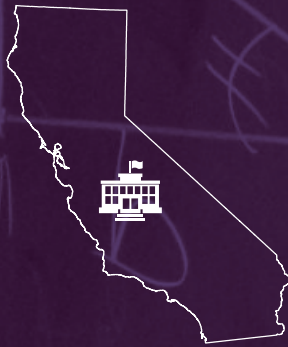


# Risking Public Money: California Charter School Fraud

Best Practices to Protect Public Dollars  
& Prevent Financial Mismanagement



March 2015



## ABOUT THE AUTHORS

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**The Center for Popular Democracy** is a nonprofit organization that promotes equity, opportunity, and a dynamic democracy in partnership with innovative base-building organizations, organizing networks and alliances, and progressive unions across the country.



**The Alliance of Californians for Community Empowerment (ACCE) Institute** is a nonprofit organization that works to improve the lives of low-income and working families in California by carrying out and supporting work that fosters community improvement and robust civic participation.



**Public Advocates Inc.** is a nonprofit law firm and advocacy organization that challenges the systemic causes of poverty and racial discrimination by strengthening community voices in public policy and achieving tangible legal victories advancing education, housing and transit equity.

# Risking Public Money: California Charter School Fraud

## Best Practices to Protect Public Dollars & Prevent Financial Mismanagement

Center for Popular Democracy  
The Alliance of Californians for Community Empowerment (ACCE) Institute  
Public Advocates Inc.

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### Executive Summary

In 1992, California became the second state in the nation to pass legislation authorizing the creation of charter schools.<sup>1</sup> Since the law's passage, which originally authorized 100 charter schools, the number of charter schools in California has grown rapidly. Today, California is home to the largest number of charter schools in the country, with over 1100 schools providing instruction to over half a million students.<sup>2</sup> In the 2013-14 school year, California charter schools received more than \$3 billion in public funding.<sup>a</sup>

Despite the tremendous investment of public dollars and the size of its charter school population, California has failed to implement a system that proactively monitors charters for fraud, waste and mismanagement. While charter schools are subject to significant reporting requirements and monitoring by oversight bodies, including chartering entities, county superintendents and the State Controller, no oversight body regularly conducts audits.

In 2006, California took a step in the right direction by amending the Charter Schools Act to permit county superintendents who suspect fraud or mismanagement at charter schools to request an "extraordinary audit" from the Financial Crisis and Management Assistance Team (FCMAT), a state agency charged with helping local educational agencies fulfill their financial and management responsibilities. Although FCMAT only conducts an audit when requested to do so, its findings reveal internal control deficiencies and various forms of mismanagement ranging in severity and form—from inappropriate self-dealing by charter school staff to the spending of thousands of public dollars without documentation. Even after 2006, charter schools in California continue to operate year in and year out without regulator-level audits that are designed specifically to determine whether the public dollars funding these privately managed schools are being spent properly. This lack of appropriate government audits is a problem, especially given the findings of FCMAT's audits.

The number of instances of serious fraud uncovered by whistleblowers and the FCMAT suggests that the fraud problem is likely not isolated to the charter operators that have been caught. In fact, California's charter oversight system's deficiencies suggest that **the \$81,400,000 in fraud, waste and abuse by charter operators that has been uncovered to date is likely just the tip of**

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<sup>a</sup> Based on a rough estimate of enrollment multiplied by \$8,006 per Average Daily Attendance (ADA) in 2013-14. See *infra* footnote d.

**the iceberg.** Based on conservative estimates, California stands to lose more than \$100 million to charter school fraud in 2015.<sup>b</sup> The vast majority of this fraud perpetrated by charter officials will go undetected because California lacks the oversight necessary to identify the fraud. In this report we describe three fundamental flaws with California's oversight of charter schools:

- **Oversight depends heavily on self-reporting by charter schools or by whistleblowers.** California's oversight agencies rely almost entirely on audits paid for by charter operators and complaints from whistleblowers. Both methods are important to uncover fraud; however, neither is a systematic approach to fraud detection, nor are they effective in fraud prevention.
- **General auditing techniques alone do not uncover fraud.** The audits commissioned by the charter schools use general auditing techniques rather than techniques specifically designed to detect and uncover fraud. The current processes may expose inaccuracies or inefficiencies; however, without audits targeted at uncovering financial fraud, state and local agencies will rarely be able to detect fraud without a whistleblower.
- **Oversight bodies lack adequate staffing to detect and eliminate fraud.** In California, the vast majority of charter schools are authorized by local school districts that lack adequate staffing to monitor charter schools and ferret out fraud. Staff members who are responsible for oversight often juggle competing obligations that make it difficult to focus on oversight and identify signs of potential fraud and abuse.

To address these serious deficiencies in California's system, we recommend the following reforms:

## Mandate Audits Designed to Detect and Prevent Fraud

- Charter schools should be required to institute an internal fraud risk management program, including an annual fraud risk assessment.
- Charter schools should be required to commission an annual audit of internal controls over financial reporting that is integrated with the audit of financial statements charter schools currently commission. These integrated audits should require auditors to provide an opinion on the quality of internal controls and financial statements.
- Oversight agencies, such as the State Comptroller's Office and Fiscal Crisis and Management Assistance Team (FCMAT), a state agency, should conduct audits on charter schools once every three years.
- Auditing teams should include members certified in Financial Forensics trained to detect fraud.

## Increase Transparency & Accountability

- Oversight agencies should create a system to categorize and rank charter audits by level of fraud risk they pose to facilitate public engagement.
- Oversight agencies should post the findings of their annual internal assessments of fraud risk on their websites.

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<sup>b</sup> Using the methodology employed by the Association for Certified Fraud Examiners 2014 Report to Nations on Occupational Fraud and Abuse to determine the total amount of fraud globally, we estimate that California's charter schools may experience more than \$100 million in fraud in 2015. See *infra* footnote d.

- Oversight agencies should determine what steps charter school nonprofit governing boards and executives have taken to guard against fraud over the past 10 years and issue a report to the public detailing their findings and recommendations.
- Charter school authorizers should take fraud risk assessments into account when evaluating whether to renew a school's charter.
- Until the state implements the oversight mechanisms described above, authorizers should only approve new charters that commit to the fraud controls recommended above.

Given the rapid and continuing expansion of the charter school industry and the tremendous investment of public dollars, California must act now to reform its oversight system. Without reform, California stands to lose millions of dollars as a result of charter school fraud, waste, and mismanagement.

