the School's needs, and that agreed upon terms are reasonable and align with prevailing market conditions.

We found that the Board did not ensure that it appropriately identified and evaluated available options before deciding to lease a building. The process used to select a firm to acquire and renovate a building on the Board's behalf was not transparent, and we question whether it was an arm's length transaction. The Board selected an unlikely firm, a nonprofit educational services corporation from the New York-New Jersey metropolitan area that did not have any apparent real estate experience. We also found that the terms and conditions of the lease agreement appear to benefit the Corporation more than the School. We estimate that the lease payments could exceed the Corporation's costs by more than $4.4 million.

**Site Selection**

The Board should establish the appropriate fiscal environment, or tone at the top, by promoting a theme of fiscal responsibility and ethical conduct among all Board members. Education Law requires a charter school to set guidance for the trustees to ensure their independence in representing the interest of the school and to avoid less than arm's length transactions. An arm's length transaction is when the buyer and seller of a service act independently and have no relationship to each other. The concept of an arm's length transaction is to ensure that both parties to a transaction are acting in their own self interest and are not subject to any pressure or duress from the other party.

From January 2004 onward, the minutes of the Board's proceedings chronicle the School's search process for a school building and include a list of the buildings that the Board considered and a list of contractors that it solicited. The Board President (President) told us that leasing from, or partnering with, a third party were the only viable options due to the School's limited financial resources and its inability to borrow because of its lack of collateral and limited charter renewal periods. However, School officials could not provide us with any documentation in the minutes of the Board's proceedings or other format to indicate that they had explored financing options such as loans.

Initially, the Board considered 10 buildings as possible school sites and eight other buildings as possible gymnasium locations. After reviewing the School's space needs and conducting a cost analysis, the Board chose to lease a 22,000 square foot building in May 2004. However, the building did not have adequate space for a gymnasium and lacked the space for future classroom expansion. By 2006, the School outgrew this space as it added grade levels and increased its enrollment; therefore, the Board continued its search for a larger building. The Board's search strategies included using various real estate agencies to identify potential sites and possible contractors/developers (firms) to acquire and renovate a building and lease it to the School. However, the President told us that the School was unable to find a firm that was willing to perform these functions.

While the Board continued its search for a larger building, it also considered entering a partnership with a firm to purchase and expand the School's existing facility. Although an appraiser hired by the School determined that the School's existing building had a market value of $1.1 million, the building's owner valued the property at $1.7 million. According to School officials, a local developer also showed some interest in purchasing the School's building. The Board requested a proposal from the developer, which included additional construction for new classrooms and gymnasium space. The developer proposed a 21-year lease that would have cost the School $423,000 for the first year, with lease payment increases tied to the Consumer Price Index.[1] The Board chose not to pursue this proposal due to high costs and a requirement to commit to a long lease period.

According to the September 2005 Board minutes, the President indicated that he would "revisit" the Young Women's Christian Association (YWCA) building as a possible School site. However, the School's records do not indicate that the Board had previously considered this site. In addition, the Board minutes indicated that it would cost approximately $1.2 million to acquire and renovate the building, which according to School officials was beyond the School's financial means. The President did not provide us with any evidence to indicate that the School contacted the owner of the building and made an offer, or explored financing options, such as

[1] With 2006 as the base year

obtaining loans to purchase and renovate the building. The building was subsequently purchased by a nonprofit educational services corporation (Corporation) for $650,000 in May 2006.

The President told us that the School did not communicate with the Corporation before it purchased the building, or solicit the Corporation as a potential financing partner. Also, School officials told us that the School's relationship with the Corporation began after the previous owner notified the School about the sale of the building to the Corporation. However, these two statements appear to contradict the November 2005 Board minutes, which indicate that the School was in the process of making an offer for the building while a "third party" was finalizing a deal with the owner of the building. The minutes' characterization of these events also aligns with the Board's expressed intent of finding a firm to purchase and renovate the building and lease it to the School. New York State Department of State records indicate that the Corporation was initially registered in November 28, 2005, which was two months after the Board initially identified the YWCA building as a potential site. The Corporation does not appear to be in the real estate business.

We find it surprising that the Corporation – in business for less than a year with no apparent real estate experience and with limited financial resources[2] – would have purchased the YWCA building without prior communication with School officials and without some form of commitment from the School to enter into a lease agreement. Although we were unable to establish a relationship between the parties prior to the building acquisition, there is a risk that this was not an arm's length transaction.

**Lease Agreement and Cost Analysis**

With respect to leases, the rental payment often is expected to address all associated costs that are borne by the landlord, such as maintenance, insurance, and property taxes. However, in certain lease arrangements, the tenant pays some or all of these types of costs, in addition to rental payments. When comparing leases for various properties, it is important to analyze the total cost for each and any leasehold improvements necessary to make the property suitable for its intended use. When partnering with a third party in the acquisition and/or lease of a building, the Board should evaluate more than one potential party to ensure that the most cost-effective option is selected. This process also should entail exploring the option of buying the building at the end of the lease, or when the School's finances permit. This requires the Board to make its decision based on current information and reliable projections of future costs.

