
AGENDA ITEM: Compliance Matters – Legacy Schools

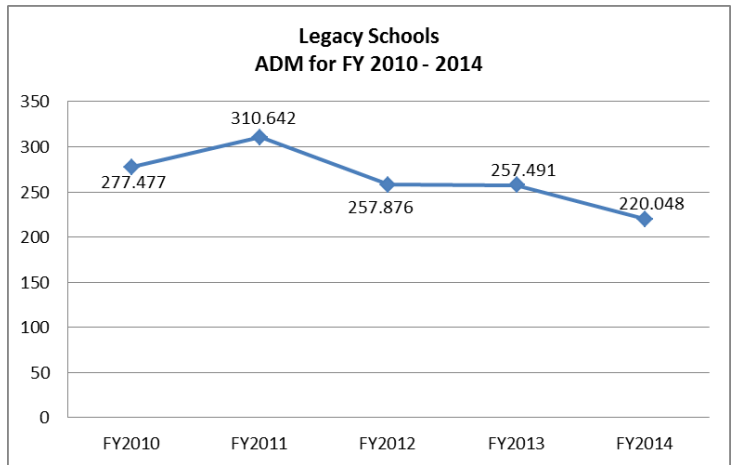
Issue

Based on its submitted fiscal year 2013 audit, Legacy Schools has violated federal payroll tax requirements during three of the last four fiscal years by not depositing taxes required to be deducted and withheld from wages of its employees and related taxes into the Treasury of the United States and has violated state record retention requirements during three of the last four fiscal years by not retaining supporting documentation for all of its non-payroll cash disbursements. Additionally, the fiscal year 2013 audit included a qualified auditors’ opinion on the financial statements because of the nature of the charter holder’s records.

Pursuant to the Board’s [Audit & Compliance Questionnaire Follow-up Matrix](#), the charter holder has been placed on the agenda for the Board’s consideration.

Background

Legacy Schools operates one school, Encore Arts Academy, serving grades K-8 in Mesa. The graph below shows the charter holder’s 100th day average daily membership (ADM) for fiscal years 2010 through 2014.



The academic dashboard for the charter school operated by the charter holder has been included below. Legacy Schools had its ten-year interval review in fiscal year 2012 and the charter holder’s academic performance is being monitored under the Board’s Academic Intervention Schedule. Additionally, Legacy Schools will be notified of its eligibility to apply for renewal in January 2015.

Academic Performance							
Encore Arts Academy							
		2012 Traditional Elementary School (K-8)			2013 Traditional Elementary School (K to 8)		
		Measure	Points Assigned	Weight	Measure	Points Assigned	Weight
1. Growth							
1a. SGP	Math	50	75	12.5	38	50	12.5
	Reading	54	75	12.5	46	50	12.5
1b. SGP Bottom 25%	Math	39	50	12.5	42.5	50	12.5
	Reading	55.5	75	12.5	33.5	25	12.5
2. Proficiency							
2a. Percent Passing	Math	61 / 63.6	50	7.5	53.4 / 64.1	50	7.5
	Reading	82 / 78.1	75	7.5	71.6 / 78.6	50	7.5
2b. Composite School Comparison	Math	2.1	75	7.5	-2.3	50	7.5
	Reading	7.8	75	7.5	0.3	75	7.5
2c. Subgroup ELL	Math	50 / 39	75	2.5	30.8 / 40	50	2.5
	Reading	75 / 52.4	75	2.5	53.8 / 51.6	75	2.5
2c. Subgroup FRL	Math	59 / 53.9	75	2.5	47.7 / 54.4	50	2.5
	Reading	82 / 70.4	75	2.5	69.8 / 71.2	50	2.5
2c. Subgroup SPED	Math	17 / 24.3	50	2.5	25.9 / 25.6	75	2.5
	Reading	46 / 37.5	75	2.5	44.4 / 37.5	75	2.5
3. State Accountability							
3a. State Accountability		B	75	5	C	50	5
Overall Rating		Overall Rating			Overall Rating		
Scoring for Overall Rating 89 or higher: Exceeds Standard <89, but > or = to 63: Meets Standard <63, but > or = to 39: Does Not Meet Standard Less than 39: Falls Far Below Standard		69.38			50.62		

The charter holder’s financial dashboard has been included below.

