



CSIS California School Information Services

Orange County Department of Education

regarding the

Epic Charter School

Extraordinary Audit

August 3, 2017

Michael H. Fine
Chief Executive Officer





August 3, 2017

Al Mijares, Ph.D., Superintendent of Schools
Orange County Department of Education
200 Kalmus Drive
Costa Mesa, CA 92628-9050

Dear Superintendent Mijares:

On December 21, 2016, the Fiscal Crisis and Management Assistance Team (FCMAT) and the Orange County Department of Education entered into a study agreement to provide an Assembly Bill 139 extraordinary audit of the Epic Charter School located in Anaheim. Specifically, the agreement stated that FCMAT would:

1. Evaluate attendance practices and review supporting documentation to determine if attendance apportionment claimed against the state of California is substantiated.
2. Determine whether the charter school engaged in related-party transactions and if those transactions were conducted in accordance with established national and state policies, standards and procedures and were transparent in nature.
 - a. To the best of our ability, identify related parties.
 - b. Conduct a review of articles of incorporation and bylaws.
 - c. Conduct a review of contracts, purchase orders, and memorandums of understanding.
 - d. Conduct a review of financial transactions that are considered consolidatable (cash disbursements, cash receipts, loan payments, loan receipts, accounts payable and accounts receivable) of the charter school and any related-party.
 - e. Conduct a review of plant, property and equipment ownership and transfers of the charter school that are considered consolidatable and any related party.
3. Determine if expenditures made by the charter school are for legitimate educational purposes and in accordance with approved contracts, purchase orders and memorandums of understanding.

FCMAT

Michael H. Fine, Chief Executive Officer

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This final report contains the study team's findings and recommendations in the above areas of review. FCMAT appreciates the opportunity to serve the Orange County Department of Education, and extends thanks to all the staff for their assistance during fieldwork.

Sincerely,

A handwritten signature in black ink that reads "Michael H. Fine". The signature is written in a cursive, flowing style.

Michael H. Fine
Chief Executive Officer

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About FCMAT

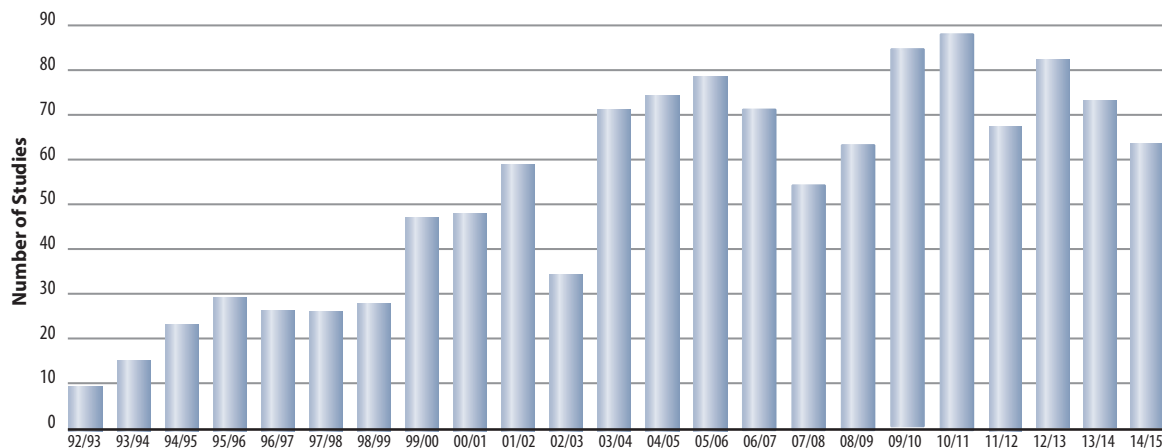
FCMAT's primary mission is to assist California's local K-14 educational agencies to identify, prevent, and resolve financial, human resources and data management challenges. FCMAT provides fiscal and data management assistance, professional development training, product development and other related school business and data services. FCMAT's fiscal and management assistance services are used not just to help avert fiscal crisis, but to promote sound financial practices, support the training and development of chief business officials and help to create efficient organizational operations. FCMAT's data management services are used to help local educational agencies (LEAs) meet state reporting responsibilities, improve data quality, and inform instructional program decisions.

FCMAT may be requested to provide fiscal crisis or management assistance by a school district, charter school, community college, county office of education, the state Superintendent of Public Instruction, or the Legislature.

When a request or assignment is received, FCMAT assembles a study team that works closely with the LEA to define the scope of work, conduct on-site fieldwork and provide a written report with findings and recommendations to help resolve issues, overcome challenges and plan for the future.

FCMAT has continued to make adjustments in the types of support provided based on the changing dynamics of K-14 LEAs and the implementation of major educational reforms.

Studies by Fiscal Year



FCMAT also develops and provides numerous publications, software tools, workshops and professional development opportunities to help LEAs operate more effectively and fulfill their fiscal oversight and data management responsibilities. The California School Information Services (CSIS) division of FCMAT assists the California Department of Education with the implementation of the California Longitudinal Pupil Achievement Data System (CALPADS). CSIS also hosts and maintains the Ed-Data website (www.ed-data.org) and provides technical expertise to the Ed-Data partnership: the California Department of Education, EdSource and FCMAT.

FCMAT was created by Assembly Bill (AB) 1200 in 1992 to assist LEAs to meet and sustain their financial obligations. AB 107 in 1997 charged FCMAT with responsibility for CSIS and its state-wide data management work. AB 1115 in 1999 codified CSIS' mission.

AB 1200 is also a statewide plan for county offices of education and school districts to work together locally to improve fiscal procedures and accountability standards. AB 2756 (2004) provides specific responsibilities to FCMAT with regard to districts that have received emergency state loans.

In January 2006, Senate Bill 430 (charter schools) and AB 1366 (community colleges) became law and expanded FCMAT's services to those types of LEAs.

Since 1992, FCMAT has been engaged to perform more than 1,000 reviews for LEAs, including school districts, county offices of education, charter schools and community colleges. The Kern County Superintendent of Schools is the administrative agent for FCMAT. The team is led by Michael H. Fine, Chief Executive Officer, with funding derived through appropriations in the state budget and a modest fee schedule for charges to requesting agencies.

Introduction

In November 2016, the Fiscal Crisis and Management Assistance Team (FCMAT) received a request from the Orange County Department of Education for an Assembly Bill (AB) 139 extraordinary audit of the Epic Charter School. The county office had concerns about student attendance, related-party transactions, and if expenditures were for legitimate educational purposes. The county is Epic Charter School's authorizer. Concerned that these issues may have violated various government and education codes related to fraud and/or misappropriation of assets, the county superintendent initiated an investigation to determine whether sufficient evidence of illegal activity exists to report the matter to the local district attorney's office for further investigation. Under the provisions of Education Code Section 1241.5, FCMAT entered into a contract with the county office to conduct an AB 139 extraordinary audit.

Study Guidelines

FCMAT provides a variety of services to school districts and county offices of education upon request. Education Code Section 1241.5(b)(c) permits a county superintendent of schools to review or audit the expenditures and internal controls of any school district or charter in that county if he or she has reason to believe that fraud, misappropriation of funds, or other illegal fiscal practices have occurred that merit examination. The Education Code provides for a review or audit conducted by the county superintendent focused on the alleged fraud, misappropriation of funds, or other illegal fiscal practices to be conducted in a timely and efficient manner. In addition, Education Code Section 47604.4(a) states as follows:

In addition to the authority granted by Sections 1241.5 and 47604.3, a county superintendent of schools may, based upon written complaints by parents or other information that justifies the investigation, monitor the operations of a charter school located within that county and conduct an investigation into the operations of the charter school.