[2] According to the Corporation's 990 form that it filed with the Internal Revenue Service for 2006, the Corporation was in a deficit position for that year.

The School signed a 15-year lease with the Corporation that requires the School to pay rent and other costs, including utilities, general maintenance, and repairs. Beginning in the 2006-07 school year, the lease required the School to make an annual payment of $442,000 for the first three years[3] followed by subsequent increases for the following nine years until the annual payment reaches $497,475, which the School is required to pay for the last three years of the lease agreement.

Because renovation costs were the responsibility of the Corporation, we were unable to verify the actual costs incurred. However, we obtained the Corporation's Internal Revenue Service (IRS) 990 forms (i.e., annual financial reports). From these reports and other public records, we estimated the Corporation's acquisition, renovation, and financing costs for the former YWCA building. The Corporation paid $650,000 to acquire the building in May 2006 and approximately $585,000 in renovation costs, which is consistent with estimates provided by the Board President. According to the Corporation's 990 forms, it financed these costs with debt of approximately $1.2 million. Using prevailing interest rates at the time,[4] we estimated that interest costs over a 15-year lease period will be approximately $700,000. However, considering the current low interest rates available, the Corporation may have reduced its financing costs.

Over the life of the lease, the Corporation will incur total costs[5] of approximately $1.9 million,[6] and the School will pay more than $6.3 million[7] in lease payments.[8] Assuming these circumstances do not change, the Corporation could receive a net rental income of more than $4.4 million, which is a return on its investment of more than 200 percent.

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[3] The School did not occupy the entire space leased for the initial three years due to renovation work that was ongoing. The rent was pro-rated to $168,420 for the first and second year and $282,400 for the third year.

[4] The prevailing interest rates in 2006 and 2007 were 6.5 percent when the building was acquired and renovations completed.

[5] These costs do not include major repairs that might be incurred by the Corporation, because routine repair and maintenance costs are the School's responsibility.

[6] This amount includes the $650,000 purchase price, $585,000 for renovations and other initial capitalized costs, and $700,000 for interest.

[7] This does not include operation and maintenance costs incurred and paid by the School.

[8] The School apparently does not have the option to terminate the lease before August 31, 2021. However, the Corporation has the option to sell the building at any time on receipt of a bona fide offer from a third party and is merely required to communicate to the School its intent to sell the property. The School has the right of first refusal to purchase or commit to a purchase within 30 days. The lease agreement also states that the School will be given a credit toward purchasing the building that is equal to 10 percent of all rent paid under the lease. However, even if the School leased the building for the full 15-year period, the credits would not exceed the Corporation's initial cost to acquire the building ($650,000).

**Other Payments**

In reviewing payments to the Corporation to ensure compliance with the lease agreement and to determine whether they represented proper School expenses, we found that the School also paid the Corporation for other services. The Corporation billed the School $37,600 for maintenance services from September 2006 to July 2007, which appears to comply with the lease agreement. The School also contracted with the Corporation to provide a student database management and assessment system and student testing for a total of $170,000[9] and staff training and development services totaling $67,000. These payments appear to comply with the contract and were appropriate School costs.

**Recommendations**

1. The Board should ensure that all its proceedings are properly documented in the minutes and all such records are maintained by the Board Secretary.

2. The Board should conduct site selection reviews and cost analyses for real estate transactions and ensure transparency in conducting its proceedings.

[9] For the 2008-09 school year through March 2013

# APPENDIX A

## RESPONSE FROM SCHOOL OFFICIALS

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

The School's response letter refers to page numbers that appeared in the draft report. The page numbers have changed during the formatting of this final report.

BUFFALO ACADEMY OF SCIENCE CHARTER SCHOOL

Buffalo Academy of Science Charter School

July 19, 2013

Mr. Robert E. Meller, Chief Examiner
Division of Local Government and School Accountability
Office of the State Comptroller
295 Main Street, Suite 1032
Buffalo, New York 14203-2510

Re: Buffalo Academy of Science Charter School Building Lease
Report of Examination - Period Covered: July 1, 2006 - April 22, 2013

Dear Mr. Meller,

We would like to thank the Office of the State Comptroller for meeting with the Buffalo Academy of Science Charter School (the "School") leaders recently to discuss the draft Report of Examination ("Report") concerning the "School Building Lease". We appreciate the in-depth review of the School's lease of the current building space, and the hard work of the local field staff.