Financial Performance - Fiscal Year 2013 Audit

Legacy Schools

Near-Term Indicators

Going Concern	Yes	Falls Far Below
Unrestricted Days Liquidity	16.30	Does Not Meet
Default	No	Meets

Sustainability Indicators

Note: Negative numbers are indicated below by parentheses.

Net Income	(\$219,232)	Does Not Meet
Fixed Charge Coverage Ratio	0.50	Does Not Meet
Cash Flow (3-Year Cumulative)	\$73,200	Meets

Cash Flow Detail by Fiscal Year	FY 2013	FY 2012	FY 2011
	\$65,158	\$8,042	-

Does Not Meet Board’s Financial Performance Expectations

Federal Payroll Taxes

Based on its fiscal years 2010, 2012 and 2013 audits, Legacy Schools has failed to comply with federal payroll tax requirements for three of the past four fiscal years. According to the fiscal year 2013 audit, the charter holder had not paid all federal payroll taxes that were incurred in the audited year and owed taxes incurred in prior fiscal years. In communications with the audit firm that occurred subsequent to the audit's submission, Board staff was told the charter holder owed approximately \$447,000, including approximately \$90,000 in penalties and interest, to the Internal Revenue Service (IRS). Additionally, the audit firm indicated the charter holder defaulted on its 2012 payment plan and re-entered the automated collection system within the IRS. During fieldwork, the charter holder was "actively negotiating" with the IRS to establish a payment plan, according to the audit firm, and a proposed payment plan was accepted by the IRS, contingent upon the charter holder making a certain payment before a given date. The audit firm indicated the charter holder failed to make the required initial payment by the due date, which had the effect of nullifying the proposed payment plan.

Between January 2014 and July 2014, Board staff and the charter holder communicated regarding this matter. The charter holder provided Board staff with the information and documentation requested. Based upon a review of the information provided, the charter holder has:

- Entered into an installment agreement with the IRS, which requires monthly payments of \$10,712 beginning April 5, 2014. According to the agreement, as of March 26, 2014, the charter holder owed the IRS \$435,863.35, including \$43,693.56 in "failure-to-pay" penalties and \$19,622.32 in interest.
- Provided evidence that it made the payments required under its installment agreement for the months of April 2014, June 2014 and July 2014. Board staff was unable to confirm the May 2014 payment using the documentation submitted by the charter holder. According to the charter holder, as recently as August 4, 2014, the IRS has indicated that Legacy Schools is in compliance with its installment agreement. An account transcript has been requested from the IRS and the charter holder anticipates providing a copy to Board staff during the week of August 4th.
- Provided evidence that it has deposited the required federal payroll tax amounts for payrolls that occurred during fiscal year 2014.
- Indicated the governing board approved a new fiscal year 2014 budget in August 2013 that reduced labor costs by \$250,000 by bringing wages closer to averages within the local area and by reducing staff to match current enrollment levels.

Financial Record Retention

Based on its fiscal years 2010, 2011 and 2013, Legacy Schools has failed to comply with financial record retention requirements found in the *General Retention Schedules for Education – K-12* published by the Arizona State Library, Archives and Public Records for three of the past four fiscal years. According to the fiscal year 2013 audit, in a sample of 30 non-payroll cash disbursements, 21 items did not have supporting documentation on file, and 22 of 40 bank statements sampled from the fiscal year were not on file.