## Introduction

In 1992, California passed the Charter Schools Act, authorizing the creation of 100 charter schools across the state.<sup>3</sup> Today, California has the largest charter school population in the nation with over 1100 charter schools providing instruction to over half a million students.<sup>4</sup> This expansion shows little sign of slowing. In 2014, 104 new charter schools opened in California,<sup>5</sup> representing a 63% increase in the annual number of charters opened in California over the last eight years.<sup>6</sup> This year, charter schools will receive over \$3 billion in public funding.

To help ensure that charter schools are held financially accountable to students, families and taxpayers, state lawmakers have enacted laws that require charter schools to submit to monitoring by oversight agencies and to report regularly to their authorizers and other government agencies. Under these regulations, every charter school in California is required to submit the following financial reports:

- A preliminary budget, an annual update, and interim financial reports to its chartering entities and the county superintendent of schools; and
- An annual independent financial audit to its chartering entities, the State Controller, and the county superintendent of the schools of the county where the school is sited.<sup>7</sup>

Chartering entities,<sup>c</sup> county superintendents, and the State Controller have primary financial oversight responsibility over charter schools.<sup>8</sup> As a result of an amendment to the Charter Schools Act in 2006, county superintendents who suspect fraud or mismanagement at charter schools may request an “extraordinary audit” from the Financial Crisis and Management Team (FCMAT), a state agency charged with helping local educational agencies fulfill their financial and management responsibilities. Serious fraud has been uncovered by FCMAT and whistleblowers; however, the state’s financial oversight system is reactionary by design and none of the state’s oversight bodies proactively monitor for fraud, waste, mismanagement or abuse. FCMAT only conducts audits when requested to do so by county superintendents and chartering entities, county superintendents, and the State Controller does not conduct regularly scheduled audits.

California has experienced \$81,400,000 in known charter school fraud, waste, and mismanagement. Given the reactive oversight approach in the state, the true figure is likely significantly larger.<sup>9</sup> Using the methodology employed by the Association for Certified Fraud Examiners 2014 *Report to Nations on Occupational Fraud and Abuse*, we estimate California’s charter schools will experience more than \$100 million in fraud in 2015 alone.<sup>d</sup>

### Regulators Critical of Charter Oversight

In 2002, the California State Auditor issued a report critical of the charter school oversight in the state, finding “that chartering entities lacked policies and procedures for [fiscal] monitoring and have not adequately monitored their charter schools’ fiscal health, even though some charter schools appear to have fiscal problems.”<sup>12</sup> While “the chartering entities [under review] asserted they had procedures for reviewing fiscal data and identifying and resolving problems, none could provide evidence of such” to the State Auditor.<sup>13</sup> In addition, chartering entities lacked “policies and procedures in place for reviewing the audit reports of their charter schools to determine the significance of any audit findings,” which prevented them from adequately reviewing financial reports and ensuring that problems were resolved.<sup>14</sup>

<sup>c</sup> In California, local school districts, county boards of education and the State Education Department may all authorize charter schools.

<sup>d</sup> Using the methodology employed by the Association for Certified Fraud Examiners 2014 Report to Nations on Occupational Fraud and Abuse, which assumes 5% of total revenues lost to fraud, to determine the total amount of fraud globally, we estimate California’s charter schools may have experienced more than \$100 million in fraud in 2013-14 alone. Calculation uses an estimate of total California charter school revenue for 2013-14 at approximately \$4 billion. A conservative estimate of total revenue is derived from 2013-14 charter school enrollment of 514,275 multiplied by per ADA figure for 2013-14 of \$8,005, amounting to more than \$4 billion and excludes additional sources of state revenue. See <http://www.lao.ca.gov/reports/2013/bud/spending-plan/spending-plan-073013.aspx> (ADA figure) and <http://www.cde.ca.gov/ds/sd/cb/ceffingertipfacts.asp> (charter enrollment).

California is not alone. The federal government has identified serious deficiencies in charter school oversight across the country. In 2010, the federal Department of Education’s Office of Inspector General issued a memorandum to the Department of Education’s Office of Innovation and Improvement. The OIG stated that the purpose of the memorandum was to “alert you of our concern about vulnerabilities in the oversight of charter schools.”<sup>10</sup> The report went on to state that the OIG had experienced “a steady increase in the number of charter school complaints” and that state level agencies were failing “to provide adequate oversight needed to ensure that Federal funds [were] properly used and accounted for.”<sup>11</sup>

Instances of reported financial misdeeds in California charter schools include:

YEAR <sup>15</sup>	DESCRIPTION
2014	FCMAT uncovered instances of related party transactions and self-dealing at Wisdom Academy of Young Scientists Charter Schools (WAYS), totaling \$2,673,805. <sup>16</sup> WAYS authorized payments for excessive amounts of school supplies, which were provided by vendors who were family members or close acquaintances of the former executive director at exorbitant prices.
2014	The Office of the Inspector General (OIG) of the Los Angeles Unified School District released an audit highlighting troubling financial practices at several Magnolia Charter Schools. After reviewing a sample of transactions conducted by the schools in 2012, the OIG “found over \$43,000 in duplicate payments to vendors, flagging those as potential misuse of funds.” <sup>17</sup> The report also highlighted a questionable relationship between the schools and one vendor, whose fees amounted to nearly 30% of the Magnolia’s total expenses over a two-year period. <sup>18</sup> In addition, Magnolia spent over \$200,000 on visa and immigration fees in 2009-2010; a review of a sample of those fees revealed that six of the nine expenses were tied to people who did not work for the school. <sup>19</sup>
2012	FCMAT uncovered a number of serious questionable financial practices at American Indian Model Charter Schools (AIMS). The schools’ founder made a number of personal charges on AIMS accounts, including San Francisco Giants’ tickets, Amazon, and Direct TV. Some of the charges occurred after the founder had stopped working for the schools. Outside of these personal charges, the schools could not provide documentation to support 35% of credit card charges under review. AIMS schools paid nearly \$350,000 to the founder’s private companies over a one-year period. <sup>20</sup> An estimated \$3.7 million of school funds may have been diverted to the founder’s businesses. <sup>21</sup>
2009	Mexican American Community Service Agency’s El Portal Leadership Academy and Academia Calmercac Charter failed to contribute employee payroll deductions into employees’ retirement accounts, illegally diverting over \$1 million to pay for the schools’ operating costs, including computers and office supplies. <sup>22</sup>
2008	A FCMAT audit of Oak Hills Academy Charter School uncovered thousands of dollars in missing equipment, falsified signatures, instances of nepotism when close friends and family members of the principal were hired or given raises, possible false billing, misuse of credit cards — with no documentation that the charges were school related. <sup>23</sup>
2007	According to an extraordinary audit conducted by FCMAT, the executive director of Albor Charter School “funneled more than \$12 millions in state funds to several businesses owned by him, his supposed wife, and their friends.” <sup>24</sup>
2005	The founder of four California Charter Academy Schools engaged in a series of questionable practices, including transferring \$3.5 million to a for-profit company he created without board approval; directing \$920,000 of charter school funds to the founder’s subsidiary companies; and using \$1.2 million of charter school funds to employ family members and close associates. <sup>25</sup>

