

# AB 139 Extraordinary Audit of the Tri-Valley Learning Corporation

Fiscal Crisis and Management Assistance Team

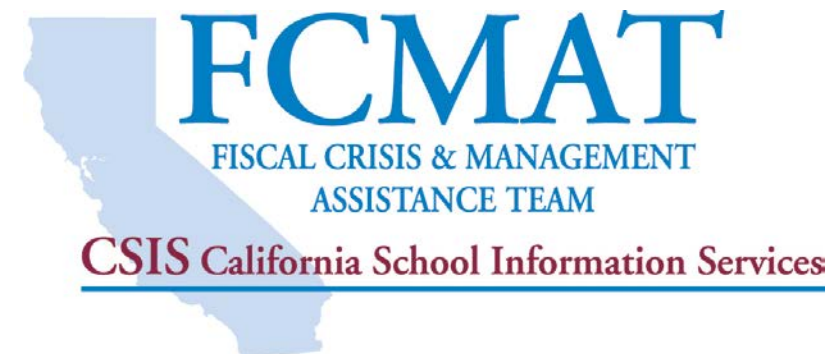
Presented by Michael Fine, CEO, and Debi Deal, Intervention Specialist



Assembly Education Committee

Informational Hearing on the Oversight of TVLC


Sacramento, July 19, 2017





# Agenda

- Overview of the AB 139 Extraordinary Audit process
- Overview of the specific AB 139 Extraordinary Audit requested by the Alameda County Office of Education of Tri-Valley Learning Corporation (Livermore Valley Charter School and Livermore Valley Charter Preparatory High School)



# Overview of the AB 139 Extraordinary Audit Process



# AB 139 Extraordinary Audits (charters)

- ▶ California Education Code **Section 1241.5(c)** states that:  
...the county superintendent 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 review or audit 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.



# AB 139 Extraordinary Audit Process

- ▶ The authority to call for an investigation rests solely with the county superintendent of schools.
- ▶ The review determines if sufficient evidence exists to further investigate the findings, or if there is evidence of potential criminal activity that should be reported to the local district attorney's office for further investigation by law enforcement.



# Others Agencies May Be Involved

- ▶ While not frequent, other state and federal agencies may already be attentive to the district or charter school under audit.
- ▶ The other agencies may watch from the sidelines or be actively involved, which necessitates coordination to avoid “stepping on toes.”
- ▶ In most cases, other agencies defer to FCMAT as the educational organization expert for the initial assessment, forensics and findings.



# Extraordinary Audit AB139 Fraud Examination Standards

- Critical first step is determining the scope of a FCMAT engagement. What are the allegations? What are the functional areas to be reviewed? What is the time frame of the alleged activity?
- Fraud investigations consist of establishing an audit plan, gathering available information and documentation pertaining to specific allegations, performing various forensic procedures, evaluating the alleged loss, and determining who may have been involved and how it may have occurred.



# Fraud Examination Standards

- Based on scope, FCMAT will prepare a document request list.
  - Examples include: detail transactions, bank records, policies, procedures, independent audits, FPPC filings, IRS filings, contracts, invoices, correspondence, back office provider records, etc.
  - Normally a sampling of transactions, not examination of all available transactions.
  - Document review and transaction testing is based on the team's experience and professional judgment.





# Fraud Examination Standards

- ▶ Based on allegations and organizational structure, FCMAT will prepare an interview list of past and present parties.
  - ▶ Questions are asked pertaining to the allegations, policies and procedures, transaction and activities, authorization levels, job duties, responsibilities and training, the overall internal control structure, lines of authority and oversight of activities.
  - ▶ Interviews are confidential. FCMAT does not normally attribute certain information to a specific person or job title, but often says, "Interviews of staff indicated...." Some exceptions apply depending on the authority of person interviewed.
  - ▶ Counsel may be present with advance notice.



# Findings

- ▶ FCMAT makes findings based on the triangulation of information. Findings are not reached or based on one piece of information.
- ▶ While FCMAT may document multiple findings and make recommendations, an AB 139 review ultimately depends on one concluding finding.
  - ▶ Limited to one of two conclusions: there **is** or **is not** sufficient evidence to demonstrate that fraud, misappropriation of funds and/or assets, or other illegal activities **may have** occurred in the specific areas reviewed.