Therefore, FCMAT focused on the allegations of misappropriation of assets, questionable contracts with third-party vendors and conflict of interest to determine whether Epic Charter School and/or its personnel were involved in or may have committed fraudulent activities.

Audit Fieldwork

Investigating allegations of fraud requires several steps that include interviewing potential witnesses and assembling evidence from internal and external sources. The FCMAT study team conducted initial county office and charter school interviews from February through May 2017. Documents were obtained and interviews were conducted in person and by telephone with individuals that had significant knowledge of attendance practices, financial transactions, financial records and/or other information pertinent to this investigation.

Specifically, FCMAT reviewed, analyzed and tested records that include individual student attendance, student data systems, computerized tracking of student progress and online login to the learning software, contracts, purchase orders, disbursements, independent auditor agreed-upon procedures, attendance assessments, and other documentation from independent third-party and other governmental sources.

The fieldwork focused on determining whether there is sufficient evidence to indicate that fraud, misappropriation of funds, or other illegal practices may have occurred related to attendance reporting, related-party transactions, and expenditures made for legitimate educational purposes.

Although there are many different types of fraud, a conflict of interest and breach of fiduciary duty exists when officers or employees of the organization have a personal financial interest in a contract(s) or transaction(s), or it is reasonably foreseeable that an economic interest results from utilizing their managerial influence in decision-making during the time of the individual's public employment, which is a form of misappropriation of assets.

Fraudulent disbursements are typically the most frequent form of asset misappropriation. This includes check tampering, cash or check register disbursement, billing, expense reimbursement and payroll schemes.

All fraud has common elements including the following:

- Knowingly making an untrue representation or a false claim of a material fact
- Intent to deceive, or concealment of the act
- Reliance on untrue information
- Damages or a loss of money or property

This report is the result of the investigation described and is divided into the following major sections:

- Introduction
- Background
- Scope and Procedures
- Findings
- Recommendation

Study Team

The FCMAT study team was composed of the following members:

Deborah Deal, CICA, CFE
FCMAT Intervention Specialist
Los Angeles, California

Michael W. Ammermon, CPA, CFE, CRFAC
FCMAT Intervention Specialist
Laguna Niguel, CA

Laura Haywood
FCMAT Technical Writer
Bakersfield, CA

Each team member reviewed the draft report to confirm its accuracy and to achieve consensus on the final recommendation.

In writing its reports, FCMAT uses the Associated Press Stylebook, a comprehensive guide to usage and accepted style that emphasizes conciseness and clarity. In addition, this guide emphasizes plain language, discourages the use of jargon and capitalizes relatively few terms.

Background

According to the Epic Charter School (Epic) website, the Epic core school model is called “One on One” and originated in Oklahoma in 2011, serving more than 9,000 students. In October 2015, the Orange County Board of Education authorized Epic to commence operations for the 2016-17 school year.

Epic is a virtual online charter school, with an office located in Anaheim, that serves TK-12 students who reside in Orange County, along with four contiguous counties: Los Angeles, Riverside, San Bernardino and San Diego.

The charter school provides an individualized curriculum for each student and offers direct and online access to a certificated instructor. At the time of FCMAT’s fieldwork, \$1,500 was provided by Epic to parents/guardians, called a Learning Fund, to purchase a computer and educational supplies for the student. Recently this amount increased to \$2,500.

Scope and Procedures

The primary focus of the audit is to determine whether there is reasonable assurance, based on the testing performed, that Epic’s apportionment for attendance claimed is substantiated; that expenditures were for legitimate educational purposes; and whether fraud, misappropriation of funds or other illegal fiscal activities may have occurred.

To accomplish the audit objectives, several audit test procedures were developed to provide an in-depth analysis and understanding of the allegations and potential outcomes. The fraud investigation consisted of gathering adequate information on the specific allegations, establishing an audit plan, and performing various audit tests to determine whether fraud may have occurred, and if so, evaluate the loss and determine who was involved and how it occurred.

FCMAT study team members interviewed management and staff to ask questions pertaining to attendance enrollment policy and procedures, financial reporting, transaction processing, job duties and responsibilities, related-party transactions, online student software, loans and disbursements. The team sampled student attendance and progress records, examined financial records, and reviewed general ledger transactions including loan proceeds.

Sample testing and analysis of the results are intended to provide reasonable but not absolute assurance as to the accuracy of the transactions and financial activity. Testing for this audit is based on sample selection and does not include the testing of all transactions and records for the sample period.

The FCMAT team was granted full access to Epic’s financial records, including supporting documentation provided by school personnel, the back-office provider, and independent auditor. When considered necessary, third-party and publicly accessible documents also were examined.

Occupational Fraud

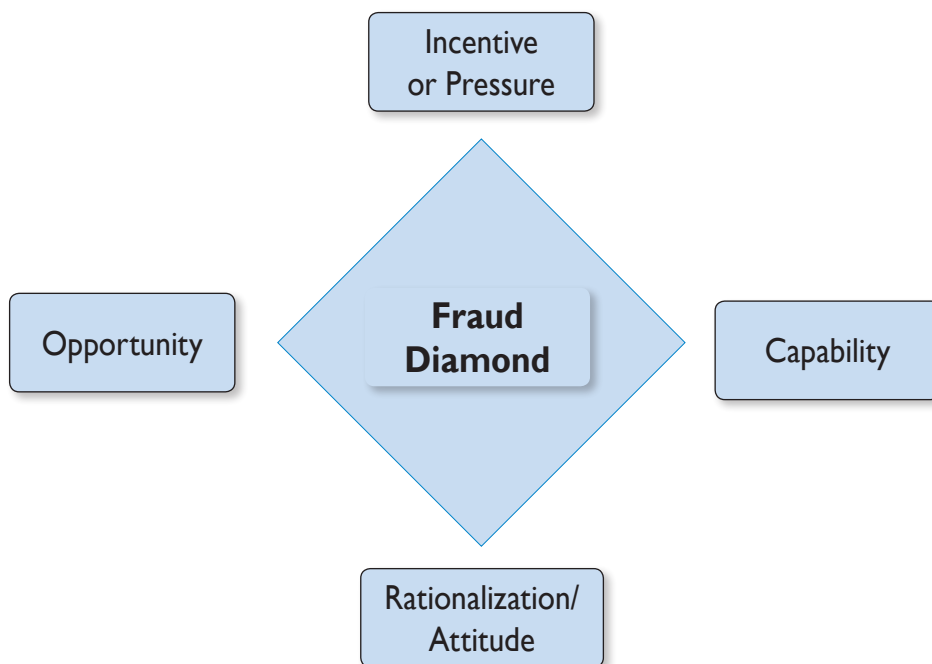
An organization's owners, executives, managers or employees may commit occupational fraud utilizing schemes related to asset misappropriation, corruption, and/or financial statements.

Asset misappropriation fraud includes cash skimming, falsifying expense reports and/or forging company checks. Corruption schemes involve an employee(s) using his or her influence in business transactions to obtain a personal benefit that violates that employee's duty to the employer or the organization; conflicts of interest fall into this category. Financial statement fraud includes the intentional misstatement or omission of material information in the financial reports.