## Holes in the Current Oversight System

The FCMAT audits and the various media exposés of charter operator fraud, waste, and abuse demonstrate consistent and possibly widespread weaknesses in the internal controls of California’s charter schools. But the annual independent audits that charter schools are required to submit fail to catch these weaknesses because they are not designed to detect or prevent fraud. In the audits typically required, independent auditors are charged to check the veracity and accuracy of the financial statements charter schools provide to them—but not to assess whether the schools’ internal controls are adequate or effective at preventing or detecting mismanagement, fraud, or other abuse. Indeed, in our review of the independent audits of charter schools in the state, we found that all of the reports contain the same disclaimer explaining that the auditors do not form an opinion on the efficacy of internal control mechanisms:

In planning and performing our audit of the financial statements, we considered [the charter school’s] internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of [charter school’s] internal control.<sup>26</sup>

To deter and uncover waste, fraud and mismanagement, charter schools and oversight agencies must adopt audit methodologies and systems specifically designed to assess the effectiveness of internal control systems and they must develop a system that regularly audits all charter schools.

### Systems that Detect and Prevent Fraud

No oversight agencies routinely audit charter schools in California. The only audits charter schools routinely undergo are the ones they commission and pay for themselves. Many of the techniques used and areas covered by the charters’ independent auditors overlap with the methodologies that specialized auditors employ to uncover fraud, but the key difference is the purpose. “Traditional audits,” writes an expert on fraud audits, “can uncover fraud, but they don’t seek it out. Instead, they look at records to check if prices charged on contracts are reasonable or if contractors have compliant accounting systems in

### California’s Attempts to Increase Charter School Oversight & Accountability

In the last two decades, California lawmakers have made efforts to combat fraud in charter schools and improve fiscal oversight of the state’s education system by augmenting the reporting requirements of charter schools and the oversight duties of authorizers.

- In 2003, lawmakers enacted AB 1137, which requires chartering entities to identify at least one staff member as a contact for each charter school; requires charter entity staff to visit charter schools at least once annually; requires chartering entities to ensure that each charter school fulfills its reporting requirements; requires chartering entities to monitor the fiscal condition of each of its charters; and requires chartering entities to notify the Department of Education whether a school’s charter will be renewed or revoked or whether the school will cease its operations for any reason.<sup>27</sup>
- In 2006, legislators enacted SB 430, which authorizes county superintendents to review the audit expenditures and internal controls of a charter school if he or she believes that fraud, misappropriation, or other illegal financial practices have occurred.<sup>28</sup> SB 430 also authorizes county superintendents to request a review of a charter school’s fiscal condition from the Fiscal Crisis Management Assistance Team (FCMAT),<sup>29</sup> an entity created by the state legislature to help local educational agencies, including chartering entities, fulfill their managerial and fiscal oversight responsibilities.<sup>30</sup>

In recent years, California legislators have made additional attempts to further improve charter school accountability, such as AB 913 from the 2013-2014 legislative session, which would have subjected charter schools to the same conflicts of interest prohibitions that apply to regular public schools. These attempts, however, have been unsuccessful. As a result, California’s current oversight system does not go far enough to detect and deter fraud.



place.”<sup>31</sup> By contrast, fraud audits are specifically designed to look for and uncover instances of fraud, mismanagement, or abuse—and to assess whether schools have adequately strong internal controls in place to prevent such misconduct. A detailed overview of fraud audit methodology can be found in Appendix B.

Regularly scheduled audits conducted by authorizers or the FCMAT would be an important first step to improving oversight of charter schools in California. Fraud controls on the school level and targeted fraud audits by oversight bodies, however, would better protect the sizeable public investment in charter schools.

### Internal Control Systems at Charter Schools

Given the millions of dollars in charter school fraud that has likely gone undetected in California and the large amounts of charter fraud occurring nationwide, the state should require the active participation of charter schools in identifying possible vulnerabilities. Notably, even in the absence of such a legal requirement, charter schools could also voluntarily implement an internal fraud prevention program.

Hallmarks of an effective, comprehensive fraud prevention system include:

- Taking proactive steps to educate all staff and board members about fraud;
- Ensuring that one executive-level manager coordinates and oversees the fraud risk assessment and reports to the board of directors, oversight bodies, and school community;
- Implementing reporting procedures that include conflict disclosure, whistleblower protections, and a clear investigation process;
- Undergoing and posting a fraud risk assessment conducted by a consultant expert in applicable standards, key risk indicators, anti-fraud methodology, control activities, and detection procedures; and
- Developing and implementing quality assurance, continuous monitoring, and, where necessary, correction action plans, with clear benchmarks and reporting.<sup>32</sup>

These internal measures would help contribute to a culture of vigilance that aligns with the public’s interest in ensuring that all resources intended for children’s education are appropriately deployed. It would also help identify areas in which each charter school is vulnerable to fraud and target areas for the oversight agencies to pay particular attention. As mentioned above, part of establishing an effective internal control system is conducting a fraud risk assessment. An effective fraud risk assessment:

- Identifies inherent fraud risk through the explicit consideration of all types of fraud schemes and scenarios; incentives, pressures, and opportunities to commit fraud; and information technology fraud risks specific to the organization;

#### Key Role Governing Boards Play

The three premier auditing membership associations, The Institute of Internal Auditors, the American Institute of Certified Public Accountants, and the Association of Certified Fraud Examiners recently partnered to develop a fraud mitigation guide titled, *Managing the Business Risk of Fraud: A Practical Guide*. The *Guide* explains the key role governing boards play:

The board of directors should ensure that its own governance practices set the tone for fraud risk management and that management implements policies that encourage ethical behavior, including processes for employees, customers, vendors, and other third parties to report instances where those standards are not met. The board should also monitor the organization’s fraud risk management effectiveness, which should be a regular item on its agenda. To this end, the board should appoint one executive-level member of management to be responsible for coordinating fraud risk management and reporting to the board on the topic.<sup>34</sup>

- Assesses the likelihood and significance of inherent fraud risk based on historical information, known fraud schemes, and interviews with staff;
- Creates effective and appropriate responses to possible, existing, or residual fraud risks; and
- Performs a cost-benefit analysis of fraud risks to help the organization decide which controls or specific fraud detection procedures to implement.<sup>33</sup>

Some of the fraud that has occurred in California is likely a symptom of weak internal controls. Since over three billion dollars of public tax dollars flow into the charter system each year, it is important that all charter schools adopt strong internal control systems that assess the risk of fraud within their schools. While it is incumbent upon charter school management and governing boards to establish strong internal controls, charter school oversight agencies must incorporate regular audits of internal controls and targeted fraud audits into their auditing protocols.

