

October 14, 2015

Michael Tracy, Headmaster
Temecula Preparatory School
35777 Abelia St.
Winchester, CA 92596

Dear Headmaster Tracy:

In April 2015, the Temecula Preparatory School and the Fiscal Crisis and Management Assistance Team (FCMAT) entered into an agreement to conduct an independent review and make findings and recommendations to meet the Temecula Valley Unified School District's action plan requirements. Specifically, the agreement states that FCMAT will perform the following:

1. Evaluate all concerns expressed in the district's letter entitled "Fiscal Issues."
 - a. Review the process and progress to revert from Heritage Classical Charter Schools of America (HCCS), a nonprofit corporation, to Temecula Preparatory School (TPS) as the corporate operator including the following:
 - i. Charter Petition
 - ii. Operations Agreement
 - iii. Facilities Agreement
 - iv. Services Agreement
 - b. Review all accounting transactions for funds expended with regard to the investment and start-up of HELM private preschool.
 - c. Describe the actions TPS plans to take and return funds expended to pursue HELM preschool investment project, if any.
 - d. Review all accounting transactions related to HCCS funds expended in pursuit of the Menifee charter petition.
 - e. Describe the methodology and actions taken to return HCCS funds described in item "d" to TPS.
 - f. Review current board policy regarding internal controls for disbursements with a specific focus on signature check/warrant authorization and backup cash receipts, and make recommendations.

FCMAT

Joel D. Montero, Chief Executive Officer

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2. Review the reimbursement of \$15,606.72 in legal fees expended by TVUSD regarding this matter per the current TVUSD/TPS Operational and Services Memorandum of Understanding, and make recommendations.
3. Develop an action plan based on findings of the FCMAT review to ensure that all funds are accounted for from TPS.
4. Provide recommendations regarding the posting of board agendas and complete meeting minutes on the school website.

FCMAT conducted staff interviews at the school and collected documentation during April and May 2015. This management letter is the result of those efforts.

Background

Located in Riverside County, the Temecula Preparatory School (TPS) was founded in 2000-01 as a nonprofit 501(c)(3) public charter school serving students in grades K-8, and expanded to include grades 9-12 by 2004-05.

This charter school was awarded a Silver Medal in U.S. News & World Report's Best High School rankings for 2015 ranking 942 out of more than 210,000 public high schools nationally. The school earned the 2012 California Distinguished School award and is Western Association of Schools and Colleges (WASC) accredited. TPS was authorized by the Temecula Valley Unified School District under the laws of the Charter Schools Act of 1992, Education Code Section 47600. Beginning in 2005 the charter school has operated on district property, starting with 189 students and growing to 1,032 students in the 2014-15 school year.

TPS serves students from kindergarten through 12th grade on one school site owned by the Temecula Valley USD. The charter school requested and the district agreed to the use of district facilities under Proposition 39 as described in Education Code Section 47614 and under Title 5, California Code of Regulations, Sections 11969.1 through 11969.9.

The district and the charter school entered into a Memorandum of Understanding (MOU) on October 15, 2008 for a five-year lease for equity ownership and use of a multipurpose room. The agreement specified that the district would design and construct the multipurpose room utilizing state school building funds. Costs in excess of state funding were to be paid by the charter school, totaling \$1,686,000. The charter school made an initial payment of \$850,000, leaving a balance of \$836,000 to be paid in 10 monthly installments of \$10,000, or \$100,000 annually, over the 10-month school year.

In exchange for its contribution to the cost of the building, the agreement granted the charter school equity ownership of \$1,686,000 in the multipurpose room, to decrease annually by \$84,300 over a 20-year period beginning July 1, 2007. If the school vacated the property or otherwise was denied access during the 20-year period, it would be entitled to a credit in the remaining equity for construction of other district facilities at a new location.

At the end of the first five-year term, the district extended the agreement from July 1, 2013 through December 12, 2017. This new agreement included language authorizing the district to relocate the charter school following the term ending on December 12, 2017, making "no guarantee that the Premises will be available for any Extension Period and/or that the Premises will be able to be used exclusively for the Charter School in future years."