Occupational fraud is one of the most difficult types of fraud and abuse to detect. However, the most common method of detection is receiving tips by telephone, email or online forms, accounting for three times the number of any other fraud prevention method for this type of scheme, and for 39.1% of detection methods overall. According to the 2016 Report to the Nations on Occupational Fraud and Abuse prepared by the Association of Certified Fraud Examiners, Inc., corruption schemes accounted for 35.4% of all occupational fraud cases reported, with a median loss of \$200,000.

Based on this study, the perpetrator's position and authority in the organization have a direct correlation with the losses incurred. Approximately 40.9% were employees; 36.8% were managers, 3.4% other categories, and 18.9% were owner/executives. Although the second lowest percentage is from owner/executives, this group generated the largest median loss of \$703,000 in the 2,410 cases reported worldwide between January 2014 and October 2015.

Essential elements of fraud must be present for a perpetrator's unethical behavior to occur. The fraud triangle (Cressey, 1953) includes three factors: Incentive/pressure/motivation, opportunity, and rationalization/attitude. An extension of the fraud triangle is the fraud diamond, which adds capability to the mix (Wolfe and Hermanson, 2004).



To commit fraud, the perpetrator needs to have:

- Incentive/Pressure/Motivation: Needs to get something accomplished, self-promoting, has financial pressures or personal reputation to protect.
- Opportunity: In a position of authority, or provides an essential function in the organization.
- Capability: Able to understand the systems (financial/accounting) and can override internal controls.
- Attitude/Rationalization: Confident that fraudulent behavior will go undetected.

This report will focus on whether attendance reporting, related-party transactions, and financial transactions are in compliance with California regulations and statutes that govern charter schools.

Findings

Attendance Reporting

While performing its oversight duties, county staff identified unusual reporting practices:

- Attendance reporting involving two different school weeks.
- Student residency data indicating that some students did not reside in Orange County, or in counties contiguous with Orange County - a California Education Code requirement.

FCMAT found that attendance practices of Epic are based on two separate school calendar tracks:

- Track A: Monday through Friday school week representing the students who were originally enrolled in the Epic charter school.
- Track B: Monday through Saturday school week representing students who transferred from California Prep charter school located in San Diego (Cal Prep).

According to Epic management, in mid-October 2016, Cal Prep was closing. Because Epic is authorized to serve students residing in San Diego County, students from Cal Prep were transferred by agreement from Cal Prep to Epic.

Cal Prep had approximately 150 students in its TK-12 program. To serve the additional students from Cal Prep, Epic hired three Cal Prep teachers and the principal. Of the 150 students, approximately 50 resided in Imperial or Kern counties, which are not contiguous to Orange County.

As shown in the map below, Orange County's boundaries are contiguous with San Diego, Riverside, San Bernardino, and Los Angeles. Kern and Imperial counties do not border and are therefore not contiguous to Orange County.



According to Epic's executive director, when the Cal Prep student database was merged into Epic's Pathways student data base system, the data included students from Kern and Imperial counties, which Epic cannot serve or count toward attendance apportionment. When the combined Pathways student database was uploaded into the California Department of Education (CDE) California Longitudinal Pupil Achievement Data System (CALPADS), approximately 50 non-contiguous Cal Prep students were included in Epic's enrollment records and CALPADS.

Orange County staff and management became aware of an unusual influx of students that included students from outside permissible boundaries and questioned Epic management about it. The executive director stated that Cal Prep had closed operations and that the students were enrolled at Epic.

Epic did not have a dedicated staff member for attendance and enrollment because teachers tracked and recorded attendance for their students. Although the executive director realized that the student data from Cal Prep had import issues and was aware of requirements prohibiting serving students from non-contiguous counties, he was new to TK-12 education and had limited technical expertise and knowledge about how information from student data systems and CALPADS worked.

In an attempt to correct the database and not create more errors, the executive director discontinued the syncing process with CALPADS, which county staff noticed and which increased their concern. Once the executive director discovered that Cal Prep students were imported incorrectly, he explained that he verified each student's residency and corrected the records. This took a considerable amount of time. Given his inability to articulate the issues, the explanations given to county staff by the executive director raised even more concerns and questions.

When fieldwork for this study began, FCMAT met with Epic staff and management, who were cooperative. Epic's executive director, principal, and other staff provided FCMAT with access to Epic's attendance software and student files.

In addition to Track A and B school calendars, Epic utilizes a variety of online curriculum, and FCMAT reviewed three of the online curriculum software programs designed to track a student's online progress:

- K12
- Compass Learning
- Apex Learning

A student's online progress, or mastery of a learning domain or subject, is the basis for earning attendance credit. Attendance credit is recognized and recorded by the certificated instructor of record (the teacher). Online progress in subject areas, such as science, math and history, are measurements that assist with attendance determination.

Unless the charter school establishes that online progress is the sole measurement process for attendance, online progress becomes one of many measurement factors used by the teacher to determine if a full day of attendance is recognized for apportionment purposes. For example, if a student is a "D" grade student, as long as the student is making an effort and progressing as determined by the teacher, a full day of attendance may be granted. Epic's teachers meet periodically with students, assess their progress, and retain samples of their work. The letter grade a student earns in a subject area is not connected to the student's attendance; however, student progress is a function of attendance.

Independent study attendance is governed by California Education Code Section 51747.5, which states:

- (a) The independent study by each pupil shall be coordinated, evaluated, and, notwithstanding subdivision (a) of Section 46300, shall be under the general supervision of an employee of the school district, charter school, or county office of education who

possesses a valid certification document pursuant to Section 44865 or an emergency credential pursuant to Section 44300, registered as required by law.

(b) School districts, charter schools, and county offices of education may claim apportionment credit for independent study only to the extent of the time value of pupil work products, as personally judged in each instance by a certificated teacher.

(c) For purposes of this section, school districts, charter schools, and county offices of education shall not be required to sign and date pupil work products when assessing the time value of pupil work products for apportionment purposes. (emphasis added)

Epic's attendance board policy reflects Education Code and provides guidance for teachers to use their professional judgment when assigning attendance based on student progress:

In California, attendance credit is reported by the school district or county office in ADA (Average Daily Attendance) units and generates an apportionment of revenue for that district or county office. Independent study attendance is based on a teacher's evaluation of the time value of a student's work.

Teachers make assignments in increments consistent with the program that the student is enrolled in (i.e., "full days" for traditional K-12). Student work must be turned in as specified in the work agreement. Teachers evaluate completed assignments and award attendance credit based on their determination of the time value of the work. For example, if there were five school days in a particular week, and a comprehensive high school student did at least five minimum days' worth of work, the supervising teacher could record attendance for five days.

The credentialed teacher of record awards attendance in accordance with applicable law and based on two criteria:

1. The overall amount of learning completed/attained, and
2. That some learning occurred on each date of attendance.

As indicated in the Governing Board independent study policy, once a student has five missed assignments during a given learning period, the student is no longer in good standing.

