
Nationwide Assessment of Charter and Education Management Organizations

FINAL AUDIT REPORT



ED-OIG/A02M0012
September 2016

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U.S. Department of Education
Office of Inspector General
Washington, DC

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**UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF INSPECTOR GENERAL**

September 29, 2016

TO: James Cole, Jr.
General Counsel, Delegated Duties of Deputy Secretary
Office of the Deputy Secretary

FROM: Patrick J. Howard /s/
Assistant Inspector General for Audit

SUBJECT: Final Audit Report
Nationwide Assessment of Charter and Education Management Organizations
Control Number ED-OIG/A02M0012

Attached is the subject final audit report that covers the results of our review of charter and education management organizations during the period of July 1, 2011, through March 31, 2013. We conducted our review at the U.S. Department of Education's offices in Washington, DC. In addition, we conducted our review at State Educational Agencies, charter schools, and management organizations in six States. See the Objective, Scope and Methodology section for more information. An electronic copy has been provided to U.S. Department of Education Audit Liaison Officers (ALOs). We received your comments agreeing that there may be increased risk to Federal programs by charter schools that are affiliated with certain management organizations and proposing alternative recommendations to those included in our draft report.

Corrective actions proposed (resolution phase) and implemented (closure phase) by your office will be monitored and tracked through the Department's Audit Accountability and Resolution Tracking System (AARTS). The Department's policy requires that you develop a final corrective action plan (CAP) for our review in the automated system within 30 calendar days of the issuance of this report. The CAP should set forth the specific action items, and targeted completion dates, necessary to implement final corrective actions on the findings and recommendations contained in this final audit report.

In accordance with the Inspector General Act of 1978, as amended, the Office of Inspector General is required to report to Congress twice a year on the audits that remain unresolved after six months from the date of issuance.

In accordance with the Freedom of Information Act (5 U.S.C. § 552), reports issued by the Office of Inspector General are available to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act.

We appreciate the cooperation given us during this review. If you have any questions, please call Daniel P. Schultz at (646) 428-3888.

Enclosure

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Abbreviations, Acronyms, Short Forms Used in This Report

CMO	Charter Management Organization
COSO framework	Committee of Sponsoring Organizations of the Treadway Commission Internal Control – Integrated Framework
CSP	Charter Schools Program
CSP SEA	Charter Schools Program State Educational Agencies Grant (Catalog of Federal Domestic Assistance 84.282A)
CSP non-SEA	Charter Schools Program Non-State Educational Agencies Planning, Program Design, and Initial Implementation Grant (Catalog of Federal Domestic Assistance 84.282B)
CSP Replication and Expansion	Charter Schools Program Grants for Replication and Expansion of High-Quality Charter Schools (Catalog of Federal Domestic Assistance 84.282M)
EMO	Education Management Organization
EMO Profiles	Profiles of For-Profit and Nonprofit Education Management Organizations: Thirteenth Annual Report–2010–2011
Green Book	Standards for Internal Control in the Federal Government
IDEA	Individuals with Disabilities Education Improvement Act of 2004, Part B (Catalog of Federal Domestic Assistance 84.027)
LEA	Local Educational Agency
OESE	Office of Elementary and Secondary Education
OII	Office of Innovation and Improvement
OSERS	Office of Special Education and Rehabilitative Services
SEA	State Educational Agency
SIG	School Improvement Grants (Catalog of Federal Domestic Assistance 84.377)
Title I	Improving Basic Programs Operated by Local Educational Agencies (Catalog of Federal Domestic Assistance 84.010)

EXECUTIVE SUMMARY

The objective of our audit was to assess the current and emerging risk that charter school relationships with charter management organizations (CMOs) and education management organizations¹ pose to the Office of Elementary and Secondary Education (OESE), the Office of Special Education and Rehabilitative Services (OSERS), and the Office of Innovation and Improvement (OII) program objectives and evaluate the effectiveness of OESE, OSERS, and OII internal controls to mitigate the risk.² Our audit period covered July 1, 2011, through March 31, 2013, and included the Elementary and Secondary Education Act of 1965, as amended, Improving Basic Programs Operated by Local Educational Agencies (Title I) and School Improvement Grants (SIG), Individuals with Disabilities Education Improvement Act of 2004, Part B (IDEA), and Charter Schools Program³ (CSP) grants. For the purposes of reviewing Office of Inspector General criminal cases, our audit period covered January 2005 through June 2016.

To accomplish the goals of this audit, we assessed the risk that charter schools pose to Department program objectives through (1) reviews we performed at selected charter schools with CMOs, (2) the body of investigative work the Office of Inspector General performed regarding charter schools with CMOs, and (3) State and local audit reports pertaining to charter schools with CMOs. We judgmentally selected 6 States and 33 charter schools with CMOs as case studies and reviewed the authorizers related to those charter schools. We also reviewed internal controls and monitoring performed at the Department.⁴

Internal controls are integral to the operations of any organization. They are a means of identifying and managing risks associated with Federal programs and a key component in preventing and detecting fraud, waste, and abuse. The Federal Government has reemphasized the importance of internal controls through recent updates of various regulations and guidance, such as Title 2 of the Code of Federal Regulations Part 200 – Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards and the U.S. Government Accountability Office Standards for Internal Control in the Federal Government issued by the Comptroller General of the United States. The development and implementation of adequate internal controls is even more important when dealing with emerging operating environments, such as the CMOs that were the focus of this audit.

¹ For our audit purposes, we refer to both CMOs and education management organizations as CMOs. We defined a CMO as any organization that operated or managed one or more charter schools, whether under contract or as charter holders, without regard to the profit motive of the organization. While we do not refer to the term education management organizations generally in this report, they are considered to be organizations that provide “whole-school operation” services.

² Throughout this document, we refer to OESE, OSERS, and OII collectively as the Department. We will use U.S. Department of Education when we refer to the agency as a whole.

³ The CSP programs included in our audit scope were the CSP State Educational Agencies Grant (CSP SEA), CSP Non-State Educational Agencies Planning, Program Design, and Initial Implementation Grant (CSP non-SEA), and the CSP Grants for Replication and Expansion of High-Quality Charter Schools (CSP Replication and Expansion).

⁴ None of the 33 charter schools received direct Department grants.

We determined that charter school relationships with CMOs posed a significant risk to Department program objectives. Specifically, we found that 22 of the 33 charter schools in our review had 36 examples of internal control weaknesses related to the charter schools' relationships with their CMOs (concerning conflicts of interest, related-party transactions, and insufficient segregation of duties).⁵ See Appendix 1 for details regarding the State summaries of 6 States and 33 charter schools we reviewed. We concluded that these examples of internal control weaknesses represent the following significant risks to Department program objectives: (1) financial risk, which is the risk of waste, fraud, and abuse; (2) lack of accountability over Federal funds, which is the risk that, as a result of charter school boards ceding fiscal authority to CMOs, charter school stakeholders (the authorizer, State educational agency (SEA), and Department) may not have accountability over Federal funds sufficient to ensure compliance with Federal requirements; and (3) performance risk, which is the risk that the charter school stakeholders may not have sufficient assurance that charter schools are implementing Federal programs in accordance with Federal requirements.

We also found that the Department did not have effective internal controls to evaluate and mitigate the risk that charter school relationships with CMOs pose to Department program objectives. The Department did not have controls to identify and address the risks related to CMO relationships because it did not believe the risk to be materially different than risks presented by other grantees that received Department funds. In addition, Department officials stated that OII uses a risk-based strategy in the monitoring and administration of CSP grants.

Further, the Department did not implement adequate monitoring procedures that would provide sufficient assurance that it could identify and mitigate the risks specific to charter school relationships with CMOs. With the exception of the SIG and the CSP non-SEA programs, the Department did not include in its monitoring tools any steps to review the relationships between charter schools and CMOs or to review the SEAs' oversight of those relationships. Also, the Department did not ensure that SEAs monitored the relationships between charter schools and CMOs in a manner that would have addressed financial risk, lack of accountability, and program performance risk. This occurred in part because the Department did not collect and analyze information needed to perform a risk assessment and then tailor its monitoring procedures accordingly. Without performing a risk assessment, the Department did not provide guidance to SEAs related to the potential risks posed by charter schools with CMOs.

As a result, the Department's internal controls were insufficient to mitigate the significant financial, lack of accountability and performance risks that charter school relationships with CMOs pose to Department program objectives.

⁵ These three types of internal control weaknesses are noted in the Code of Federal Regulations, the U.S. Government Accountability Office Standards for Internal Control in the Federal Government, COSO framework, or the American Institute of Certified Public Accountants guidance.

We recommend that the Delegated Deputy Secretary—

- Convene a formal oversight group including high level representatives from the following offices: Office of the Deputy Secretary, OESE, OSERS, OII, and the Office of the Chief Financial Officer. The oversight group would determine the most appropriate manner to conduct an analysis and assessment of the risks to Department programs posed by charter schools with CMOs. The assessment would consider actions appropriate to the U.S. Department of Education's Federal role to assist SEAs, LEAs, and charter school authorizers to fulfill their obligations for oversight of Federal funding. Such actions would include, but not be limited to the recommendations that follow.
 - Provide further guidance to SEAs that offers a general strategy for performing a minimum level of monitoring, risk assessment, and mitigation procedures related to charter school relationships with CMOs.
 - Develop modifications to program monitoring protocols for Title I, IDEA, CSP grants, and other programs to assist Federal grantees in meeting their monitoring and oversight responsibilities with respect to CMOs.
 - Work with external partners and interest groups to help SEAs and authorizers consider risks to Federal funds in their evaluation of proposals for charter schools, including the consideration of what is an acceptable level of risk related to charter school relationships with CMOs.
- Collaborate and coordinate with the Office of the Chief Financial Officer's Post Audit Group to update the Office of Management and Budget Circular A-133 Compliance Supplement to include procedures to determine whether the SEA and LEA, as appropriate, have internal controls to ensure that charter schools with relationships with CMOs have effective controls to mitigate financial risks, provide for accountability over Federal funds, and mitigate performance risks.

We suggest the Department propose legislative changes for Congress to consider that would clearly identify the governance responsibilities of the Department and SEAs with respect to the roles, responsibilities, and expectations of the administration and oversight over grants provided to charter schools and require the Department to ensure the integrity of the grants provided to charter schools, specifically with regard to the risks associated with CMOs.

We also suggest the Department propose legislative changes for Congress to consider that would clearly identify the governance responsibility of authorizing entities with respect to the roles, responsibilities and expectations of the approval, renewal, and revocation of charters at a nationwide level and ensure that either SEAs or the Department adequately oversee authorizing entities.

In response to the draft audit report, the Department agreed that there may be increased risk to Federal programs by charter schools that are affiliated with certain management organizations. The Department also agreed that, when appropriate, it needs to continue to provide guidance and technical assistance to SEAs so that SEAs can assess and mitigate the risks posed by charter schools with CMO relationships. The Department proposed alternative language to the report recommendations, including convening a formal oversight group of high level U.S. Department of Education officials to analyze and assess the risks to Department programs posed by charter school relationships with CMOs.

We revised the recommendations based on the alternative language provided by the Department because we agreed that forming a working group with representatives from various offices of the U.S. Department of Education was an appropriate method forward to apply the recommendations we included in the draft report. We appreciate the actions the Department has taken or plans to take regarding the CMO risks we noted that affect Department programs at charter schools. It is important that the Department take the recommended actions to work with SEAs and authorizers to ensure that the risks posed by charter schools with CMO relationships are properly identified and mitigated.