The school has approximately 1,800 students on a waiting list. This waiting list and concerns about the availability of district facilities prompted the TPS governing board to seek alternative options for both expansion and the ability to have permanent facilities.

School Expansion and Corporation Name Change

Due to the facilities concerns and the desire to house more students, the charter school's governing board pursued opening a charter school in the neighboring Menifee Union School District. Opening a charter school in the Menifee district using the Temecula Preparatory School name was problematic. Therefore, in January 2013 the governing board decided to change the name of the nonprofit public benefit corporation from Temecula Preparatory School to Heritage Classical Charter Schools of America (HCCS) and to broaden the charitable purposes stated in the Articles of Incorporation to operate multiple public charter schools.

While negotiating an MOU following the renewal of the TPS charter petition in 2012, the district became aware that the HCCS nonprofit public benefit corporation now operated TPS. This was not disclosed prior to the name change taking place and created concern in the district that the charter school changed nonprofit public benefit corporations.

Based on assurances in a letter by TPS/HCCS to the district dated August 22, 2013 that the new structure would not change current operations, the Temecula Valley USD's governing board approved a material revision to accept the new governance structure at the October 1, 2013 regular meeting based on staff recommendations.

In the same letter dated August 22, 2013, the charter school disclosed that HCCS filed a petition with Menifee Union School District stating that, if approved, the new school would be separate from TPS and would operate as a second charter school under HCCS. Ultimately, the Menifee district denied the petition.

A charter school cannot repurpose state apportionment dollars for non-charter school operations. Anything outside the charter petition and MOU, entity or activity, is not an allowable purpose.

A nonprofit public benefit corporation may solicit donations and have other revenue sources, such as fees assessed for services provided, that can be used for other purposes. In the case of a service for fee agreement, the agreement should be included and approved as a component of the petition or MOU. To expense donations made to the nonprofit public benefit corporation for activities outside of the charter petition and MOU, the nonprofit public benefit corporation must be able to account for funds of the corporation separately from the charter school. For nonprofit public corporations operating a single charter school where the separation is not distinct, it is common practice for a second nonprofit public benefit corporation to solicit and account for donations.

Legal costs related to the start-up of a separate charter school of \$25,292.50 were paid by TPS/HCCS with apportionment-sourced funds. The costs were included in the budget as a component of legal costs for approval by Temecula Valley USD, although not explicitly stated for this purpose. Charter staff indicates that management time to prepare the new charter petition was not done during scheduled work time.

Private Preschool and Investment Loan

In July 2013, the TPS governing board was notified of and approved the formation of a separate corporate entity called Heritage Educational Leadership & Management (HELM) to develop and operate a private preschool and act as a future charter management organization (CMO) for charter schools other than TPS and the proposed school under Menifee Union School District. Management of TPS/HCCS

and HELM determined there was enough parental interest to start a preschool transition program to kindergarten with curriculum that mirrored the classical curriculum of the charter school.

Records from legal counsel billings paid by HCCS reference that attorneys were drafting corporate documents to create HELM in June 2013. By July 2013, these same records show that articles of organization and board formation of a CMO were in the final stages of completion. Legal counsel prepared a management agreement between HELM and HCCS dated September 3, 2013. Filings with the Secretary of State occurred on February 4, 2014, listing HELM's Statement of Information.

On April 17, 2014, HELM entered into a sublease agreement with Kindercare Learning Centers LLC (KLC) to sublet the existing KLC property. The monthly rental agreement was signed by the former chief executive officer of TPS in his current position of board president of HELM for a private preschool doing business as Heritage Learning Center. The property was turned over to HELM on May 9. To start up the preschool, loan documents were prepared by HCCS's legal counsel. A draft loan agreement, promissory note, and board resolution for both HCCS and HELM were prepared on February 14, 2014. The rental agreement stipulated that the first 60 days of operations would be rent-free. Thereafter, the payment schedule was as follows:

Period	Monthly Rent	Fiscal Year	Fiscal Year Total	Lease Total
July 2014 – October 2014	\$13,857.00			
November 2014 – April 2015	\$14,780.80	July 2014 – June 2015	\$172,023*	\$172,023
May 2015 – April 2016	\$15,519.84	July 2015 – June 2016	\$187,716	\$359,740
May 2016 – April 2017	\$16,258.88	July 2016 – June 2017	\$194,585	\$556,324
May 2017 – April 2018	\$16,997.92	July 2017 – June 2018	\$206,931	\$763,255
May 2018 – July 2021	\$18,476.00	July 2018 – July 2021	\$683,612	\$1,446,867

*Approximate based on number of days and final agreement schedule.

Significant funding was necessary to start the preschool. HCCS and HELM governing boards agreed to a start-up loan to commence operations. The final loan agreement dated April 2, 2014 identifies HCCS as the lender and HELM as the borrower. The original principal amount of \$125,000 provided start-up capital for use in establishing preschool operations. The loan period of 472 days would yield 5.25% interest per annum and was issued as an unsecured promissory note with no collateral. On October 10, 2014,

a second unsecured loan of \$125,000 was made to the private preschool for a period of 20 months at 5.25% interest per annum. The following table summarizes the repayment information for the two loans:

Loan Date	Contract Loan Repayment Date	Principal	Estimated Interest*
April 2014	July 2015	\$125,000	\$8,486.30
October 2014	June 2016	\$125,000	\$10,937.50
Total		\$250,000	\$19,423.80

*Estimated interest calculation is based on non-compounding rate of 5.25%.

With regard to the propriety of the loan, the district cites California Constitution Article XVI, Section 6 – Public Finance, prohibiting gifts and loans of public funds, as well as California Constitution Article IX, Section 8:

No public money shall ever be appropriated for the support of any sectarian or denominational school, or any school not under the exclusive control of the officers of the public schools; nor shall any sectarian or denominational doctrine be taught, or instruction thereon be permitted, directly or indirectly, in any of the common schools of this State.

In response, the charter school cites legal advice that the loan is an appropriate investment because the Government Code §53600 definition of “public agency” excludes operators of charter schools. Therefore, there is no case law imposing limitations on charter school investments beyond the rules applicable to HCCS under the Corporations Code.

While the code allows operators of charter schools greater investment flexibility, funds loaned should be either 1) secured by collateral and written contract if they are apportionment funds or 2) non-apportionment funds derived from fees paid by the charter school and/or from outside fundraising or donations raised through the nonprofit public benefit corporation. Further, a loan of apportionment dollars should be budgeted and the loan process transparent to the charter’s oversight agency. Additional requirements regarding a charter school’s ability and process for entering into a loan or other type of investment may be stipulated in the petition or MOU.

The MOU does not explicitly permit or deny TPS’ ability to enter into a loan as the lender, nor does it provide an oversight and approval process for such arrangements. It is recommended the MOU be revised to stipulate whether loans or investments are allowable and, if allowed, to establish an oversight and approval process for such agreements.

The contract agreements between TPS and HELM were entered into as two \$125,000 (\$250,000 total) unsecured loans, which were primarily funded through state apportionment. The charter school gave public notice that the board would be considering approval of the loans through posting of board agendas in multiple accessible locations.

The contract agreement was not communicated or provided directly to Temecula Valley USD, nor was the loan included in the charter school budget prior to commencement. The charter school board

approved the loan separate from the second interim report at the same board meeting. Temecula Valley USD learned of the loan when it appeared in the audit report. This lack of transparency to the oversight agency prevented Temecula Valley USD from reviewing and evaluating the potential effect of the loan transactions on TPS' future operations.

As of the date of FCMAT's fieldwork, TPS management stated that the repayment of the loan was questionable, and further stated that the preschool would most likely cease operations by the end of 2015. It is recommended that the charter's governing board seek an independent legal opinion regarding this loan transaction, and the possible remedies should the private preschool default.

FCMAT reviewed all legal counsel billings and related party transactions between TPS/HCCS and HELM. Although TPS invoiced HELM on March 12, 2015 for \$10,883.75 in legal costs associated with the start-up of the private preschool, reimbursement has not been received.

