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STATE AUDITOR'S REPORT ON CERTAIN ACTIVITIES OF THE SOUTH SHORE CHARTER SCHOOL JULY 1, 1995 THROUGH DECEMBER 31, 1997

OFFICIAL AUDIT REPORT
MAY 26 1999
ISSUED BY THE
Department of the State Auditor

INTRODUCTION

Background

The South Shore Charter School (SSCS), a nonprofit corporation, was organized on May 24, 1994, under the provisions of Chapter 71, Section 89, of the Massachusetts General Laws to operate a public charter school for the five-year period of July 1, 1995 through June 30, 2000. Section 89 of Chapter 71 of the General Laws, as amended, originally authorized 25 charter schools to operate within the Commonwealth. SSCS, which was one of these original 25 charter schools, was granted its charter on October 31, 1994. According to its bylaws, SSCS was established to operate a public school for grades kindergarten through 12 with the purpose of providing students with an education that fosters initiative, leadership, problem-solving skills, critical thinking, team work, and communication and promotes life skills for individual achievement in education, career, and community.

Under a charter granted by the state's Board of Education (BOE), charter schools such as SSCS operate independently of any school committee and are managed by a Board of Trustees. The Board of Trustees of a Commonwealth charter school, upon receiving a charter from the BOE, is deemed to be a public agent authorized by the Commonwealth to supervise and control the charter school. Charter schools receive funding directly from the Commonwealth in the form of per-student tuition reimbursements. These reimbursements are equal to either the average cost per student as determined by the Department of Education (DOE) in the school district in which the charter school is located or the average cost per student in the school district in which the student resides. The Commonwealth deducts the amounts of these tuition reimbursements from the educational aid it provides the non-charter public schools in which each charter school student resides.

In order to receive funding, charter schools must submit various enrollment reports to DOE, which in turn provides each charter school with quarterly reimbursements. The first two quarterly reimbursements to charter schools are based on pre-enrollment reports (estimated enrollment numbers), whereas the final two quarterly payments are made based on actual enrollment figures adjusted for any discrepancies between the actual and estimated enrollment figures submitted by the charter school in its pre-enrollment reports.

During the two fiscal years covered by our review, SSCS received tuition reimbursements from the Commonwealth and other revenue, as detailed below:

South Shore Charter School
Summary of Revenue
Fiscal Years 1996 and 1997

Revenue Source	Fiscal Year 1996	Fiscal Year 1997
State:		
Commonwealth of Massachusetts, Department of Education (Tuition)	$808,062	$1,878,900
Other Revenue:		
Program Fees	26,268	37,637
Grants	66,832	146,557
Fundraising	5,755	1,783
Miscellaneous	-	717
	$906,917	**$2,065,594**

SSCS's enrollment consisted of 150 and 340 students for the two fiscal years ended June 30, 1997, respectively, whereas its average cost per student was approximately $5,732 for fiscal year 1996 and $5,735 for fiscal year 1997.

This audit was conducted in conjunction with the OSA's ongoing review of charter schools. On October 30, 1998, the OSA issued Audit Report No. 99-4080-9, entitled State Auditor's Report on Establishing Standardized Accounting and Reporting Methods for Massachusetts Charter Schools Pursuant to Chapter 46 of the Acts of 1997. This report detailed a standard Chart of Accounts and other pro forma financial statements developed by the OSA, that can be used by charter schools when reporting to DOE. Additionally, the OSA currently is conducting an audit of DOE's administration of the charter school system within the Commonwealth.

Audit Scope, Objectives, and Methodology

The scope of our audit was to examine various fiscal and administrative activities of SSCS during the period July 1, 1995 through December 31, 1997. Our audit was conducted in accordance with applicable generally accepted governmental auditing standards for performance audits issued by the Comptroller General of the United States and included procedures and tests considered necessary by the Office of the State Auditor (OSA) to meet these standards.

Our audit objectives consisted of the following:

1. A determination of whether SSCS has established and implemented adequate and effective management controls, including:
   - Policies and procedures to ensure internal, administrative, and accounting controls over SSCS revenues, expenses, and fixed assets;
   - Processes for planning, organizing, directing, and controlling program operations;
   - Policies and procedures to ensure that resource use is consistent with laws and regulations; and
   - Policies and procedures to ensure those resources are safeguarded and efficiently used.

2. An assessment of SSCS's business practices and its compliance with applicable laws, rules, and regulations and its own policies and procedures.

In order to achieve our audit objectives, we first assessed the system of management controls established and implemented by SSCS over its operations. The purpose of this assessment was to obtain an understanding of management's attitude, the control environment, and the flow of transactions through the SSCS accounting system. The assessment was used in planning and performing our audit tests. We then held discussions with SSCS officials and reviewed organizational charts; internal policies and procedures; and all applicable laws, rules, and regulations. Finally, we reviewed SSCS's financial statements, enrollment reports, budgets, cost reports, invoices, and other pertinent records. This was done to determine whether expenses incurred by SSCS were reasonable; properly authorized and recorded; and in compliance with all applicable laws, rules, and regulations. Finally, we designed audit procedures to follow up on deficiencies identified in a report dated June 19, 1997 issued by the Office of the Inspector General.

During our audit engagement, SSCS's management conducted various activities that limited our ability to perform our audit testing. A scope limitation occurs during an audit engagement when an auditee places restrictions on the scope of the auditor's work. These restrictions result in a disruption in the timing of the work, including the ability to apply all the audit procedures considered necessary in the circumstances of the engagement. Specifically, the Office of the State Auditor is authorized by its enabling legislation, Chapter 11, Section 12, of the General Laws, to perform audits of entities, such as SSCS, that contract with the Commonwealth to "determine compliance with the provisions and requirements of such contracts or agreements and the laws of the Commonwealth." This statute further mandates that "the state auditor shall have access to such records at reasonable times and said department may require the production of books, documents, vouchers, reports and other records relating to any matter within the scope of such audit." In addition, Chapter 71, Section 89, Subsection (hh) authorizes the OSA to audit the activities of charter schools by stating, in part;

> [The State Auditor] may investigate the budget and finances of charter schools and their financial dealings, transactions and relationships, and shall have the power to examine the records of charter schools and to prescribe methods of accounting for the rendering of periodic reports.