Between January 2014 and July 2014, Board staff and the charter holder communicated regarding this matter. The charter holder provided Board staff with the information and documentation requested. Based upon a review of the information provided, the charter holder has:

- Provided a printout from its accounting system of all non-payroll disbursements for July 1, 2013 through April 7, 2014.
- Provided supporting documentation for 20 non-payroll disbursements selected from the printout by Board staff.
- Addressed steps taken to ensure future compliance in this area. These steps include copies of supporting documentation and bank statements being maintained by the third party vendor with the charter holder maintaining the originals and revisions to the charter holder's Debit Card Use Policy addressing documentation requirements.

Qualified Auditors' Opinion

The fiscal year 2013 audit included a qualified auditors' opinion on the financial statements because of the nature of the charter holder's records. The auditors' report indicated the audit firm was unable to obtain complete records supporting the charter holder's accounts payable balance stated at \$269,575 and the "receivable from other agencies" balance stated at \$490,291 as of June 30, 2013. In communications with the audit firm that occurred subsequent to the audit's submission, the audit firm identified for Board staff three findings that provide additional information regarding the qualified opinion. The findings addressed record retention (see "Financial Record Retention" section above), detail tie-in of accounts payable, and cost allocation with Legacy Education Group.

Between January 2014 and July 2014, Board staff communicated with the charter holder regarding this matter. The charter holder provided Board staff with the information and documentation requested. Based upon a review of the information provided, in addition to the items addressed in the "Financial Record Retention" section above, the charter holder has:

- Provided a copy of its "Policy for Determination of Shared Costs" with Legacy Education Group.
- Contracted with a third party vendor for accounting services.

Other Matters

In addition to the matters identified above, the fiscal year 2013 audit identified issues of noncompliance with state unemployment contribution requirements and weaknesses in internal controls related to segregation of duties. The charter holder submitted a satisfactory corrective action plan. Further, the fiscal year 2013 audit identified repeat noncompliance with state payroll tax requirements. Since the audit indicated the charter holder addressed the noncompliance prior to the audit's release, the charter holder was not required to submit a corrective action plan regarding this issue.

Board Options

Option 1: The Board may choose to withhold 10% of the charter holder's monthly State aid apportionment and to issue a Notice of Intent to Revoke the charter holder's charter contract unless the charter holder agrees to the terms of a consent agreement. Staff recommends the following language for consideration:

I move to find Legacy Schools is in noncompliance with federal law for its failure to comply with federal payroll tax requirements and with state law for its failure to comply with financial record retention requirements and approve withholding 10% of the charter holder's monthly State aid apportionment until compliance is demonstrated. Compliance will be demonstrated as follows:

- No material weaknesses, significant deficiencies or other instances of noncompliance identified in the charter holder's fiscal year 2014 audit report package relating to noncompliance with financial record retention requirements.
- Evidence that the charter holder has timely made the August 2014 through November 2014 payments required under its installment agreement with the IRS.

Further, I move to issue a Notice of Intent to Revoke the charter contract of Legacy Schools for failing to comply with state and federal law and its charter contract when it failed to comply with federal payroll tax requirements and state financial record retention requirements, which contributed to the charter holder's fiscal year 2013 audit including a qualified opinion on the financial statements.

- Within 48 hours of receipt of the Notice the charter operator shall notify staff and parents/guardians of registered students of the Notice of Hearing on Intent to Revoke Charter and provide a school location where the copy may be reviewed;
- Within 20 days of receipt of the Notice the charter operator shall provide copies of all correspondence and communications used to comply with the preceding provision; and
- Within 20 days of receipt of the Notice the charter operator shall provide the Board with the names and mailing addresses of parents/guardians of all students registered with the school.

All that taken into consideration, the Board will enter into a consent agreement that includes the same terms and provisions as the consent agreement included with the staff report provided for this agenda item.

If Legacy Schools is unwilling to agree to the terms of the consent agreement and a signed consent agreement, along with governing board minutes approving the consent agreement, are not received within 20 business days of today's date, then it is the Board's decision that the 10% withholding will begin with the charter holder's October payment and the revocation process will proceed based on the reasons already specified.