### Fraud Audits

While state law requires charter schools to submit independent annual financial audits as part of their annual reports, oversight agencies can and should broaden the parameters of their oversight by conducting risk based targeted fraud audits that are designed specifically to detect misappropriation, financial reporting fraud, and corruption.<sup>36</sup> These fraud audits should begin with a review of the internal control system itself. While fraud can occur in companies with strong or weak internal control mechanisms, studies show that the companies with the best track record of preventing and detecting fraud are those with the strongest internal control fraud risk management programs.<sup>37</sup>

For schools with stronger internal control systems, oversight agencies would use a fraud risk assessment to identify areas of particular vulnerability and target areas for the fraud audit. Where internal control systems are weaker, the authorizer would conduct broader fraud audits. In order to facilitate fraud audits across oversight agencies, the agencies should coordinate to identify possible fraud schemes, how they occur, and what symptoms they exhibit.

In addition, we recommend that FCMAT conduct audits of every charter school in California every three years.

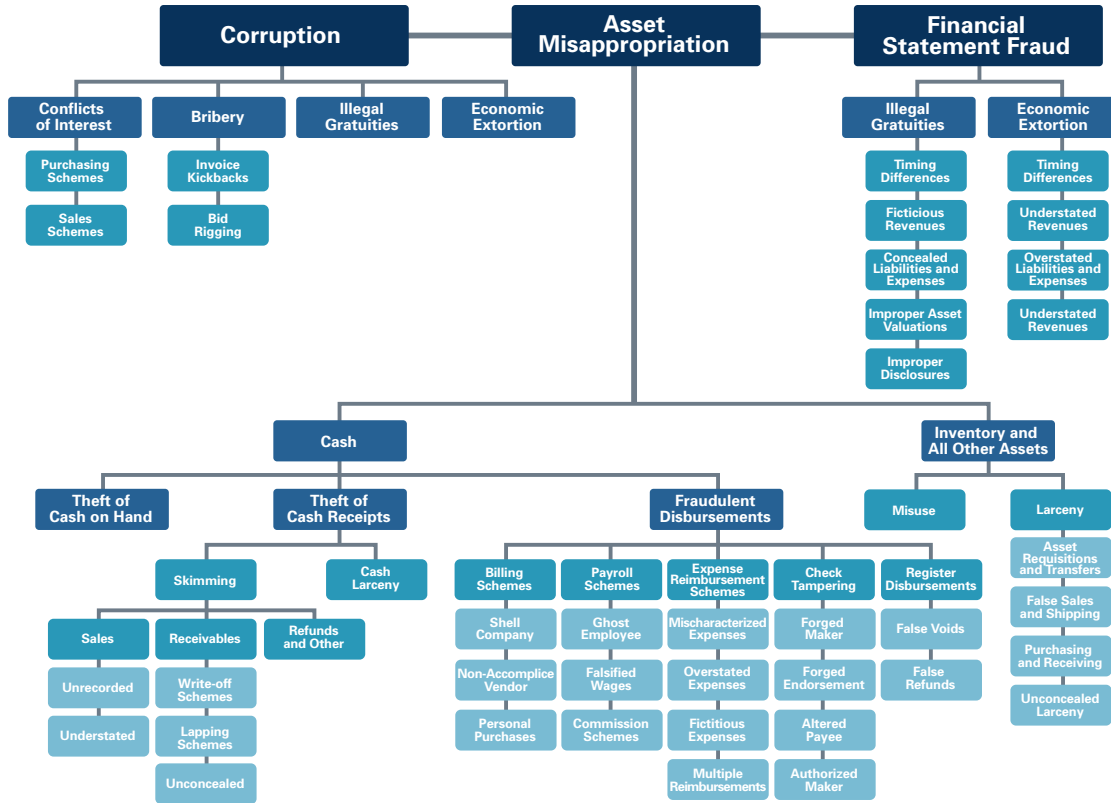
### Government Agencies Adopt Proactive Fraud Practices

Recognizing the difference between traditional audits and fraud audits, the United States General Services Administration (GSA) inspector general's office recently rolled out a five-person team devoted to using forensic auditing techniques to dig up evidence of fraud. They did this after other agencies, including the Department of Defense, NASA, and the EPA brought on their own fraud auditing teams. The GSA and other agencies did this at the urging of the National Procurement Fraud Task Force, an interagency group that promotes the prevention, early detection and prosecution of fraud. The GSA explained their move in a press release stating,

"As new computer-based data-mining techniques have evolved, new possibilities have emerged for auditors to be more proactive in looking for improper activity such as fraud. Now, auditors have tools that can allow them to more easily and regularly analyze and compare vast sets of data to reveal patterns of behavior that would evade traditional audit reviews...Forensic auditors try to match symptoms of fraud, think about how perpetrators might defraud the system, and then run tests to see if the symptoms of that kind of fraud show up... By being more proactive—through regular forensic audits—auditors can help keep some fraud from ballooning into multimillion-dollar cases."<sup>35</sup>

## Fraud Tree

The Association of Certified Fraud Examiners (ACFE) has diagrammed a ‘fraud tree’ to explain the distinction between the three major types of fraud.<sup>38</sup> Asset misappropriation fraud is the most common type of fraud committed within corporations, and it is also the type of fraud most commonly found in Illinois’ charter schools. This type of fraud involves the misuse or theft of assets belonging to a company.<sup>39</sup> According to a 2014 global fraud study conducted by the ACFE, 85 percent of all internal fraud schemes involved asset misappropriation.<sup>40</sup>



## Enough Auditors

While school districts, county boards of education, and the state Board of Education can authorize charter schools in California, “most charter schools are authorized by school districts, and most school districts have authorized only one school.”<sup>41</sup> School districts vary considerably in terms of their resources, size, and capabilities.<sup>42</sup> As FCMAT has noted, “[n]ot all school districts are equally capable of providing oversight for charter schools they may authorize.”<sup>43</sup> Authorizers, particularly local school districts, often lack sufficient staff and resources to conduct in-depth and targeted audits. According to one report, less than a quarter of authorizers have full-time staff whose sole duty is charter school oversight.<sup>44</sup> About 70 percent of chartering authorities have full-time staff assigned part time to the oversight of charter schools.<sup>45</sup> Usually, staff members who are responsible for oversight serve dual roles and have additional responsibilities, such as managing special education programs, serving as an administrator or teacher at a charter school.<sup>46</sup> As a result, staff members may juggle competing commitments that make it difficult to focus on oversight and identify signs of potential fraud or abuse.

