

PENNSYLVANIA CYBER CHARTER SCHOOL
BEAVER COUNTY, PENNSYLVANIA
PERFORMANCE AUDIT REPORT

DECEMBER 2012

The Honorable Tom Corbett
Governor
Commonwealth of Pennsylvania
Harrisburg, Pennsylvania 17120

Dr. David Jaskiewicz, Board President
Pennsylvania Cyber Charter School
1200 Midland Avenue
Midland, Pennsylvania 15059

Dear Governor Corbett and Dr. Jaskiewicz:

We conducted a performance audit of the Pennsylvania Cyber Charter School (Cyber Charter School) to determine its compliance with applicable state laws, contracts, grant requirements, and administrative procedures. Our audit covered the period July 1, 2008 through July 18, 2011, except as otherwise indicated in the report. Additionally, compliance specific to state subsidy and reimbursements was determined for the school years ended June 30, 2010 and June 30, 2009. Our audit was conducted pursuant to 72 P.S. § 403 and in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States.

Our audit found that the Cyber Charter School complied, in all significant respects, with applicable state laws, contracts, grant requirements, and administrative procedures. However, we identified five matters unrelated to compliance that are reported as observations. A summary of these results is presented in the Executive Summary section of the audit report.

As we have reported in numerous reports on charter schools, the existing charter school funding formula is flawed. A clear example of this is revealed in observations 3 and 4 of this report. Observation 3 provides details on how management of the Cyber Charter School has accumulated over \$13 million dollars in unreserved funds as of June 30, 2010. This unreserved general fund balance consists of taxpayer funds that can be spent in any fashion. Though management of the Cyber Charter School contends that the designated funds within the unreserved general fund balance will be used for anticipated spikes in required employer contributions to retirement and social security accounts for employees, we believe this accumulation of funds is inappropriate and is a clear indication that the Cyber Charter School funding formula is flawed.

Observation 4 describes how the Cyber Charter School spent \$3.5 million in advertising with taxpayers dollars over a two year period. Management of the Cyber Charter School stated that advertising costs are necessary to increase student enrollment and to promote its programs to parents and students statewide. Advertising expenses for the Cyber Charter School during one year of our audit period were higher than the total business expenses of 98 percent of public schools in Pennsylvania. Clearly, this is an inappropriate use of public tax dollars and another example of Pennsylvania's flawed charter funding formula. Taxpayer dollars should not be utilized for advertising purposes to attract students from other public schools.

In addition, Observation 5 describes how the Cyber Charter School entered into a contract with a private, non-profit management company. This company was founded by the same individual who founded the Cyber Charter School. The contract was structured so that the Cyber Charter School paid fees to the company based on the total revenue of the Cyber Charter School and not based on services provided by the company. The contract resulted in the duplication of services and provided the management company with mostly all of its revenues. This represents an excessive profit margin in public education with public taxpayer dollars.

I once again call on the Governor and the General Assembly to make significant changes to Pennsylvania's methodology of funding charter schools and cyber charter schools.

Additionally, it is important to note that it became public in July 2012, after completion of our audit fieldwork, that individuals associated with the Cyber Charter School and its related entities are the subject of a federal investigation. This news surfaced after the completion of our audit fieldwork, so our audit report includes standard audit objectives and did not include a review of the issues identified thus far as part of the federal investigation. Moreover, the focus of our audit was on the Cyber Charter School, and not on specific individuals or entities associated with or doing business with the Cyber Charter School.

Our audit observations and recommendations have been discussed with the Cyber Charter School's management and their responses are included in the audit report. We believe the implementation of our recommendations will improve the Cyber Charter School's operations and facilitate compliance with legal and administrative requirements. We appreciate the Cyber Charter School's cooperation during the conduct of the audit and its willingness to implement our recommendations.

Sincerely,

/s/

JACK WAGNER
Auditor General

December 6, 2012

cc: **PENNSYLVANIA CYBER CHARTER SCHOOL** Board of Trustees

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Executive Summary

Audit Work

The Pennsylvania Department of the Auditor General conducted a performance audit of the Pennsylvania Cyber Charter School (Cyber Charter School). Our audit sought to answer certain questions regarding the Cyber Charter School's compliance with applicable state laws, contracts, grant requirements, and administrative procedures and to determine the status of corrective action taken by the Cyber Charter School in response to our prior audit recommendations.

Our audit scope covered the period July 1, 2008 through July 18, 2011, except as otherwise indicated in the audit scope, objectives, and methodology section of the report. Compliance specific to state subsidy and reimbursements was determined for school years 2009-10 and 2008-09.

Cyber Charter School Background

The Cyber Charter School, located in Beaver County, Pennsylvania, opened in July 2000. It was originally chartered on October 7, 1999, for a period of five years by the Midland Borough School District. The Charter School's mission states, "The Pennsylvania Cyber Charter School is dedicated to the success of all students who have not had their needs met in a traditional educational setting. PA Cyber is dedicated to providing the services and educational programs using current technology necessary for these students to receive a high school diploma as well as to give them the opportunity to grow beyond the normal curriculum and confines of a traditional school setting. PA Cyber is committed to

providing a safe and orderly environment and protecting the health, safety, and welfare of all students. It is our desire that PA Cyber students graduate and successfully procure satisfying employment or further their education to become independent, responsible citizens." During the 2009-10 school year, the Cyber Charter School provided educational services to 8,539 pupils from 484 sending school districts through the employment of 176 teachers, 241 full-time and part-time support personnel, and 7 administrators. The Cyber Charter School received more than \$1.9 million in tuition payments from school districts required to pay for their students attending the Cyber Charter School in school year 2009-10.

Adequate Yearly Progress

The Cyber Charter School made Adequate Yearly Progress (AYP) for the 2009-10 school year by meeting all AYP measures.

AYP is a key measure of school performance established by the federal No Child Left Behind Act (NCLB) of 2001 requiring that all students reach proficiency in Reading and Math by 2014. For a school to meet AYP measures, students in the school must meet goals or targets in three areas: (1) Attendance (for schools that do not have a graduating class) or Graduation (for schools that have a high school graduating class), (2) Academic Performance, which is based on tested students' performance on the Pennsylvania System of School Assessment (PSSA), and (3) Test Participation, which is based on the number of students that participate in the

PSSA. Schools are evaluated for test performance and test participation for all students in the tested grades (3-8 and 11) in the school. AYP measures determine whether a school is making sufficient annual progress towards the goal of 100 percent proficiency by 2014.

Audit Conclusion and Results

Our audit found that the Cyber Charter School complied, in all significant respects, with applicable state laws, contracts, grant requirements, and administrative procedures, except for five matters unrelated to compliance that are reported as observations.

Observation No. 1: May Have Improperly Received Tax Benefits Without Applying for Tax-Exempt Status with the IRS. Our review found the Cyber Charter School may have been receiving benefits without properly applying for and being granted a tax-exempt status from the Internal Revenue Service (see page 10).

Observation No. 2: Logical Access Control Weaknesses. Our review found the Cyber Charter School has weaknesses over vendor access to the Cyber Charter School's system (see page 17).