# Consequences of Uncooperative Parties

- ▶ FCMAT depends on a variety of information in order to reach a conclusion.
- ▶ Cooperation is expected and appreciated.
- ▶ Cooperation is generally more advantageous.
- ▶ Parties (individuals, entire organizations) that choose not to cooperate with the AB 139 process are so noted in FCMAT's report.
- ▶ CMOs are not public entities and access to documents and personnel may be non-existent; however, uncooperative CMOs do not prevent a final conclusion.



# Final Report



- ▶ FCMAT's goal and interest in any report written is that it be accurately factual.
  - ▶ Reports are reviewed and edited by FCMAT's technical writing staff, legal counsel, and senior management.
- ▶ A draft final report is provided to the client for review of factual information.
  - ▶ For AB 139 reviews, the client is the county superintendent.
  - ▶ Suggested revisions are taken into consideration.
- ▶ FCMAT will review compelling information received after a report is issued. A response to such information depends on the impact on the observations, recommendations and conclusion in the final report.



# AB 139 Follow Up

- Within 45 days of completing the review the county superintendent of schools shall report the findings and recommendations to the governing board of the charter school at a regularly scheduled meeting, and provide a copy of the information to the chartering authority.
- Within 15 calendar days after receipt of the report, the governing board of the charter shall notify the county superintendent and its chartering authority of its proposed response to the recommendations.
- The district attorney determines whether to prosecute or not.
- The actual existence of fraud, misappropriation or illegal activity is solely the purview of the courts.



# AB 139 Post Report Activities

- ▶ Every FCMAT AB 139 report is different and generates a different post-report response.
- ▶ For many, there is no further FCMAT involvement.
- ▶ For others, we are asked to provide briefings, analysis and other professional support to local district attorneys, and an expanding list of other law enforcement and state and federal agencies.
  - ▶ Local PD, IRS, FTB, FBI, USDE OIG, SEC, pension systems, FPPC, etc.
- ▶ For some, the subject LEA will contact FCMAT for assistance in implementing corrective action.
  - ▶ FCMAT will only consider this request if no formal legal action is pending. Otherwise, FCMAT maintains its independence.



# AB 139 Staff Qualifications


- ▶ FCMAT has a highly qualified staff and sets a rigorous standard for any outside experts utilized in an AB 139 audit.
  - ▶ School business experts
  - ▶ CPA, CFE, CICA, CGMA, DABFA, CRFAC, MBA, MPA
  - ▶ FCMAT supports its staff in achieving and maintaining CFE certifications.
- ▶ FCMAT has a SOP that requires that all AB 139 reviews include a certified fraud examiner.



# Who Pays for an AB 139 Review?

- ▶ FCMAT receives a state appropriation to conduct AB 139 reviews.
- ▶ The initial cost is billed to the requesting county superintendent, who may then make a request to FCMAT for reimbursement from the state appropriation.
- ▶ Reimbursements are subject to Department of Finance review and consent.





Overview of the AB 139  
Extraordinary Audit of  
Tri-Valley Learning Corporation  
(Livermore Valley Charter School  
and Livermore Valley Charter  
Preparatory High School)



# Request for an Extraordinary Audit

- ▶ Requested by the Alameda County Office of Education in November 2016
- ▶ Based on allegations of conflict of interest and self-dealing by TVLC's former executive director as well as other close privately held business associates and a network of companies that either participated in or were party to bond transactions, loans and lines of credit.



# Scope of Work

- ▶ Timeframe: July 1, 2010 through June 30, 2016
- ▶ Review source and use of bond proceeds and transactions.
- ▶ Review Political Reform Act Form 700 filings.
- ▶ Review charter school's internal control structure and applicable policies and procedures related to bonds and other debt instruments to determine if adequate procedures are in place to safeguard assets.



# Procedures

- Establish an audit plan, gather adequate information on specific allegations and perform various audit test procedures to determine whether fraud may have occurred
- Record review, financial record review and sampling, and interviews
- It should be noted that the team had limited access to the general ledger records, but relied on partial financial records, supporting documentation, credit card statements, third-party and publicly accessible documents.