BACKGROUND

Charter Schools and the Emergence of Charter Management Organizations

Charter schools came into existence after Minnesota passed the first State charter school law in 1991. During our audit period, 42 States and the District of Columbia had charter school laws. Charter schools originated as an alternative to the existing local public schools and most early charter schools were opened by teachers, parents, and other community members as stand-alone schools. Over time, the individual school approach to chartering has been joined by a network approach with the emergence of charter management organizations (CMOs).

CMOs have evolved together with charter schools and have now become a more prevalent part of the charter school system. According to a study performed by the National Education Policy Center at the University of Colorado Boulder, School of Education, “Profiles of For-Profit and Nonprofit Education Management Organizations: Thirteenth Annual Report—2010–2011” (EMO Profiles), CMOs emerged in the early 1990s in the context of widespread interest in market-based school reform proposals. About 5,700 charter schools operated nationwide during the 2010–2011 school year, and CMOs serviced about 1,900 charter schools, or roughly 34 percent.⁶ Additionally, about two-thirds of the 296 CMOs nationwide operated as nonprofits, and a little more than 10 percent operated in multiple States.

There is some debate over the pros and cons of using CMOs to manage schools. Proponents of CMOs claim that they bring a much-needed dose of entrepreneurial spirit and a competitive environment to public education. Supporters argue that a network approach enables rapid charter school growth that can potentially influence greater change at district-run schools. Opponents argue that outsourcing to CMOs results in already limited school resources being redirected for service fees, profits, or both while creating another layer of administration. Opponents also have concerns about transparency and the implications of public bodies relinquishing control or ownership of schools.

Entities define CMOs in various ways. The definitions we considered relevant were the definitions within the Department regulations, State charter school laws of the six States we selected, and definitions that were published from two non-governmental organizations.

Within the Department, the Office of Innovation and Improvement’s (OII) Charter Schools Program State Educational Agencies grant (CSP SEA), the CSP Grants for Replication and Expansion of High-Quality Charter Schools (CSP Replication and Expansion), and the Office of Elementary and Secondary Education’s (OESE) School Improvement Grants (SIG) defined CMOs as nonprofit organizations that operate or manage multiple charter schools by centralizing or sharing certain functions and resources among charter schools. For the CSP SEA and SIG grants, OII and OESE defined education management organizations (EMOs) as organizations that provide “whole-school operation” services. OESE’s Improving Basic Programs Operated by

⁶ We obtained the number of charter schools serviced by CMOs and background information regarding CMOs from the EMO Profiles study.

Local Educational Agencies (Title I) program and Office of Special Education and Rehabilitative Services' (OSERS) Individuals with Disabilities Education Improvement Act of 2004, Part B (IDEA) program have not established a definition of a CMO.

The States we reviewed varied in how they defined CMO in their charter school law. Two of the six States in our sample did not define CMOs at all, and four State charter school laws either defined or described CMOs. Two State charter school laws described CMOs as nonprofit entities that operate charter schools within the State. One State's charter school law defined a CMO as any nonprofit entity other than the charter holder⁷ that provided management services to the charter school, which differed from the definitions established by OESE and OII.

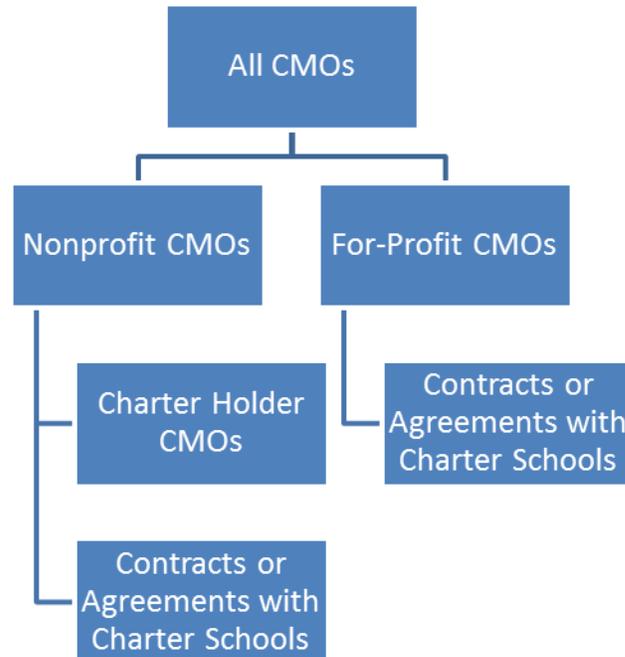
The National Resource Center on Charter School Finance and Governance points out that “the label ‘[CMO]’ has been used as an umbrella term to describe a variety of management structures that charter schools may employ.” It also states that some State laws demand that each charter school managed by a CMO must have its own independent board of directors; other States allow those schools to be governed by a single board. A study performed by the Center for Research on Education Outcomes at Stanford University, “Charter School Growth and Replication, Volume II,” states, “a CMO network is defined as an organization with at least three schools in which the network operates the schools directly.” It further states that, “[a]lternatively, an EMO network is one which has secured contractual agreements from the governing boards of participating charter schools to operate the schools.” The National Education Policy Center defined EMOs as private organizations or firms, whether for-profit or nonprofit, that manage public schools.⁸

We are using the term CMO to include any organization that operates or manages one or more charter schools, whether under contract or as charter holders, without regard to the profit motive of the organization. We use this definition because of the significant variation in the definitions of CMOs and EMOs used by the Department, States, and in the charter community. It ensures our consideration of as many potential definitions as possible in our sampling of charter schools. CMOs may operate in single or multiple States; may be engaged to work with a charter school through a contract, or hold the charter for the charter school. CMOs may perform some or all of the following services: administrative, financial, compliance, human resources, professional development, instructional, and facilities management. Figure 1 illustrates the types of CMOs in our audit.

⁷ According to this State's charter school law, a charter holder is an entity to which a charter is granted.

⁸ We determined that the National Education Policy Center defines EMO to be inclusive of the definition of CMO as used in this report.

Figure 1. Types of CMOs in our Audit



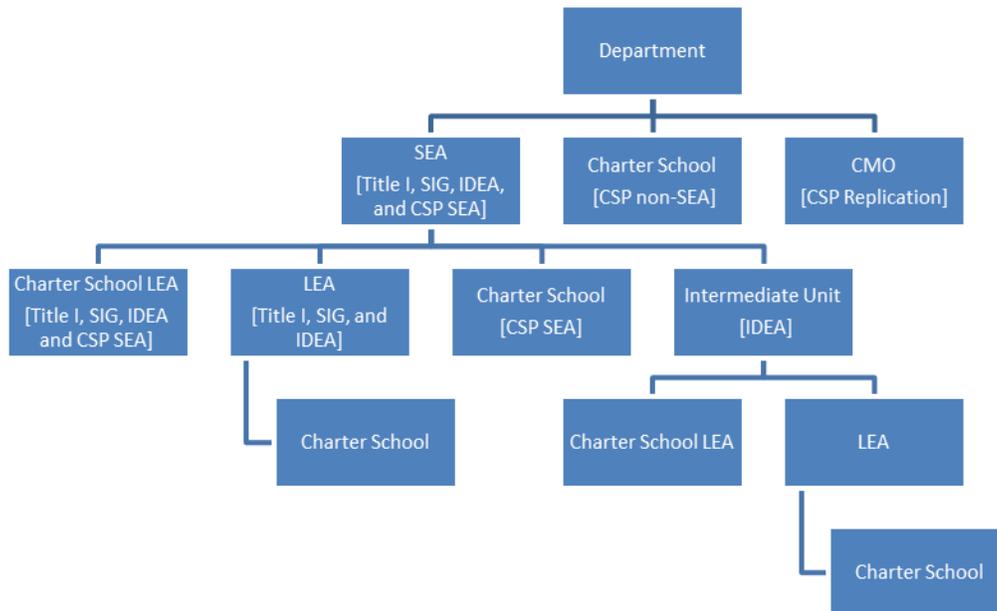
Federal Funds Received by Charter Schools

Like traditional public schools, charter schools may receive Federal funds under Title I formula grants, SIG formula grants, and IDEA formula grants. Charter schools and CMOs may also receive funding through the following CSP grants:

- discretionary grants to State educational agencies (SEAs) (CSP SEA), which OII awards to SEAs, and SEAs subgrant to charter schools;
- discretionary grants to non-SEAs (Charter Schools Program Non-State Educational Agencies Planning, Program Design, and Initial Implementation Grant (CSP non-SEA)); which OII awards directly to charter schools for planning, program design, and initial implementation for up to 3 years; and
- replication grants (CSP Replication and Expansion), which OII awards directly to nonprofit CMOs through the Replication and Expansion for High-Quality Charter School grants. The purpose of the CSP Replication and Expansion grant program is to enable nonprofit CMOs to replicate charter school models that demonstrated success, including increasing student academic achievement.

Figure 2 shows the flow of Federal funds from the Department to charter schools. The six SEAs we selected in this audit used intermediate units or local educational agencies (LEAs) to disseminate IDEA funds or services. IDEA allows SEAs to require an LEA that will not meet and maintain programs of sufficient size and scope to effectively meet the needs of children with disabilities to establish its eligibility jointly with another LEA. However, charter schools cannot establish joint eligibility unless State charter school law specifically permits joint eligibility for charter schools.

Figure 2. Flow of Federal Funds from the Department to Charter Schools



We were unable to determine total Federal funding amounts that SEAs provided to charter schools with CMOs because the Department did not track and SEAs did not consistently track that information. While the Department tracks grant funding at the grantee level, it does not typically track funding at the subgrantee level. Therefore, only the directly awarded CSP non-SEA grant funding information for the charter schools was available at the Department level. The Department awarded over \$334 million to all charter schools in CSP SEA and CSP non-SEA grants from fiscal year (FY) 2010 through FY 2012. In addition, for the same period, the Department awarded over \$77 million in CSP Replication and Expansion grants directly to CMOs.

The six SEAs we selected could not provide consistent funding data on charter schools with CMOs for the 2010–2011, 2011–2012, and 2012–2013 school years for the following reasons:

- Three SEAs (California, New York, and Florida) could not provide IDEA funding data because an LEA or an intermediate unit disbursed those funds to charter schools.⁹
- Two SEAs (Pennsylvania and California) could not identify which charter schools used CMOs but provided funding data, if available, for the 2010–2011 school year based on a list of charter schools with CMOs we provided to them.
- Two SEAs (Michigan and Florida) tracked whether charter schools used CMOs; however, the information was unreliable because charter schools self-reported the information and the SEAs did not validate it.
- One SEA (Florida) provided only allocations for Title I and SIG grants as the SEA did not collect expenditure data.

⁹ For IDEA, the SEAs make subgrants to intermediate units that could be multiple LEAs. The intermediate units were responsible for providing IDEA funding or services to LEAs and charter schools that were within their jurisdiction.

- One SEA (Texas) defined CMOs differently than OESE and OII.

We also obtained limited data concerning the number of students enrolled at charter schools in our sample, as shown in Table 1.

Table 1. Enrollment Counts of Charter Schools With CMOs at Selected SEAs

School Year	California Enrollment	Michigan Enrollment	New York Enrollment	Pennsylvania Enrollment	Texas Enrollment	Florida Enrollment
2010–2011	51,222	106,216	19,633	17,563	71,715	70,605
2011–2012*	N/A	114,435	27,699	N/A	N/A	86,485
2012–2013*	N/A	128,534	N/A	N/A	N/A	N/A

Source: We obtained student enrollment data from the SEAs. The cells marked N/A indicate that the SEA could not provide enrollment data because two SEAs (Pennsylvania and California) could not identify which charter schools used CMOs but provided enrollment data for the 2010–2011 schools year based on a list we provided. One SEA (Texas) did not define CMOs in a manner consistent with OESE and OII definitions and as such we used our nationwide universe of charter schools with CMOs to extract enrollment data provided by the SEA only for the 2010–2011 schools year; one SEA (New York) did not have student enrollment data available; and one SEA (Florida) did not have a list of charter schools with CMOs for the 2012–2013 school year.