Option 2: The Board may choose to withhold 10% of the charter holder's monthly State aid apportionment and to issue a Notice of Intent to Revoke the charter holder's charter contract. The following language is provided for consideration: I move to find Legacy Schools is in noncompliance with federal law for its failure to comply with federal payroll tax requirements and with state law for its failure to comply with financial record retention requirements and approve withholding 10% of the charter holder's monthly State aid apportionment until compliance is demonstrated. Compliance will be demonstrated as follows:

- No material weaknesses, significant deficiencies or other instances of noncompliance identified in the charter holder's fiscal year 2014 audit report package relating to noncompliance with financial record retention requirements.
- Evidence that the charter holder has timely made the August 2014 through November 2014 payments required under its installment agreement with the IRS.

Further, I move to issue a Notice of Intent to Revoke the charter contract of Legacy Schools for failing to comply with state and federal law and its charter contract when it failed to comply with federal payroll tax requirements and state financial record retention requirements, which contributed to the charter holder's fiscal year 2013 audit including a qualified opinion on the financial statements.

- Within 48 hours of receipt of the Notice the charter operator shall notify staff and parents/guardians of registered students of the Notice of Hearing on Intent to Revoke Charter and provide a school location where the copy may be reviewed;
- Within 20 days of receipt of the Notice the charter operator shall provide copies of all correspondence and communications used to comply with the preceding provision; and
- Within 20 days of receipt of the Notice the charter operator shall provide the Board with the names and mailing addresses of parents/guardians of all students registered with the school.

Option 3: The Board may choose to withhold 10% of the charter holder's monthly State aid apportionment. The following language is provided for consideration: I move to find Legacy Schools is in noncompliance with federal law for its failure to comply with federal payroll tax requirements and with state law for its failure to comply with financial record retention requirements and approve withholding 10% of the charter holder's monthly State aid apportionment until compliance is demonstrated. Compliance will be demonstrated as follows:

- No material weaknesses, significant deficiencies or other instances of noncompliance identified in the charter holder's fiscal year 2014 audit report package relating to noncompliance with financial record retention requirements.
- Evidence that the charter holder has timely made the August 2014 through November 2014 payments required under its installment agreement with the IRS.

CONSENT AGREEMENT

This Consent Agreement (“Agreement”) is made by and between Legacy Schools (“Charter Operator”), a nonprofit corporation organized under the laws of the state of Arizona and operating Encore Arts Academy, a charter school, and the Arizona State Board for Charter Schools (“Board”) collectively referred to herein as the “Parties.”

JURISDICTION

The Board is charged by Arizona Revised Statutes (“A.R.S.”) §§ 15-182(E)(1) and (2) and 15-183(R) with granting charter status to qualifying applicants for charter schools and exercising general supervision over the charter schools it sponsors. A charter is effective for fifteen years. A.R.S. § 15-183(I). The charter may be renewed for successive periods of twenty years. A.R.S. § 15-183(J). The Board may submit a request to the Arizona Department of Education to withhold up to ten percent of the monthly apportionment of state aid that would otherwise be due a charter school if the Board determines at a public meeting that the charter school is not in compliance with federal law, with the laws of this state or with its charter. A.R.S. § 15-185(H). The Board may revoke a charter of a school it sponsors at any time if the charter school breaches one or more provisions of its charter or if the Board determines that the charter holder has failed to comply with charter school statutes or any provision of law from which the charter school is not exempt. A.R.S. § 15-183(I)(3).

RECITALS

1. The Charter Operator operates Encore Arts Academy (“the School”) pursuant to a charter contract (“Charter”) executed on June 29, 2009 between the Charter Operator and the Board following a transfer from the sponsorship of the Arizona State Board of Education.
2. Pursuant to A.R.S. § 15-183 and the Charter, the Board sponsors the Charter

Operator to operate one school site to serve students in grades kindergarten through eight.

3. Kathy Tolman is the Charter Representative and person authorized to execute documents on behalf of the Charter Operator.