# Definitions and Standards

- ▶ In order to reach a conclusion, FCMAT looked at the definitions and standards related to:
  - ▶ Occupational Fraud - schemes related to asset misappropriation, corruption (includes conflicts), and/or financial statements
  - ▶ Internal Controls - policies, procedures, checks and balances
  - ▶ Conflict of Interest - Political Reform Act, Gov Code 1090, Gov Code 87100, Corp Code 5233, etc.)
  - ▶ Political Reform Act – conflict of interest code, disclosure



# Definitions and Standards (continued)

- Conflict of Interest - Political Reform Act, Gov Code 1090, Gov Code 87100, Corp Code 5233, etc.)
- Corporations Code Section 5233 - self-dealing (IRS Form 990)
- Related-Party Transactions, Significant Influence, Self-Dealing – Financial Accounting Standards Board (FASB)



# Findings and Conclusions

- ▶ FCMAT's analysis concludes that management of TVLC may have:
  - ▶ Filed incomplete FPPC Form 700 conflict of interest forms
  - ▶ Failed to fully disclose affiliated or related parties to the charter authorizer (LVJSD) and TVLC's auditor
  - ▶ Concealed the true nature of related-party relationships
  - ▶ Misled independent auditors
  - ▶ Failed to file IRS Form 1099s for host family payments
  - ▶ Contributed to an environment of significantly deficient internal controls



# Findings and Conclusions (continued)

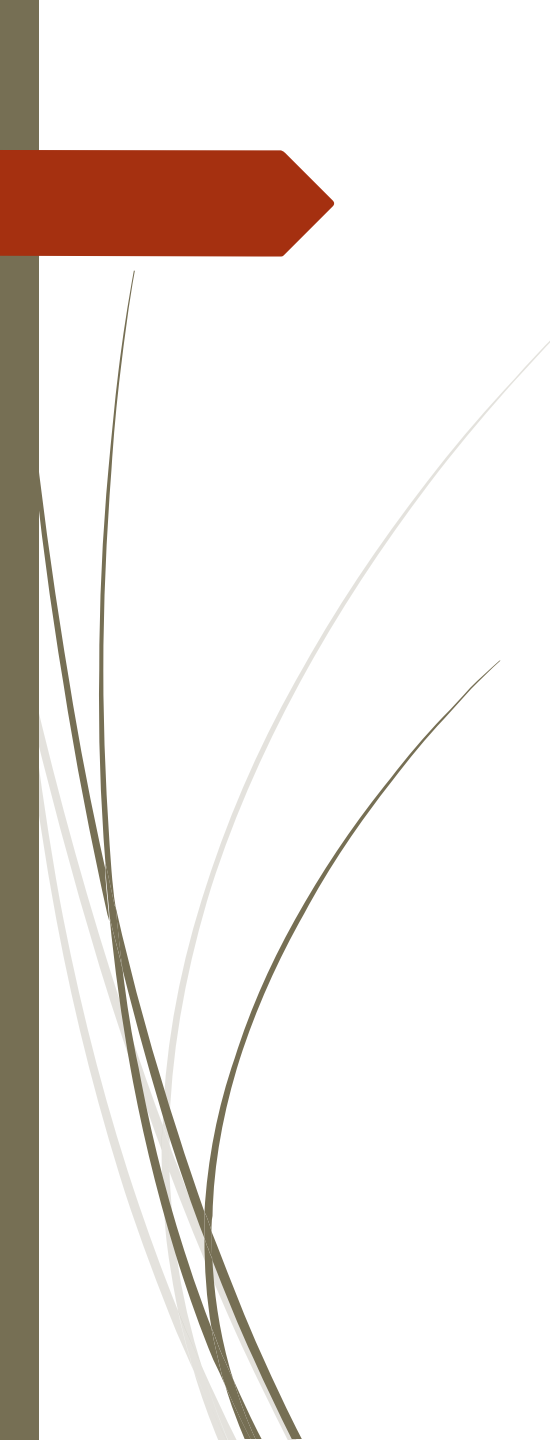
- Converted the use of tax exempt public bonds and QSCBs totaling over \$67 million to purchase land and buildings under the pretext that the acquisition was for a public charter school and a private school
- Diverted \$2,728,202 of public school funds as off-book transactions
- Diverted and commingled funds with Independence Support, LLC (ISC), California Preparatory Academy (CPA) and Livermore Charter Zone Corporation (LCZC)
- Diverted \$40,000 of public school funds to a tenant of ISC
- Used LCZC as a conduit entity