Oversight Concerns and Legal Reimbursement

TPS' and Temecula Valley USD's legal councils agree the indemnification clause contained in the Operational and Services Memorandum of Understanding permits Temecula Valley USD to request reimbursement for legal expenses incurred in researching concerns regarding TPS/HCCS operations.

The district issued a request for information seeking clarification and documentation dated June 26, 2014 and July 28, 2014 to which the charter responded on August 8, 2014. Further clarification regarding the financial and operational relationship between TPS and HELM; HCCS and HELM; expending school resources to start new charters; development of a private preschool; possible conflict of interest; and more prompted another district letter requesting information dated September 29, 2014 but received by the charter August 31, 2014.

Invoices and copies of checks verified that the legal fees expended by Temecula Valley USD to research concerns regarding TPS/HCCS operations were fully repaid by TPS.

Board Policy: Internal Controls

The TPS governing board approved an amendment on January 22, 2014 to Board Policy and Administrative Regulation 1402, Fiscal Operating Procedures, which specifically addresses fiscal and internal controls for charter operations and continues to be a work in progress. This board policy details the following sections:

- Budget Adoption Timelines and Public Availability
- Budget Development
- Procurement Policies
- Tracking and Reporting of Expenditures

It is industry standard and best practice that proper segregation of duties is in place to strengthen and enhance the internal control environment of the charter school. Control activities are actions formed by policies and procedures, established by management, to detect or prevent fraud, misappropriation of funds and other illegal acts. Internal control is applicable to all business entities, including government, nonprofit, and private enterprise. Charter management should ensure that all of the action plan elements are included in the updated Board Policy 1402 including dual signatures for checks. In addition, a separate board policy focusing on internal controls should be developed and adopted.

Posting of Board Meeting Agendas and Minutes

TPS maintains a location on its website for agendas and board minutes. However, the vast majority of links are not maintained and have errors. The purpose of California Government Code Section 54950 et seq., commonly referred to as the Brown Act, is to facilitate public participation in local government decisions. It requires the deliberations and actions taken by public agencies to be conducted openly. While a charter school is exempt from many laws applicable to school districts, it is not exempt from the legal requirement to hold open meetings. The law requires an agenda to be posted on the school's website at least 72 hours prior to a regular meeting and 24 hours prior to a special meeting. Board meeting agendas and minutes are subject to permanent retention. Making these items available on the school website aids transparency by providing the public easy access to prior discussion items and action results. FCMAT recommends the posting and maintenance of board meeting agendas and minutes in a publicly accessible area on the school website.

Action Plan to Address Temecula Valley USD Fiscal Concerns

District staff and charter management agreed to meet on several occasions to resolve the issues. On March 23, 2015, the parties agreed to an action plan to address the district's fiscal and operational concerns, which called for:

- Conduct a FCMAT review in conjunction with Temecula Valley USD input.
- Resolve the following Temecula Valley USD concerns:
 - Revert from HCCS to TPS as the corporate operator.
 - Provide full accounting of the funds expended to start up the Heritage Learning Center by HELM and describe the actions to return funds expended.
 - Provide full accounting of the funds expended in the attempt to start up a second charter school in Menifee and describe the actions to return funds expended.
- Develop an action plan based on any findings of the review to ensure greater transparency and accountability of TPS resources, i.e., more conspicuous posting of board agendas and detailed board minutes on the TPS website.

The status of each applicable point has been addressed in this report. For outstanding items, it is recommended that district and charter management continue to meet and monitor the elements of the action plan and establish regular communication.

Subsequent to the completion of fieldwork, FCMAT was notified on July 28, 2015 that the Internal Revenue Service has acknowledged the reversion of the corporate name back to Temecula Preparatory School.

This concludes FCMAT's work for the Temecula Preparatory School. We appreciate the opportunity to serve you and we extend thanks to all the staff of the school for their cooperation and assistance during fieldwork.

Sincerely,



Andrea C. Alvarado
FCMAT Management Analyst