* Some SEAs provided the enrollment figures for the 2011–2012 and 2012–2013 school years; however, we could not assess the completeness of these figures because data for the 2011–2012 and 2012–2013 school years were not available in the National Center for Education Statistics database.

Governmental Oversight Specific to CMOs

The major entities that oversee charter schools are the Department, SEAs, LEAs, and authorizers. The Department is responsible for providing guidance, overseeing, and monitoring grantees to ensure that they comply with applicable Federal laws and regulations. Specifically, SEAs are the grantees for formula grant programs and the CSP SEA program, charter schools are the grantees for the non-SEA CSP program, and nonprofit CMOs are the grantees for the CSP Replication and Expansion grant program. As grantees, SEAs are primarily responsible for overseeing and monitoring subrecipients, including charter schools that are LEAs. With the exception of CMOs that are recipients of an OII CSP Replication and Expansion grant (and therefore are treated as a Department grantee), CMOs that are contracted to manage charter schools are not grantees and generally not subject to direct governmental oversight.

Charter school laws, which differ by State, provide additional requirements about State, local, and authorizer responsibilities for accountability and oversight of charter schools. Under State charter school laws, authorizers in our review were responsible for conducting oversight activities to ensure the performance of charter schools they authorize. Authorizers also approve charter applications, oversee and ensure compliance with State charter school laws, review and renew charter contracts, and terminate charter schools when necessary. Although authorizers approve the charter and enable the charter school to start the process to receive Federal funds, authorizers generally do not oversee Federal funds. Generally, once an authorizer approves an application, the authorizer executes a charter contract that outlines, but is not limited to, the time period of the charter school contract, requirements for the governing board and bylaws, exemptions to traditional school legal obligations, performance goals, the number of schools allowed under the charter, fiscal goals, and reporting requirements. According to the National Conference of State Legislatures, authorizers monitor charter school’s progress and compliance.

Requirements Applicable to Charter Schools With CMOs

Charter schools with CMOs that receive Federal grant funds must comply with statutes authorizing the applicable grant program, regulations, the terms and conditions of their grant awards, and relevant Department-issued guidance. Additionally, under Title 2 of the Code of Federal Regulations Part 200 – Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards (Uniform Grant Guidance), non-Federal entities that receive Federal grants must establish and maintain effective internal control over those funds starting December 26, 2014.¹⁰ Internal controls are processes designed to provide reasonable assurance that recipients are managing their awards in compliance with Federal statutes, regulations, and the terms and condition of their awards.

According to the Uniform Grant Guidance, non-Federal entities' internal controls should comply with the U.S. Government Accountability Office (GAO) "Standards for Internal Control in the Federal Government" (Green Book), issued in November 1999 and updated in September 2014, or the "Internal Control – Integrated Framework," issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 1992 and updated in May 2013. The Green Book and the COSO Internal Control – Integrated Framework (COSO framework) provide specific requirements for assessing and reporting on controls in the Federal Government. Before the Uniform Grant Guidance became effective, non-Federal entities could adopt but were not required to follow the Green Book or the COSO framework. Because the Uniform Grant Guidance is now in effect, the Department, SEAs, LEAs, and charter schools with CMOs receiving Federal funds should consider the guidance in the Green Book and the COSO framework when assessing, updating, and applying internal control systems of charter schools with CMOs.

The GAO Green Book states that as programs change and entities strive to improve operational processes and implement new technology, management must continually evaluate its internal control system to ensure that it is effective and updated when necessary. Further, according to Office of Management and Budget (OMB) Circular A-123 §II.B, an organization's management should identify internal and external risks that may prevent the organization from meeting its objectives. Therefore, when identifying risks, management should take into account relevant interactions within the organization as well as interactions outside the organizations. Charter school relationships with CMOs are relevant interactions that should be considered when evaluating internal controls.

In addition to the internal control requirements described above, we identified the following additional requirements applicable to non-Federal entities receiving Federal funds: (1) the Code of Federal Regulations (C.F.R.) includes requirements regarding conflicts of interest, (2) the American Institute of Certified Public Accountants provide guidance regarding related-party transactions, and (3) the GAO Green Book and COSO framework provide guidance regarding segregation of duties that is also applicable to charter school relationships with CMOs. We discuss these additional requirements below.

¹⁰ The Department generally adopted the Uniform Grant Guidance on December 2, 2015.

Conflicts of Interest

The C.F.R. outlines requirements related to conflicts of interest that apply to grantees, subgrantees, recipients of Federal funds, and non-Federal entities, including subrecipients. The Department also issued non-regulatory guidance and States and local agencies have their own procurement standards. Some of those requirements are as follows:

- **Conflicts of Interest for Department Grantees.** Department grantees must avoid conflicts of interest when administering Federal grants. Specifically, a person cannot participate in an administrative decision regarding a project if the decision is likely to benefit that person or their immediate family member and the person is a public official or has a family or business relationship with the grantee.¹¹ Further, a person cannot participate in a project to use their position for a purpose that is, or gives the appearance of being, motivated by a desire for a private financial gain for that person or for others.¹²
- **Conflicts of Interest Nonregulatory Guidance Specific to CSP Grantees.** CSP grantees also must avoid conflicts of interest. The U.S. Department of Education considers the following factors in determining whether charter schools are independent of for-profit CMOs contracted to provide services:
 - whether the charter school’s governing board is selected by, or includes members who are employees of, the for-profit CMO;
 - whether the charter school has an independent attorney, accountant, and audit firm that works for the charter school and not for the for-profit CMO;
 - whether the contract between the charter school and the for-profit CMO was negotiated at “arm’s length,” clearly describes each party’s rights and responsibilities, and specifies reasonable and feasible terms under which either party may terminate the contract (for example, the charter school does not lose the right to use facilities);
 - whether the fee paid by the charter school to the for-profit CMO is reasonable for the type of management services provided; and,
 - whether any other agreements (such as loans and leases) between the charter school and for-profit CMO are fair and reasonable, documented appropriately, align with market rates, and include terms that will not change if the management contract is terminated.
- **Procurement Standards of Conduct for Grantees and Subgrantees.** Grantees and subgrantees must use their own procurement procedures that reflect applicable State and local laws and regulations, provided that the procurements conform to applicable Federal law and standards, including the requirement that they maintain a written code of conduct that addresses conflicts of interest for employees responsible for administering and awarding contracts.¹³ Specifically, employees cannot participate in the administration or award of contracts funded with Federal grants if conflicts of interest could arise. A conflict of interest exists when an employee, family member, spouse, or employer of the employee or family has a financial interest in a contractor. The employee is also forbidden from accepting gratuities, favors, or money from contractors, potential contractors, or subcontractors.

¹¹ 34 C.F.R. §75.525(a).

¹² 34 C.F.R. §75.525(b).

¹³ 34 C.F.R. §80.36(b).

- **Procurement Standards of Conduct for Recipients.** Recipients should maintain written standards of conduct applicable to employees who are responsible for the administering and awarding of contracts.¹⁴ Employees must not participate in the selection, award, or administration of a contract funded with Federal grants if they have conflicts of interest.
- **Procurement Standards of Conduct for Non-Federal Entities, Including Subrecipients.** Non-Federal entities, including subrecipients, must maintain a written code of conduct that covers conflicts of interest and the performance of employees responsible for administering and awarding contracts.¹⁵ Employees who have real or potential conflicts of interest cannot participate in the selection, awarding, and administration of contracts funded with Federal grants. In addition, if the non-Federal entity is involved with a company that is not a State or local government entity, it must maintain written standards of conduct covering organizational conflicts of interest. An organizational conflict of interest is one in which the non-Federal entity is unable or appears to be unable to be impartial in conducting a procurement action involving a related organization.
- **Procurement Standards for Recipients.** Part of recipient procurement standards include cost and price analysis.¹⁶ Price analysis may be accomplished in various ways, including the comparison of price quotations submitted, market prices, and similar indicators. Procurement records must include a basis for contractor selection, a justification for lack of competition when the recipient did not obtain competitive bids or offers are not obtained, and a basis for award cost or price.¹⁷ The recipient must also include provisions in all its contracts that allow for administrative, contractual, or legal remedies in instances in which a contractor breaches the contract terms and provides for remedial actions as appropriate; that allow the recipient to terminate the contract; and that allow the recipient, the U.S. Department of Education, the Comptroller General of the United States, or any of their authorized representatives, to have access to the contractor's records that are directly pertinent to a specific program for the purpose of audits and other activities.¹⁸

In addition to the Federal conflicts of interest rules, States and local governments may have their own conflicts of interest rules. The rules vary across jurisdictions and may be included in various sections of State or municipal law. For example, some States may have conflicts of interest rules within the State charter school law (specifically applicable to charter schools in the State), within the education code (applicable to all public education institutions in the State), or in general rules that apply to public officials within the State (including employees of public education institutions). These rules may be applicable only to charter school officials and not to the CMO officials beyond their capacity as contractors of the charter school.

State charter school laws for two of the six States we selected, Michigan and California, did not include rules regarding conflicts of interest. The other four charter school laws did include varying degrees of rules on conflicts of interest. In Florida, the State's education code requires

¹⁴ 34 C.F.R. §74.42.

¹⁵ 2 C.F.R. §200.318(c).

¹⁶ 34 C.F.R. §74.45.

¹⁷ 34 C.F.R. §74.46.

¹⁸ 34 C.F.R. §74.48.

public officials to fully disclose the identity of all relatives employed by the charter school who are related to top charter school employees, charter school board members, or any other person employed by the charter school who has equivalent decision-making authority, and it requires board members to disclose financial interests. In New York, the charter application must include a code of ethics that set forth the guidance for its trustees, officers, and employees the standards of conduct expected of them, including the requirement to disclose conflicts of interest regarding any matter brought before the board of trustees.¹⁹ In Pennsylvania, the charter school law states that an administrator in a charter school cannot receive compensation from a company that provides management or other services to another charter school. It also specifies that administrators and trustees are public officials and subject to ethics standards and financial disclosure.²⁰ In Texas, before voting or deciding on any matter involving the business entity, a local public official of a charter school that has a substantial interest in a business entity must file an affidavit stating the nature and extent of the interest of the business.²¹ Texas defines a local public official as a member of the governing body of a charter holder, a member of the governing body of an open-enrollment charter school, or an officer of an open-enrollment charter school.²²

Related-Party Transactions

The American Institute of Certified Public Accountants Statement on Auditing Standards No. 45 AU § 334, notes that the Financial Accounting Standards Board Accounting Standards Codification defines related-parties as:

- affiliates of the entity;
- entities for which investments in their equity securities would be required 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; and
- other parties that can significantly influence the management or operating policies, or have ownership interest in the transacting parties to the extent of preventing the transacting parties from fully pursuing its own separate interests.

Although not all related-party transactions are inappropriate, entities must ensure the integrity of all transactions. The American Institute of Certified Public Accountants encourages an organization's external auditors to be aware of the possible existence of material related-party transactions. In addition, the Financial Accounting Standards Board requires entities to disclose material related-party transactions in its financial statements.

Segregation of Duties

As defined by the GAO Green Book and the COSO framework, segregation of duties is an example of a control activity under the five components of internal controls. The purpose of this

¹⁹ New York State Charter Schools Act of 1998, as amended, Article 56 §2851(2).

²⁰ Pennsylvania Charter School Law §17-1715-A(12).

²¹ Texas Administrative Code §100.1133.