However, during the conduct of our audit fieldwork, SSCS did not make all of its records available to the audit staff at reasonable times. On March 9, 1998, the then interim Commissioner of DOE sent a letter to all charter schools, which stated, in part:

> *The Office of the State Auditor, under the authority of General Laws Chapter 11 & 12, is conducting an audit of the Department of Education's administration of charter schools. The Department of Education is working with the State Auditor in this endeavor.*

As part of the audit process, representatives of the State Auditor are visiting charter schools and reviewing relevant records. The auditors may need to review student records in order to verify enrollment and attendance.

In accordance with the Student Records Regulations, 603 CMR [Code of Massachusetts Regulations] 23.07 (4) (d), you are hereby authorized to provide student record information to representatives of the State Auditor in connection with their review and verification of student enrollment and attendance. Such authorized access does not require prior written consent by the student or parent. The representatives of the State Auditor shall protect the confidentiality of any personally identifiable student data they review or collect, in accordance with 603 CMR 23.07 (4) (d).

Despite this authorization from DOE, SSCS officials did not allow us to review all the information in its student files. According to SSCS officials, in their opinion, this letter from DOE only authorized the audit team to review student enrollment reports and attendance records, neither of which was being maintained by SSCS in its students' records. However, in our opinion, our enabling statute, Chapter 71 of the General Laws, and the written authorization provided to us by DOE clearly authorize the OSA to review any and all records, including the information in student files deemed necessary to complete our audit testing. This resulted in a protraction of the audit process and impaired the audit team's ability to fully complete its testing of student attendance and enrollment. It was our intention to review these files for the purpose of verifying student attendance and service delivery. Consequently, the results of our audit of SSCS's student enrollment and attendance are based solely on the limited amount of information that was made available to us by SSCS.

Our special-scope review was not made for the purpose of forming an opinion on SSCS's financial statements. We also did not assess the quality and appropriateness of program services provided by SSCS from its state-funded contracts. Rather, our report was intended to report findings and conclusions on the extent of SSCS's compliance with laws, rules, and regulations; the adequacy of SSCS's performance; and specific processes, methods, and internal controls that could be made more efficient and effective.

AUDIT RESULTS

1. Improper Administration and Use of $112,058 in Massachusetts Teachers Retirement System Funds

During our audit, we found that the South Shore Charter School (SSCS) failed to remit to the Massachusetts Teachers Retirement System (MTRS) $112,058 in retirement funds that it withheld from teachers and other eligible staff. In fact, rather than remitting these funds, SSCS used these payroll withholdings to pay for various operational expenses of the school and, as of the end of our audit period, did not have the funds available to pay for this liability. As a result, the MTRS lost the opportunity to invest this $112,058 in funds to pay for retirees' pensions. In addition, by using these funds in this manner, SSCS risked not having the funds available to pay for these individuals' retirement. Subsequent to the end of our audit period, SSCS officials told us that they had utilized a line of credit to pay these funds to the MTRS and had established an accounts payable for this obligation in its accounting system.

According to Chapter 71, Section 89, of the Massachusetts General Laws, and subsequent guidance issued by the state's Department of Education (DOE), certain employees of charter schools are required to participate in the MTRS. Specifically, Section 89 of Chapter 71 of the General Laws states, in part:

> *Teachers employed by a charter school shall be subject to the state teacher retirement system under chapter thirty-two and service in a charter school shall be "creditable service" within the meaning thereof....*

As an employer of staff who are participants in the MTRS, SSCS has the fiduciary responsibility of withholding the appropriate amount of pension contribution from each employee's paycheck and remitting these funds to the MTRS on behalf of the employee in the manner prescribed by state law. In this regard, Chapter 32, Section 22, of the General Laws establishes the following requirements for remittance of these funds by employers, such as SSCS, to the MTRS.

> *In the case of teachers who are members of the teachers' retirement system, the various amounts withheld for any month for deposit in the annuity savings fund of such system shall, together with proper vouchers therefor, be transmitted by the disbursing authorities to the*

secretary of the teachers' retirement board on or before the tenth day of the next succeeding month....

Despite this statutory requirement, SSCS was not remitting the retirement funds that it was withholding from its teachers and other eligible staff in the manner mandated by Chapter 32. Specifically, as of May 30, 1998, SSCS had withheld a total of $187,699 in pension funds from its staff and had remitted only $75,641 of these funds to the MTRS, leaving an outstanding balance of $112,058 in unremitted funds. Of particular concern is that these pension funds are the property not of SSCS but of the individual employees making the contributions. SSCS has a fiduciary responsibility to act as a transferring agent of these funds but does not have any legal authority to use these funds for its own purposes. Despite this fact, as of the end of our audit fieldwork, SSCS had expended these pension withholdings on its operational expenses and did not have funds to pay for this liability.

Regarding this matter, SSCS's Director of Finance stated that, she had obtained verbal permission from an MTRS official to use these funds in this manner and intended to make payments to the MTRS as funding became available. However, the Executive Director of the MTRS stated that his agency never authorized SSCS to use these pension withholdings in this manner. He added that there are no exceptions to Chapter 32 and that any pension funds withheld must be remitted in accordance with the requirements of this statute.