# Filed Incomplete FPPC Form 700s

- ▶ A total of 71 FPPC Form 700 forms were provided and reviewed representing past and present board members and designated employees.
- ▶ At least 23 of the 71 filings were incomplete or clearly incorrect.



## Failed to Disclose, Concealed True Nature, and Misled Auditors Related to Affiliated or Related Parties

- Affiliated and related party relationships existed between the former CEO of TVLC and other nonprofit public benefit corporations and for-profit companies that created intertwined companies evidenced by bond documents, contracts, lease agreements and ownership records.
- The personal involvement and financial interest violates conflict of interest statutes, California Corporations Code and TVLC's board policy and employment contract.
- Failure to disclose these relationships violates conflict of interest statutes, FASB statements, generally accepted auditing standards, IRS and FTB regulations and other codes.



# Failed to File IRS Form 1099s for Host Family Payments

- ▶ TVLC operated a foreign exchange program for 115 students. (FCMAT concluded that no state apportionment was received for these students.)
- ▶ TVLC paid \$558,071 host families to house the foreign students without filing the necessary IRS forms reporting such payments.



# Contributed to an Environment of Significantly Deficient Internal Controls

- Proper internal controls are the foundation of safeguarding of assets and producing financial transactions and reports that fully disclose the financial activities and present fairly the financial position of an organization.
- Accounting records were largely non-existent, lost or held by others. Many credit card statements were in the original unopened envelopes.
- Little to no documentation or authorization on transactions.
- One example: \$600,000 loan (at a computed 15% interest rate) was not recorded or disclosed to auditors and missing from the accounting records in the year the loan was entered into.



# Converted Tax Exempt Bond Proceeds for Private Use

- ▶ Over time, TVLC issued tax exempt public bonds and QSCBs totaling over \$67 million to purchase land and buildings.

## Series 2012A

- ▶ Series 2012A bonds were issued by the state of California's School Finance Authority under the authorization of the California School Finance Authority Act.
- ▶ The 2012A bonds had a principal amount of \$27,500,000, were unrated and loaned to TVLC for the acquisition and improvement of land and buildings, along with playfields, to accommodate TVLC's LVCS and LVCP.



# Converted Tax Exempt Bond Proceeds for Private Use (continued)

- The assets to be acquired were part of the Montevina Office Park and included 12 of 14 buildings, referred to as Phase I, and two remaining buildings and a vacant 12.4 acre parcel, referred to as Phase II. Phase I and II were appraised at \$19,275,000.
- At closing, the authority made a one-time, up-front rental payment from bond proceeds of \$7.4M for Phase I. Another \$15M of proceeds was set aside for the acquisition of Phase II.
- At closing, the ownership of Phase I and Phase II was transferred to Anthony Cone and Mark Holmstedt of the Westhoff, Cone and Holmstedt firm who also acted as underwriter on the 2012A bonds.



# Converted Tax Exempt Bond Proceeds for Private Use (continued)

- The 2012A bonds are now in default as a result of non-payment. The trustee for the bonds is entitled to pursue foreclosure and other remedies on behalf of bond holders.
- In addition to the bond financing, TVLC, through a sublease with the authority, received another \$15,000,000 in federal Qualified School Construction Bonds (QSCBs), a component of the American Recovery and Reinvestment Act of 2009.
- QSCBs provide tax credits to bond holders in lieu of interest payments, lowering the cost of borrowing. The principal is still payable.