²² Texas Education Code §12.1054.

control activity is to ensure that no one person can control all aspects of any particular transaction. Different people should handle the duties and responsibilities required for various parts of a transaction to reduce the risk of error or fraud. Examples of duties that should be separated are "...authorizing transactions, processing and recording them, reviewing the transactions, and handling any related assets."²³

In addition, the GAO Green Book establishes that internal controls should include procedures to identify risk of external and internal factors that may affect an agency at the entity-wide and activity levels and perform risk assessments. Entities can identify risk by using qualitative and quantitative ranking activities, engaging in management conferences, forecasting and strategic planning, and considering findings from audits and other assessments. The entity should then assess the identified risks for their possible effects. Risk generally includes estimating the risk's significance, assessing the likelihood of its occurrence, and deciding what actions are needed to manage the risk.

²³ For the purposes of our audit, we applied the GAO Green Book definition of segregation of duties at the organizational level to evaluate whether duties were sufficiently segregated at charter schools and their CMOs. We defined segregation of duties to include a separation of functions and duties between the charter school and the CMO.

AUDIT RESULTS

We assessed the current and emerging risk that charter school relationships with CMOs pose to Department program objectives as significant. We determined that the Department did not have effective internal controls to mitigate the risks related to charter school relationships with CMOs. We categorized the significant risks as financial, accountability, and performance risks that can negatively impact the use of funds and successful implementation of program objectives.

Charter School Relationships With CMOs Identified in our Case Studies, Investigative Cases, and Related State and Local Audit Reports Posed a Significant Risk to OESE, OSERS, and OII Program Objectives

We identified significant risk to Department program objectives based on our audit procedures performed at 33 charter schools in 6 States for the audit period July 1, 2011, through March 31, 2013, including reviewing the related State and local audit reports, as well as trends identified by Office of Inspector General (OIG) investigative cases involving CMOs performed nationwide from January 2005 through June 2016.

To assess the current and emerging risk that charter school relationships with CMOs pose to Department program objectives, we performed reviews at selected SEAs and charter schools with CMOs that received Federal funds during our audit period. We judgmentally selected 33 charter schools with CMOs in 6 States; therefore, the rate of occurrence of these internal control weaknesses cannot be projected to the universe of all charter schools with CMOs. However, through these case studies, we determined that similar systemic internal control issues could occur at other charter schools. We selected the 33 charter schools based on a variety of factors including, but not limited to:

1. information from the Internal Revenue Service form 990;²⁴
2. findings related to charter school relationships with CMOs from State and local audit reports, where available;
3. news article searches regarding charter school relationships with CMOs; and
4. management and operational characteristics, such as the CMOs' for-profit/nonprofit status, the number of States in which the CMOs operated, the number of years that the charter schools were open, and the charter schools' LEA status.²⁵

²⁴ Nonprofit corporations use the Internal Revenue Service form 990 to file annual information returns that include information on revenues, various functional expenses, and administrative fees.

²⁵ Depending on a State's charter school law, a charter school may operate as its own LEA or within an existing LEA. Additionally, 34 C.F.R. §300.209 (d)(1) states that SEAs are responsible for ensuring that charter schools that are not their own LEA or are schools within an LEA meet certain requirements with respect to students with disabilities who attend those schools.

We found 36 examples of internal control weaknesses, conflicts of interest, related-party transactions, and insufficient segregation of duties concerning charter school relationships with CMOs at 22 of the 33 charter schools we reviewed. Furthermore, we identified additional examples of internal control weaknesses from other audit reports and nationwide OIG investigative cases. We determined that the internal control weaknesses we identified have the potential to affect charter schools' entity-wide operations and consequently pose risk to all State and Federal funds awarded to the schools. Specifically, we concluded that the examples we found of internal control weaknesses represent the following significant risks to Department program objectives:

1. **Financial risk.** This is the risk of waste, fraud, and abuse resulting from conflicts of interest, related-party transactions, and insufficient segregation of duties.
2. **Lack of accountability over Federal funds.** This is the risk that, as a result of charter school boards ceding fiscal authority to CMOs, charter school stakeholders (the authorizer, SEA, and Department) may not have sufficient accountability over Federal funds to ensure grantees and subgrantees are complying with Federal requirements. As a result, the CMO may spend Federal funds on expenditures that are not in accordance with Federal law, regulation, and grant requirements.
3. **Performance risk.** This is the risk that, as a result of charter school board ceding operational authority to CMOs, charter school stakeholders may not have sufficient assurance that grantees and subgrantees are implementing Federal programs in accordance with Federal requirements. As a result, the CMO may not provide charter school students with services that are in accordance with Federal program requirements.

We found that 13 of the 36 examples of internal control weaknesses were applicable to multiple categories of significant risk to the Department. Therefore, the number of internal control weaknesses is different from the number of significant risks discussed below.

Financial Risk

In our reviews, we found 24 examples at 17 charter schools of conflicts of interest, related-party transactions, and insufficient segregation of duties that, if unmitigated, present significant financial risk to Departmental programs and could put charter schools at risk of closing.²⁶ Specifically, we noted weaknesses in the operating controls of charter schools that provided opportunities for key charter school personnel, charter school board members, and the CMO to have conflicts of interest. Further, we identified relationships between the charter school board members and CMOs, as well as relationships between charter schools and CMO-affiliated vendors, that may put Federal, state and local funds at risk of misuse.

²⁶ We found one school in Florida that terminated its management agreement with its CMO in January 2013. The school's facility lease agreement with the CMO was also terminated effective June 2015 causing the school to be at risk of closing because it had to move out of the facility it operated in prior to it having an opportunity to identify a new operating location.

Risk of Violation of Program Integrity Requirements

Recipients of Federal funds are required to ensure that they comply with applicable Federal and State rules regarding conflicts of interest. At 8 of the 17 charter schools, we identified 11 examples of relationships between charter school employees, board members, CMO officials, or vendors that presented potential conflicts of interest that, if unmitigated, could violate applicable conflict of interest rules. The following are some examples:

- Four charter school board members at one charter school in Pennsylvania had potential conflicting interests with the CMO because they were also the CMO chairman, CMO board member, CMO president, and CMO chief financial officer. The president and the chief financial officer signed the management contract on behalf of both the charter school and the CMO.
- Officials at five charter schools in Texas were also officials at the CMOs and did not disclose potential conflicts of interests they had with vendors providing services to the charter schools.²⁷ In one of the five charter schools, an official was a member of the charter school and the CMO boards, provided legal services to the charter school but did not recuse himself from voting on compensating himself for legal services he provided to the charter school. At another two charter schools in Texas, the charter school board president, CMO board member, former superintendent, and former assistant superintendent had substantial interest in two companies that provided services to the two charter schools.
- Two charter schools in Florida that had the same CMO leased their facilities through two affiliated companies of the CMO. We found a series of potential conflicts of interest between key officials of the charter school, the CMO, and the two affiliated companies. The founder of the charter school operator was also the founder of the CMO, and the sibling of the founder had managing responsibilities at the two affiliated companies that leased the buildings to the two charter schools. The siblings occupied positions including board member at the two charter schools, the CMO president, the CMO vice-president, and the manager and president at the two affiliated companies.

Risk of Misuse of Public Funds

Recipients of Federal and other public funds are required to ensure they have internal controls to prevent putting Federal and other public funds at risk of misuse. We identified 13 examples of potential conflicts of interest, related-party transactions, and insufficient segregation of duties affecting school and CMO financial transactions that may put Federal and other public funds at risk of misuse. We found that 6 of the 17 charter schools with examples that represented financial risk that had charter school governing board members that were fully or partially appointed by the contracted CMO or were the same board members as the contracted CMO's board members.

This risk was also present in situations where charter schools relied on their CMOs for facilities services. We identified 9 charter schools that had lease agreements with the CMO or an affiliate of the CMO. Charter school boards that leased facilities from their CMOs and maintained the

²⁷ According to Texas charter school law, charter holders are not CMOs, but are allowed to provide management services to charter schools under its charter. For the purposes of our audit, we considered charter holders to be CMOs. Two of the charter schools in Texas had separate charter school boards from that of their CMOs. Four of the selected case study charter schools in Texas had the same board as their CMOs.

lease agreement but ended the relationship with their CMOs could have been at risk of not being able to readily terminate their management services relationship with the CMO.

The following are examples we found of charter schools that had weaknesses in internal controls that could put Federal and other public funds at risk of misuse:

- The Chief Executive Officer (CEO) of one CMO in Pennsylvania had the authority to write and issue checks without charter school board approval and wrote checks to himself from the charter school's accounts totaling about \$11 million during the 2008–2009 school year. While legal counsel for the charter school stated that the school subsequently established procedures to prevent this from reoccurring, the charter school could not provide us with documentation to support the change.
- One of the vendors that supplied services to a charter school in Pennsylvania was owned by the charter school's CMO. The charter school paid the CMO \$485,000, without charter school board approval, over the past 6 years for services the vendor rendered. The charter school board did not independently approve vendor services because the CMO had significant authority over charter school operations.
- One charter school in Florida, which shared the same board as its CMO, entered into a 10-year lease agreement with the CMO in 2006 for the charter school facility and subsequently decided to expand the facility, extend the lease, and increase the rental payments. Because the charter and the CMO had the same board there were conflicting interests that may not have been in the best interest of the charter school.

The examples above demonstrate the significant internal control risks associated with doing business with vendors closely affiliated with CMOs that exert significant control over charter schools. The CMOs that maintained controls over expenditures and lease arrangements also may have had an opportunity to charge unsupported costs to the charter school.

Lack of Accountability Over Public Funds

Recipients are required to have internal controls to properly account for and spend Federal and other public funds. We found that 13 of the 33 charter schools had examples of charter school boards ceding substantial fiscal authority to CMOs in their management contracts.

Decision-making authority granted to the CMO over charter school operations was included in the CMO contracts for two charter schools. We found that two charter school boards gave its CMO authority to select charter school board members or control charter school bank accounts, which included the ability to write checks on behalf of the charter school boards without obtaining board approval. We also found that, while charter school boards may have approved an initial budget, CMOs were able to make expenditure decisions without prior approval from the charter school board. The charter school boards that delegated their authority could not fully exercise some of their duties as recipients of Federal and other public funds, including overseeing and administering those funds. As a result, the charter school boards were unable to mitigate risks of CMOs misusing Federal and other public funds. Charter school boards must ensure that Federal funds are used for expenses that were reasonable, allocable, and allowable for

the programs implemented at the charter schools.²⁸ The following are some examples of the lack of accountability over public funds:

- One CMO had significant authority over operations of three Michigan charter schools and one New York charter school. The charter school boards signed CMO contracts that required the charter schools to remit all Federal, State, and local funds to the CMO and gave the CMO responsibility for paying the charter school expenditures. The charter school boards did not approve expenditures throughout the school year or final expenditures. The CMO was contractually allowed to retain all charter school funds not spent at the end of the year as the management fee.
- As previously discussed under “Risk of Misuse of Public Funds,” the CEO of one CMO had sufficient authority and control over charter school operations to write and issue checks without charter school board approval for one charter school in Pennsylvania. We found that the CEO wrote checks to himself totaling about \$11 million during the 2008–2009 school year.
- Another CMO in Pennsylvania selected the members of a charter school’s board, and those members selected the remaining board members. The CMO handled all of the finances on behalf of the charter school and did not need the charter school board’s approval.

When charter school boards delegated financial or operational authority to CMOs, the charter school board may not have been able to review, approve, or reject decisions made by the CMO, including awarding contracts, expenditures, and personnel decisions. Therefore, the charter school board may have been unable to determine whether the CMO complied with laws and regulations to ensure that Federal funds were properly managed and spent.