Observation No. 3: Pennsylvania Cyber Charter School Operated with a \$13 Million Unreserved General Fund Balance. As part of our audit, we found that the Cyber Charter School operated with an unreserved general fund balance in excess of \$13 million and \$11 million for the 2009-10 and 2008-09 school years respectively (see page 19).

Observation No. 4: Pennsylvania Cyber Charter School Should Reevaluate Its Advertising Expenses, which Totaled \$3.5 Million. Our audit of the Cyber Charter School found that the Cyber Charter School had higher than average administrative and business costs when compared to other public school entities, including \$2 million and \$1.5 million in advertising expenses for the 2009-10 and 2008-09 school years, respectively(see page 23).

Observation No. 5: Poorly Constructed Management Company Service Contract Creates Inefficient Spending and Duplication. Our audit found the Cyber Charter School contracts with a private, nonprofit management company, and pays fees based on a percentage of the Cyber Charter School's total revenue and **not** on the management services provided. We also found that the Cyber Charter School pays for various managerial services under the same contract, while also directly employing various managerial employees with similar job duties (see page 27).

Status of Prior Audit Findings and Observations. Our prior audit for the 2001-02 and 2000-01 school years resulted in no findings or observations.

Background Information on Pennsylvania Charter Schools

Description of Pennsylvania Charter Schools:

Charter and cyber charter schools are taxpayer-funded public schools, just like traditional public schools. There is no additional cost to the student associated with attending a charter or cyber charter school. Charter and cyber charter schools operate free from many educational mandates, except for those concerning nondiscrimination, health and safety, and accountability.

Pennsylvania ranks high compared to other states in the number of charter schools:

According to the Center for Education Reform, Pennsylvania has the 7th highest charter school student enrollment, and the 10th largest number of operating charter schools, in the United States.

Source: "National Charter School and Enrollment Statistics 2010." October, 2010.

Pennsylvania Charter School Law

Pennsylvania's charter schools were established by the Charter School Law (Law), enacted through Act 22 of 1997, as amended. In the preamble of the Law, the General Assembly stated its intent to provide teachers, parents, students, and community members with the opportunity to establish schools that were independent of the existing school district structure.¹ In addition, the preamble provides that charter schools are intended to, among other things, improve student learning, encourage the use of different and innovative teaching methods, and offer parents and students expanded educational choices.²

The Law permits the establishment of charter schools by a variety of persons and entities, including, among others, an individual; a parent or guardian of a student who will attend the school; any nonsectarian corporation not-for-profit; and any nonsectarian college, university or museum.³ Applications must be submitted to the local school board where the charter school will be located by November 15 of the school year preceding the school year in which the Charter School will be established,⁴ and that board must hold at least one public hearing before approving or rejecting the application.⁵ If the local school board denies the application, the applicant can appeal the decision to the State Charter School Appeal Board,⁶ which is comprised of the Secretary of Education and six members appointed by the Governor with the consent of a majority of all of the members of the Senate.⁷

¹ 24 P.S. § 17-1702-A.

² *Id.*

³ 24 P.S. § 17-1717-A(a).

⁴ *Id.* § 17-1717-A(c).

⁵ *Id.* § 17-1717-A(d).

⁶ *Id.* § 17-1717-A(f).

⁷ 24 P.S. § 17-1721-A(a).

With certain exceptions for charter schools within the School District of Philadelphia, initial charters are valid for a period of no less than three years and no more than five years.⁸ After that, the local school board can choose to renew a school's charter every five years, based on a variety of information, such as the charter school's most recent annual report, financial audits, and standardized test scores. The board can immediately revoke a charter if the school has endangered the health and welfare of its students and/or faculty. However, under those circumstances, the board must hold a public hearing on the issue before it makes its final decision.⁹

Act 88 of 2002 amended the Law to distinguish cyber charter schools, which conduct a significant portion of their curriculum and instruction through the Internet or other electronic means, from brick-and-mortar charter schools that *operate in buildings similar to school districts*.¹⁰ Unlike brick-and-mortar charter schools, cyber charter schools must submit their application to the Pennsylvania Department of Education (PDE), which determines whether the application for a charter should be granted or denied.¹¹ However, if PDE denies the application, the applicant can still appeal the decision to the State Charter School Appeal Board.¹² In addition, PDE is responsible for renewing and revoking the charters of cyber charter schools.¹³ Cyber charter schools that had their charter initially approved by a local school district prior to August 15, 2002, must seek renewal of their charter from PDE.¹⁴

Funding of Pennsylvania Charter Schools:

Brick-and mortar charter schools and cyber charter schools are funded in the same manner, which is primarily through tuition payments made by school districts for students who have transferred to a charter or cyber charter school.

The Charter School Law requires a school district to pay a per-pupil tuition rate for its students attending a charter or cyber charter school.

Pennsylvania Charter School Funding

The Commonwealth bases the funding for charter schools on the principle that the state's subsidies should follow the students, regardless of whether they choose to attend traditional public schools or charter schools. According to the Charter School Law, the sending school district must pay the charter/cyber charter school a per-pupil tuition rate

⁸ 24 P.S. § 17-1720-A(a).

⁹ Pennsylvania Department of Education, Basic Education Circular, "Charter Schools," Issued 10/1/2004.

¹⁰ 24 P.S. §§ 17-1703-A, 17-1741-A *et seq.*

¹¹ 24 P.S. § 17-1745-A(d).

¹² *Id.* § 17-1745-A(f)(4).

¹³ 24 P.S. § 17-1741-A(a)(3).

¹⁴ 24 P.S. § 17-1750-A(e).

based on its own budgeted costs, minus specified expenditures, for the prior school year.¹⁵ For special education students, the same funding formula applies, plus an additional per-pupil amount based upon the sending district's special education expenditures divided by a state-determined percentage specific to the 1996-97 school year.¹⁶ The Charter School Law also requires that charter schools bill each sending school district on a monthly basis for students attending the charter school.¹⁷

Typically, charter schools provide educational services to students from multiple school districts throughout the Commonwealth. For example, a charter school may receive students from ten neighboring, but different, sending school districts. Moreover, students from numerous districts across Pennsylvania attend cyber charter schools.

Under the Public School Code of 1949, as amended, the Commonwealth also pays a reimbursement to each sending school district with students attending a charter school that amounts to a mandatory percentage rate of total charter school costs.¹⁸ Commonwealth reimbursements for charter school costs are funded through an education appropriation in the state's annual budget. However, the enacted state budget for the 2011-12 fiscal year eliminated funding of the charter school reimbursement previously paid to sending school districts.¹⁹

¹⁵ See 24 P.S. § 17-1725-A(a)(2).

¹⁶ See *Id.* §§ 17-1725-A(a)(3), 25-2509.5(k).

¹⁷ See 24 P.S. § 17-1725-A(a)(5).

¹⁸ See 24 P.S. § 25-2591.1. Please note that this provision is contained in the general funding provisions of the Public School Code and not in the Charter School Law.

¹⁹ Please note that the general funding provision referenced above (24 P.S. § 25-2591.1) has not been repealed from the Public School Code and states the following: "For the fiscal year 2003-2004 and each fiscal year thereafter, if insufficient funds are appropriated to make Commonwealth payments pursuant to this section, such payments shall be made on a pro rata basis." Therefore, it appears that state funding could be restored in future years.