SSCS does not have the authority to use the pension funds that it withholds from its staff in any manner it deems necessary. Rather, SSCS clearly has a fiduciary responsibility to safeguard these funds and ensure that they are withheld and deposited in a manner consistent with state statutes. By not doing so, SSCS has deprived the MTRS of the ability to invest these funds and earn returns on behalf of SSCS employees that could be used to pay for retirement benefits. Subsequent to the end of our audit period, SSCS officials stated that they had utilized a line of credit to pay these funds to the MTRS and had established an accounts payable for this obligation in its accounting system.

Recommendation: In order to address these issues, SSCS should take appropriate measures to ensure that all pension withholdings are remitted to the MTRS in the manner and time mandated by Chapter 32 of the General Laws. Additionally, SSCS should not use any pension funds that it withholds from its staff to fund agency expenses. Such actions constitute an unauthorized loan and represent a violation of the law and of SSCS's fiduciary responsibility to safeguard these assets.

2. **No Documentation to Support an Estimated $1,095,324 in Billings for Student Services and Potentially Incorrect Billings for Nine Students**

According to state regulations, charter schools must maintain accurate student attendance records to ensure that they are reimbursed only for the students who are provided services. Despite this requirement, SSCS could not provide daily attendance information for approximately 59% of the students for which it billed the Department of Education (DOE) between October 1995 and February 1997. The amount it billed to and received payments from DOE for all of their students during this period totaled approximately $1,856,481. As a result, there is inadequate assurance that the $1,095,324 ($1,856,481 x 59%) in undocumented billings were necessary and proper. In addition, we found that SSCS submitted what appears to be incorrect and inappropriate billings for nine students. Although SSCS took measures to correct these billing errors, it should implement better controls over its billings for tuition reimbursements to ensure that its billings are accurate.

DOE has promulgated 603 Code of Massachusetts Regulations (CMR), which governs the major operations of public schools, including charter schools, within the Commonwealth. Section 10 of these regulations establishes specific recordkeeping and reporting requirements for schools. Regarding the maintenance of student enrollment and attendance information, 603 CMR 10.05 (2) and 10.05 (3), respectively, state, in part:

> *Each school district shall maintain, for every school year, a roster identifying the students enrolled and the amount of time spent in each program.... Each school district shall adopt and maintain a reliable data collection and retention system in which the student data*

required by 603 CMR 10.00 shall be recorded. This system shall be the basis for the district's periodic reporting to the Department.

Regarding the reporting of student attendance and enrollment information, 603 CMR 10.03 (6) states, in part:

On or before May 1 of each year, every charter school shall provide to the Department, in a form or through an electronic data transfer method established by the Department, its projected enrollment as of April 15 for the next school year. On or before October 15 and March 1 of each year, each charter school shall report to the Department its actual attendance as of October 1 and February 15 of that year....

Despite these requirements, SSCS did not have uniform written policies and procedures relative to how its teachers should document student attendance. Rather, SSCS allowed each teacher to independently determine how student attendance was to be taken and documented. We attempted to reconcile the enrollment reports submitted by SSCS to DOE in October 1995, February 1996, October 1996, and February 1997 to SSCS's attendance records. However, SSCS was unable to provide us with the attendance records for a significant number of the students for which it billed DOE on these enrollment reports. The table below summarizes our analysis in this area:

South Shore Charter School
Comparison of Billings to Attendance Records
October 1995 to February 1997

Date of Report	Students per Enrollment Form	Students per Attendance Records	Students Overbilled/ Overclaimed	Percentage of Overclaim
October 1995	157	106	51	32%
February 1996	173	118	55	32%
October 1996	341	99	242	71%
February 1997	374	104	270	72%
Totals	1,045	427	618	59%

During the period of our audit, SSCS billed and received payments totaling $1,856,481 from DOE for all of its students. However, as can be seen from the above table, SSCS could not substantiate that 618 (59%) of the students for whom it billed to DOE during the period of our audit testing were actually in attendance at the school. Therefore, there is inadequate assurance that all of the $1,095,324 in undocumented billings for these 618 students was necessary and proper.

In addition to the undocumented billings discussed above, we also found nine instances in which SSCS may have submitted erroneous billings to DOE. Each year charter schools such as SSCS must submit to DOE Charter School Claim Forms in October and February. These forms indicate various student enrollment information such as each students name, address and dates of attendance. DOE uses this information to provide quarterly tuition reimbursements to charter schools based on these student enrollment reports. If a student leaves a charter school before the school year ends, the charter school is required to identify the date on which the student stopped attending in these claim forms. DOE then reimburses the charter school on a prorated basis for the specific number of days the student attended the school. During our audit, we contacted the various public school departments in the cities and towns in which the students who appeared on SSCS's enrollment reports resided and asked these school departments to verify that the students who SSCS listed on their enrollment reports from these communities were in fact attending SSCS. As a result this audit test, we identified nine students for whom SSCS may have submitted erroneous bills for during the period of our audit, as follows:

- According to representations we received from various public school departments, four students who appeared on SSCS's October 1996 billing to DOE never attended SSCS. Rather, three of these students were attending the Rockland, Weymouth, and Hanover public school systems during this period. The fourth student transferred from the Mansfield public school system to the Fall River public school system on February 25, 1997 but did not attend SSCS. Subsequent to submitting this erroneous bill, SSCS appropriately contacted DOE to correct these billing errors.

- SSCS billed and received tuition reimbursements from DOE totaling $995 for two students whom SSCS indicated attended SSCS for a total of 16 days during the 1996-97 school year.

However, according to a written confirmation we received from the Hull public school system, these two students were in attendance in this school system during this period of time. SSCS officials contend that these two students did in fact attend the school for the days that were indicated on the bill they submitted to DOE.