In 2003, the study *Charter School Operations and Performance* warned that, “[u]nderstaffing creates a substantial risk that waste, fraud, financial mismanagement and employee misconduct go undetected.”<sup>47</sup> To mitigate the risk of fraud, the state must fully fund and staff authorizers and the

California Department of Education at levels that allow them to carry out the oversight functions necessary to detect waste, fraud and abuse.

## Recommendations

Self-policing audits commissioned by charter schools routinely fail to uncover fraud, waste, and abuse of public tax dollars and oversight agencies fail to routinely audit charter schools to ferret out fraud. As a result, significant risk is built into the current charter sector in California. The limited number of oversight agency audits that have been conducted since California passed its charter school law suggests that fraud, waste and mismanagement may be widespread among charter schools. Oversight agencies must better protect the \$3 billion investment in charters by the State of California and local school districts. Until the state implements the oversight mechanisms described above, authorizers should only approve new charters that commit to the fraud controls recommended above.

Detecting and deterring potentially millions of dollars in charter school fraud will likely offset the necessary costs of effective charter school oversight.

In order to uncover existing fraud schemes and deter future fraud, we recommend that every charter be required to conduct a mandatory fraud risk assessment and update the assessment annually. Charter schools should be required to use an external fraud risk assessment consultant with expertise in applicable standards, key risk indicators, anti-fraud methodology, control activities, and detection procedures to assist charter school governing boards and management in their fraud risk assessments. We further recommend that charter school authorizers take fraud risk assessments into account when evaluating whether to renew a school's charter.

We also recommend that charter schools be required to commission an annual audit of internal controls over financial reporting that is integrated with the audit of financial statements that charter schools are already required to do on an annual basis. These integrated audits should require auditors to provide an opinion on the quality of internal controls and financial statements. Charter schools should also include the audit of internal controls in their annual update, which state law already requires.

In addition to the above measures, we recommend every charter school institute a fraud risk management program, which will involve:

- Taking proactive steps to educate all staff and board members about fraud;
- Ensuring that one executive-level manager coordinates and oversees the fraud risk assessment and reports to the board, oversight bodies, and school community;
- Implementing reporting procedures that include conflict disclosure, whistleblower protections, and a clear investigation process;
- Undergoing and posting a fraud risk assessment conducted by a consultant expert in applicable standards, key risk indicators, anti-fraud methodology, control activities, and detection procedures; and
- Developing and implementing quality assurance, continuous monitoring, and, where necessary, corrective action plans with clear benchmarks and reporting.

We recommend requiring the FCMAT to conduct audits of charter schools once every three years, with audits posted on their websites within 60 days of completion. They should also design a system that indicates the level of risk uncovered at each school. The FCMAT should also create a dedicated charter school fraud hotline for whistleblowers. In addition, the Attorney General's office

should partner with the State Controller's office to determine what steps charter school nonprofit governing boards and executives have taken to guard against fraud. The investigation should involve requests for information from each charter school detailing their fraud risk assessments and fraud risk management program over the past 10 years. The investigation should be presented to the public in a report detailing the findings and recommendations based on the investigation.

We recommend that the FCMAT's auditors assigned to charter schools be certified in fraud examinations by the Association of Certified Fraud Examiners and in financial forensics by the American Institute of Certified Public Accountants, or by an equivalent certification body. If current auditors do not have this certification, they should be provided the time and funding to acquire it. If auditors lack certain critical elements in their fraud auditing team, such as a forensic fraud computer expert, we recommend that they be required to contract with an independent firm or be required to collaborate with another auditing body to fill that capacity need.

# Appendix A: Examples of Charter School Fraud, Waste, and Abuse in California

## California Charter Academy

Former Hesperia, California mayor and councilman Tad Theron Honeycutt and California Charter Academy founder Charles Steven Cox were indicted in 2007 for misappropriating \$5.5 million in public funds from the network of charter schools. Political wrangling has kept the case from going to trial for six years.

The pair shares a combined 117 felony charges for misappropriation of public funds, grand theft, tax evasion and filing a false tax return, court records show. A state audit indicates that Honeycutt's spending of funds included \$18,000 for two jet skis and \$1,942 at the Guitar Center. The 2005 audit, commissioned by the California Department of Education, also claimed Cox took millions from the public schools to benefit his friends and family, eventually leading to the collapse of the academy. The two also controlled two management firms that provided services to the network of schools.

Sources: <http://www.vvdailypress.com/articles/counts-2668-cox-charter.html> <http://www.vvdailypress.com/articles/trial-42605-charter-hearing.html>

## Ivy Academia Charter School

Yevgeny "Eugene" Selivanov and his wife, Tatyana Berkovich, founders of Ivy Academia Charter School with three campuses in the San Fernando Valley, were sentenced on October 4, 2013 for misappropriating more than \$200,000 in public funds. Selivanov received a sentence of four years, eight months, and Berkovich received a forty-five day sentence and 320 hours of community service followed by five years' probation. They argued that most of the funds were spent on teacher appreciation activities to build morale. The California Charter Schools Association filed a brief in the case arguing that no crime had occurred, and warned that the case could undermine charter school flexibility and expose other operators to prosecution.

Source: <http://articles.latimes.com/print/2013/oct/04/local/la-me-1005-charter-sentence-20131005>

## LA Academy

Steven A. Bolden pleaded guilty on January 2, 2014 to stealing more than \$7.2 million worth of computers from a government program. Between 2007 and 2012, Bolden invented more than a dozen education non-profits, including fake charter schools, to benefit from a General Services Administration program that gives surplus computer equipment to public schools and non-profits. In July 2012, a GSA undercover investigator was contacted by Palmdale Educational Development Schools, one of Bolden's organizations, and sent Bolden 9 laptop computers, which Bolden sold via Craigslist.