Audit Scope, Objectives, and Methodology

Scope

What is a school performance audit?

School performance audits allow the Department of the Auditor General to determine whether state funds, including school subsidies, are being used according to the purposes and guidelines that govern the use of those funds. Additionally, our audits examine the appropriateness of certain administrative and operational practices at each Local Education Agency (LEA). The results of these audits are shared with LEA management, the Governor, the Pennsylvania Department of Education, and other concerned entities.

Our audit, conducted under authority of 72 P.S. § 403, is not a substitute for the local annual audit required by the Public School Code of 1949, as amended. We conducted our audit in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States.

Our audit covered the period July 1, 2008 through July 18, 2011, except for the verification of professional employee certification which was performed for the period July 1, 2009 through December 3, 2010.

Regarding state subsidy and reimbursements, our audit covered school years 2009-10 and 2008-09.

For the purposes of our audit work and to be consistent with Pennsylvania Department of Education (PDE) reporting guidelines, we use the term school year rather than fiscal year throughout this report. A school year covers the period July 1 to June 30.

Objectives

What is the difference between a finding and an observation?

Our performance audits may contain findings and/or observations related to our audit objectives. Findings describe noncompliance with a statute, regulation, policy, contract, grant requirement, or administrative procedure. Observations are reported when we believe corrective action should be taken to remedy a potential problem not rising to the level of noncompliance with specific criteria.

Performance audits draw conclusions based on an evaluation of sufficient, appropriate evidence. Evidence is measured against criteria, such as laws and defined business practices. Our audit focused on assessing the Cyber Charter School's compliance with applicable state laws, contracts, grant requirements, and administrative procedures. However, as we conducted our audit procedures, we sought to determine answers to the following questions, which serve as our audit objectives:

- ✓ Was the Cyber Charter School in overall compliance with the Public School Code of 1949²⁰ (PSC) and the Charter School Law²¹ (Law)?
- ✓ Did the Cyber Charter School have policies and procedures regarding the requirements to maintain student health records and perform required health services, and keep accurate documentation supporting

²⁰ 24 P.S. § 1-101 *et seq.*

²¹ 24 P.S. § 17-1701-A *et seq.*

its annual health services report filed with the Department of Health to receive state reimbursement?

- ✓ Did the Cyber Charter School receive state reimbursement for its building lease under the Charter School Lease Reimbursement Program, was its lease agreement approved by its board of trustees, and did its lease process comply with the provisions of the Public Official and Employee Ethics Act?²²
- ✓ Did the Cyber Charter School comply with the open enrollment and lottery provisions of the Law?
- ✓ Does the Cyber Charter School provide the services required for its special education students through outside agencies and/or through properly certified professional staff with the required instructional hours and/or training?
- ✓ Did the Cyber Charter School board of trustees and administrators, and the chartering school board members comply with the PSC, the Public Official and Employee Ethics Act, and the Sunshine Act?
- ✓ Were at least 75 percent of the Cyber Charter School's teachers properly certified and did all of its noncertified teachers meet the "highly qualified teacher" requirements?
- ✓ Did the Cyber Charter School require its noncertified professional employees to provide evidence that they are at least 18 years of age, a U.S. citizen, and certified by a licensed Pennsylvania physician to be neither mentally nor physically disqualified from successful performance of the duties of a professional employee of the cyber charter school?
- ✓ Did the Cyber Charter School accurately report its membership numbers to PDE and were its average daily membership and tuition billings accurate?
- ✓ Did the Cyber Charter School comply with the Law's compulsory attendance provisions and, if not, did the cyber charter school remove days in excess of ten

²² 65 Pa.C.S. § 1101 *et seq.*

consecutive unexcused absences from the Cyber Charter School's reported membership totals pursuant to the regulations?²³

- ✓ Did the Cyber Charter School take appropriate steps to ensure school safety?
- ✓ Did the Cyber Charter School require that all of its employees enroll in the Public School Employees' Retirement System at the time of filing its cyber charter school application as required by the Law, unless the board of trustees had a retirement plan that covered the employees or the employees were already enrolled in another retirement program?
- ✓ Did the Cyber Charter School use an outside vendor to maintain its membership data and, if so, are internal controls in place related to vendor access?
- ✓ Were there any other areas of concern reported by local auditors, citizens, or other interested parties which warrant further attention during our audit?
- ✓ Did the Cyber Charter School take appropriate corrective action to address recommendations made in our prior audits?

Methodology

What are internal controls?

Internal controls are processes designed by management to provide reasonable assurance of achieving objectives in areas such as:

- Effectiveness and efficiency of operations;
- Relevance and reliability of operational and financial information;
- Compliance with applicable laws, contracts, grant requirements, and administrative procedures.

Government Auditing Standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings, observations, and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings, observations and conclusions based on our audit objectives.

The Cyber Charter School's management is responsible for establishing and maintaining effective internal controls to provide reasonable assurance that the Cyber Charter School is in compliance with applicable laws, contracts, grant requirements, and administrative procedures. Within the context of our audit objectives, we obtained an understanding of internal controls and assessed whether those controls were properly designed and implemented.

²³ 22 Pa. Code § 11.24.

Any significant deficiencies found during the audit are included in this report.

Our audit examined the following:

- Records pertaining to professional employee certification, state ethics compliance, student health services, special education, lease agreements, open enrollment, vendor contracts, and student enrollment.
- Items such as board of trustees' meeting minutes, pupil membership records, IRS 990 forms, and reimbursement applications.
- Tuition receipts and deposited state funds.

Additionally, we interviewed selected administrators and support personnel associated with Cyber Charter School operations.

Findings and Observations

Observation No. 1

May Have Improperly Received Tax Benefits Without Applying for Tax-Exempt Status with the IRS

Charter School Law and criteria relating to the observation:

Section 17-1720-A(a) of the Charter School Law, 24 P.S. § 17-1720-A(a), states, in part:

“A charter will be granted only for a school organized as a public, **nonprofit** corporation.”

Nonprofits are eligible to apply for tax-exempt status with the IRS under the IRC.

The IRC requires tax-exempt entities, including charter schools, to file an annual information return, such as an IRS Form 990, “Return of Organization Exempt from Income Tax,” or IRS Form 990EZ, “Short Form Return of Organization,” unless a filing exception is met.

Nonprofits, including charter schools, granted tax-exempt status by the IRS are required to file an IRS Form 990, “Return of Organization Exempt from Income Tax,” or IRS Form 990EZ, “Short Form Return of Organization Exempt from Income Tax” unless they meet one of the exceptions.

Our audit of Pennsylvania Cyber Charter School (Cyber Charter School) records found the Cyber Charter School was incorporated as a public, nonprofit corporation with the Pennsylvania Department of State, Bureau of Corporations, and may have been operating and receiving benefits of a tax-exempt, nonprofit organization without applying for and being granted a tax-exempt status from the Internal Revenue Service (IRS). As a result, we further found that the Cyber Charter School was not filing a Form IRS 990, a publicly available tax return required to be filed annually by tax-exempt organizations that do not meet a filing exception.