Program Performance Risk

Participants in Federal programs are required to ensure that they comply with applicable program requirements. We found 2 of the 33 charter schools had examples of charter school boards ceding program operational authority to CMOs.

For example, one CMO had complete authority to make personnel decisions for a charter school in Florida, including unilaterally terminating its contract with the charter school board if the board did not adopt the CMO’s personnel recommendations. The contract required the CMO to comply with Federal, State, and local laws and the school’s charter when hiring and firing personnel, determining staffing levels, and performing staff evaluations. However, given the scope of the CMO’s authority in this area, we questioned the school board’s ability to fully exercise its programmatic control. When charter school boards did not maintain sufficient authority over charter school operations, they may not have had assurance that schools implemented Federal programs in accordance with Federal requirements, and this could potentially put charter schools at risk of closing.

²⁸ OMB Circular A-122 Attachment A (A)(2), states that, to be allowable, expenditures need to be reasonable and allocable.

OIG Investigations Have Identified Fraud That Represented the Significant Risk of Charter Schools Relationships With CMOs

From January 2005 through June 2016, the OIG investigated a number of significant criminal cases that reflected the risk of misuse and the lack of accountability over Federal and other public funds. These cases are indicative of CMOs having too much control over charter school operations without management and oversight. The following are examples of some of these cases:

- **Oregon Charter School Management Company and Two Former Executives Misused Federal and State Charter School Funds.** The CMO in this case managed about 18 charter schools in Oregon. The CMO and two executives violated various Oregon statutes related to charter schools such as failing to provide audit reports, submitting grant expenditure and activity reports that contained false statements, comingling school funds, and improperly merging charter schools. The false statements on the grant expenditure and activity reports caused the Oregon Department of Education to continue to allow the CMO to request and receive Federal charter school startup grant funds. The two executives controlled the charter schools to the extent that the charter schools functioned and operated as one singular enterprise with its central hub at the CMO. The stipulated judgment and injunction for this case required the CMO and executives to pay a total of \$475,000.
- **Board Director and Wife Defraud a Charter School in Minnesota.** In this case, the husband was the charter school's board director, and the couple jointly formed the CMO. However, the board director failed to disclose to the other board members or employees the full extent of his interest in the CMO. Over the course of 4 years, the couple repeatedly billed the charter school excessive amounts for services the CMO allegedly rendered. The couple diverted over \$400,000 in local, State, and Federal funds for personal use, including purchasing a vacation cruise, paying off personal credit card debt, and purchasing sporting event tickets. In addition, the couple had the charter school pay a vendor without a contract or board approval. The vendor was a business that the board director's wife operated. The charter school's president and board director and his wife were sentenced to 37 months and 30 months in prison, respectively, and ordered to pay more than \$480,000 in restitution.

These cases generally involved risks that resulted in potential harm to Federal and other public funds. Specifically, the cases involved one or more people taking actions that resulted in false grant expenditure and activity reports, overpayments, and fraudulent contracts used to bill charter schools for services not actually performed. These cases illustrate the potential risks that exist when charter schools and CMOs have conflicts of interest.

State and Local Auditing Entities Performed Limited Work

Between FYs 2010 and 2013, a State audit entity in New York conducted an audit involving charter schools with CMOs and a local audit entity in Pennsylvania conducted an investigative review involving various charter schools. The reports cited questionable service and lease agreements, uncertainty as to the fiscal controls maintained at the charter schools, and a CMO that refused to provide documentation to support its activities. The CMO, which operated charter schools in eight States, was unwilling to provide financial information related to its charter school management to the State auditing entity because the CMO claimed the information was private and proprietary.

Two State auditing entities had limited authority to perform audits related to charter schools with CMOs. Specifically, one State auditing entity in Michigan claimed it did not have the authority to audit a charter school or a CMO. Another State auditing entity in Pennsylvania indicated that the CMOs did not want to provide their information because they stated that they were a private entity and were not the auditee. As an alternative, the auditing entity used the Internal Revenue Service form 990 to obtain information.

Risks in Charter School Relationships With CMOs

Given the internal control weaknesses, substantiated cases of fraud, and limited State and local audit work discussed above, we determined that the unique attributes of the relationships between charter schools and CMOs can result in a significant risk to Federal and public funds. Oversight entities at the Federal, State, and local level have a shared responsibility of protecting funds that are awarded to charter schools; however, as discussed below, there are numerous barriers to effective oversight that compound the risk internal control weaknesses pose to the Department.

Finding – The Department Did Not Have Effective Oversight to Evaluate and Mitigate the Risk That Charter School Relationships With CMOs Pose to Department Programs

The Department did not establish effective oversight to evaluate and mitigate the significant risks that charter school relationships with CMOs pose to the Title I, SIG, IDEA, and CSP grants program objectives. Specifically, the Department did not assess the programs' exposure to the risks and did not develop monitoring procedures that would provide sufficient assurance that the financial, lack of accountability, and program performance risks specific to charter school relationships with CMOs were identified and mitigated.

For the majority of the funds from the Departmental programs we reviewed, the SEA is the grantee receiving the funds. The Department monitors the SEAs for compliance with program requirements of Federal grants and generally relies on the SEAs to oversee subgrantees, typically LEAs. Some charter schools operate as their own LEA and some operate as schools within an existing LEA. The Department stated that charter schools with CMOs did not involve additional risk to the Department.

The Department did not establish effective oversight to ensure that it properly assessed risks associated with charter school relationships with CMOs. In addition, the Department did not provide instructions to the SEAs to ensure that they took steps to identify and mitigate risks or alert the Department to the risks that may be identified by the SEA or authorizers. According to the GAO Green Book and COSO framework, an organization's management should implement effective internal control systems that adapt to changing operating environments. As such, the Department should have assessed the risk that charter school relationships with CMOs posed to Department program objectives.

The Department conducted risk assessments of Title I, SIG, IDEA, and CSP grants at the SEA level that were based on administrative, internal controls, and financial risk factors. However, the factors in the risk assessment tools were not adapted to separately address the risk and the change in operating environment represented by charter school relationships with CMOs. In addition, officials from the six SEAs we reviewed stated that they did not treat charter schools differently from other subgrantees, which indicated that they also did not recognize the change in environment that charter schools with CMOs presented. Consequently, the six SEAs did not develop procedures, such as specific elements in their monitoring protocols for Federal programs at charter schools managed by CMOs.

The Department did not obtain information from the SEAs on what they were doing to assess and mitigate potential risks. Furthermore, the Department did not have procedures to identify the type of data that would indicate risky relationships of charter schools with CMOs. Specifically, the Department did not ensure that SEAs identified the extent and nature of risky relationships between charter schools and their CMOs and evaluate those risks to determine whether the risks were detrimental to Department program objectives. The Department should provide SEAs with guidance on collecting and analyzing critical information available at the SEA level, including:

- the charter school management contract or agreement,
- details about the type of relationships that the charter school established with the CMO,

- details about existing relationships between the charter school and CMO board members,
- the lease agreement of charter school facilities, and
- whether the CMO was for-profit or nonprofit.

Further, the Department should implement controls to address risks related to charter school relationships with CMOs.

If the Department had decided to assess the risk of charter school relationships with CMOs, the lack of a standard definition of a CMO at the Department level, coupled with inconsistent and sometimes conflicting definitions at the State level, would impede any analysis of comparable nationwide CMO data. As a result, the Department was, and remains, unable to adequately assess its exposure to the significant risks that charter school relationships with CMOs pose to Department grant programs and to develop effective mitigating controls, including monitoring procedures.

The Department Considered the Risk of Charter Schools With CMOs the Same as Other Grantees

The Department did not perform a risk assessment because Department officials stated that risks posed by charter schools with CMOs were not materially different from the risks presented by other grantees that received Department funds. Department officials stated that they addressed risks associated with charter schools in the same manner as risks associated with other grantees. In addition, they stated that OII uses a risk-based strategy in the monitoring and administration of CSP grants. However, they did not have a risk model that included criteria indicative of the risks unique to charter school relationships with CMOs. In particular, they did not assess the risks associated with governance arrangements because they believed that issues concerning the direct governance of charter schools are primarily the responsibility of the appropriate State and local governments, including charter school authorizers. While the Department reviewed the management of charter schools regarding program requirements, it stated its role involving the governance of charter school relationships with CMOs was limited.

OMB Circular A-123 §§ I.A. and II.D. state that internal controls are a means of managing the risk associated with Federal programs and operations. Managers should perform risk assessments to identify weaknesses within the organization's control environment and improve internal controls in those areas. Management should timely communicate relevant internal control information to relevant personnel at all levels within an organization.

The GAO Green Book states that internal controls should provide for an assessment of the risks the agency faces from both external and internal sources. Once management has identified the risks, it should analyze the risks for their possible effect, including the risk's significance and likelihood of occurrence. Management should then determine how to manage the risk and what actions it should take.

The Department Did Not Have Effective Monitoring Procedures to Mitigate Risk

The Department did not have monitoring procedures that would provide sufficient assurance that the risks specific to charter school relationships with CMOs were being identified and mitigated. Specifically, the Department did not assess how SEAs were monitoring the relationships between charter schools and CMOs. Because it did not take steps in its monitoring efforts to assess SEA oversight, the Department could not rely on State and local monitoring of charter

school relationships with CMOs. As a result, the Department's monitoring procedures were insufficient to mitigate the significant risks that charter school relationships with CMOs pose to Department program objectives.

Insufficient Department Monitoring of Charter School Relationships With CMOs

The Department did not implement comprehensive monitoring procedures to identify and mitigate the risks that relationships between charter schools and CMOs pose to Title I, SIG, IDEA, and CSP grants program objectives. For SIG and CSP non-SEA programs, the Department had steps in their monitoring tools that addressed the CMO relationship with charter schools. However, it did not have similar steps in their Title I, IDEA, and CSP SEA grant monitoring tools.

- The OESE Student Achievement and School Accountability Programs monitoring plan for the SIG program in FY 2012 included a section to monitor charter school relationships with CMOs.²⁹ This plan required obtaining the charter school's contract with the CMO but did not include steps that would have sufficiently addressed financial risk, lack of accountability, and program performance risk stemming from charter school relationships with CMOs. The monitoring activities were not sufficient because they focused on grantees, which were SEAs, and performed limited monitoring of LEAs. If a charter school was not an LEA, it would be unlikely that the charter school would be selected for monitoring.
- In FY 2011, OII required SEAs applying for the CSP SEA grant to provide assurances, including a description of how the charter schools would be managed and how the CSP SEA grant would be used in conjunction with other Federal programs. OII provided charter school monitoring through a contractor. The CSP SEA monitoring tool included steps to review the SEAs' assurances made during the application phase. However, these steps did not specifically include steps to require the contracted vendor to evaluate charter schools relationships with CMOs.
- The CSP non-SEA monitoring tool had steps to review CMOs' involvement in charter schools operations. These steps were related to charter schools' use of CMOs, CMO roles in daily charter school operations, and charter schools' conflicts of interest policies. The CSP non-SEA monitoring tool included steps to specifically review at least once during the grant period for potential conflicts of interest between charter schools and CMOs.

Insufficient SEA Monitoring of Charter School Relationships With CMOs

We found that all six of the SEAs performed insufficient monitoring of charter school relationships with CMOs for the Title I, SIG, IDEA, and CSP grantees. As the grantees, SEAs were responsible for the compliance and fiscal monitoring of these Federal grants that charter schools with CMOs received as subgrants. According to all six of the SEA officials, charter schools were monitored the same as traditional public schools for the Title I, SIG, and IDEA grants. Therefore, the SEAs did not include specific steps geared to examine CMO relationships at charter schools.