For the ADA reporting purposes, it is the effort devoted to the assigned work, not the quality of achievement or learning, that is computed. The credentialed teacher of record uses their professional determination to assign the percent of learning that occurred... (emphasis added)

Based on CALPADS issues and the FCMAT audit, Epic commissioned a 100% attendance agreed-upon procedures evaluation by its independent audit firm, Squar Milner, LLP. Epic also retained, based on FCMAT's recommendation during fieldwork, a CALPADS consulting expert to ensure that student enrollment reporting information was accurate. Because the state's second attendance principal apportionment period (P-2) had not ended when Epic and the county staff uncovered the attendance errors, there was sufficient time to correct over- and under-reporting of attendance. The official P-2 report was certified and filed subsequent to the Squar Milner review of 100% of Epic's attendance.

The agreed-upon procedures between Squar Milner and Epic were based on the Nonclassroom Based Instruction/Independent Study for Charter Schools Audit Program as required by the

2016-17 Guide for Annual Audits of K-12 Local Education Agencies and State Compliance Reporting, issued by the Education Audit Appeals Panel (Audit Guide), for the P-2 reporting period of July 1, 2016 through April 15, 2017.

The summarized Audit Guide procedures applied by Squar Milner as presented in its report to Epic were as follows:

1. Determine whether the governing body of the charter school had adopted written policies for independent study as required by the provisions of Education Code Section 51747.
2. Verify the charter school's independent study ratio calculation, made pursuant to title 5, California Code of Regulations, Section 11704, Education Code Section 51745.6 and the instructions provided by California Department of Education ("CDE"), and the resulting ineligible Average Daily Attendance ("ADA"), if any, generated through independent study.
3. Verify that the documentation used by the charter school to summarize monthly attendance provides accurate information and performed the following procedures:
 - a. Determine the total number of days of attendance and reconcile the monthly totals to the summary maintained for the P2 attendance report.
 - b. Verify the mathematical accuracy of the monthly report, or its equivalent if no monthly report is prepared, and trace totals to attendance summary.
 - c. Verify that a certificated employee of the charter school, as defined by title 5, California Code of Regulations, section 11700.1, coordinated, evaluated, and provided general supervision, as that term is defined in section 11700(b), of each pupil's independent study.
 - d. Verify the mathematical accuracy of the teachers' attendance records of pupil attendance. Trace the monthly totals from the monthly report to the attendance records.
4. Obtain the attendance records, for pupils for whom ADA generated through independent study was claimed, including pupils on intermittent ("short term") independent study, if the charter school offered that option, and perform the following procedures:
 - a. Determine each pupil's county of residence at the time of commencing independent study and verify that it is the county in which the apportionment claim is reported or a contiguous county within California.
 - b. Determine whether mailing addresses or other evidence of residency changed during the time the pupils were in independent study and, if so, whether each pupil remained a resident of the same or a contiguous county within California.

- c. Verify that on each day for which a pupils' (sic) attendance was reported, the pupil engaged in an educational activity or activities required of him or her by the charter school.
- d. Verify that each day of each pupil's attendance included in calculations of Average Daily Attendance took place on one of the charter school's schooldays.
- e. Verify that a total of not more than one day of attendance was recorded for each pupil for any calendar day on which school was in session.
- f. Verify that a written agreement exists for each pupil.
- g. Verify that every written agreement contained all the elements required by the provisions of Education Code Section 51747(c) as follows:
 - 1. The manner, time, frequency, and place for submitting a pupil's assignments and for reporting of his or her progress.
 - 2. The objectives and methods of study (pupil activities selected by the supervising teacher as the means to reach the educational objectives set forth in the written agreement) for the pupil's work.
 - 3. The methods utilized to evaluate that work (any specified procedure through which a certificated teacher personally assesses the extent to which achievement of the pupils meets the objectives set forth in the written assignment).
 - 4. The specific resources, including materials and personnel, to be made available to the pupils (resources reasonably necessary to the achievement of the objectives in the written agreement, not to exclude resources normally available to all pupils on the same terms as the terms on which they are normally available to all pupils).
 - 5. A statement of the policies adopted pursuant to subdivisions (a) and (b) of Education Code section 51747:
 - (a) The maximum length of time allowed between the assignment and the completion of a pupil's assigned work; and
 - (b) The number of assignments a pupil may miss before there must be an evaluation of whether it is in the pupil's best interests to continue in independent study.
 - 6. The duration of the independent study agreement, including the beginning and ending dates for the pupil's participation in independent study under the agreement, with no agreement being for a period longer than one school year.
 - 7. A statement of the number of course credits or, for the elementary grades, other measures of academic accomplishment appropriate to the agreement, to be earned by the pupil upon completion.

8. A statement in each independent study agreement that independent study is an optional educational alternative in which no pupil may be required to participate.
9. Signatures, affixed prior to the commencement of independent study, by:
 - (a) the pupil
 - (b) the pupil's parent, legal guardian, or caregiver as that term is used in Family Code Section 6550 and following, if the pupil was less than 18 years of age
 - (c) the certificated employee who was designated as having responsibility for the general supervision of the pupils' independent study; and
 - (d) all other persons, if any, who had direct responsibility for providing assistance to the pupil.
- h. Verify that no days of attendance were reported for dates prior to the signing of the agreement by all parties.
- i. Verify that pupil work samples have been retained in the file.
5. Verify that ADA reported on the P2 agrees to ADA claimed in attendance reports.

The results of the Squar Milner attendance procedures found:

- One minor finding at procedure number one. The finding was Epic's independent study policy did not include a reference to Education Code Section 51747(c)(8)(B), which allows that signed written agreements may be maintained as an electronic file.
- All other procedures performed revealed positive results including:
 - Independent study ratio calculations complied with regulations and no ineligible ADA was generated.
 - No mathematical errors.
 - Teachers' certifications were current, met requirements, and provided general supervision of each student's independent study.
 - No errors in teachers' records of pupil attendance.
 - Each pupil's county of residence was in counties contiguous to Orange County.
 - Pupil graded work product complied with Epic policy.
 - Average daily attendance claimed agreed to the school calendar.
 - Written agreements for all pupils in each track had no errors.
 - All written master agreements for all pupils complied with Education Code Section 51747(c).
 - The summarized ADA reported on the P-2 claimed for each learning period for each track agrees.

Although FCMAT may rely on the work and procedures performed by independent external auditors, FCMAT expanded testing of teacher credentials, student existence, and students' use of online learning.

Teacher Credentials

Ten teachers at Epic were fully responsible for student work and attendance. The California Commission on Teacher Credentialing website at <https://www.ctc.ca.gov/commission/lookup> confirms that teacher credentials were current for all 10 teachers.

Student Existence

Former Cal Prep San Diego Track B students were further examined. Records show 130 Track B students. Confirmation letters were sent to 27 parents of students, or 20.8% of the total Track B population, to confirm the existence of the student and parents/guardian. Of the 27 confirmations directly mailed by FCMAT, 11 confirmations were returned and signed by the parent or guardian, representing 40.7% response. The balance of 16 confirmations was not returned.

FCMAT selected six students out of the 16 confirmations that were not returned to personally visit their address of record. Neither Epic management nor parents/guardians were informed of the selection for confirmation.

During a three-day period between 7 a.m. Monday, May 15, 2017, and 8 p.m. Wednesday, May 17, 2017, visits were made to each address selected until contact was made with a parent or guardian. Over the course of three days, FCMAT staff met with five parents. One of the addresses visited did not have a parent or student available. Epic management assisted FCMAT and coordinated parent/guardian visits, thereby confirming all six in the second sample for a total of 17 confirmations, or 63%.