The Charter School Law requires charter schools to incorporate as a nonprofit corporation in Pennsylvania before a charter may be granted. By organizing as a Pennsylvania nonprofit, charter schools are eligible for certain benefits, such as state sales, property, and income tax exemptions.

Nonprofits, including charter schools, are also eligible to apply for a federal tax-exempt status with the IRS. The benefits of a federal tax-exempt status include exemption from federal income tax and eligibility to receive tax-deductible charitable contributions. To receive these benefits, most organizations must file an application for recognition of exemption with the IRS. Educational organizations, such as charter schools, generally apply for a 501(c)(3) tax-exempt status.

For a charter school to establish a 501(c)(3) tax-exempt status under the Internal Revenue Code (IRC), whether it purchases some or all of the services required to operate, it must establish that it is organized and operated for the benefit of the public and not for the benefit of any private person, such as a service provider (i.e. management company). The Cyber Charter School uses a private nonprofit entity management company, National Network of Digital Schools Management Foundation (NNDS), to provide the following services for its daily operations

according to the approved Management Agreement
Article 1 - Services:

- (a) The Management shall engage and maintain technical and administrative personnel for the purpose of providing the services hereunder, and the Manager shall perform and render management, administrative, consulting and other services to the School as may be required by the School to conduct properly its business, including the following:
 - i. Providing general business advice, about the operation and management of the School and its resources;
 - ii. Negotiating and entering into such agreements on behalf of the School, but only with the approval of the Board of Directors of the School, to carry out and implement the purposes of the School;
 - iii. Fulfilling the School's obligations under its agreement with third parties;
 - iv. Maintaining the principal financial and business records of the School and books of account of the School;
 - v. Assisting the School in establishing and maintaining the accounting policies of the School and consulting with professionals in connection therewith;
 - vi. Providing such assistance to the School, and the legal counsel and auditors of the School, as generally may be required to carry on the business and operations of the School in compliance with applicable law;
 - vii. Providing human resources services, including the negotiation and implementation of health insurance coverage and other fringe benefits, but the Manager will have no authority to hire or terminate School employees, which authority to hire and terminate School employees is reserved to the Board of Directors of the School;

- viii. Marketing of the School for purposes of increasing student enrollment;
- ix. Providing professional development and quality assurance services;
- x. Providing procurement, shipping and receiving, materials handling and inventory, and transportation services;
- xi. Providing physical plant maintenance services;
- xii. Providing information technology services;
- xiii. Doing all that is necessary or desirable in connection with the foregoing or otherwise contemplated by this Agreement.

Section (d) provides:

In performing the Services on behalf of the School, the Manager will have reasonable access to the use of all property and equipment of the School, including intellectual and other intangible property, subject to the provisions of Article 4. In addition, the Manager will have the right to lease at fair market value all property and equipment of the School.

Article 2 – Management Fees and Cost; Payments - provided in part (a) The School shall pay the Manager for the Services monthly in arrears, on the last business day of each month, a management fee equal to 12% of the total gross revenues received by the School during the preceding month from whatever source . . . except interest or revenue from investments or gifts or endowments . . .

As a result of the management services received from NNDS, the Cyber Charter School may not be eligible to receive a tax-exempt status under section 501(c)(3).

Tax-exempt organizations with \$25,000 or more in gross receipts, or \$50,000 or more for tax years ending on or after December 31, 2010, are required to file an IRS Form 990, “Return of Organization Exempt from Income Tax,” or IRS Form 990EZ, “Short Form Return of Organization.” The Cyber Charter School received total revenue of

\$95,331,380 and \$83,266,435 for the school years ending June 30, 2010 and 2009, respectively; therefore, a Form 990 may have been required to be filed.

The IRS Form 990 is a public document open to public inspection. The IRS Form 990 provides the public and interested parties with information about the organization's mission, programs, and finances. Specifically, the IRS Form 990 contains information about the organization's governance structure, board members, salaries, contracts, financial transactions, management policies, and disclosure practices. The Cyber Charter School's failure to file an annual return with the IRS may lessen the transparency and accountability needs of the state, the authorizing school district, the Pennsylvania Department of Education (PDE), and local community members served by the organization, such as teachers, parents and students.

According to Cyber Charter School personnel and as evidenced by a letter dated December 2006, the Cyber Charter School was advised by its legal counsel that it did not need to file for tax-exempt status with the IRS because it was automatically exempt from federal income taxation under the doctrine of intergovernmental immunity. The letter further advised the Cyber Charter School that as a cyber school, it is considered both an instrumentality of the Commonwealth of Pennsylvania (Pennsylvania) and an integral part of Pennsylvania, and therefore, it is exempt from taxation under the doctrine of intergovernmental immunity. As a result, the Cyber Charter School may have been operating as and receiving the benefits of a tax-exempt entity without applying for such with the IRS because it was advised that it was a "governmental entity."

Similarly, according to Cyber Charter School's Director of Finance and Compliance, he thought the Cyber Charter School was not required to file a Form 990 because the Cyber Charter School was a government entity, and government entities meet one of the filing exceptions and are not required to file a Form IRS 990. However, ordinarily, charter schools are not treated as governmental units or affiliates of governmental units because they are not "operated, supervised, or controlled by a governmental unit." In Pennsylvania, charter schools operate under a contract (i.e. a charter) with a governmental unit (i.e. a local school district, or PDE if a cyber charter school), but

the governmental unit does not elect or appoint the charter school's board of trustees or control the operations or finances of the charter school. In fact, the Charter School Law defines a charter school as “an independent public school.” As such, the Cyber Charter School is an independent public charter school organized as a Pennsylvania nonprofit corporation and may not be considered a governmental unit or affiliate of a governmental unit under state law. Therefore, the Cyber Charter School may not qualify for automatic exemption from federal income taxation and the requirement to file a Form IRS 990 as a governmental unit with the IRS.

Recommendations

The *Pennsylvania Cyber Charter School* should:

1. File for a tax-exempt status with the IRS to determine whether it is eligible to receive the benefits of a tax-exempt organization, particularly since it is using a management company.
2. File Form IRS 990 for the school years ending 2009-10 and 2008-09 and each subsequent year, if the IRS grants the Cyber Charter School a tax-exempt status.
3. Request its solicitor to provide a summary of all the Cyber Charter School’s legal requirements under the Charter School Law, the Nonprofit Corporations Law of 1988, and the Internal Revenue Code.

The *Pennsylvania Department of Education*, as authorizer of cyber charter schools, should:

4. Provide the Cyber Charter School and all cyber charter schools with proper guidance regarding their formation, treatment under local, state and federal laws, filing requirements, and use of a management company.

Management Response

Management stated the following:

We agree with the observation to the extent that it recommends best practice and the Pennsylvania Cyber Charter School will seek to file a formal application for recognition of tax-exempt status with the IRS even though we have obtained a legal opinion that we did not need to do so. We will file any Form 990’s required upon a determination of such by the IRS.