²⁹ The Student Achievement and School Accountability Programs is a component of OESE that oversees and monitors the Title I, SIG, and other grant programs that were not within the scope of our audit.

All of the SEAs that received CSP SEA grants had a division within their education departments specifically dedicated to administering the grants and monitoring their charter schools that received CSP grants. Five of the six SEAs that received the CSP SEA grant performed limited steps to examine the relationship between charter schools and CMOs.³⁰ Although the five SEAs had steps to examine the relationship between charter schools and CMOs, the steps did not include procedures sufficient to identify specific internal control weaknesses such as conflicts of interest, related-party transactions, and insufficient segregation of duties.

Authorizer Monitoring of Charter Schools With CMOs

All 16 authorizers in the 6 States we reviewed had varying degrees of oversight and monitoring of charter schools. To receive Federal funds, charter schools must have an approved charter from an authorizer. Authorizers have a role under State charter school laws to oversee the quality of charter schools.

The various State charter school laws describe the roles and responsibilities of authorizers regarding approval, renewal, and revocation of a charter. Because we did not audit the authorizers, we did not fully evaluate the quality of their oversight efforts. However, we reviewed documentation that the authorizers provided to determine whether the authorizers identified the same instances of internal control weaknesses that we identified and whether the authorizers determined the acceptability of fiscal risks to carry out the charter school's program objectives. We found examples of charter schools approved by 11 of the 16 authorizers with internal control weaknesses and determined that 5 of the 11 authorizers were aware of some of the weaknesses we identified in our audit. The authorizers sometimes reviewed the risks to determine whether the risks were acceptable to charter school program's objectives and we found only one authorizer that had steps included in their protocols to address the risks.

State charter school laws governing authorizer oversight varied significantly from State to State regarding conflicts of interest, related-party transactions, and segregation of duties. The State charter school laws in the six States we reviewed mandated that the authorizers perform some type of review of charter school relationships with CMOs. However, we determined that these reviews did not generally address the areas of internal control weaknesses that we identified in our work because the charter school laws did not consistently require the authorizers to:

- review the contract between the charter school and the CMO,
- require the charter school governing board to be separate from the CMO, and
- require the charter school governing board to disclose conflicts of interest in the charter application and renewal application.

Table 2 shows State requirements for authorizers to review charter school relationships with CMOs.

³⁰ One SEA did not receive the CSP SEA grant during our audit period.

Table 2. Authorizer Review of Charter School Relationships With CMOs

State Charter School Law Requirements	New York	California	Texas	Michigan	Florida	Pennsylvania*	Total States With Yes
For-Profit and Nonprofit CMOs Allowed	Y**	Y	Y	Y	Y	Y	6
Contract Required if the Charter School Has a CMO	N	N	Y	Y	N	Y	3
Authorizer Required to Review Terms of the Charter School Contract With CMO	N	N	Y	Y	N	Y	3
Authorizer Required to Review Charter School Board Independence From CMO	Y	N	Y	Y	N	N	3
Conflicts of Interest Required to be Disclosed in the Charter Application	Y	N	Y	N	Y	Y	4

* While the Pennsylvania charter school law is silent on charter school relationships with CMOs, this information was based on the 2013 charter school application and our audit work.

** In May 2010, the New York charter school law excluded for-profit CMOs from participating in new applications with charter schools, unless the charter applications specifically included the extent of the CMOs' participation in the management and operation of the school.

The authorizers in California, Pennsylvania, and Texas were not aware of the potential conflicts of interest, related-party transactions, and insufficient segregation of duties that we found. The authorizers selected in New York and Michigan were aware of some of the conflicts of interest and related-party transactions examples that we identified, and determined whether the internal control weaknesses posed a detrimental fiscal risk to carrying out the charter school's program objectives. The authorizer in Florida was aware of most of the instances of conflicts of interest

and related-party transactions (through a charter school audit report issued by an LEA audit group), as well as the instances of insufficient segregation of duties that we found.

Sharing of Information Regarding Charter Schools With CMOs Between SEAs and Authorizers

State charter school laws in the six States did not require SEAs to ensure that authorizers monitored charter school compliance with applicable regulations. As grantees, SEAs have a responsibility to oversee Federal funds that flow through the State and ensure that the funds are properly administered by the SEAs' subgrantees, including charter schools with CMOs. For one of the six States, the SEA program offices responsible for oversight of Federal and State funds had communications with the authorizers.

The Michigan SEA took steps to monitor authorizer reviews of charter school compliance with the State charter school law; however, it had only limited authority to monitor the activities of the 37 authorizers operating in the state. The Michigan SEA "Authorizer Assurance and Verification Visits" policy established voluntary procedures to ensure that authorizers complied with all requirements of the Michigan charter school law, provided technical assistance, and promoted communication between authorizers and the SEA. The Michigan SEA provided a report with feedback to the authorizers, but did not make the results public. Because it was voluntary for authorizers to comply with the policy, the Michigan SEA was limited in its ability to ensure authorizers complied with State charter school law.

We found that authorizers in five of our selected States were required to share charter school performance and fiscal information with States. While authorizers played a role in establishing charter school eligibility for Federal funds, we determined that they were not required to share information regarding risky charter school relationships with CMOs with the SEAs. Sharing such key relationship risk information with SEAs would better enable the SEAs to identify and mitigate potential risks to Federal programs.

Federal Requirements Regarding Oversight and Monitoring of Federal Programs

Current Federal requirements do not describe the role of authorizers in oversight and monitoring of Federal programs. Further, none of the State charter school laws for the six States we reviewed address authorizer's responsibility regarding Federal programs and vary in what is required to be reported to the SEA. For additional detail, see Appendix 1.

OMB Circular A-123 describes management's responsibility for internal controls. In addition, Federal requirements applicable to the Department's and the SEAs' oversight and monitoring are as follows:

- According to the GAO Green Book, internal controls should generally be designed to assure that ongoing monitoring occurs in the course of normal operations of the organization. Monitoring of internal controls should include policies and procedures for ensuring that the findings of audits and other reviews are promptly resolved.
- According to 34 C.F.R. § 76.702, a State and a subgrantee must use fiscal control and fund accounting procedures that insure proper disbursement of and accounting for Federal funds.
- According to 34 C.F.R. §§ 80.20, 76.730 and 76.731, States and subgrantees must maintain records that adequately identify the source and application of funds and compliance with program requirements. They must also maintain records to facilitate an effective audit.

- According to 34 C.F.R. § 80.40(a), grantees must monitor grant and subgrant supported activities to ensure compliance with applicable Federal requirements and performance goals are met.

The Department Should Provide Guidance to Help SEAs Identify and Mitigate Potential Risks of Charter School Relationships with CMOs

According to Department officials, for programs where the SEAs were the grantees,³¹ it was the SEAs' responsibility to oversee subgrantees and ensure that they complied with grant requirements. However, the Department did not provide guidance to the SEAs to identify and address risks resulting from the relationships between charter schools and CMOs. Even though Department officials stated that issues regarding the direct governance or administration of charter schools were primarily the responsibility of the appropriate State or local governments, we found that these entities were not taking actions to assess the risk that the relationships between charter schools and CMOs pose to Department program objectives.

The Department should provide guidance that would help SEAs assess risks related to charter schools with CMO relationships and share information regarding the risks identified with other SEAs and with the Department. The Department did not provide guidance to SEAs regarding consistent monitoring of charter school authorizers. Although the authorizers do not directly oversee Federal funds, they approve charter applications, which enable charter schools to be recipients of direct and flow-through Federal grants. An SEA official stated that the State law did not grant the SEA authority to conduct monitoring of authorizers in the respective State. We found no specific provision in State legislation in the six States requiring or precluding the monitoring of authorizers by SEAs. In addition, no entities oversaw authorizers in five of the six States; in the sixth State, the SEA performed a review of authorizers that was voluntary for authorizers to participate in. Given the lack of Department guidance to address the risks that charter school relationships with CMOs pose to the Department's programs, SEA oversight and monitoring may not have been mitigating these risks.

Recent Department Program Guidance

While the Department has not developed guidance to mitigate risks specific to CMOs, it has issued guidance for its programs that broadly addresses areas of risk management, oversight, and monitoring. This guidance suggests procedures related to monitoring, such as risk-based monitoring and sharing monitoring results. The Department also issued Dear Colleague letters that discussed the need to minimize conflicts of interest between grantees, subgrantees, and contractors, as well as the role of SEAs in oversight and monitoring of charter schools to ensure that they use Federal funds properly. The guidance described below does not directly address the risks that charter school relationships with CMOs posed to Department programs; however, they provide examples of the Department's efforts to improve oversight that could be modified or adapted to more directly address the issues raised in this report.

U.S. Department of Education Grant Bulletin 14-06, April 28, 2014, establishes guidance that helps program offices within the U.S. Department of Education develop monitoring plans for formula grant programs consistent with their Principal Office Monitoring Frameworks. Specifically, the guidance encourages program offices to consider proactively assisting grantees

³¹ SEAs were the grantees for the Title I, SIG, IDEA, and CSP SEA grants. OII awards the CSP non-SEA grant directly to charter schools, and awards the CSP Replication and Expansion grant directly to nonprofit CMOs.

to meet performance standards and grant requirements by sharing information. The guidance also suggests that program offices could conduct risk-based monitoring of grantees that includes a risk rubric to identify and assess a grantee's potential risk in the areas of meeting performance standards and complying with program, financial, and administrative requirements.

In a Dear Colleague letter dated March 10, 2014, OESE provided suggested measures to help prevent fraud and abuse in the use of Federal education funds. This guidance was in response to OIG management information report, "Fraud in Title I-Funded Tutoring Programs," October 2013 (ED-OIG/ X42N0001). In this report, the OIG presented the findings and results of investigations and audits conducted on Supplemental Educational Services providers in multiple States over the past decade, which included findings concerning conflicts of interest and a lack of monitoring similar to those presented in this report. In the Dear Colleague letter, OESE states that SEAs and LEAs should consider taking steps to strengthen protections against fraud and corruption. Specifically, OESE suggested steps to minimize conflicts of interest that, if effectively implemented, may help prevent the types of risks from occurring and would greatly facilitate identification, prosecution, and recovery of funds where fraud is committed. Like Supplemental Education Services providers, CMOs provide services to charter schools; however, CMOs are not required to seek SEA approval to provide services and, with the exception of those CMOs that receive CSP Replication and Expansion grants, are generally not subject to monitoring from oversight entities.

The U.S. Department of Education issued a Dear Colleague letter on September 28, 2015, to remind SEAs of their role in helping to ensure that Federal funds received by public charter schools are used for intended and appropriate purposes. The guidance advised that States could play a helpful role in areas such as charter school operational oversight, CMO relationship transparency, and strong authorizing practices. The Department plans to work with OMB and the OIG to revise the government-wide guidance provided to auditors in the OMB Circular A-133 Compliance Supplement to ensure that single audits provide a deeper review of State and local oversight of charter schools and their management practices, as they relate to Federal program funds. The letter reminds SEAs that the Department is available to help SEAs as they oversee and monitor the use of Federal funds by charter schools.

Recommendations

We recommend that the Delegated Deputy Secretary —

- 1.1 Convene a formal oversight group including high level representatives from the following offices: Office of the Deputy Secretary, OESE, OSERS, OII, and the Office of the Chief Financial Officer. The oversight group would determine the most appropriate manner to conduct an analysis and assessment of the risks to Department programs posed by charter schools with CMOs. The assessment would consider actions appropriate to the Department's Federal role to assist SEAs, LEAs and charter school authorizers to fulfill their obligations for oversight of Federal funding. Such actions would include, but not be limited to the recommendations that follow.
- 1.2 Provide further guidance to SEAs that offers a general strategy for performing a minimum level of monitoring, risk assessment, and mitigation procedures related to charter school contractual relationships with CMOs.