Source: <http://www.seattlepi.com/local/article/Charter-school-con-man-admits-to-7-2-million-5112206.php>

## Center for Excellence in Education

On September 7, 2004, the Bear Valley Unified School District board of trustees voted unanimously to revoke the charter of the Center for Excellence in Education. The school district argued that the charter school had failed to comply with a number of regulations on teaching credentials, conflicts of interest, and what the district characterized as "inappropriately close" relationships with several religious organizations. The founding director of the school, John Dunn, simultaneously acted as a board member and as the school's landlord. His successor director also violated the California Government Code by serving as a paid employee and board member. Employees received bonuses and advances paid with public funds, in violation of the state Constitution. In 2006, Dunn filed suit against the district, superintendent, and school board members, alleging that the charter revocation violated due process rights.

Sources: [http://www.bigbeargrizzly.net/news/article\\_bedcf990-92df-5bf3-bf1e-a352328eabca.html](http://www.bigbeargrizzly.net/news/article_bedcf990-92df-5bf3-bf1e-a352328eabca.html)

[http://www.bigbeargrizzly.net/news/article\\_e0e50ee5-ac1f-5743-b2d7-c03417bd7d77.html](http://www.bigbeargrizzly.net/news/article_e0e50ee5-ac1f-5743-b2d7-c03417bd7d77.html)

## American Indian Public Charter School II

In 2012, California's Fiscal Crisis and Management Assistance Team conducted an investigation into the American Indian Public Charter School II in Oakland after a former employee blew the whistle on suspicious financial activity between the school and a real estate company owned by the school's founder and chief executive, Ben Chavis. The investigation found up to \$3 million of questionable transactions between the charter school and Chavis's companies. Chavis is accused of embezzling with the help of his wife, an administrator at the school. "When an organization lacks internal controls and governing board oversight is minimal," the auditing team wrote in a letter to Alameda County Superintendent Sheila Jordan, "the likelihood of fraud greatly increases."

Source: <https://www.wsws.org/en/articles/2012/04/char-a24.html>

### Cato School of Reason Charter School

In 1998, LA Weekly investigated the operations of the Cato School of Reason. The charter entity, created in 1994, had come up with a money making scheme that netted it millions of public dollars. Cato formed various types of partnerships with private schools, allowing the charter to “enroll” hundreds of private school students and bring in millions in public dollars, which were then shared with some of the private school operators. In a second wave of fraud, the California State Controller found that the now-closed CATO II School of Reason had signed up 40 private schools that were converted into charter schools, receiving both state funds and paid tuition. All told, Cato’s founder Thomas Cosgrove has netted millions on the schools. According to the LA Weekly, “Cosgrove has successfully exploited the flip side to the charter-school mantra of deregulation and local control. Along with the freedom to reform came a distinct lack of oversight. Charter-school legislation never clearly addressed who was responsible when something went wrong. Nor did reformers fully consider that a charter school could exist for reasons other than the best interests of children. They never contemplated that their reforms would unchain dollars as well as ideas. And that state education funds were dangling for the taking by school operators who could obtain a local charter, then devise ways to crunch down costs for financial gain.”

Sources: <http://www.laweekly.com/1998-08-20/news/charter-school-for-scandal-page-1/>

<http://www.laweekly.com/1998-08-20/news/charter-school-for-scandal-page-2/?storyPage=2> <http://irascibleprofessor.com/comments-3-27-00.html>

### Magnolia Charter Schools

In 2014, the California State Auditor launched an investigation into Magnolia Public Schools, a Southern California-based charter network in response to findings of the L.A. Unified’s Office of the Inspector General. The investigation revealed a litany of suspicious financial activity and mismanagement, including \$43,000 in duplicate payments to vendors and almost \$3 million in payments to Magnolia’s management organization in poorly documented loans that were never paid back. The audit also highlighted the overly close relationship between Magnolia and its vendor, Accord Institute for Education Research, which provided services like curriculum development and teacher evaluations. Over a two year period, Accord’s fees amounted to nearly 30% of Magnolia’s total expenses. According to the audit, “[t]his expenditure in excess of available funds can be construed as mismanagement and lack of proper budget controls” at the schools. Magnolia also spent \$206,489 on immigration fees—six of nine expense reports the audit team sampled were linked to people who were not even school employees.

Source: <http://www.scpr.org/blogs/education/2014/08/14/17153/california-state-auditor-probing-la-s-magnolia-cha/>

### Wisdom Academy of Young Scientists

In May 2013, the Los Angeles County Office of Education contacted Fiscal Crisis and Management Assistance Team to conduct an extraordinary audit of Wisdom Academy of Young Scientists (WAYS) charter schools, after the county office received multiple allegations of questionable expenditures and financial irregularities at the schools. The audit found that WAYS’ management and governing board engaged in a “litany of financial irregularities...which investigators described as rife with possible criminal fraud, conflicts of interest, and misappropriation of public funds.” According to the audit, the WAYS board failed to properly oversee the network, giving the founder and former director of WAYS, Kendra Okonkwo, carte blanche access to the networks’ assets and authority to enter into several business arrangements for personal gain. In 2011, when the L.A. Unified District agreed to conditionally approve the operation of the charter on the condition that Okonkwo resign as director, Okonkwo appointed several family members to key posts in the organization. In total, Okonkwo’s family members and acquaintances received \$2.6 million in payments from the school. The audit also found that the organization paid Okonkwo nearly \$1 million in lease payments for properties she owned and nearly \$230,000 in unused vacation and severance despite the lack of documentation to substantiate the payout. The investigation revealed that the school paid \$158,800 to a company owned by one of Okonkwo’s relatives for supplies that the organization could not prove it ever received. Perhaps, most troubling, the audit found that the organization paid a “\$566,803 settlement to a former teacher who sued the organization for wrongful termination after she was directed by Okonkwo to travel with her to Nigeria to marry Okonkwo’s brother-in-law, for the purpose of making him a United States citizen.”

Sources: <http://www.latimes.com/local/education/la-me-wisdom-academy-20140929-story.html>

<http://fcmat.org/wp-content/uploads/sites/4/2014/03/LACOEWAYSAB139finalreport3-20-14.pdf>

### El Portal Leadership Academy and Academia Calmercac Charter Schools

In 2012, prosecutors charged two former officials at Mexican American Community Service Agency’s El Portal Leadership Academy and Academia Calmercac Charter Schools with felony grand theft, following allegations that they used nearly \$1 million in employee employment retirement savings to cover the schools’ operating costs, including \$13,000 for office supplies and \$7,000 for new computers, and their own pay. At least one of the charged officials personally benefited from the scheme when she stopped making contributions to her retirement account and received a 3% raise in two successive years. Presumably, the employee pension contributions were used to cover her raises.