The Pennsylvania Cyber Charter School has always responded positively to recommendations by its independent auditors, the Pennsylvania Department of Education (PDE) and the Department of the Auditor General and will continue to do so. In regard to this observation and recommendation, we would like to note that we have followed the guidance of qualified legal counsel, prior auditors and PDE review teams. The initial audit by the Department of the Auditor General dating back to 2002 and all subsequent audits by independent certified public account[ant]s did not document any audit findings, observations, weaknesses, etc. relative to “improperly received tax benefits”. In fact, our administration recalls having discussions with staff auditors at that time about whether the Pennsylvania Cyber Charter School was required to file a Form 990 and the verbal answer was that we were not required to file the form.

The Pennsylvania Cyber Charter School has been in operation for over 10 years and has had its charter renewed twice (2005 and 2010) by the Department of Education which does a significant review of its operations and organizational structure prior to authorizing such renewal. Both renewals were granted without any stipulations, recommendations, etc. relative to the topic noted in the observation. Our administration also recalls having discussions in 2005 with the review team about the potential requirement to file a Form 990 with the same verbal response that they did not see any current compliance issues. The review team just noted that some other charter schools do file the form. However, following the first charter renewal process and operating with continued due diligence, our organization did seek the opinion of qualified legal counsel to give an opinion on this topic since it was repetitively discusses at the various reviews and audits. The legal opinion was that the Pennsylvania Cyber Charter School was not required to file a formal application for recognition of tax-exempt status with the IRS.

We will not request any further legal positions or summaries from our solicitor since we will seek to file a formal application for recognition of tax-exempt status with the IRS even though we have obtained a prior legal opinion that we did not need to do so.

Once, again we agree with the observation to the extent that it recommends best practice and we have responded positively to follow the best practice and clear any ambiguity surrounding this topic. We would like to reiterate that we have followed the advice of qualified legal counsel and that this observation by the Department of the Auditor General was not listed as a finding, observation, weakness, footnote, etc. in any prior independent, state or federal governmental audit/review of the Pennsylvania Cyber Charter School.

Auditor Conclusion

We appreciate that management generally agrees with this observation and has represented that it will be filing for tax-exempt status with the IRS. We will follow-up on this matter during our next audit.

However, in response to management's explanation that it agrees with this finding to the extent that it recommends "best practice," we respectfully disagree and maintain our position that it is required to file for tax exempt status.

First, as stated in the observation, the Charter School Law requires Pennsylvania charter and cyber charter schools to organize as a public **nonprofit corporation** before a charter may be granted by a local school district or PDE in the case of cyber charter schools. It is this nonprofit status that triggers the tax-exempt filing requirement. Second, although the Cyber Charter School explained that it has not filed for tax-exempt status at the direction of its legal counsel and that it was not directed to do so by PDE, its authorizing entity, these explanations do not dismiss the filing requirement.

Further, our analysis of IRS records revealed that more than 90 percent of Pennsylvania charter and cyber charter schools operating during the 2009-10 school year filed for and received a tax-exempt status with the IRS, and over 85 percent have filed IRS Form 990 Returns. Moreover, 9 of the 11 operating cyber charter schools filed an IRS 990, with the Cyber Charter School being one of the two not filing. As such, this observation will be forwarded to the IRS .

Observation No. 2 →

What is logical access control?

“Logical access” is the ability to access computers and data via remote outside connections.

“Logical access control” refers to internal control procedures used for identification, authorization, and authentication to access the computer systems.

Logical Access Control Weaknesses

The Pennsylvania Cyber Charter School (Cyber Charter School) uses software purchased from an outside vendor for its critical student accounting application (membership and attendance).

Based on our current year procedures, we determined that the Cyber Charter School has manual compensating controls in place to verify the integrity of the membership and attendance information in its database.

Reliance on manual compensating controls becomes increasingly problematic if the Cyber Charter School would ever experience personnel and/or procedure changes that could reduce the effectiveness of the manual controls. Logical access control weaknesses could lead to unauthorized changes to the Cyber Charter School’s membership information and result in the School not receiving the funds to which it was entitled from the state.

During our review, we found the Cyber Charter School had the following weaknesses over access to the Cyber Charter School’s system:

The Cyber Charter School has certain weaknesses in logical access controls. We noted that the Cyber Charter School’s system parameter settings do not require all users, including the vendor, to change their passwords every 30 days; to use passwords that are a minimum length of eight characters and include alpha, numeric, and special characters; to maintain a password history (i.e., approximately ten passwords); and to lock out users after three unsuccessful attempts.

Recommendations

The *Pennsylvania Cyber Charter School* should:

Implement a security policy and system parameter settings to require all users, including the vendor, to change their passwords on a regular basis (i.e., every 30 days). Passwords should be a minimum length of eight characters and include alpha, numeric, and special characters. Also, the Cyber Charter School should maintain a password history that will prevent the use of a repetitive password

(i.e., last ten passwords), and lock out users after three unsuccessful attempts.

Management Response

Management stated the following:

We agree with the observation to the extent that it recommends best practice. We are confident that our current controls are sufficient. Due to several necessary integrations with disparate systems, we are unable to implement these recommended changes at this time. We are planning a project that will upgrade our authentication servers and will implement the recommended changes at that time.

Auditors Conclusion

We continue to encourage the Cyber Charter School to adopt our recommendations regarding security policies and passwords. We will follow-up on this issue during our next audit.

Observation No. 3

Pennsylvania Cyber Charter School Operated with a \$13 Million Unreserved General Fund Balance

What is a General Fund Balance?

The fund balance of the General Fund is of primary significance because the General Fund is the primary fund through which most functions are financed and which includes state aid and local taxes.

Source: Pennsylvania Department of Education, “*Manual of Accounting and Financial Reporting for PA Public Schools - Chart of Accounts,*” Revised July 1, 2008.

Why is the Unreserved General Fund Balance important?

The unreserved portion of the fund balance is particularly important because it represents a cash flow that is readily available for use for any purpose at all.

What are the financial requirements of charter schools?

Charter schools must comply with financial reporting requirements like all public school entities in Pennsylvania, including the annual filing of a General Fund Budget, Annual Financial Report and an audit.

Source: Pennsylvania Department of Education, “*Manual of Accounting and Financial Reporting for PA Public Schools –Special School Entities (Chapter 18).*” May, 2005.

As part of our audit, we found that the Pennsylvania Cyber Charter School (Cyber Charter School) operated with an unreserved general fund balance in excess of \$13 million and \$11 million for the 2009-10 and 2008-09 school years respectively, the highest amounts among all operating charters and cyber charters. Within its general fund, we also found that the Cyber Charter School’s “designated” fund balances for both years were the largest amounts reported by charters and cyber charters, of which 20 percent or less had “designated” funds.

<u>School Year</u>	<u>Unreserved</u>		<u>Total</u>
	<u>Designated</u>	<u>Undesignated</u>	
2009-10	\$11,415,257	\$2,406,089	\$13,821,346
2008-09	7,899,445	3,532,677	11,432,122

The unreserved portion of the general fund balance is not legally segregated for a specific future use and can be appropriated for any fund-related purpose. The unreserved fund balance had two components during the years reviewed, **designated and undesignated**. “Designated” represents money set aside for an intended use, but there is no legal requirement that the money be used for its intended purpose. “Undesignated” represents money that is not legally or otherwise segregated for specific or tentative future use. Collectively, unreserved funds represent funds that are available for immediate use without any legal restrictions. As such, unreserved funds are typically considered “discretionary” funds because they can be spent however the school decides.