The FCMAT team had a predetermined audit risk sample that if less than 50% of the mailed confirmations and personal visits failed to result in positive confirmation, then three additional students would be selected for testing, and if greater than 50% of the confirmations and personal visits resulted in positive attendance, only one additional student would be selected. This was done and was positively confirmed.

Based on the results of confirmation letters and visits to student residences, FCMAT concludes that the Track B student population fairly represents the existence of students and parents within the Epic attendance boundaries.

Online Curriculum Login

FCMAT extended its audit procedures to determine whether, if a student was marked as present in the attendance record, there were also sufficient student online curriculum logins that corresponded to positive attendance. Track B students were the focus of additional testing; however, a few students in Track A also were tested.

As previously mentioned, attendance is assigned by the certificated teacher. Students access the learning software by logging into their online lessons. Logging in and performing work assignments is an additional measurement of a student's existence. However, logging into the learning software is not a perfect indicator of attendance since attendance days may be awarded if the student is learning one-on-one with the teacher or involved in other activities that are not registered through a login. Nevertheless, in any given week of positive attendance, FCMAT expected to see sampled students logged into the learning software.

To understand Epic's learning software, FCMAT arranged for a telephone discussion with K12 technical support to understand software login parameters. On May 12, 2017 Epic's principal and FCMAT spoke with a K12 representative who explained how the system records and displays student logins. According to technical support:

The only logins shown in the system are those that occur when a lesson is completed. Therefore, if a student is progressing in a lesson but has not completed the lesson, or is watching a tutorial video, there is no query or report that will demonstrate the student was logged in on a given day.

Therefore, depending on how quickly a student progresses with a lesson, logins can represent daily or some other frequency depending on when the student completes the lesson. FCMAT established a login frequency of at least four times within a 17- to 21-day period representing completed lessons on attendance days that were marked present. (The time periods are 17 to 21 days because different teacher attendance samples were in three separate months.)

To sample logins, FCMAT determined a sample size of 10 Track B students. If Track B student sample results demonstrated sufficient logins, then three Track A students also would be sampled. If Track B student samples failed to demonstrate sufficient logins, then 10 Track A students would be sampled. Selections were also made to sample each of the three software systems. The following table summarizes the results of the sampling:

Software	Track	Login Activity	Average Student Logins	Number of Days	Sample Results
K12	Track B	82	8.2	21	Positive
Compass Learning	Track A	14	4	17	Positive
Apex Learning	Track A	5	5	20	Positive

The results of attendance sample testing and attendance reporting are as follows:

- FCMAT's examination of student login activity determined the sample of student logins is representative of both Track A and B student populations. FCMAT therefore finds that student logins correspond to the attendance claimed.
- Epic's independent accounting firm's attendance agreed-upon procedures for the P-2 reporting period of July 1, 2016 through April 15, 2017 resulted in substantiation that the ADA certified by Epic agrees to ADA reported to the state.
- FCMAT's review of Epic's independent accounting firm's audit procedures and work papers, and FCMAT's own evaluation of Epic's attendance practices and review of documentation concur that Epic's certification of attendance for the P-2 reporting period agrees with the ADA reported to CDE.

Related-Party Transactions

Related-party transactions were a cause for concern with the county because, while performing its oversight duties, the county identified that:

- An organization known as Community Strategies-CA, LLC was providing services to Epic under an operating agreement, and
- Community Strategies-CA, LLC is related to Epic in Oklahoma.

Related parties do not necessarily create a fraudulent relationship. In fact, related parties may provide benefits including favorable terms or services to an organization. What is necessary is that related-party transactions should be transparent and fully disclosed.

The Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 850-10-50 contains the disclosure requirements for related-party relationships and transactions:

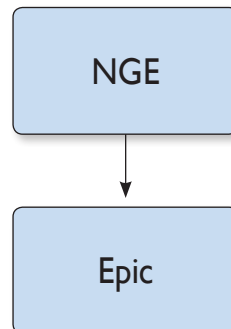
- Affiliates of the entity.
- Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity.
- Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management.
- Principal owners of the entity and members of their immediate families.
- Management of the entity and members of their immediate families.
- Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests.
- Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests. The FASB ASC glossary also defines the terms: affiliate, control, immediate family, management, and principal owners.

The executive management of Epic is responsible for documenting conflict of interest disclosure reporting requirements in detail, and fully disclosing to the auditors, governing board and the authorizing agency all current and potential related-party transactions. Disclosure is required for compliance with Generally Accepted Accounting Principles (GAAP). Failure to disclose related-party transactions may be a departure from GAAP, which may result in a qualified or adverse audit opinion and the potential for civil and criminal prosecution.

FCMAT reviewed Epic's vendor documents, contracts, financial transactions, purchases and general ledger financial transactions, interviewed management, and reviewed emails and Epic's written responses to identify and review potential undisclosed related parties. The 2016-17 school year is Epic's first year of operation. Epic has not completed its first-year independent audit; therefore, there are no undisclosed related-party issues specific to Epic's audited financial statements.

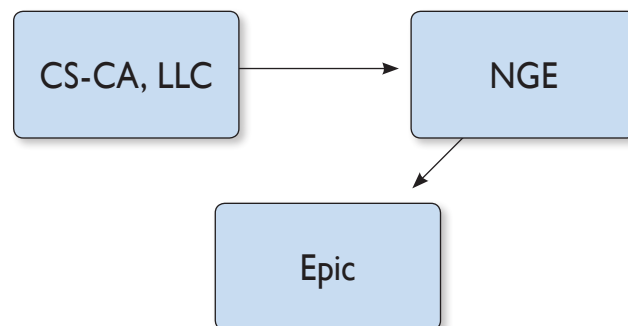
Epic is operated by Next Generation Education (NGE), a California nonprofit public benefit corporation.

Figure 1



The governing board of NGE is the governing board of Epic. FCMAT identified one vendor, Community Strategies-CA, LLC (CS-CA, LLC), which entered into an operating agreement with NGE on April 13, 2016. Figure two depicts the CS-CA, LLC relationship with NGE and Epic.

Figure 2



The operating agreement was provided to the county staff. The CS-CA, LLC operating agreement is signed by the chairman of NGE and manager of CS-CA, LLC. The operating agreement describes “The BOARD” which is Epic’s governing board, and states:

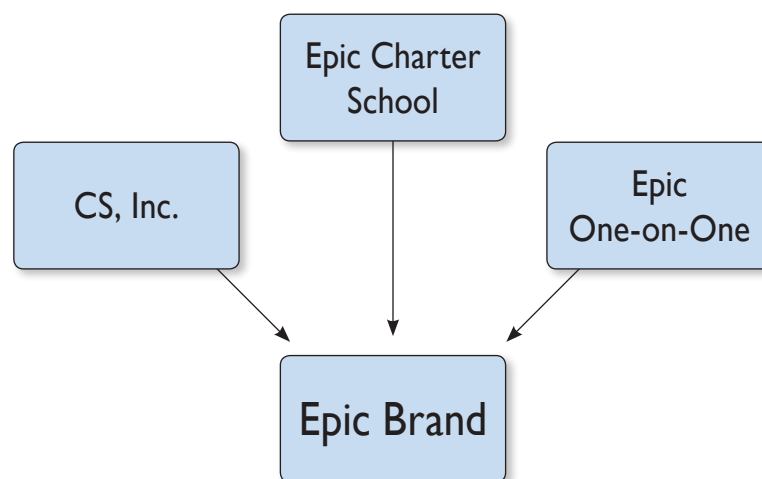
The BOARD has been granted a charter (the “Charter”) by the Orange County Board of Education (the “Authorizer”) to organize and operate a charter school, with the Authorizer as the authorizing body.