- One student left SSCS after the second week in September 1996. However, SSCS billed DOE for this student's attendance through October 2, 1996. Subsequent to submitting this erroneous bill, SSCS appropriately contacted DOE to correct this billing error.
- In its October 1996 billing to DOE, SSCS claimed and received reimbursements for the same student twice. Subsequent to submitting this erroneous bill, SSCS appropriately contacted DOE to correct this billing error.
- In its February 1997 billing to DOE, SSCS received payments for a student who was reported as being in attendance through February 15, 1997. However, information we received from the Weymouth public school system indicated that this student returned to this school system on January 13, 1997. Subsequent to submitting this erroneous bill, SSCS appropriately contacted DOE to correct this billing error.

Regarding the incomplete attendance records, SSCS's headmaster of its secondary school stated that a former employee, the MIS secretary for the secondary school, would routinely provide to parents original student records rather than copies. These records contained the only written copies of the students' attendance at SSCS. The headmaster added that, although attendance records were maintained on a computer disc, the former MIS secretary erased this attendance information before she left. Finally, the headmaster stated that attendance information was maintained on this disc by a consultant, Edu Core, Inc., that was hired by the school to perform this function. Edu Core, Inc., was owned by SSCS's current Chief Executive Officer (CEO) and founder and his partner. For the first two years of SSCS's operation, the school used Edu Core, Inc.'s software to track school attendance. SSCS's contract with Edu Core, Inc., was terminated in July 1997. However, copies of the attendance records that were being maintained by Edu Core, Inc., are in the possession of the former partner of SSCS's CEO, and this partner was not willing to turn this information over to SSCS without additional compensation. Subsequently, SSCS initiated standardized attendance procedures for its primary and secondary students for the 1997-98 school year.

Regarding the questionable billing for the nine students, during the conduct of our audit work, SSCS officials admitted that some erroneous billings were submitted to DOE but indicated that these billings were corrected. In addition, these officials added that subsequent to our audit period, SSCS has taken measures to implement a more standardized system for recording student attendance.

Recommendation: Since the recording of daily class attendance is basic and inherent in any well-managed public or private school system, SSCS should develop and implement more effective controls over the documentation and reporting of student attendance to provide assurance that enrollment reports submitted to DOE are prepared in an accurate manner. Finally, DOE should perform its own review of the $1,095,324 in undocumented billings for student tuition that SSCS received that we identified during our audit to determine the propriety of these expenses and take appropriate measures to remedy such problems.

3. **Undocumented Expenses Totaling $2,572, Inadequately Documented Expenses Totaling $28,301, Questionable Expenses Totaling $11,500, and $4,376 in Expenses Not Properly Approved**

During our audit we found that SSCS had not developed and implemented adequate controls over its expenses. For example, there was inadequate segregation of duties relative to the review, approval, and recording of SSCS expenses. As a result, of the $336,616 in expenditures that we tested during fiscal years 1995 through 1997, we found no documentation to substantiate $2,572 of these expenses; $15,967 of these expenses was inadequately documented; and an additional $4,376 in expenses was not properly approved. Moreover, we found $23,834 in questionable or undocumented expenditures relative to the activities of SSCS's CEO.

According to state law, charter schools are required to maintain complete and accurate records of all their activities. Specifically, Chapter 71, Section 89 (hh), states, in part;

Each charter school shall keep an accurate account of all its activities and all its receipts and expenditures and shall annually cause an independent audit to be made of its account.

Also, according to the American Institute of Certified Public Accountants (AICPA), it is the responsibility of management to establish and maintain an effective internal control structure over an entity's operations, which includes effective controls over the authorization, documentation, and reasonableness of disbursements.

During our audit, we selected a sample of expenditures totaling $336,616 incurred by SSCS during fiscal years 1995 through 1997. Based on our review, we noted the following deficiencies relative to $22,915 of these expenses, as follows:

- There was no documentation for five of these expenses totaling $2,572.
- There was inadequate documentation (e.g., payments were made using copies of invoices or credit card statements with no other supporting documentation) to support $15,967 of these expenditures.
- Thirteen expenditures totaling $4,376 were not properly approved prior to payment. For example, time sheets for substitute teachers were not authorized by an administrator, and invoices were paid without evidence of having been reviewed and approved by a member of SSCS's administrative staff.

In addition, we also found questionable or inadequately documented expenditures totaling at least $23,834 relative to the activities of SSCS's CEO, as follows:

- During our audit, SSCS paid its CEO $11,500 ($500 per month) for home business expenses. A total of $9,500 was billed for Dovetail Consulting, which was owned by the CEO, to SSCS for the period of August 15, 1995 to March 3, 1997. Subsequent to the termination of SSCS's contract with Dovetail Consulting, $2,000 was billed by the CEO to SSCS for the period of March 28, 1997 through June 25, 1997. According to an October 9, 1995 memorandum from SSCS's CEO to the Treasurer of SSCS's Board of Directors, the monthly payment was for the following expenses being incurred by the CEO:

	Monthly Reimbursement Amount
Primary use of two computers	$75
Primary use of two offices with all utilities	250
Primary use of a van	100
Primary use of basic telephone services	75
	$500

Regarding this matter, SSCS officials stated that, because of the limited space for offices in the school buildings and the fact that the board could not afford to build additional space, it was a cost-effective option to pay the CEO for these home business expenses and provided us with their analysis as to why it was cost-effective. However, because SSCS provided us this information subsequent to the end of our audit field work, the reasonableness of this assertion was not audited.

- SSCS did not have adequate documentation to substantiate 19 reimbursements totaling $12,334 made to the CEO. For example, on July 7, 1997, SSCS provided its CEO with a check for $4,000. The check request form completed by the CEO stated that it was reimbursement for rent he had paid for SSCS's elementary school. While nothing came to our attention that would lead us to believe that these funds were not used for this purpose, there was inadequate documentation (e.g., a cancelled check) to indicate that the CEO actually incurred this expense prior to receiving reimbursements from SSCS.