Sources: [http://www.mercurynews.com/ci\\_20433326/report-two-be-charged-san-jose-community-group](http://www.mercurynews.com/ci_20433326/report-two-be-charged-san-jose-community-group)

<http://fcmat.org/wp-content/uploads/sites/4/2014/02/SantaClaraCOEMACSAfinalrepor.pdf>

### Westwood Charter School

Following an audit conducted by the Fiscal Crisis and Management Assistance Team, the state investigated a school administrator for violation of state conflict of interest laws. Henry Bietz, the official under investigation, served as the superintendent of Westwood Unified School District, the superintendent of Westwood Charter School, which the district authorized, and the CEO of Westwood Charter School Services, Inc., which provided services to the charter school. The audit team found that Bietz' employment as superintendent of the school district and the services he provided to the charter school may have violated provisions of California law. Between 2004 and 2008, Bietz received over \$800,000 in earnings from Westwood Charter School and Westwood Charter School Services and over \$100,000 in earnings as superintendent of the Westwood Unified School District. Bietz also worked as a consultant for 65 days during the audit period. The audit team found that many of the consulting days occurred during days that had already been contracted for by the Westwood Unified School District.

Sources: <http://www.redding.com/news/lassen-county-school-superintendent-investigated>  
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### Oak Hills Academy Charter School

In 2007, following allegations of fraud at Oak Hills Academy Charter School, the Fiscal Crisis and Management Assistance Team conducted an extraordinary audit, which revealed serious deficiencies in the school's internal controls and management. According to the audit, the charter school failed to properly account for its inventory, as required by its charter agreement. For instance, the audit team could not find 151 of 193 plants purchased by the school estimated to cost \$1,656 and two computers estimated to cost \$2,600. The school also failed to maintain adequate and complete payroll records. The audit team found evidence that school personnel falsified authorization for pay rates increases and positions and evidence of rampant nepotism, with the principal making hiring and compensation decisions for family members and close associates. The audit's finding on nepotism, for example, states the principal made the decision to hire her mother as a teacher, a position supervised by the principal herself. The board clerk authorized hiring his wife's cousin, who had a serious illness. According to the document, "[t]he individual earned \$1,200 in 2005-06 and \$870 in 2006-07. However, the individual received full-time health and welfare benefits costing \$874.65 per month." The audit uncovered insufficient documentation to substantiate that credit card charges to the amount of \$18,526 in 2006-07 and \$14,332 in 2007-08 were school-related. In addition, the audit found the employees falsified signatures for expenses incurred by family members and close friends. The audit has been turned over to the Butte County District Attorney's Office for further investigation.

Sources: [http://www.chicoer.com/ci\\_10432891](http://www.chicoer.com/ci_10432891)  
<http://fcmat.org/wp-content/uploads/sites/4/2014/02/ButteCOEOakHillsCharterrepor.pdf>

### Albor Charter School

In 2007, an audit revealed that the executive director of Albor Charter School, Emilio Vazquez, "funneled more than \$12 million in state funds to several businesses owned by him, his supposed wife, and their friends." Allegations of fraud and mismanagement led to the revocation of Albor's charter in 2005. The school managed to stay open following a legal challenge the following year. In 2006, Emilio Vazquez, closed the school with little to no notice and failed to perform financial accounting of the school's liabilities and assets as required by state law, which triggered an extraordinary audit by Fiscal Crisis and Management Assistance Team. According to the audit, "while Albor was purportedly a high school, it appeared in reality to be a vocational school for adults. Brochures mentioned certified nursing assistant, medical assistance and computer technology programs, with little, if any, description of high school classes." The audit also found that students may have been charged attendance fees, which are illegal. Lastly, the audit found "Vazquez had delegated administrative operations of Albor and funneled more than \$12 million in state funds to MI—Vocational School, a business he also controlled. Some of this money was then given to Vagabond Entertainment, EMPE Inc., A&E Financing Inc. and other companies controlled by Vazquez, his supposed wife...and their associates." These companies did not seem to be "related in any way, shape or form to educating students" at the school. The audit findings were turned over the Orange County district attorney's office for further review.

Sources: <http://articles.latimes.com/2007/oct/10/local/me-charter10>  
<http://fcmat.org/wp-content/uploads/sites/4/2014/02/AlborCharterSchoolExtraordin.pdf>

### Sierra Summit Academy Charter School

In 2005, former Sierra City school superintendent and charter school executive Jeff Bauer was sentenced to 8 months in jail and 5 years' probation as a result of an audit and investigation by the California State Controller's Office. According to an audit, Bauer "misused state funds intended to help children." As part of his sentence, Bauer had to pay the state \$317,668. Bauer pleaded no contest to criminal charges of conflict of interest and misappropriation of public funds.

Source: [http://www.sco.ca.gov/Press-Releases/2005/bauer\\_case0113.pdf](http://www.sco.ca.gov/Press-Releases/2005/bauer_case0113.pdf)



## Challenge Charter School

Challenge Charter High School will close its doors at the end of the school year, following a decision by school administrators and staff at Wednesday evening's Oroville Union High School District board meeting.

With the school's petition up for renewal this year, the board of trustees was to consider the approval or denial of the school's charter at Wednesday's meeting. However, before board members could discuss the issue, school Principal Walt Gess withdrew the petition renewal -- opting to simply let the petition run out in July, with the school closing at that time. As Superintendent Oran Roberts was about to deliver his recommendation to the board regarding the charter school, Gess approached Roberts, requesting permission to address the board. Roberts obliged and Gess controlled the lectern for several minutes, ultimately telling the board and audience that the school could not remain open and that "with reluctance" he "wished to respectfully withdraw the petition for renewal." Gess cited severe financial problems for his decision, claiming the school will not only face reduced funding due to state budget cuts this year, but actually owes the state an estimated \$591,000. Although the school was allotted money for the students, it was discovered earlier this year that approximately 65 percent of the students the school received money for did not actually attend Challenge Charter for the required amount of time. In a memorandum that was circulated to the board and audience members, Roberts stated that in addition to the school's fiscal issues, Challenge Charter "presents an unsound educational program." When comparing standardized test scores of Challenge Charter to the two comprehensive high schools, Roberts found that the school continually under-performed, with test score averages considerably lower than Las Plumas and Oroville High. AND "District staffers suspect fraud in the closures of some San Diego charters, most notably Children's Conservation Academy, which closed in August. San Diego Unified claims that CCA spent hundreds of dollars on Padres tickets, cell phone bills and gym memberships, and paid more than \$11,000 to executive director Nicole Decatur's mother, a past board president, with little proof of the work she'd performed."