After a thorough review of the Report, the Board would like to reiterate its disagreement with the following statements:

See Note 1 Page 13

1. The Report states on page 6, "*the Board did not appropriately identify and evaluate available options before deciding to lease a building.*" The Board did, in fact, do this. A Facility Search Committee was formed in 2004. This committee spent thirty (30) months working with three different (3) real estate agencies evaluating nineteen (19) possible locations. After a thorough analysis (considering factors such as location, building size, suitability for intended use, future expansion, and related costs), the Committee ultimately narrowed the list to two (2) finalists.

   After in-depth comparison of both options, the Board selected the site with the lowest price per square foot ratio, i.e., $7 versus $11/square foot, which also offered a shorter lease term, i.e., 15 versus 21 years. This lease cost is well below market level and significantly less than the rates paid by other charter schools located in the same market. In addition, the lease contained a number of favorable terms for the School, e.g., ability to renovate the existing building on a phased basis so as to allow for immediate occupancy of the building, a reduction in the upfront security deposit, and the Landlord agreed to make significant and extensive capital improvements to the building at the Landlord's expense, etc.

   This surely demonstrates the Board's due diligence in fully evaluating building space options for the School.

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2. The Report also states on page 6, "*The process used to select a firm to acquire and renovate a building...was not transparent, and we question whether it was an arm's length transaction.*" The Board finds this statement misleading and prejudicial. The Board decisions throughout the search are well documented in Board meeting notes and letters, and such documentation does not violate record-keeping regulations. The State Education Department has stated that while charter schools are encouraged to use the same records retention schedule used by traditional public schools, they are not subject to the regulatory authority of the State Archives.

   The documentation provided to the Comptroller's Office demonstrate that the School and Landlord acted independently and had no relationship to each other prior to the purchase of 190 Franklin Street by the Landlord.

See Note 2 Page 13

3. The Report further states on page 6, "*...the terms and conditions of the lease agreement appear to benefit the corporation more than the School.*" The Board has responsibility to safeguard the school's interest and resources. The Board could not analyze the long-term financial gains of the Landlord (aforementioned corporation) nor does it agree that the return on investment for the Seller or Landlord in a real estate transaction should be a factor in the cost analysis. As previously stated, the negotiated lease agreement is well below market level and contained several favorable terms not found in other proposals. It was the most cost-effective option and to the best interest of the School regardless of the unverifiable financial benefits the Landlord may receive over the life of the lease.

The Board would like to thank the Office of the State Comptroller again for its time and consideration. We will carefully consider the report's recommendations for improved site selection review process and documentation. We will take this as an opportunity to improve the rigor of our procedures for future real-estate transactions.

Please do not hesitate to contact me if you have any questions or wish to discuss the matter further.

Respectfully submitted,

Dr. Murat Demirbas
President, Board of Trustees

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# APPENDIX B

## OSC COMMENTS ON THE SCHOOL'S RESPONSE

Note 1

Based on the totality of the information, the lack of transparency, and other issues, we have concerns with the manner in which this significant financial transaction was handled. As such, our assessment of the process used by the School has not changed.

Note 2

It is unclear to us what documentation School officials are referring to or how any such information would demonstrate that the two entities acted independently and had no relationship with one another.

# APPENDIX C

## AUDIT METHODOLOGY AND STANDARDS

The objective of our examination was to assess the financial operations of the School. To accomplish this, we performed an initial assessment of the internal controls so that we could design our audit to focus on those areas most at risk. Our initial assessment included evaluations of the following areas: general governance, financial oversight and condition, cash receipts and disbursements, purchasing, payroll, and information technology.

During the initial assessment, we interviewed appropriate School officials, performed limited tests of transactions, and reviewed pertinent documents, such as School policies, procedures, by-laws, Board minutes, and financial records and reports.

After reviewing the information gathered during our initial assessment, we then decided on the reported objective and scope for the area with the greatest risk. We examined the School's processes for selecting and evaluating building and financing options. Our audit included various procedures to gather relevant evidence concerning our stated objective, as follows:

- We interviewed School officials to get an understanding of the processes used and reviewed related School records.
- We reviewed the lease agreement and Board minutes relating to the lease agreement and search processes.
- We conducted Internet searches to determine the selling price and acquisition date of the school building by the Corporation.
- We conducted Internet searches to gain an understanding of the relationship between the School and the Corporation and any such related entities.
- We reviewed the 990 forms filed with the IRS for the Corporation and related entities to establish building acquisition, renovation, and financing costs.
- We conducted an Internet search for historical mortgage rates for 2006 and 2007.
- We reviewed all payments made to the Corporation to ensure they were accurate, supported, and in accordance with any applicable agreements.

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.

## APPENDIX D

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# APPENDIX E

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Andrew A. SanFilippo, Executive Deputy Comptroller
Nathaalie N. Carey, Assistant Comptroller

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