Recommendation: In order to address these issues, SSCS should develop and implement adequate internal controls over its expenses to ensure that all costs are properly documented, authorized, recorded, and related to the operation of SSCS. At a minimum, such controls should ensure that there is an independent review and approval of all reimbursement requests and require supporting documentation for all expenses prior to processing payments. Finally, DOE should review and assess the propriety of these $46,749 in questionable expenses and take appropriate measures necessary to resolve this matter.

4. Inadequate Controls over the Classification and Reporting of $130,920 in Staff and Consultant Compensation

During our audit, we found that SSCS did not have adequate controls over its payroll activities. Specifically, SSCS had no written policies and procedures relative to the proper classification of its labor costs or the proper issuance of appropriate income information forms to the Internal Revenue Service (IRS) and the Department of Revenue for staff and consultant services. As a result, we found numerous deficiencies in SSCS's payroll records, including SSCS's (a) potentially misclassifying nine staff members as consultants for calendar years 1996 and 1997 and paying them a total of $83,897 and $30,698, respectively, during these two calendar years, which may have resulted in SSCS's not paying approximately $40,436 in payroll taxes; (b) issuing an IRS Form 1099 to one staff member during fiscal year 1996 that indicated compensation of $5,000 less than the amount actually received during this calendar year; (c) failing to issue an IRS Form 1099 to an individual who performed services for SSCS for calendar years 1996 and 1997 amounting to $6,549 and $4,780, respectively; (d) erroneously issuing an IRS Form 1099 totaling $17,246 during calendar year 1995 for the purchase of computer equipment.

The IRS has issued guidelines on how entities such as SSCS should classify their labor costs and how these costs should be reported to federal and state authorities. During our audit, we reviewed the job descriptions and associated payroll records of all of SSCS employees during calendar years 1996 and 1997 and compared SSCS payroll activities to IRS guidelines. IRS Publication 15-A, Employer's Supplemental Tax Guide, provides the criteria and guidance for distinguishing between employees and independent contractors. This publication describes the rules between classifying individuals as employees or individual contractors, such as the degree of control and the degree of independence. Control includes such considerations as whether the business has a right to direct and control how the worker does the task for which the worker is hired, including the type and degree of instructions the business gives the worker, the extent of training the business gives the worker, the extent to which the worker makes the services available to the relevant market, and how the business pays the worker. The type of relationship includes such considerations as (a) a written contract describing the relationship the parties intended to create; (b) whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay; (c) the permanency of the relationship; and (d) the extent to which services performed by the worker are a key aspect of the regular business of the company.

In comparing the IRS criteria to SSCS's records, we found that SSCS reported as consultant compensation $114,595 it paid to nine of its staff members despite the fact that these nine individuals appeared to have met the IRS's definition of "employees," as follows:

South Shore Charter Schools
Summary of Incorrectly Reported Compensation
Calendar Years 1996 and 1997

Employee Title	1996	1997	Total Incorrectly Reported
Finance Director	$ 8,398	$ 11,698	$ 20,096
Curriculum Director	16,000	4,000	20,000
Coteacher and Manager of SSCS's Extended Day Program	24,666	15,000	39,666
Permanent Substitute Teachers (6 positions)	34,833	-	34,833
Total	$83,897	$30,698	$114,595

In addition, by reporting this compensation as being paid under the classification of independent contractor rather than employee compensation, SSCS may have failed to remit approximately $40,436 in payroll taxes to the appropriate authorities for the two calendar years ended December 31, 1997, as indicated in the following table:

	Calendar Years		
	1996	1997	Totals
Employee Withholdings*	$18,548	$ 6,786	$25,334
Employer's Share of FICA and Unemployment Tax*	11,057	4,045	15,102
	$29,605	$10,831	$40,436

* Based on IRS-prescribed calculations

- Our comparison of SSCS's payroll records with the IRS Forms 1099 and Forms W-2 that were submitted to federal and state taxing agencies revealed that an IRS Form 1099, issued to the co-teacher and manager of SSCS's Extended Day Program, reported her income as $24,666 rather than $29,666 (a $5,000 difference) as indicated by SSCS's payroll records for calendar year 1996.

- SSCS disbursed two payments amounting to $6,549 and $4,780 for calendar years 1996 and 1997, respectively, to a college for the payment of tuition for a employee in lieu of a payment to the employee for services provided by her to SSCS. However, this compensation was not included in this individual's Form W-2 as required by IRS regulations.

- According to IRS regulations, agencies such as SSCS are not supposed to issue Form 1099s to report the purchase of equipment. Despite this, we found that during calendar year 1995, SSCS inappropriately issued a Form 1099 to Psych Soft Inc., for the purchase of $17,246 in computer equipment.

SSCS officials stated that they believed that the nine individuals in question were properly classified as consultants. However, the documentation we were provided by SSCS officials during our audit indicated that these individual may have been misclassified and in fact should have been classified as employees of the agency. By failing to comply with IRS rules and regulations, SSCS could be subjecting itself to additional employment taxes and costly penalties.

Recommendation: In order to address these issues, SSCS should (a) develop better controls over the proper classification and reporting of compensation and take measures to ensure that all compensation provided to employee staff and consultants is done in a manner consistent with all IRS and Department of Revenue requirements; (b) issue a corrected Form 1099 in the amount of $29,666 to the co-teacher and manager of the Extended Day Program; and (c) issue an amended Form W2 for 1996 and 1997 to the individual who received the benefit of tuition payments in lieu of compensation from SSCS.