Community Strategies Inc. is a not-for-profit Oklahoma corporation (Epic One-On-One Charter Schools) that operates Epic One-On-One Charter Schools in Oklahoma. STRATEGIES will subcontract the performance of some administrative duties contained in this Agreement to Epic One-On-One Charter Schools.

The BOARD and STRATEGIES desire to create an enduring educational alliance, whereby the BOARD and STRATEGIES will work cooperatively to promote educational excellence and innovation, based on STRATEGIES’ school design, comprehensive educational program and management principles.

Epic uses the Epic brand, which started in Oklahoma and operates Epic One-On-One charter schools. The Epic brand of family of charter schools is served by Community Strategies, Inc., (CS, Inc.) doing business as Epic Charter School, which is Epic One-On-One charter schools. Figure three depicts the Epic brand of charter schools.

Figure 3

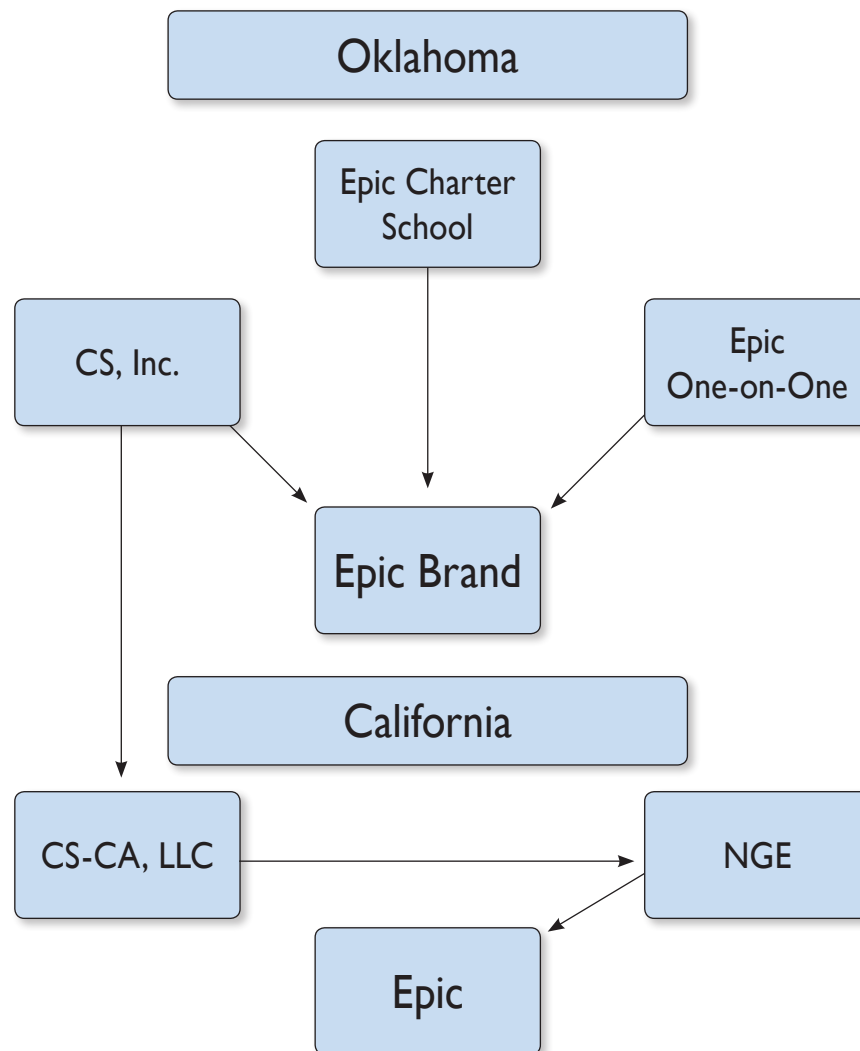


Management of CS-CA, LLC further described the relationships as:

Community Strategies-CA, LLC is a single member, not for profit Oklahoma LLC that is a subsidiary of Community Strategies, Inc., an Oklahoma nonprofit corporation. The single member of the LLC is the parent corporation, Community Strategies, Inc. This organization structure simply provides clear lines when it comes to accounting, contracts, banking, and governance; which is the reason for the structure in the first place. None of the three organizations (NGE, CS, Inc., or CS-CA, LLC) ... share ANY board members. Also, each of these three organizations are represented by different legal counsel ... Epic Charter School is simply the DBA brand of CS, Inc. in OK and for NGE in CA.

FCMAT obtained the Community Strategies, Inc. IRS Form 990, Return of Organization Exempt from Income Tax, which identifies Community Strategies, Inc. as doing business as Epic Charter School. Therefore, Oklahoma named entities known as Community Strategies, Inc., Epic Charter School, and Epic One-On-One are one and the same. Figure 4 depicts the relationships of Epic Oklahoma and California.

Figure 4



Management of CS-CA, LLC further described the structure of the IRS Form 990 tax return:

CS-CA, LLC will not ever file its own 990. Since it is a single member subsidiary of CS, Inc., the financial activity of this entity will simply roll up to a consolidated filing of the 990 for CS, Inc.

Management of CS-CA, LLC also provided the Certificate of Limited Liability Company and Articles of Organization confirming management's statements about CS-CA, LLC.

The operating agreement, at Article I, Section D, status of the parties, is summarized:

NGE is not in any way affiliated with STRATEGIES. The relationship created by this Agreement is that of an independent contractor and not employer-employee.

The operating agreement also allows for termination of the contract at Article VII, Termination of Agreement, Sections A and B. Termination Section A defines strict causes for termination; however, Section B states that:

In the event this Agreement is terminated by either party prior to the end of the term specified in Article II, absent extraordinary circumstances ... the termination will not

become effective until the end of the academic year during which the notice of termination is delivered.

This means the agreement may be terminated, even without extraordinary circumstances, but must continue through the end of the school year.

The governing board members of NGE-Epic are not management or board members of CS-CA, LLC or Community Strategies, Inc. Oklahoma. Epic board members and management have expressed that if the county is concerned about the relationship between Epic and CS-CA, LLC or Community Strategies, Inc., they would consider terminating the relationship. During FCMAT's interview of an Epic-Oklahoma representative, the representative stated NGE could terminate the operating agreement with CS-CA, LLC at will with 30 days' notice. However, FCMAT's review of the operating agreement did not find any such wording in the agreement.

After discussing the operating agreement with CS-CA, LLC, FCMAT recommends amending the operating agreement with specific terms and defined dates with wording that Epic may terminate the operating agreement at will, with or without cause, with 30 days' notice; that any contractual financial obligation owed to CS-CA, LLC existing at the end of the 30-day period should be paid at the end of that period; and any further financial obligation to CS-CA, LLC also terminates at the end of the 30 days.

Based on FCMAT's analysis, management and board members of Epic are not operating as if CS-CA, LLC has an ownership interest in Epic, or can exercise control or significantly influence management or operating policies of Epic. Therefore, FCMAT cannot conclude Epic is involved in undisclosed related-party transactions where Epic management might be prevented from fully pursuing its own separate interests.