According to the Cyber Charter School’s management, money was designated for anticipated spikes in required employer contributions to retirement and social security accounts for employees. Although the Cyber Charter School is permitted, and may have even been encouraged to set funds aside for these reasons, we have noted the Cyber Charter School’s designated balances because these funds are not under any legal restriction to be used for the reason that they were set aside or designated, and they still

represent discretionary money that is available to the school for immediate use.

We have noted the Cyber Charter School's unreserved fund balances as part of our responsibility to monitor state and taxpayer money, and not because the Cyber Charter School improperly managed these funds. Since charter and cyber charter schools are funded under the law largely by tuition payments from school districts, including local taxpayer money, with students attending the charter or cyber charter school, the need for accountability and monitoring of these discretionary funds is heightened. Any misuse of these "discretionary" unreserved fund balances could result in financial disaster for the school and in a loss of state and local taxpayer money intended for public education.

School districts are prevented under state law from having a total general fund balance of more than 8 to 12 percent of their annual expenditures when raising property taxes. These limits help ensure that taxpayer funds are spent responsibly and equitably, and that school districts do not unnecessarily raise property taxes if "discretionary" general fund money exceeds these maximum percentages.

Currently, the Charter School Law does not limit charter and cyber charter schools' unreserved-undesignated fund balances, so the Cyber Charter School's carry-over balance is completely permissible. In fact, a large fund balance may be an indicator an organization's financial health and credit worthiness. Furthermore, the law does not require charter and cyber charter schools to report the size of their unreserved designated and undesignated fund balances to their sending school districts, or their authorizing school district. As a result, the Cyber Charter School can spend the large amount of taxpayer money within those accounts with little or no oversight. Nevertheless, we are not questioning the Cyber Charter School's intentions or its financial planning capabilities. Instead we are merely pointing out that the lack of specific reporting related to the size of these accounts and how they are expended means that the cyber school does not have to publicly account for their use. In addition, unlike school districts, which have to off-set large unreserved designated and undesignated balances with a reduction in revenue, charter and cyber charter schools, like the Cyber Charter School, do not have

to adjust their tuition billings to reduce their fund balances if a certain percentage is exceeded.

Recommendations

The *Pennsylvania Cyber Charter School* should:

Ensure that taxpayer dollars transferred to the Cyber Charter School's unreserved general fund account are properly expended for an educational purpose.

Management Response

Management stated the following:

We agree that all public schools should ensure that taxpayer dollars are properly expended. The positive results, with no findings noted in this performance audit conducted by the Auditor General's office or in the most recent annual audit conducted by our independent auditors, strongly support the fact that the Pennsylvania Cyber Charter School does maintain such fiscal responsibility. We would also agree that all public schools should be held to similar standards relative to fund balance limitations to ensure that taxpayer funds are spent responsibly and equitably. Please note that the Pennsylvania Cyber Charter School follows state law (24 PS 6688) with regard to limitations on fund balances to no more than 8 to 12 percent of annual expenditures.

Our preliminary ending fund balance for the year ended June 30, 2012 is approximately 11 percent of annual expenditures. A note in this observation that our fund balances were "the highest amounts among operating charters and cyber charters" is a reflection of the fact that we are one of the largest schools in the Commonwealth of Pennsylvania. A close comparison of fund balances (to include all funds within brick-and-mortar traditional schools) on a percentage basis, would show that our fund balance is far from excessive, as the notes reflected in this observation may lead one to believe.

As part of our financial planning, we have assigned funds for anticipated spikes in employer retirement contributions and for future health-care contributions as recommended by our independent auditor and outlined by the Pennsylvania Association of School Business Officials, as a fiscally-responsible measure to manage the long-term viability of the School. We must also maintain sufficient fund balances to secure short term financing for the

operation of the School for several months at the beginning of each school year due to the current funding method for charter schools. Hence, we agree and appreciate that this observation is “not questioning the Cyber Charter School's intentions or its financial planning capabilities,” and understand it is merely pointing out some potential accountability gaps in the Charter School Law which could mirror the above-referenced state law relative to fund balances. As previously noted the Pennsylvania Cyber Charter School already follows this state law in practice and manages its fund balance within its guidelines.

Auditor Conclusion

We appreciate the Cyber Charter School’s willingness to consider this observation as it relates to ensuring that taxpayer dollars are spent properly and in further mentioning the potential accountability gaps in the Charter School Law. As stated in the observation, we are not questioning the Cyber Charter School’s intentions or its financial planning capabilities. Rather, we are merely pointing out that its general fund balances for the 2009-10 and 2008-09 school years represent large amounts of taxpayer money that can be spent with little or no oversight.

Observation No. 4 →

Pennsylvania Cyber Charter School Should Reevaluate Its Advertising Expenses, which Totaled \$3.5 Million

Facts relating to the observation:

Charter and cyber charter schools are public schools funded by state and local taxpayer dollars. The local school district where the student resides pays tuition with state and local tax money through a state funding formula.

24 P.S. § 17-1701 et seq.

In 2008-09, charter and cyber charter schools received 86.69 percent of their revenue from local sources, for which tuition paid by local school districts accounted for 95 percent of this local revenue.

Pennsylvania Department of Education (PDE). *2008-09 Annual Financial Reports*.

PDE's "*Manual of Accounting and Financial Reporting for Pennsylvania Public Schools*" contains the following financial reporting requirements:

Advertising expenses are to be reported in the 2500 (Business) category of the Annual Financial Report required to be filed with the Department of Education.

Details regarding these "business expenses," such as advertising fees, are to be categorized under sub-accounts, such as Object Level Detail 500 (Other Purchased Services) or 540 (Expenditure Detail) specific to "Printing, Publishing and Duplicating Services," including advertising expenses.

Our audit of Pennsylvania Cyber Charter School (Cyber Charter School) found that the Cyber Charter School had higher than average administrative and business costs when compared to other public school entities, including \$2 million and \$1.5 million in advertising expenses for the 2009-10 and 2008-09 school years, respectively.

Specifically, we found that the Cyber Charter School spent \$2 million in 2009-10 and \$1.5 million in 2008-09 on expenses associated with advertising for students to attend the cyber charter school. The Cyber Charter School's current marketing practices include television, newspaper, and radio advertisements throughout the state. The Cyber Charter School's management explained that advertising expenses are incurred to increase student enrollment and to promote its programs to parents and students statewide.