5. Inadequate Internal Controls over Several Aspects of SSCS's Operations

According to standards published by the AICPA, it is the responsibility of management to establish and maintain an effective internal control structure. Sound internal controls are essential in maintaining full accountability for resources and in achieving management objectives in the most effective and efficient manner. However, during our review, we found that SSCS had not developed and implemented an effective internal control system over several aspects of its operations. Specifically, our audit noted that SSCS (a) had not developed written policies and procedures relative to accounting transactions, (b) did not ensure that employees duties were properly segregated, (c) was not maintaining an accurate inventory of its furnishings and equipment items, (d) was inappropriately advancing funds to certain employees, (e) was not performing bank reconciliations in a timely manner, (f) was not utilizing appropriate budgeting techniques, and (g) was not remitting employee deferred compensation deductions in a timely manner, as discussed below:

a. No Written Policies and Procedures Relative to the Accounting System: Sound accounting practices advocate that entities should establish a proper accounting system that is documented in an accounting manual and describes the accounting system and the policies and procedures that are utilized in an agency's accounting process. This documentation serves to ensure the continuity of the accounting system in case of staff turnover and also establishes accountability for various operational activities. However, during our review we noted that SSCS had not developed such a manual, nor had it developed and implemented any formal written policies and procedures relative to its accounting process.

b. SSCS Did Not Ensure That Employee Duties Were Properly Segregated: An effective internal control system ensures that no one person is in charge of a complete transaction. Specifically, duties should be segregated among different personnel so that procedures designed to detect errors and irregularities are performed by personnel other than those who are in a position to initiate errors and irregularities. However, we found that the duties of those SSCS employees responsible for authorizing, recording, and reporting cash receipts and disbursements were not adequately segregated. Examples of this problem include the following:

- The administrative office and official mailing address of SSCS is located at the home of its CEO and founder. Therefore, all mail, which occasionally would include receipts and donations, is received by one person (the CEO), who forwards these receipts to the Director of Finance for deposits and entry into the accounting records. Since this individual has the ability to authorize payments and cash checks, he should not have control and custody of these assets and records.

- We found three instances totaling $14,082 in our review of SSCS disbursements in which the CEO authorized a purchase, approved payment, and signed and issued a check to a vendor.

- SSCS's accounting department consists of one employee, the Director of Finance, whose responsibilities include performing all of the following activities:

  a. the monthly reconciliation of bank statements;

b. the daily deposit of receipts;

c. the preparation of check payments;

d. the recording of receipts and disbursements into the accounting records;

e. the preparation of monthly financial reports;

f. the payment of all invoices and reimbursements; and

g. the preparation and submission of Forms 1099 to the federal and state tax regulatory agencies for all individuals who received non-employee compensation, which also included herself.

c. Inadequate Inventory Controls: During our audit, we found that, contrary to Generally Accepted Accounting Principles, (GAAP), SSCS was not maintaining an accurate inventory of its furnishings and equipment items, which as of June 30, 1997 was valued at $86,080.

The AICPA Codification of Statements on Auditing Standards (SAS) defines an adequate internal control structure and what is required to properly safeguard the assets of the organization. Specifically, SAS No. 55[1] states:

Establishing and maintaining an internal control structure is an important management responsibility. In establishing specific internal control structure policies and procedures concerning an entity's ability to record, process, summarize and report financial data that is consistent with management's assertions embodied in the financial statements, some of the specific objectives management may wish to consider include the following:

Access to assets is permitted only in accordance with management's authorization.

The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

However, we found that, contrary to these requirements, SSCS was not maintaining accurate records of its inventory, did not have any policies and procedures in place to restrict access to these assets, and did not perform annual physical counts of furniture and equipment items for comparison to inventory

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[1] SAS No. 55 was amended subsequent to our audit by SAS No. 78, which became effective for audits beginning after January 1, 1997.

records. In addition, we noted that the last entry relative to the purchase of a furnishings and equipment item recorded in SSCS's inventory listing was October 22, 1996, despite the fact that its general ledger documented that purchases of furnishings and equipment items were made subsequent to this date. We also noted a discrepancy of $2,870 between the inventory value reported in SSCS's fiscal year 1997 financial statements ($86,080) to the amount recorded in its subsidiary inventory listing ($88,950) as of the same time. Because of the deficiencies, there is inadequate assurance that SSCS's inventory of furnishings and equipment were properly safeguarded against loss, theft, or misuse.

d. Advances to Employees: SSCS did not have a formal written policy that allowed it to advance funds to its employees for the payment of college tuition. However, we noted that such advances totaling over $1,000 during our audit period were made to two SSCS employees. No accounts receivable were established in SSCS's accounting records relative to these advanced funds. According to SSCS officials, these advances were to pay for courses that these individuals were taking; however, there was inadequate documentation on file to substantiate this assertion. Although a repayment plan was set up between SSCS and these individuals, in order to ensure that these funds are used for their intended purposes such payments should be reimbursement based upon documentation indicating the employee's successful completion of the course, rather than an advanced amount prior to the employee taking a course.

e. Lack of Timely Preparation of Bank Reconciliations: GAAP advocates that organizations reconcile bank statements to the general ledger accounts to ensure that account balances are accurate and that transactions have been properly authorized and recorded. However, during our audit period, SSCS could not adequately document that bank reconciliations were prepared on a timely basis. We noted during our audit field work that SSCS was four to six months in arrears in reconciling its bank statements to the general ledger.

f. Lack of Utilization of Monthly Expense Budgets to Monitor and Evaluate the Operations of SSCS: Prudent business practices advocate that entities such as SSCS utilize various budgets to monitor and evaluate operations and to ensure that sufficient cash flow exists to meet operational needs. However, we found that, for the first two fiscal years of its existence, SSCS was not utilizing any formal monthly budgeting techniques and, therefore, could not be assured that it had sufficient funds to meet current operational needs. The lack of formal monthly cash and expense budgeting techniques was further evidenced by the following observations during our audit:

- In February 1996, April 1996, July 1996, December 1996, and November 1997, SSCS had overdrawn its funds on deposit on 30 separate occasions totaling $13,844, as follows:

SSCS Overdrawn Checks

Month	Number of Overdrawn Checks	Amount
February 1996	1	$ 4,000
April 1996	13	4,530
July 1996	3	695
December 1996	3	765
November 1997	10	3,854
Total	30	$13,844

- The monthly financial statements prepared by SSCS's Finance Director for the monthly board meetings revealed that SSCS's current liabilities consistently exceeded its current assets throughout the audit period.