# Converted Tax Exempt Bond Proceeds for Private Use (continued)

## Series 2014

- ▶ FCMAT obtained a copy of a preliminary offering memorandum for the Series 2014 Bond Anticipation Notes (BANS).
- ▶ The BANS were intended to raise funds on a short-term basis to undertake the projects that were later funded through the issuance of the California Statewide Communities Development Authority Series 2015 bonds.
- ▶ Based on interviews and other documents, FCMAT determined that the 2014 BAN was never issued and sold.





# Converted Tax Exempt Bond Proceeds for Private Use (continued)

## Series 2015

- ▶ Series 2015 bonds were issued by the California Statewide Communities Development Authority under the authorization of the California Joint Exercise of Powers Act.
- ▶ Similar to the 2012A bonds, the 2015 bonds represent one component of a complex and simultaneous public finance and real estate transaction.
- ▶ The 2012A bonds had a principal amount of \$25,540,000, were unrated and intended for the acquisition and improvement of a building referred to as Independence Plaza. Proceeds were loaned by the authority to Independence Support, LLC (ISC).



# Converted Tax Exempt Bond Proceeds for Private Use (continued)

- ISC acquired the building, and then leased the building, through its sole member Livermore Charter Zone Corporation – LCZC, to TVLC for charter school purposes, and to CPA for private school purposes.
- In March 2017, a notice was filed by the trustee for the 2015 bonds that TVLC and CPA, as tenants under the lease, failed to comply or perform in accordance with the lease, including, but not limited to, failure to pay rent. It is likely as a result of these facts, the trustee for the bonds is entitled to pursue foreclosure and other remedies.



# Converted Tax Exempt Bond Proceeds for Private Use (continued)

## Other Short-Term Borrowing

- ▶ The 2015 TVLC audit lists a \$675,000 line of credit with Heritage Bank of Commerce, along with a Standby Letter of Credit with Heritage for \$200,000 in favor of the California School Finance Authority, the issuer of the 2012A bonds.
- ▶ TVLC entered into other short-term borrowing obligations for cash flow that were not intended to be used for facilities.



# Diverted \$2.7M of Funds As Off-Book Transactions

- Included in TVLC's auditor's work papers are off-book transactions totaling:
  - \$2,128,202 paid on behalf of Independence Support, LLC for operating expenditures, supplies and corporate project support; and
  - \$600,000 paid on behalf of California Preparatory Academy for capital acquisition and improvement.
- Diversions occurred over a five-year period without disclosure and remained unpaid until after discovery by new management at TVLC.
- After the auditor questioned the transactions, the auditor subsequently booked them as receivables. The transactions were not recorded in the financial records until discovered by the auditor.



# Diverted and Commingled Funds

- In addition to the diverted funds with Independence Support, LLC and California Preparatory Academy, TVLC diverted and comingled funds with Livermore Charter Zone Corporation (LCZC).
- Thirty-six transactions totaling \$1,544,836 represent funds flowing through several TVLC accounts to LCZC without documentation.
- Funds transferred from LCZC to TVLC total \$2,414,000.



## Diverted \$40,000 of School Funds to a Private Party

- Premiere Retail Services, Inc. was a tenant of Independence Support, LLC. Premiere and ISC entered into a lease termination agreement where ISC agreed to pay Premiere \$212,200 to vacate the space.
- The \$212,000 included \$100,000 paid at the time of the agreement, \$72,200 upon vacating the premises, and \$40,000 as a secured promissory note.
- TVLC paid Premiere the \$40,000 from the charter high school bank account (LVCP) and then establishing a receivable for the same transaction in the charter school elementary account (LVCS).



# Used a Related Party as a Conduit Entity

- ▶ Bank statements identify further commingling of funds between TVLC and LCZC with LCZC potentially being used as a conduit entity by TVLC to support other related and unrelated parties.
- ▶ Transfers of funds were between CPA, LCZC, SFBAPA and ISC. All entities that were under the control of the former executive director and beyond the reach of the charter authorizer's (LVJUSD) oversight.



# Findings and Conclusion

- ▶ The county superintendent should notify the governing boards of Alameda County Office of Education, Tri-Valley Learning Corporation, Livermore Valley Joint Unified School District, the State Controller, the Superintendent of Public Instruction, and the local district attorney that fraud, misappropriation of assets or other illegal activities **may have occurred**.