Source: <http://voiceofsandiego.org/2007/12/04/when-charters-close-public-schools-foot-the-bill/>

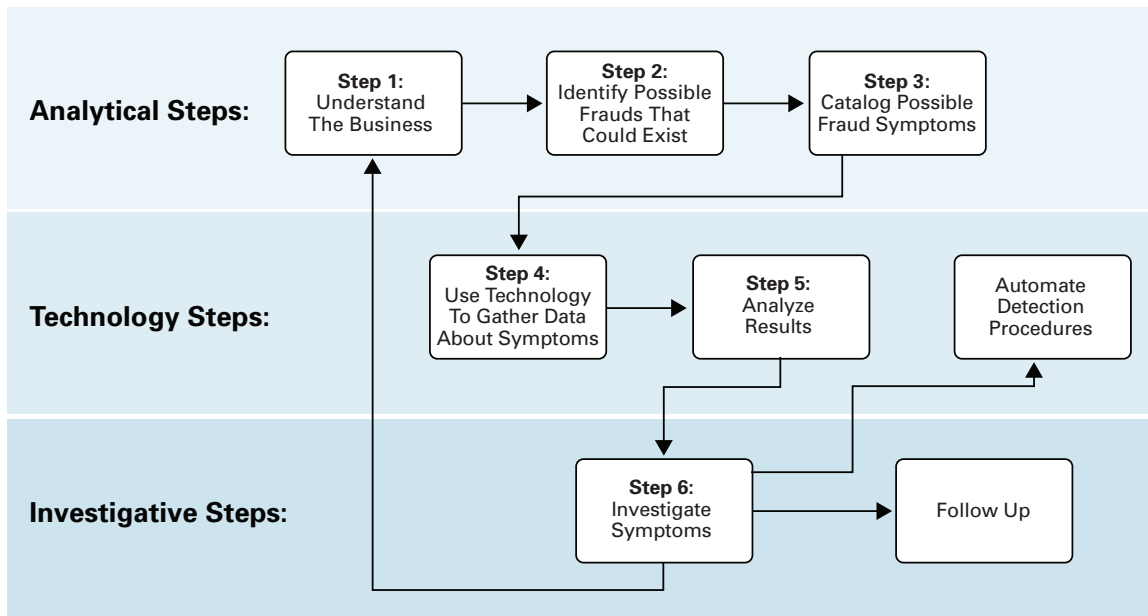
## Children's Conversation Academy

Financially troubled Children's Conservation Academy shut down in 2007 despite last minute attempts to salvage the school. According to the district, the school failed to properly account for "tens of thousands of dollars in questionable expenses, including an athletic club membership (\$638), restaurant food (\$2,219), Starbucks coffee (\$143), Padres tickets (\$369) and cell phone bills (\$1,505)." "According to district documents, the school operated for a year and a half without workers' compensation insurance required by state law, and it lacked proof that all of its employees had undergone checks for criminal background and tuberculosis, posing safety and health hazards to students." Nicole Decatur, the school's founding executive, was among the employees who lacked proper clearances. The district also "expressed concerns about 'conflicts of interest' and 'self-dealing' on the school's governing board." Decatur's mother, for example, received over \$11,000 in payment from the school "without authorization and without supporting documentation to reflect the work performed."

Source: [http://www.utsandiego.com/uniontrib/20070824/news\\_1m24charter.html](http://www.utsandiego.com/uniontrib/20070824/news_1m24charter.html)

## Appendix B: Fraud Audit Methodology

Fraud audits involve six core analytical, technological, and investigative steps.<sup>50</sup> The below fraud steps are those taught by Dr. Conan Albrecht, a professor who teaches fraud auditing techniques at Brigham Young University. The first three steps are those performed during a fraud risk assessment. The targeted fraud audit would begin at Step four.



**Step 1: Understand the Business**—Develop a firm understanding of the business being examined. Having a detailed understanding of the business underlies the entire strategic fraud detection process.<sup>51</sup> This step includes:

- Inclusion of an experienced business employee on detection team
- Tour the business
- Interview key personnel
- Analysis of financial statements
- Work with auditors/security personnel

**Step 2: Identify Possible Frauds that Could Exist**—Once fraud examiners feel confident that they understand the business, they determine what possible frauds might exist or could occur in the operation being examined. This risk assessment step requires an understanding of the nature of different frauds, how they occur, and what symptoms they exhibit.<sup>52</sup> This step includes:

- Divide business unit into individual functions
- Determine the players
- Determine types of interactions between insiders and outsiders
- Ask questions such as:
  - How could employees commit fraud alone?
  - How could vendors commit fraud alone?
  - How could vendors/employees collude?
- Develop a list of possible frauds specific to this business unit

**Step 3: Catalog Possible Fraud Symptoms**—This step involves the cataloging of frauds identified in Step 2. A matrix, tree diagram, or brainstorming map can be created that correlates specific symptoms with specific possible frauds.<sup>53</sup>

- Analytical anomalies
- Document or record symptoms
- Internal control symptoms

Lifestyle symptoms  
Behavioral symptoms  
Tips and complaints

**Step 4: Use Technology to Gather Data About Symptoms**—Once symptoms are defined in Step 3, supporting data is extracted from company databases and other sources. While traditional audit procedures call for limited transaction tests, such as those currently employed by authorizer auditors, technology-based fraud-detection queries are run against full transaction populations. Because even significant frauds can occur in very few transactions, the use of sampling potentially misses fraudulent records (sampling error) and circumvents the ability of computers to quickly analyze full populations.<sup>54</sup> This step includes:

Pulling data from company databases.  
Creating custom data warehouses to store data.

**Step 5: Analyze and Refine Results**—Once relevant data are retrieved, they are compared against expectations and models. Computerized algorithms examine records and highlight anomalies, unknown values, suggestive trends, or outliers that should be analyzed directly by examiners. This step includes:<sup>55</sup>

Analysis using time algorithms, statistical queries, and other tools.  
Conducting iterative runs to hone results.

**Step 6: Investigate Symptoms**—Once anomalies are highlighted and determined to be indicators of fraud, they are investigated either using traditional or technology-based approaches. Investigation of leads are only done on anomalies that cannot be explained through continued analysis. This step includes:<sup>56</sup>

Use computer-based analyses for efficiency  
Work with auditors and/or security personnel  
Refine algorithms and queries from steps 4 and 5

**Additional Activities—After Process:** Fraud examiners then follow up on all identified symptoms. While finding fraud is certainly the primary objective, the process often highlights control weaknesses, ineffective systems, undocumented policies, and data errors. Each of these anomalies should be corrected to make company processes more efficient and effective. This step includes:<sup>57</sup>

Follow-up on suspected frauds  
Automate detection procedures  
Use lessons learned to cycle through the process again

# Notes

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