- Starting in July 1997, SSCS prepared a statement comparing budgeted annual revenues and expenditures to monthly actual receipts and disbursements as part of SSCS's trustee monthly financial reporting system. However, SSCS's was still not properly reconciling its cash accounts. As noted in the table above, our review of the SSCS bank statement and cancelled checks for November 1997 revealed that 10 checks, totaling $3,854, were returned by the bank because SSCS did not have funds on deposit to cover these checks. As a result, SSCS incurred unnecessary bank service charges of $225 for this month, and at least $465 in bank service charges for the other four months that SSCS overdrew its funds on deposit without timely bank reconciliations.

g. <u>Lack of Timely Remittance of Employee Deferred Compensation Deductions to the Massachusetts Deferred Compensation Program</u>: According to officials from the Office of the State Treasurer, the Massachusetts Deferred Compensation Plan requires employers to remit employee withholdings of its participants in the plan immediately upon the date of the deduction. However, we found that SSCS did not remit $19,599 in Massachusetts Deferred Compensation funds that it withheld from employees participating in the plan for several months after these funds were withheld from staff members' compensation. Our review of the SSCS general ledger and cancelled checks made payable to the Massachusetts Deferred Compensation Plan revealed the following:

Check Number	Amount of Check	Date of Check	Time Period of Employee Deductions*
3295	$ 8,611	05-23-97	09-29-96 to 04-18-97
3531	4,387	08-04-97	04-18-97 to 07-23-97
3866	1,249	11-06-97	07-23-97 to 09-19-97
4039	5,352	01-02-98	09-19-97 to 12-26-97
Total	$19,599		

* As of December 31, 1997, SSCS did not have any outstanding withholdings due to the Massachusetts Deferred Compensation Plan.

As a result of SSCS's not submitting these funds on a timely basis, the participating employees may have lost potential earnings and appreciation on their funds.

Recommendation: SSCS should develop and implement adequate internal controls over all aspects of its operations in order to ensure that its financial records are properly authorized, recorded, and reported and that its assets are properly safeguarded and transferred on a timely basis.

6. **Follow-Up Review of the Office of the Inspector General's Report**

On June 19, 1997 the state's Office of the Inspector General (OIG) issued a report to SSCS in which the OIG identified three deficiencies, including: (1) noncompliance with 30B of the General Laws relative to the use of applicable competitive procurement procedures, (2) questionable related-party transactions, and (3) a lack of internal controls in SSCS's accounting department. Subsequent to the end of our audit field work, DOE officials informed us that charter schools are not subject to requirements of Chapter 30B. Additionally, SSCS had taken measures to address some of the major concerns raised by the OIG relative to its related-party relationships. However, during our audit we found at least one instance in which SSCS may have not properly disclosed a related-party transactions in its financial statements as required by GAAP. Finally, as noted in Audit Result No. 5, although SSCS was making progress in effectively controlling its operations, it still had not developed and implemented adequate internal controls over several aspects of its operations.

On June 19, 1997, the OIG issued a report to SSCS stating that SSCS had awarded numerous contracts in violation of Chapter 30B of the General Laws. Moreover, the report disclosed that a number of contracts awarded by SSCS were related-party transactions between SSCS and private companies owned by SSCS employees or volunteers, contrary to the General Laws, Chapter 268A, and that there was a lack of internal controls in SSCS's accounting department. In this report, the OIG recommended that, "The SSCS Board of Trustees should take immediate steps to ensure that all employees and consultants with procurement responsibilities comply with the law. . . . employees who have engaged in related-party transactions [should] seek written opinions from the State Ethics Commission regarding the legality of these contractual relationships." Further, SSCS's board should immediately implement procedures to address the lack of internal controls in SSCS's accounting department.

During our audit we found that, although SSCS was making progress in implementing better controls over its operations, it had not implemented adequate controls over many aspects of its operations (see Audit Result No. 5). Our follow-up review of the other two deficiencies cited in the aforementioned OIG reported are discussed below:

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The South Shore Charter School (SSCS), a nonprofit corporation, was organized on May 24, 1994 under the provisions of Chapter 71, Section 89, of the Massachusetts General Laws to operate a public charter school for the five-year period of July 1, 1995 through June 30, 2000. According to its bylaws, SSCS was established to operate a public school for grades kindergarten through 12 with the purpose of providing students with an education that fosters initiative, leadership, problem solving skills, critical thinking, team work, and communication and that promotes life skills for individual achievement in education, career, and community. Our audit, which covered the period July 1, 1995 through December 31, 1997, examined the accounts and various operational activities of SSCS. Our objectives were to (1) determine whether SSCS had established an adequate system of management controls over revenues, expenses, and fixed assets and (2) assess SSCS's business practices and its compliance with applicable laws, rules, and regulations. Our audit revealed that SSCS improperly administered $112,058 in staff pension funds; had undocumented billings and questionable costs totaling $1,142,073; and had inadequate internal controls over many aspects of its operations.