These advertising costs were part of the Cyber Charter School's "business expenses" totaling \$12.6 million for the 2008-09 school year, which we noted was the 3rd highest amount reported by all 500 school districts and 127 charter and cyber charter schools that filed annual financial reports with PDE in 2008-09. We also found that of the 11 operating cyber charter schools in 2008-09, the Cyber Charter School's "business expenses" were the highest and almost fourteen times the amount reported by the cyber charter with the next largest amount. The Cyber Charter School's "business expenses" included \$9.7 million paid to a management company in 2008-09, which is further discussed in Observation No. 5. According to the Pennsylvania Department of Education's (PDE) "*Manual of Accounting and Financial Reporting for Pennsylvania Public Schools*, including charters and cyber charters, the "business expenses" category of the annual financial report represents fiscal and internal operating activities like advertising, warehousing, distributing, and purchased services, and excludes activities like student transportation that increases costs at districts and is not applicable to charter and cyber charter schools.

Moreover, when we compared the Cyber Charter School's \$1.5 million in advertising expenses alone to total "business expenses" reported by all of the

Commonwealth's public schools for the 2008-09 school year, we found that 98 percent of public schools reported total "business expenses" less than the \$1.5 million spent by the Cyber Charter School on just advertising fees. Annual financial data for all public schools for 2009-10 was not available during our fieldwork, so the Cyber Charter School's advertising and total business expenses were not compared to these costs at other schools for that year.

Furthermore, we found that Cyber Charter School's contract with its management company, National Network of Digital Schools Management Foundation (NNDS), includes marketing and advertising services. Thus, the Cyber Charter School's total advertising costs are likely even higher than \$3.5 million over two years since NNDS's fees are supposed to include these same services.

More than 90 percent of the Cyber Charter School's revenue in the 2008-09 and 2009-10 school years came from tuition payments received from local school districts required to pay tuition for their students who have transferred to the cyber charter school (see the revenue chart in Observation No. 5). Consequently, the \$3.5 million the Cyber Charter School spent on advertising during two school years is comprised largely of taxpayer dollars that were allocated specifically for funding public education. Therefore, we encourage the Cyber Charter School to reevaluate whether millions of dollars in advertising expenses is a necessary expense and whether these taxpayer dollars might be better spent on student education services. For example, based on the Cyber Charter School's average expenses per student, 195 students could have been educated in 2009-10 and 155 students in 2008-09 with the amount spent on advertising.

Moreover, by definition, a cyber charter school is a school that "uses technology in order to provide a significant portion of its curriculum and to deliver a significant portion of instruction to its students through the Internet or other electronic means." As such, the Cyber Charter School may benefit from utilizing its existing technology to explore alternative ways to communicate its programs to parents and students other than costly television and radio advertisements. Furthermore, the Cyber Charter School

and PDE, its authorizing entity, should work collaboratively to develop public service outreach efforts to parents and students that utilize PDE's ability to communicate with schools and parents statewide as an alternative method to expensive advertising strategies with taxpayer dollars.

Recommendations

The *Pennsylvania Cyber Charter School* should:

1. Consider re-evaluating its marketing strategies aimed at increasing student enrollment and total revenue of the cyber similar to for-profit business models, and instead, develop more cost effective ways other than television and radio advertisements to communicate its programs to parents and students.
2. Consider alternative ways to communicate the availability of its programs to all students across the state, including the use of the Internet, to ensure that public education dollars are being spent for their intended purpose.

Management Response

Management stated the following:

Cyber charter schools are schools of choice and are required to engage in outreach to parents and students throughout the entire Commonwealth of Pennsylvania. To achieve this level of outreach, PA Cyber needs to use marketing and advertising.

Traditional school districts have no such outreach requirement and, in fact, operate with a captive audience. PA Cyber is not so fortunate. Without a carefully planned and budgeted marketing and advertising effort, the School would lose students and could face financial disaster culminating in the inability to educate existing students and, ultimately, the loss of hundreds of jobs. While it may be true that the organization could use these advertising dollars to educate additional students, it is certainly true that without advertising there would be no additional students.

It has been suggested that, since PA Cyber is a school that uses technology to deliver its instruction, it could use these same means to meet its obligation to engage in outreach. It is a fact that many of our families come to the school with

ready access to the Internet; however, there is no effective way to only leverage the Internet to achieve the desired and required results. PA Cyber uses a small portion of its overall budget on marketing and advertising to help ensure its ongoing success and longevity as required by the Charter School Law, as do its competitors.

While we disagree with this observation, PA Cyber will engage in an active effort to investigate other means of outreach; however, the School will not sacrifice its level of commitment to the families of Pennsylvania who seek alternatives to the traditional public education system.

Auditor Conclusion

We accept that the Cyber Charter School must recruit new students in order to grow and thrive. However, we question whether it needed to spend \$3.5 million on advertising during two school years, which was taxpayer money allocated to educate students attending the Cyber Charter School. Moreover, we also questioned whether the Cyber Charter School spent more than \$3.5 million on advertising because its management company contract with NNDS was supposed to include marketing and advertising.

As such, we continue to recommend that the Cyber Charter School reevaluate its current advertising strategies and spending to determine whether more cost effective approaches could be utilized without jeopardizing the school's enrollment growth. Moreover, we encourage the Cyber Charter School and PDE, its authorizing entity, to work collaboratively to develop public service outreach efforts to parents and students that utilize PDE's ability to communicate with schools and parents statewide as an alternate, and likely more cost effective, method to expensive television and radio advertisements with taxpayer dollars.

Observation No. 5



Poorly Constructed Management Company Service Contract Creates Inefficient Spending and Duplication

Criteria relating to the observation:

A 2011 Pennsylvania study on fiscal accountability found that one area of inefficiency and redundancy in state government programs and services is the administration of the educational system. Specifically, a review of annual financial reports filed with the Pennsylvania Department of Education revealed that public school districts spend a wide range of amounts on “administrative costs” demonstrating varying levels of efficiency. The study concluded that “administrative costs” represent an area where significant costs savings could be achieved through some level of consolidation (i.e. reduction in administrative staff; caps on administrative and business office spending; consolidation with other local schools; etc.) with no visible change to the delivery of education to students.

Report of the Fiscal Responsibility Task Force. Pennsylvania Institute of Certified Public Accountants (PICPA). January 2011.

Our audit of the Pennsylvania Cyber Charter School (Cyber Charter School) found that the Cyber Charter School contracts with a private, nonprofit management company, National Network of Digital Schools Management Foundation (NNDS), and pays fees based on a percentage of the Cyber Charter School’s total revenue and **not** on the management services provided. We also found that the Cyber Charter School pays for various managerial services under the same contract, while also directly employing various managerial employees with similar job duties, thereby creating a potential duplication of services and costs.

We also noted that the founder and chief executive officer (CEO)²⁴ of the Cyber Charter School also founded and was formerly the president of NNDS, the management company. NNDS was created in 2005, and immediately entered into a management company contract with the Cyber Charter School based on 12 percent of the Cyber Charter School’s total revenue and not on the services provided. We found that these fees paid by the Cyber Charter School represented nearly all of NNDS’s revenue. While the Cyber Charter School’s CEO was the original founder of NNDS, he did not hold a position with the management company during the 2009-10 and 2008-09 audit period.