4. The Charter of the Charter Operator and the Board requires that the Charter Operator comply with all state, federal and local laws applicable to the operation of a charter school.

5. A.R.S. §§ 15-183(E)(6) and 15-914 and the Charter of the Charter Operator and the Board require that the Charter Operator undergo an annual financial and compliance audit, including the completion of a legal compliance questionnaire, by an independent certified public accountant (“Annual Audit”).

6. Federal law requires the Charter Operator to pay taxes required to be deducted and withheld from wages of its employees and related taxes (“Federal Tax Deposits”¹) into the Treasury of the United States. 26 U.S.C. § 3401 et seq. (“Internal Revenue Code”).

7. The Charter Operator’s Annual Audit for the fiscal years ending June 30, 2010, 2012 and 2013 found that the Charter Operator was delinquent in remitting its Federal Tax Deposits to the U.S. Department of the Treasury.

8. The Charter Operator defaulted on its 2012 payment plan with the Internal Revenue Service (“IRS”).

9. According to its installment agreement with the IRS, as of March 26, 2014, the Charter Operator is in arrears in its remittance of Federal Tax Deposits in the amount of approximately \$435,863, including interest and penalties. The installment agreement requires the Charter Operator to make designated monthly payments to the IRS by the 5th of each month.

¹ “Federal Tax Deposits” are the income taxes, Social Security and Medicare taxes that the Charter Operator is required to withhold from its employees’ salaries, plus the Charter Operator’s share of Social Security and Medicare taxes, that must be timely deposited into the U.S. Department of the Treasury.

10. The Charter Operator breached its Charter and federal law when it failed to timely remit its Federal Tax Deposits into the U.S. Department of the Treasury as identified in the Annual Audit for the fiscal years ending June 30, 2010, 2012 and 2013.

11. A.R.S. § 39-121.01 requires the Charter Operator to maintain and preserve all records reasonably necessary or appropriate to maintain an accurate knowledge of its official activities which are supported by state monies.

12. The Charter Operator is required to retain financial records in accordance with the General Retention Schedules for Education – K-12 published by the Arizona State Library, Archives and Public Records.

13. The Charter Operator's Annual Audit for the fiscal years ending June 30, 2010, 2011 and 2013 found that the Charter Operator failed to retain financial records, including invoices and other supporting documentation.

14. The Charter Operator's failure to retain financial records contributed to the Charter Operator's Annual Audit for the fiscal year ending June 30, 2013 including a qualified auditors' opinion on the financial statements.

15. The Charter Operator breached its Charter and state law when it failed to maintain, preserve and retain financial records as identified in the Annual Audit for the fiscal years ending June 30, 2010, 2011 and 2013.

16. At its public meeting held on August 11, 2014, the Board determined that the Charter Operator was not in compliance with federal law and with its Charter when it failed to timely remit its Federal Tax Deposits to the U.S. Department of the Treasury and was not in compliance with the laws of this state and with its Charter when it failed to retain financial records as demonstrated by three of the Charter Operator's last four Annual Audits. The Board

passed a motion to withhold ten percent of the monthly apportionment of state aid that would otherwise be due the Charter Operator and to issue a notice of intent to revoke the Charter of the Charter Operator. The Board's motion provided for the Parties to enter into a consent agreement in lieu of a revocation proceeding and hearing, and the withholding of ten percent of the Charter Operator's monthly apportionment of state aid.

AGREEMENT TERMS AND CONDITIONS

The Parties agree as follows:

17. Because of the Board's determination that the Charter Operator is not in compliance with federal law, with the laws of this state or with its Charter, the Charter Operator is subject to a withholding of ten percent of its monthly apportionment of state aid.

18. Because of the Board's decision to issue a notice of intent to revoke the Charter, the Charter Operator is subject to the revocation and termination of its Charter.

19. A.R.S. §§ 15-183(Q) and 41-1092.07(F)(5) provide that informal disposition of this matter may be made by stipulation, agreed settlement, consent order or default.