Financial Transactions

FCMAT examined financial transactions made during Epic's first year of operation from July 1, 2016 through April 13, 2017. FCMAT reviewed Epic's general ledger and vendor detail transactions.

Transactions were systematically selected based on the transaction type and vendor activity. For example, transaction types such as loan transactions or large dollar amounts were selected for further review to determine if the transactions were for legitimate educational purposes. FCMAT identified one large expenditure and a possible related-party loan as follows:

- The largest expenditure transaction paid during the school year was to Learning Re: Defined, LLC (LRD-LLC) for \$37,000.
- The largest amount recorded as a liability during the school year was to CS-CA, LLC, for \$276,000.

The team selected 13 financial transactions for examination comprised of 12 expenditures and one loan payable for \$276,000.

Operating Expenditures

FCMAT's analysis of the 12 sampled expenditures led to additional questions about LRD-LLC. The LRD-LLC transaction of \$37,000 was a deposit for K12 software licenses. During the county's oversight inquiries, staff became aware of a purchase order from Epic to Fuel Ed for \$274,813.60 to purchase 182 Fuel Ed software licenses, although FCMAT confirmed that Epic had not made any payments to Fuel Ed.

FCMAT discussed the purchase with Epic management and cross-confirmed with Epic's back-office service provider the purchase order and transaction details, and supporting documentation. The back-office service provider confirmed Epic management's explanation of Fuel Ed and K12 and provides the following:

"At the time that Epic enrolled a group of students formerly enrolled at Cal Prep in San Diego in Fall 2016, Epic committed to purchasing licenses for the Fuel Ed educational program (www.fueleducation.com) for Cal Prep students to use.

"Fuel Ed is a rebranding of K12, Inc. Fuel Ed or K12 are unrelated to Epic and have no interrelationship, affiliation or other connection to Epic, CS-CA, LLC, or any Epic affiliated entities. The Fuel Ed licenses provide a package of online access to curriculum as well as educational support via certificated teachers. As part of the license, Fuel Ed provides certificated support for their curriculum. However, the certificated staff providing such support are neither employed by Epic nor replacing the teacher of record, who is an Epic employee in each case. The Fuel Ed support is similar to using a certificated tutor for certain classes, but is all under the oversight and coordination of the Epic certificated staff teacher of record and does not supplant or replace the Epic employee.

"Epic purchased the Fuel Ed licenses from Learning Re: Defined, LLC. The original purchase order, number 3300, dated January 10, 2017, for the software license purchase was for \$222,000, of which Epic instructed \$37,000 be paid. The \$37,000 was issued by the back-office service provider with check number 50181 dated January 30, 2017. The original purchase order number 3300 was then updated on February 9, 2017 using purchase order number 3323 to reflect a revised total cost of \$274,813.60. The \$237,813.60 is the remaining balance due after applying the \$37,000 payment.

“However, since the initial payment was made and the revised purchase order number 3323 submitted, Epic and Learning Re: Defined, LLC negotiated a much lower total cost for these licenses because there is a much lower student participation rate than initially expected. The total cost is now anticipated to be approximately \$75,000. This means after applying the \$37,000 already paid, the potential remaining balance is \$38,000 with the final amount remaining to be negotiated when the final invoice from Learning Re: Defined is received.”

As previously discussed, the use of the online curriculum software is determined to have a legitimate educational purpose.

Loans

As of March 10, 2017, CS-CA, LLC loaned \$276,000 to Epic to support Epic’s operations and educational purposes during the first year of operation. The \$276,000 received is part of a \$500,000 promissory note to CS-CA, LLC.

NGE’s board president signed the \$500,000 promissory note, dated December 15, 2016. The NGE Epic governing board approved this note on December 15, 2016. According to the terms of the note, there is no interest and it indicates “For value received.” A copy of the promissory note is shown below.

PROMISSORY NOTE

\$500,000


December 15, 2016

FOR VALUE RECEIVED, the undersigned, Next Generation Education, Inc., Borrower, promises to pay to Community Strategies-CA, Inc., (Note Holder), the principal sum of up to Five Hundred Thousand Dollars (\$500,000.00) on or before June 30, 2018.

Principal shall be payable to Community Strategies-CA, Inc., at 4101 NW 122nd Street, Suite B, Oklahoma City, OK 73120, or such other place as the Note Holder may designate in writing.

If payment required by this Note is not paid when due, or if any default occurs, the Note Holder shall be entitled to collect all reasonable costs and expense of collection and/or suit, including but not limited to, reasonable attorney’s fees.

Borrower hereby waives presentment, notice of dishonor and protest, and only agrees to any extensions of time of payment, in writing, at or after maturity.



Next Generation Education, Inc.
Board Chairman Troy Medley

Review of Epic's general ledger showed that the loan proceeds were not advanced as a lump sum of \$500,000 upon signing of the note. Instead, through March 10, 2017 funds were released to Epic in various amounts totaling \$276,000.

FCMAT did not find a single transaction totaling \$500,000. Because the note is not due and payable until June 30, 2018, Epic may receive additional note proceeds; however, the total amount of \$500,000 is due on or before June 30, 2018 based on the promissory note language.

Typically, a promissory note funds the entire amount on a date certain with repayment terms defined. This promissory note paid incrementally is typical of a line of credit. FCMAT considers the funds received by Epic from CS-CA, LLC as a line of credit, not a traditional promissory note. Epic and CS-CA, LLC should restructure the \$500,000 loan document.

FCMAT's examination and sampling of Epic's financial transactions finds there is no evidence to support that expenditures were not for legitimate educational purposes.

Recommendation

In accordance with Education Code Section 47604.4(a), FCMAT focused on the allegations of misappropriation of assets, questionable contracts with third-party vendors and conflict of interest to determine whether Epic Charter School and/or its personnel were involved in or may have committed fraudulent activities.

Based on the findings in this report, FCMAT concludes that there is no evidence to demonstrate that fraud and/or misappropriation of funds and assets, or other illegal activities may have occurred.

Appendix

Appendix A - Study Agreement



CSIS California School Information Services

**FISCAL CRISIS & MANAGEMENT ASSISTANCE TEAM
AB139 STUDY AGREEMENT
December 21, 2016**

The Fiscal Crisis and Management Assistance Team (FCMAT), hereinafter referred to as the team, and the Orange County Department of Education, hereinafter referred to as the COE, mutually agree as follows:

1. BASIS OF AGREEMENT

The team provides a variety of services to local educational agencies (LEAs). Pursuant to the provisions of Education Code (EC) Section 1241.5 (c), a county superintendent of schools may review or audit the expenditures and internal controls of any charter school in his or her county if he or she has reason to believe that fraud, misappropriation of funds, or other illegal fiscal practices have occurred that merit examination. The extraordinary audits conducted by the county superintendent shall be focused on the alleged fraud, misappropriation of funds, or other illegal fiscal practices and shall be conducted in a timely and efficient manner.

All work shall be performed in accordance with the terms and conditions of this agreement.