In addition to the management company fees, the Cyber Charter School also pays NNDS for curriculum, and these curriculum payments are separate from and in addition to the management company fees discussed in this observation. According to information provided by the Cyber Charter School in July 2012 to the Pittsburgh Post Gazette under a Right to Know request, the Cyber Charter School paid NNDS \$13.1 million in management company fees, and \$31 million for curriculum in 2010-11.²⁵

²⁴ The individual holding the position of chief executive officer of Pennsylvania Cyber Charter School throughout our audit work retired on June 30, 2012. However, since this individual held the position of CEO at the time of the audit, he is referenced throughout as “CEO.”

²⁵ “Millions flow to Beaver County-based PA Cyber School’s spinoffs.” Pittsburgh Post-Gazette. July 15, 2012.

Inefficient Spending

In accordance with the contract, the Cyber Charter School paid 12 percent of its total revenue received to NNDS for management services, which totaled \$11.4 million and \$9.7 million for the 2009-10 and 2008-09 school years, respectively. The Cyber Charter School receives the largest amount of revenue and has the most students among operating charter and cyber charter schools.

The following chart identifies the Cyber Charter School’s total revenue for the 2009-10 and 2008-09 school years, which consists mainly of school district tuition payments:

<u>Revenue</u> <u>Classification</u>	<u>School Years</u>	
	<u>2009-10</u>	<u>2008-09</u>
Local Sources *	\$90,341,474	\$76,902,081
State Revenue	1,989,300	1,764,600
Federal Revenue	2,958,999	1,679,767
Other Financing Sources	<u>41,607</u>	<u>2,919,987</u>
Total	<u>\$95,331,380</u>	<u>\$83,266,435</u>

* Local Sources for the 2009-10 and 2008-09 school year included \$87,942,928 and \$75,356,461, respectively, in tuition payments from sending school districts.

Consequently, because charter and cyber charter funding is driven by the number of students and districts they come from, the Cyber Charter School receives almost twice as much revenue as any other cyber charter school and nearly three times as much as any other bricks and mortar charter school. As such, basing contract payment terms on a percentage of the Cyber Charter School’s total revenue is not a prudent business practice because the fees reflect the size of the school not the extent of the services provided by the management company.

Moreover, these management fees, combined with other business costs like advertising, resulted in the Cyber Charter School having the third highest “business expenses” reported by the Commonwealth’s other 700 public schools for the 2008-09 school year. Additionally, management fees accounted for the large

majority of the Cyber Charter School's total "business expenses" in 2008-09 and 2009-10. Consequently, the Cyber Charter School's higher than average business costs, which include these management fees, represent a potentially inefficient use of the school's state and local tax dollars.

Potential Duplication of Management Services and Costs

Under the terms of the contract described above, NNDS provides the Cyber Charter School with "management company services," including general business advice, contract negotiating, human resources services, marketing services, professional development and quality assurance services, maintaining financial and business records, and establishing and maintaining accounting policies. Yet, members of the Cyber Charter School's in-house management staff have titles that suggest that they should be responsible for the same activities. For example, the charter school employs a CEO, executive director, director of finance and compliance, director of administrative services, and a business manager. Not including the business manager's salary, which was not provided to the auditors,²⁶ the annual cost of these positions totaled \$452,507, not including benefits, according to records provided by the Cyber Charter School for the 2010-11 school year. Thus, maintaining internal staff whose responsibilities are similar to those of a contracted management company already receiving 12 percent of the Cyber Charter School's revenue is both duplicative and inefficient.

As such, the Cyber Charter School should reevaluate the payment terms of its management company contract and the services to be provided to ensure that it is spending citizens' tax dollars prudently and efficiently.

Recommendations

The *Pennsylvania Cyber Charter School* should:

1. Reevaluate the terms of its contract for management services to ensure fees are based on the services provided and not the revenue received by the Cyber Charter School.

²⁶ Auditors obtained salaries for the eight highest administrative positions, and the Business Manager was not included on this list.

2. Avoid entering into any new contracts or contract renewals for any services that involve paying a percentage of the Cyber Charter School's revenues to the contractor.
3. Request its solicitor to review the management agreement to ensure the Cyber Charter School is receiving the full management services entitled.
4. Ensure the Cyber Charter School funds expended for management services are prudent, necessary, and do not duplicate the job duties performed by the Cyber Charter School employees.

Management Response

Management stated the following:

We disagree with this observation to the extent that it implies that there is inefficient spending or that it implies that a percentage-fee arrangement is never an acceptable contract format.

The Pennsylvania Cyber Charter School continually evaluates the terms and services provided under the management contract, in order to ensure that fees are reflective of the value of services provided under such contract. We engaged in the initial contract as a result of market analysis done by an independent third party to set the market rate for such percentage fee. Subsequently, we had a third party perform a valuation to ensure that the fees were reasonable for the services performed.

We also evaluate the services provided on an ongoing basis, summarized in monthly reporting from the management organization, and have done due diligence to ensure we receive value in the services we pay for, including adding levels of service to be covered under such contract each year. We have upper management employees oversee the services of the management company as an accountability measure. When the on-site audit staff asked us about the appearance of duplicative services, we thoroughly explained this accountability piece in every area of the contract and received positive feedback on such, and no feedback of a potential observation. We were shocked to see observations added at the exit conference as we had constant rapport and feedback regarding other noted observations during the eight (8) months of on-site field

work. That being said, we do agree that we need to constantly re-evaluate our relationship as we grow with new employees to ensure that any services that can be provided under the management agreement are provided.

Our legal counsel has reviewed the management agreement and has guided the most recent valuation process to ensure the Pennsylvania Cyber Charter School is receiving the management services outlined in the contract. We are aware that fee-for-service arrangements may contain more direct billing for such services, but are also aware that they can be more expensive by creating a fee-generating vendor instead of a service-generating vendor. The flexibility of the current business partnership has allowed our school to adapt to technology changes on the fly and get 24/7 support in all services without up charges. However, we do understand the content of this observation, and will continue to do due diligence relative to ensuring the funds we expend for management services are prudent, necessary, and not duplicative.

Auditor Conclusion

Although management disagrees, we maintain our position that basing contract payment terms on a percentage of the Cyber Charter School's total revenue is not a prudent business practice because the fees reflect the size of the school not the extent of the services provided by the management company.

Additionally, the fact that the Cyber Charter School's founder and CEO also founded and was formerly the president of NNDS, the management company, heightens our concerns about the fee structure and potential duplication of services, and ultimately, the potential for misuse of taxpayer dollars due to the closeness of these entities.

Furthermore, our performance audits of all public school entities, including our audit of the Cyber Charter School, include objectives related to compliance with rules and regulations and defined business practices aimed at determining whether state and taxpayer dollars were spent efficiently, effectively, and for their intended purpose. As such, this observation is based on the data reviewed consistent with our audit procedures, a comparative spending analysis of other similar public schools, and best practice criteria. Although management disagrees with our

determination, we believe our audit results and recommendations can serve as a valuable tool for the Cyber Charter School's management as it considers future spending of taxpayer dollars and potential areas of cost savings and increased efficiency.

Status of Prior Audit Findings and Observations

Our prior audit of the Pennsylvania Cyber Charter School resulted in no findings or observations.



Distribution List

This report was initially distributed to the chief executive officer of the Cyber Charter School, the board of trustees, our website address at www.auditorgen.state.pa.us, and the following:

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