20. In consideration of the Parties foregoing their option to proceed with the charter revocation proceedings and hearing, it is in the best interests of the Board and the Charter Operator to mutually resolve this matter.

The Charter Operator agrees as follows:

21. The Charter Operator waives its right to a hearing and to provide its defense, except as set forth herein, on the Recitals set forth in this Agreement.

22. By entering into this Agreement, the Charter Operator agrees to the Recitals set forth in this Agreement and understands that it cannot contest any of the Recitals in the future.

23. This Agreement does not limit other actions the Board may take under the law if it

determines that the Charter Operator is not in compliance with its Charter or with state or federal law.

24. On or before the 20th day of each month, beginning in September and continuing until paid in full, the Charter Operator shall provide evidence to the Board that it has made the required monthly payments under its installment agreement with the IRS.

25. On or before the 20th day of September 2014, the Charter Operator shall provide evidence to the Board that the August 2014 payment has been made under the installment agreement with the IRS.

26. The Charter Operator shall remain current in the remittance of its Federal Tax Deposits for fiscal year 2014 through fiscal year 2019. Within 5 days of the IRS Form 941 due date (October 31, January 31, April 30 and July 31) for fiscal year 2015 through fiscal year 2019, the Charter Operator shall submit to the Board a copy of the completed IRS Form 941 along with evidence that the Charter Operator timely remitted the associated Federal Tax Deposits to the U.S. Department of the Treasury.

27. The Charter Operator shall retain its financial records, including invoices, other supporting documentation, and bank statements, in accordance with the General Retention Schedules for Education – K-12 (financial records) published by the Arizona State Library, Archives and Public Records. Compliance with this provision shall be demonstrated by no material weaknesses, significant deficiencies or other instances of noncompliance being identified through the Charter Operator's Annual Audits for the fiscal years ending June 30, 2014 through 2019 related to noncompliance with financial record retention requirements and by the Annual Audit auditors' report including an unqualified opinion on the Charter Operator's financial statements for the fiscal years ending June 30, 2014 through 2019.

The Parties agree as follows:

28. If the Charter Operator fails to comply with the terms and conditions of this Agreement, the Board may, on no less than thirty (30) calendar days' notice, hold a hearing at which time the Board will receive information to determine whether evidence exists that the Charter Operator failed to comply with the terms and conditions of this Agreement. The Charter Operator shall be entitled to present all appropriate evidence at this hearing. If the Board determines that a breach of this Agreement has occurred, the Board may revoke the Charter Operator's Charter to operate the School and terminate its Charter for breach of this Agreement and of its Charter and the state and federal laws identified in the Recitals.

29. The Board may also consider the Charter Operator's failure to comply with the terms and conditions of this Agreement in its determination of the Charter Operator's request for the renewal of its Charter.

30. This Agreement is not binding on either party until both the Board and the Charter Operator's governing board accept it by the number of votes necessary to pass a measure at a public meeting. This Agreement is effective immediately upon its approval and execution by the authorized representatives of the Charter Operator and the Board.

31. If either party rejects this Agreement or any part of it, then this Agreement is null and void, and not binding on the Parties and the Board may proceed with the charter revocation hearing and may direct the Arizona Department of Education to begin withholding ten percent of the Charter Operator's monthly state aid apportionment.

32. The Charter Operator has the legal right to consult with an attorney prior to entering into this Agreement.

33. The Parties shall be responsible for their own attorneys' fees and costs, if any, in this

matter.

ARIZONA STATE BOARD FOR CHARTER SCHOOLS

By: Janna Day
President, Arizona State Board for Charter Schools
Date: _____

LEGACY SCHOOLS AND ENCORE ARTS ACADEMY

By: Kathy Tolman
Charter Representative, Legacy Schools
Date: _____

COPY mailed this
_____ day of _____, 2014 to:

Legacy Schools
Attention: Kathy Tolman, Charter Representative
7420 East Main Street
Mesa, AZ 85207

By _____