2. SCOPE OF THE WORK

A. Scope and Objectives of the Study

The Orange County Department of Education has requested that the team assign professionals to conduct an extraordinary audit on behalf of the Epic Charter School. Per Education Code Section 1241.5(c), the superintendent has reason to believe that fraud, misappropriation of funds, or other illegal practices may have occurred. The review of the district will include but not be limited to the following:

1. Evaluate attendance practices and review supporting documentation to determine if attendance apportionment claimed against the state of California is substantiated.
2. Determine whether the charter school engaged in related-party transactions and if those transactions were conducted in accordance with established national and state policies, standards and procedures and were transparent in nature.

- a. To the best of our ability, identify related parties.
 - b. Conduct a review of articles of incorporation and bylaws.
 - c. Conduct a review of contracts, purchase orders, and memorandums of understanding.
 - d. Conduct a review of financial transactions that are considered consolidatable (cash disbursements, cash receipts, loan payments, loan receipts, accounts payable and accounts receivable) of the charter school and any related party.
 - e. Conduct a review of plant, property and equipment ownership and transfers of the charter school that are considered consolidatable and any related party.
3. Determine if expenditures made by the charter school are for legitimate educational purposes and in accordance with approved contracts, purchase orders and memorandums of understanding.

B. Services and Products to be Provided

1. Orientation Meeting - The team will conduct an orientation session at the district to brief management and supervisory personnel on the team's procedures and the purpose and schedule of the study.
2. On-site Review - The team will conduct an on-site review at the district office and at school sites if necessary; and will continue to review pertinent documents off-site.
3. Progress Reports - The team will inform the COE of material issues as the review is performed.
4. Exit Meeting – The team will hold an exit meeting at the conclusion of the on-site review to inform the COE of any significant findings to that point.
5. Draft Report – When appropriate, electronic copies of a preliminary draft report will be delivered to the COE's administration for review and comment on a schedule determined by the team.
6. Final Report - Electronic copies of the final report will be delivered to the COE and/or district following completion of the review. Printed copies are available from the FCMAT office upon request.
7. Follow-Up Support – If requested, the team will meet with the COE and/or district to discuss the findings and recommendations of the report.

3. PROJECT PERSONNEL

The study team will be supervised by Michael H. Fine, Chief Administrative Officer, Fiscal Crisis and Management Assistance Team, Kern County Superintendent of Schools Office. The study team may also include:

- | | | |
|----|-------------------------|--------------------------------------|
| A. | Deborah Deal, CICA, CFE | FCMAT Fiscal Intervention Specialist |
| B. | Michael Ammermon, CPA | FCMAT Consultant |

Other equally qualified staff or consultants will be substituted in the event one of the above individuals is unable to participate in the study.

4. PROJECT COSTS

The cost for studies requested pursuant to EC 42127.8 (d) (1) shall be:

- A. \$950 per day for each staff team member while on site, conducting fieldwork at other locations, presenting reports, or participating in meetings. The cost of independent FCMAT consultants will be billed at their actual daily rate for all work performed.
- B. All out-of-pocket expenses, including travel, meals and lodging.

Based on the elements noted in Section 2A, the total estimated cost of the study will be \$75,000.

- C. Any change to the scope will affect the estimate of total cost.

Payments for FCMAT services may be reimbursed from funds pursuant to EC 1241.5 set aside for this purpose. Other payments, when deemed necessary, are payable to Kern County Superintendent of Schools - Administrative Agent.

5. RESPONSIBILITIES OF THE COE AND/OR DISTRICT

- A. The district will provide office and conference room space during on-site reviews.
- B. The district will provide the following if requested:
 - 1. Policies, regulations and prior reports addressing the study request
 - 2. Current or proposed organizational charts
 - 3. Current and two prior years' audit reports
 - 4. Any documents requested on a supplemental list. Documents requested on the supplemental list should be provided to FCMAT only in electronic format; if only hard copies are available, they should be scanned by the district and sent to FCMAT in an electronic format

5. Documents should be provided in advance of fieldwork; any delay in the receipt of the requested documents may affect the start date and/or completion date of the project. Upon approval of the signed study agreement, access will be provided to FCMAT's online SharePoint document repository where the district shall upload all requested documents.
- C. The COE and/or district's administration will review a preliminary draft copy of the study. Any comments regarding the accuracy of the data presented in the report or the practicability of the recommendations will be reviewed with the team prior to completion of the final report.

Pursuant to EC 45125.1(c), representatives of FCMAT will have limited contact with pupils. The district shall take appropriate steps to comply with EC 45125.1(c).

6. **PROJECT SCHEDULE**

The following schedule outlines the planned completion dates for different phases of the study and will be established upon the receipt of a signed study agreement:

<i>Orientation:</i>	<i>To be determined</i>
<i>Staff Interviews:</i>	<i>To be determined</i>
<i>Exit Meeting:</i>	<i>To be determined</i>
<i>Preliminary Report Submitted</i>	<i>To be determined</i>
<i>Final Report Submitted</i>	<i>To be determined</i>

7. **COMMENCEMENT, TERMINATION AND COMPLETION OF WORK**

FCMAT will begin work as soon as it has assembled an available and appropriate study team consisting of FCMAT staff and independent consultants, taking into consideration other jobs FCMAT has previously undertaken and assignments from the state. The team will work expeditiously to complete its work and deliver its report, subject to the cooperation of the district and any other parties from which, in the team's judgment, it must obtain information. Once the team has completed its fieldwork, it will proceed to prepare a preliminary draft report and a final report. Prior to completion of fieldwork, the district may terminate its request for service and will be responsible for all costs incurred by FCMAT to the date of termination under Section 4 (Project Costs). If the district does not provide written notice of termination prior to completion of fieldwork, the team will complete its work and deliver its report and the district will be responsible for the full costs. The district understands and agrees that FCMAT is a state agency and all FCMAT reports are published on the FCMAT website and made available to interested parties in state government. In the absence of extraordinary circumstances, FCMAT will not withhold preparation, publication and distribution of a report once fieldwork has been completed, and the district shall not request that it do so.

8. INDEPENDENT CONTRACTOR

FCMAT is an independent contractor and is not an employee or engaged in any manner with the district. The manner in which FCMAT's services are rendered shall be within its sole control and discretion. FCMAT representatives are not authorized to speak for, represent, or obligate the district in any manner without prior express written authorization from an officer of the district.

9. INSURANCE

During the term of this agreement, FCMAT shall maintain liability insurance of not less than \$1 million unless otherwise agreed upon in writing by the district, automobile liability insurance in the amount required under California state law, and workers compensation as required under California state law. FCMAT shall provide certificates of insurance, with Orange County Department of Education named as additional insured, indicating applicable insurance coverages upon request.

10. HOLD HARMLESS

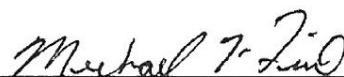
FCMAT shall hold the district, its board, officers, agents and employees harmless from all suits, claims and liabilities resulting from negligent acts or omissions of its board, officers, agents and employees undertaken under this agreement. Conversely, the district shall hold FCMAT, its board, officers, agents and employees harmless from all suits, claims and liabilities resulting from negligent acts or omissions of its board, officers, agents and employees undertaken under this agreement.

11. CONTACT PERSON

Contact: Nina Boyd, Associate Superintendent
 Telephone: (714) 966-4485
 E-mail Address: nboyd@ocde.us


 Al Mijares, Superintendent of Schools
 Orange County Department of Education

 Date


 Michael H. Fine
 Chief Administrative Officer
 Fiscal Crisis & Management Assistance Team

December 21, 2016

 Date