- 1.3 Develop modifications to program monitoring protocols for Title I, IDEA, CSP grants, and other programs to assist Federal grantees in meeting their monitoring and oversight responsibilities with respect to CMOs.
- 1.4 Work with external partners and interest groups to help SEAs and other authorizers consider risks to Federal funds in their evaluation of proposals for charter schools, including the consideration of what is an acceptable level of risk related to charter school relationships with CMOs.
- 1.5 Collaborate and coordinate with the Office of the Chief Financial Officer's Post Audit Group to update the OMB Circular A-133 Compliance Supplement to include procedures to determine whether the SEA and LEA, as appropriate, have internal controls to ensure that charter schools with relationships with CMOs have effective controls to mitigate financial risks, provide for accountability over Federal funds, and mitigate performance risks.

Matters for Congressional Consideration

We identified a number of significant issues related to charter school use of CMOs, including the lack of consistency among the various oversight entities responsible for overseeing and monitoring charter schools.

We suggest the Department propose legislation for Congress to consider that would clearly identify the governance responsibilities of the Department and SEAs with respect to the roles, responsibilities, and expectations of the administration and oversight over grants provided to charter schools, specifically with regard to the risks associated with CMOs.

We also suggest that the Department propose legislation for Congress to consider that would clearly identify the governance responsibility of authorizing entities with respect to the roles and responsibilities for the approval, renewal, and revocation of charters at a nationwide level.

Department Comments

The Department agreed that there may be increased risk to Federal programs by charter schools that are affiliated with certain management organizations. The Department also agreed that, when appropriate, it needs to continue to provide guidance and technical assistance to SEAs so that SEAs can assess and mitigate the risks posed by charter schools with CMO relationships. The Department proposed alternative language to the report recommendations, including convening a formal oversight group of high level U.S. Department of Education officials to analyze and assess the risks to Department programs posed by charter school relationships with CMOs.

The Department stated that there should be a distinction between nonprofit CMOs and for-profit EMOs because for-profit entities are not eligible to receive direct grants from the Department under the programs covered by the audit. The Department stated that while recipients of Federal funds may enter into contracts with for-profit entities for the provision of goods or services, Federal regulations require that the Federal grant recipient directly administer or supervise the administration of the grant to ensure such costs are necessary, reasonable, and allocable to the grant.

The Department provided comments which describe actions it has recently taken, including the issuance of Dear Colleague letters. The Department announced new plans to collect additional information from SEAs on charter school affiliations with management organizations in order to

improve transparency. The Department also pointed out that by statute, SEAs bear primary responsibility for ensuring that Federal funds that they award to charter schools are expended properly. In addition, the Department noted that its authority is limited by law, and that it does not have the resources to monitor directly each and every charter school.

The Department also noted that because of limited U.S. Department of Education authority and resources, and its work with grantees to facilitate a smooth transition to the Every Student Succeeds Act, it would be premature for the U.S. Department of Education to make significant commitments of resources in response to the report recommendations. However, the Department stated that it can commit to the Office of the Deputy Secretary leading an internal working group that was suggested to OIG in its alternative recommendation language.

In addition to proposing alternative recommendation language, the Department also provided comments to the OIG recommendations. The Department's comments to recommendations 1.1 and 1.3 were in general agreement with the recommendations. For recommendation 1.2, the Department stated that it will consider the recommended action to provide guidance to SEAs. For recommendation 1.4, the Department stated that it will consider the need and appropriateness of the Department taking the recommended action to work with external partners and interest groups to help SEAs and authorizers consider risk to Federal funds, including the consideration of what is an acceptable level of risk related to the charter school relationship with CMOs. For recommendation 1.5, the Department stated that it will consult with the Office of Chief Financial Officer's Post Audit Group to determine the feasibility of updating the Compliance Supplement to include procedures to ensure for effective controls over charter school relationships with CMOs.

OIG Response

We appreciate the actions the Department has taken or plans to take regarding the CMO risks we noted that affect Department programs relating to charter schools, and we also recognize the challenges it faces to ensure proper oversight. Particularly, in addition to the efforts to communicate CMO risks through letters and guidance, we commend the Department on its planned effort to improve transparency and enhance oversight ability by collecting more information on charter school affiliations with management organizations. It is important that the Department take the recommended actions and continue to work with SEAs and authorizers to ensure that the risk posed by charter schools with CMO relationships is properly identified and mitigated. With respect to the term CMO used in the report, we noted in the report that we used a broader definition as there is a significant variation in the definition of CMOs and EMOs used by the Department, States, and in the charter community. The term used in the report ensured our consideration of as many potential definitions as possible in our review of charter schools that had relationships with such entities. While we agree that Federal regulations require that the Federal grant recipient directly administer or supervise the administration of the grant, we noted examples where the charter school board had relinquished control to the CMO and did not directly administer or supervise the administration of the grant.

We revised the recommendations based on the alternative language the Department provided because we agreed that forming an oversight group of high level U.S. Department of Education officials representing the Office of the Deputy Secretary, OESE, OSERS, OII, and the Office of the Chief Financial Officer was appropriate to address the issues we noted in the draft report.

The actions the Department proposed in its comments to Recommendations 1.1 and 1.3 were generally in agreement with the recommendations. However, the actions the Department proposed for Recommendations 1.2, 1.4, and 1.5 indicated it would consider providing additional guidance, continuing to work with SEAs and authorizers, and assessing the feasibility of modifying the compliance supplement. We understand that the working group may need to weigh and consider different approaches as it looks to modify guidance and oversight tools, but believe that based on the issues that we identified in this report that actions are needed in each of these 3 areas. Furthermore, as the Department pointed out in its response that it faces challenges due to limits on its authority and resources, taking action to address these three recommendations are critical to ensuring effective oversight of charter schools with CMOs. For example adding appropriate steps to the compliance supplement will provide necessary oversight on the ground level as single audits are conducted which then can be utilized to better identify risks related to charter schools with CMOs.

We have made changes to the report where appropriate for clarity as a result of the Department's comments.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of our audit was to assess the current and emerging risk that charter school relationships with CMOs and EMOs pose to OESE, OSERS, and OII program objectives and evaluate the effectiveness of OESE, OSERS, and OII internal controls to mitigate the risk. Our audit period covered July 1, 2011, through March 31, 2013, for Title I, SIG, IDEA, CSP SEA, CSP non-SEA, and CSP Replication and Expansion grants. For the purposes of reviewing OIG Investigation Services criminal cases, our audit period covered January 2005 through June 2016.

Test Case

We conducted a test case study of the Pennsylvania SEA, the School District of Philadelphia, and two charter schools with CMOs that were authorized by the School District of Philadelphia School Reform Commission. We performed an informational site visit to the City of Philadelphia, Office of the Controller to obtain an understanding of existing issues regarding charter schools with CMOs.

We judgmentally selected two charter schools with CMOs that the School District of Philadelphia School Reform Commission authorized from a preliminary list of charter schools with CMOs that operated within Philadelphia. We selected the charter schools based on management and operational characteristics of both the CMO and the charter school. We selected schools operated by for-profit and nonprofit CMOs, CMOs operating exclusively in Pennsylvania, and CMOs operating in multiple States. We also considered the charter school's longevity and whether the charter schools were stand-alone LEAs or operated within an existing LEA. We also considered charter schools that opened before 2007 because they have been renewed at least once by an authorizer.

Fieldwork

To achieve our audit objective at the Department we gained an understanding of internal controls through interviewing Department officials and reviewing Department policies and procedures applicable to the oversight and monitoring of Title I, SIG, IDEA, and CSP grants. We identified applicable criteria related to the oversight and monitoring of Federal grants, including, but not limited to internal control standards and relevant program guidance.

We selected 6 States (California, Texas, Michigan, Florida, Pennsylvania, and New York) out of 42 States and the District of Columbia that enacted charter school laws to use as case studies. We judgmentally selected these States based on the number of charter schools with CMOs within the States for the 2010–2011 school year. From those six States, we judgmentally selected 33 charter schools with CMOs and the related 16 authorizers that approved the schools' charters.³² The factors we considered in selecting these charter schools included information

³² None of the 33 charter schools received direct Department grants. Five of the CMOs who had relationships with charter schools selected received one or more CSP Replication and Expansion grants directly from the Department.

from the Internal Revenue Service form 990, findings from charter schools' audit reports, news article searches regarding charter school relationships with CMOs, and management and operational characteristics. Because this was not a statistical sample, the rates of internal control weakness at these charter schools cannot be projected to the universe of charter schools with CMOs within those States or nationwide. In each of the six States, we did the following:

- A. Identified requirements for oversight and monitoring of charter schools within the States' charter school law.
- B. Reviewed information regarding OIG investigations nationwide from January 2005 through June 2016 that identified fraud in charter schools with CMOs.
- C. Reviewed State and local charter school audit reports.
- D. Conducted interviews with State and/or local auditors to gain an understanding of the audit procedures performed on charter schools and CMOs.
- E. Conducted the following work to obtain an understanding of the SEAs' oversight and monitoring of charter schools with CMOs:
 - a. Reviewed the SEA's application, awarding, monitoring, and/or reporting procedures for Title I, SIG, IDEA, and CSP SEA grants for charter schools with CMOs.
 - b. Interviewed key SEA officials responsible for administering and monitoring the Title I, SIG, IDEA, and CSP SEA grants.
 - c. Reviewed documents of each SEA, including:
 - i. Charter schools monitoring reports for the 2009–2010 to 2011–2012 school years;
 - ii. State-issued audit reports or reviews of charter schools performed between the 2009–2010 to 2011–2012 school years;
 - iii. Reviews, management letters, IT audit reports, internal audit reports, and/or corrective actions of charter schools performed from the 2009–2010 to 2011–2012 school years;
 - iv. State policy and procedure manuals related to monitoring and oversight of grants awarded to charter schools;
 - v. State criteria relevant to the responsibility of the SEA, authorizers, and/or LEAs with respect to charter schools and CMOs;
 - vi. Total student enrollment of charter schools with CMOs for the 2010–2011 to 2012–2013 school years, if available; and
 - vii. Amounts disbursed or expended to charter schools with CMOs from FY 2011 to FY 2013, if available.
- F. Conducted the following work to obtain an understanding of authorizer oversight and monitoring at selected charter schools with CMOs:
 - a. Reviewed documents related to approval, renewal, revocation, and monitoring.
 - b. Obtained authorizer monitoring and oversight policy and procedure manuals. Specifically, we reviewed:
 - i. Monitoring plans and any monitoring performed for the case study schools they authorize; and
 - ii. A list of relevant State laws and regulations pertaining to authorizers' responsibility with respect to charter school operations, oversight, and authorization.
 - c. Interviewed key authorizer officials responsible for the approval, renewal, and monitoring.

- G. Conducted the following work at the 33 selected charter schools with CMOs to obtain an understanding of the oversight and monitoring over both entities:
- a. Interviewed charter school board members, charter school officials, and CMO officials regarding the charter schools' governance and oversight, charter school fiduciaries and agents, the CMO contract and fees, and other vendor contracts.
 - b. Reviewed documentation provided by the selected charter schools. The documentation included:
 - i. Charter applications;
 - ii. Lists of directors and trustees of the schools' governing boards, as well as information and records, that included State ethics filings;
 - iii. Charter school information, including, but not limited to:
 1. Charter contract and bylaws;
 2. Charter school employee information;
 3. Charter school vendor and service provider information, including contracts; and
 4. Charter school vendor affiliations.
 - iv. Audited financial statements for FYs 2008, 2009, 2010, 2011, and 2012; and
 - v. Award letters for Title I, SIG, IDEA, and CSP SEA and Non-SEA grants awarded to charter schools.
 - c. Reviewed documentation provided by the CMOs for the selected charter schools. The documentation reviewed included a list of parent companies, subsidiaries, affiliates, and other entities under common control of the charter school's CMO, as well as the name and position of CMO employees.