1. **Improper Administration and Use of $112,058 in Massachusetts Teachers Retirement System Funds**: During our audit, we found that SSCS failed to remit to the Massachusetts Teachers Retirement System (MTRS) $112,058 in retirement funds that it withheld from teachers and other eligible staff. In fact, rather than remitting these funds, SSCS used these withholdings to pay for various operational expenses of SSCS. As a result, the MTRS lost the opportunity to invest this $112,058 for retirees' pensions. In addition, by using these funds in this manner, SSCS risked not having the funds available to pay for these individuals' retirement. Subsequent to the end of our audit period, SSCS officials stated that they had utilized a line of credit to pay these funds to the MTRS and had established an accounts payable for this obligation in SSCC's accounting system. 6

2. **No Documentation to Support an Estimated $1,095,324 in Billings for Student Services and Potentially Incorrect Billings for Nine Students**: According to state regulations, charter schools must maintain accurate student attendance records to ensure that they are reimbursed only for the number of students for whom they provide services. Despite this requirement, SSCS could not provide daily attendance information for approximately 59% of the students for which it billed the Department of Education (DOE) between October 1995 and February 1997. The amount billed to and received from DOE for all SSCS students during this period totaled approximately $1,856,481. As a result, there was inadequate assurance that all of the $1,095,324 ($1,856,481 x 59%) in undocumented billings were necessary, proper, and for students who attended SSCS. In addition, we found that SSCS submitted what appears to be incorrect and inappropriate billings for nine students. Although SSCS took measures to correct these billing errors, the agency should implement better controls over its billings for tuition reimbursements to ensure that its billings are accurate. 8

a. <u>Compliance with General Laws Chapter 30B</u>: Chapter 30B establishes procurement guidelines relative to the awarding of contracts for the procurement of supplies, services, or real property and for disposing of supplies or real property by a governmental body. Subsequent to the issuance of the OIG report, we did not identify any contracting activities conducted by SSCS that would have been subject to Chapter 30B. Therefore, SSCS's compliance with the recommendations made by the OIG in its report relative to this matter could not be tested. However on July 1, 1998, the Commissioner of Education issued Charter School Technical Advisory 98-1 to all charter schools, which stated, in part:

> *Commonwealth charter schools, which operate under a charter granted by the Board of Education, are, as a matter of law, instrumentalities of the state. They are established and operated independent of any municipal or regional school committee. As a result, these schools are not subject to the procurement requirements of the Uniform Procurement Act (G.L.c. 30B), which governs "governmental bodies" of cities, towns, districts, and counties.*

According to DOE, SSCS is exempt from the requirements of Chapter 30B. However, in order to ensure that SSCS obtains the highest quality goods and services at the lowest possible cost, SSCS should develop and implement formal written policies and procedures relative to the procurement of goods and services.

b. <u>Related-Party Transactions</u>: GAAP requires entities such as SSCS to disclose all related-party transactions. Specifically, Statement of Financial Accounting Standards (SFAS) No. 57 states, in part:

> *Financial statements shall include disclosures of material related party transactions, other than compensation arrangements, expense allowances, and other similar items in the ordinary course of business. However, disclosure of transitions that are eliminated in the preparation of consolidated or combined financial statements is not required in those statements. The disclosures include:*
>
> *a. The nature of the relationship(s) involved.*
>
> *b. A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements.*

c. *The dollar amounts of transitions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period.*

d. *Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement. . . .*

An Affiliate is. . . . A party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an enterprise.

According to this SFAS, a related party is defined as follows:

Principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one ore more of the transacting parties might be prevented from fully pursuing its own separate interests.

As a result of the OIG Report and according to the minutes of SSCC's Board of Directors, SSCS took a variety of measures relative to the conduct of related-party transactions, including the following:

- SSCS and Dovetail Consulting, a business owned by SSCS's CEO, mutually agreed to immediately terminate Dovetail Consulting's present contract with SSCS and not enter into any new contract with any entity from which SSCS's CEO may financially benefit. No funds have been spent under this contract since June 1996.

- SSCS added to its personnel policies the requirement that "no full time employee of SSCS may financially benefit from any contract into which SSCS enters."

- SSCS added to its personnel policies the requirement that, "In accordance with Advisory #11 of the State Ethics Commission covering the subject of Nepotism, the SSCS Board of Trustees will directly name an unrelated individual to represent SSCS in regard to hiring, salary reviews, promotions, supervising, etc. with any employee who is an immediate family member of the Founder & CEO, Head of Secondary School, or Head of the Primary School."

- The Board of Trustees terminated the $70,000 revolving loan that had been extended to SSCS by the CEO and his wife.

Although SSCS has been responsive to the concerns raised in the OIG report relative to the conduct of related-party transactions, we found one instance in which, during our audit period, SSCS may have fully complied with the OIG's recommendations relative to disclosing related-party transactions, as follows:

- During our audit period, SSCS purchased 55% of its computer equipment costing $37,993 from Psych Soft Inc. Psych Soft is an entity that is owned by an SSCS consultant who is also an employee of Dovetail Consulting, an entity that is controlled by SSCS's CEO and his wife. SSCS did not obtain a written opinion from the State Ethics Commission pertaining to this contractual relationship as recommended by the OIG in its report. Of particular concern is that SSCS paid $37,993 for this equipment, and there is inadequate documentation to substantiate that the computer equipment was actually provided. For example, we noted that there was no documentation describing the model numbers, the serial numbers, and the manufacturer's name of the computer equipment purchased from this vendor.

Regarding this matter, SSCS officials stated that they were unaware that this transaction needed to be disclosed in its financial statements.

Recommendation: SSCS should develop policies and procedures that require all SSCS employees and consultants, when appropriate, to seek written opinions from the State Ethics Commission to determine the propriety of such contractual relationships. Also, SSCS should comply with AICPA standards by properly disclosing all related-party transactions.

SUBSEQUENT EVENTS

On August 18, 1998, the Commonwealth of Massachusetts Architectural Access Board ordered the South Shore Charter School (SSCS) to stop using the second and third floors of its secondary school because the building lacked an elevator. The issue as to who should be responsible for the installation of and payment for an elevator has been the focus of a legal dispute between SSCS and the lessor, AIT Realty Trust.

Subsequent to the end of our audit field work, SSCS provided us with various documents, including a copy of a Stipulation and Order from the Superior Court Department Plymouth (Docket No. 98-0274A). The order requires the landlord to install the elevator and that the SSCS and the landlord split the expense.

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