Locations and Dates

We began our audit with preliminary work at the Department and a test case study in Pennsylvania from December 4, 2012 through February 7, 2013. To achieve our objective we conducted site visits at 6 States, which included 6 SEAs, 33 charter schools with CMOs, and 16 authorizers between April 19, 2013, and May 13, 2014. We held our exit conference with the Department on July 29, 2014. Additionally, we held update meetings with Department officials through July 2016. We conducted fieldwork at the following locations:

- A. SEAs. We conducted primary work related to the 6 SEAs via teleconference. We conducted on-site visits where authorizers were co-located with SEAs in New York and Texas. The SEAs were located in Albany, NY; Harrisburg, PA; Tallahassee, FL; Lansing, MI; Austin, TX; and Sacramento, CA.

B. Authorizers. We conducted site work at the 16 authorizers related to the 33 charter schools with CMOs as specified in Table 3.

Table 3. Work Conducted at the Authorizers

Authorizer*	Location
NY-A	Albany, NY
NY-B	Albany, NY
NY-C	New York, NY
PA-A	Chester, PA
PA-B	Philadelphia, PA
FL-A	Miami, FL
MI-A	Grand Rapids, MI
MI-B	Sault Ste. Marie, MI
MI-C	Brimley, MI
MI-D	Big Rapids, MI
MI-E	Mt. Pleasant, MI
TX-A	Austin, TX
CA-A	Stockton, CA
CA-B	Oakland, CA
CA-C	San José, CA
CA-D	Sacramento, CA

*To preserve the authorizers' anonymity, we have replaced their names with a unique identifier.

C. Charter Schools with CMOs. We conducted site work for the 33 charter schools with CMOs in 6 States.

Table 4. Charter Schools with CMOs Case Studied

Charter School*	Location
NY-1	New York, NY
NY-2	Yonkers, NY
NY-3	Brooklyn, NY
NY-4	New York, NY
NY-5	Brooklyn, NY
PA-1	Chester, PA
PA-2	Philadelphia, PA
PA-3	Philadelphia, PA
PA-4	Philadelphia, PA
PA-5	Philadelphia, PA
FL-1	Miami, FL
FL-2	Miami, FL
FL-3	Hialeah, FL
FL-4	Hialeah Gardens, FL
FL-5	Miami, FL
MI-1	Holland, MI
MI-2	Kentwood, MI
MI-3	Grand Rapids, MI
MI-4	Orleans, MI
MI-5	Grand Rapids, MI
MI-6	Muskegon, MI
MI-7	Walker, MI
TX-1	Dallas, TX
TX-2	Dallas, TX
TX-3	Desoto, TX
TX-4	Desoto, TX
TX-5	Dallas, TX
TX-6	Dallas, TX
CA-1	Stockton, CA
CA-2	Oakland, CA
CA-3	Oakland, CA
CA-4	San José, CA
CA-5	Sacramento, CA

*To preserve the charter schools' anonymity, we have replaced their names with a unique identifier.

Sample Methodology for Charter Schools With CMOs Case Studies

We could not obtain a list of charter schools with CMOs nationwide; therefore, we performed alternative procedures to determine the nationwide universe of charter schools with CMOs. We relied on Common Core of Data from the National Center for Education Statistics³³ and on an independent EMO study performed by the National Education Policy Center, EMO Profiles. The report focused on both for-profit and nonprofit CMOs. In addition, we identified charter schools with CMOs that received Title I funding.

To determine our universe, we matched a list of charter schools reported to have CMOs from the EMO Profile list for the 2010–2011 school year to the National Center for Education Statistics' Common Core dataset for the 2010–2011 school year. We excluded charter schools that were not a Title I recipient, charter schools that were not open, and virtual charter schools. Ultimately, we identified 1,221 open charter schools with CMOs that received Title I funds for the 2010–2011 school year.

Once we developed a universe of charter schools with CMOs, we analyzed the list to (1) find States with a high number of charter schools and (2) identify the prevalence of different management and operational characteristics³⁴ found within specific geographic clusters within those States. We selected States so that we could (1) maximize the total number of charter schools within States selected and (2) find geographic clusters of charter schools whose characteristics spanned different management and operational characteristics. We also considered the proximity of the States and geographic clusters. Based on those attributes, we judgmentally selected six States: Texas, California, Michigan, Florida, New York, and Pennsylvania. Within those States, the geographic clusters we selected were Dallas, Sacramento and Bay Area, Grand Rapids, Miami, New York, and Philadelphia.

Within each geographic cluster, we narrowed the list of potential charter schools for case studies by enrollment. First, we included only charter schools with CMOs whose extrapolated allocation (using student enrollment and average funding amount per pupil) exceeded 0.1% of the State's total Title I allocation. Using the same methodology, we limited the number of CMOs to those whose charter schools had at least 0.02% of the State's total Title I allocation. For each geographic cluster, this resulted in a list ranging from 14 to 24 schools from which we judgmentally selected the schools.

³³ The Common Core of Data in the National Center for Education Statistics included profile information regarding charter schools such as the name, location, contact, and Title I funding indicator.

³⁴ We considered four attributes as management and operational characteristics: (1) for-profit or nonprofit status of the CMO-affiliated with the school (sourced from EMO Profiles), (2) single or multiple state presence of the CMO (sourced from EMO Profiles), (3) whether the school is affiliated with a charter or noncharter LEA (sourced from Common Core of Data), and (4) the longevity of the school (based on EMO Profile's reported opening date of school being before 2007 or after).

Within each geographic cluster, we selected five to seven charter schools with CMOs to include in the case studies based on one or more of the following:

- information in the charter school's Internal Revenue Service form 990
- findings from previous audit reports
- news article searches regarding charter school relationships with CMOs, and
- management and operational characteristics

We judgmentally selected 33 out of 758 charter schools with CMOs for review. Because we judgmentally selected charter schools, the results of our audit cannot be projected across the universe of charter schools with CMOs.

We concluded that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our findings and conclusions as related to the audit objectives. We based our conclusions on discussions with officials at the entities reviewed, documents, and records obtained.

We obtained an understanding of the Department's internal controls concerning charter school relationships with CMOs. We assessed the risk that charter school relationships with CMOs pose to Department program objectives through inquiries of Department, State, and authorizing officials, review of written monitoring policies and procedures and monitoring reports, and analysis of Federal, State, and local audit reports and corrective actions on the recommendations included in those reports. We identified weaknesses in the internal controls at the Department and States, which are fully discussed in the Audit Results section of this report.

We relied on computer-processed data to construct the universe of charter schools with CMOs and to obtain student enrollment at charter schools in the six States selected. First, we assessed reliability of the constructed universe of charter schools with CMOs by comparing EMO Profiles data with publicly available Common Core of Data from the National Center for Education Statistics by matching on multiple data entries including charter school name, location, and enrollment. We validated the universe of charter schools with CMOs by contacting an acceptance sample of 60 charter schools in the universe to verify charter school information and CMO relationship. Second, we relied on computer-processed data SEAs provided to determine enrollment for charter schools with CMOs in selected States. To assess the completeness of these data, we compared the enrollment values provided by the SEAs to Common Core of Data enrollment values in the National Center for Education Statistics. We determined that the data we used were sufficiently reliable for the purpose of our audit.

We conducted this audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

APPENDIX 1: State Summaries

We performed work at the SEA, authorizer, charter school, and CMO. We found 36 examples of internal control weaknesses at 22 of the 33 charter schools in our sample. Tables 5 and 6 show the number of charter schools selected with examples of internal control weaknesses by State and show the types of internal control weaknesses by State found at 22 of the 33 charter schools selected.

Table 5. Number of Charter Schools Case With Internal Control Weaknesses by State³⁵

State	Number of Charter Schools with CMOs Selected	Charter Schools with CMOs with Internal Control Weaknesses
California	5	1
Florida	5	5
Michigan	7	7
New York	5	1
Pennsylvania	5	3
Texas	6	5
Total	33	22

Table 6. Numbers of Internal Control Weaknesses by State and by Type

State	Potential Conflicts of Interest	Related-Party Transactions	Insufficient Segregation of Duties
California	-	1	-
Florida	2	5	2
Michigan	7	5	-
New York	-	1	-
Pennsylvania	4	1	2
Texas	6	-	-
Total	19	13	4
Total Number of Internal Control Weaknesses	36		

Although each SEA and authorizer had monitoring procedures, they typically did not identify and address the risk of internal control weaknesses of charter schools relationships with CMOs. Below is a detailed discussion of our work at SEAs, authorizers, and charter schools with CMOs.

³⁵ The examples of internal control weaknesses cited throughout this report, which included potential conflicts of interest, related-party transactions, and insufficient segregation of duties, were those that we found were related to CMOs.

California

SEA

We reviewed the SEA’s monitoring tools for Title I and IDEA and found that the SEA designed the tools to review programmatic and fiscal aspects of the grants in accordance with Federal regulations. We also found that the California SEA SIG monitoring tool did not fully incorporate the indicators for charter schools suggested in the OESE’s Student Achievement and School Accountability Programs monitoring plan for the SIG program. For the CSP SEA grant, the monitoring tool contained steps to look for conflicts of interest, related-party transactions, and segregation of duties. However, the steps were not sufficient to monitor the relationship between charter schools and CMOs because the steps were limited to the charter school and charter school board.

Authorizers

Authorizers in California are required to comply with the monitoring requirements found in the State charter school law. The law requires the authorizers to visit each charter school at least annually; ensure that each charter school under its authority complies with all reports required of charter schools by State law; monitor the fiscal condition of each charter school under its authority; and provide timely notification to the California SEA if renewal of the charter is granted or denied, the charter is revoked, or the charter school will cease operation for any reason. The five charter schools in California that were part of our case study had four different authorizers; three were LEAs and one was a county office of education.³⁶

We did not identify any conflicts of interest or insufficient segregation of duties between the charter schools and their CMOs in this case study. However, we observed a related-party transaction between one charter school board member and a contractor. A charter school board member was the CEO of an information technology services company that was contracted to provide services to the charter school.³⁷ While the charter school board member recused himself from voting to contract the information technology company for services, we determined that this transaction was a related-party transaction and an internal control weakness because the CMO did not report this related-party properly on its Internal Revenue Service form 990. Table 7 illustrates the related-party transaction we found at the selected charter school in California.

Table 7. Example of Internal Control Weakness by Charter School in California

Charter School	Example of Internal Control Weakness	Example Detail
CA-3	Related-party transaction between the charter school and a contracted company	The charter school board contracted with an information technology company whose CEO was also a charter school board member.

Review of related-party transactions are not included in the authorizer’s monitoring tools; therefore, the authorizer may not have been aware of this related-party transaction.

³⁶ Two of the charter schools had the same authorizer.

³⁷ The charter school and the CMO shared the same board of directors. Therefore, the charter school did not have a separate board.

Authorizer Requirements in California Charter School Law

California State charter school law describes the role and responsibility of authorizers regarding the approval, renewal, and revocation of a charter. California State charter school law empowers authorizers to inspect or observe any part of a charter school at any time. Authorizers are required to conduct oversight procedures, including annual charter school visits, identify a point of contact at the charter school and ensure that charter schools comply with State charter school laws. California State charter school law requires authorizers to notify charter schools of potential problems and provide reasonable opportunity for the charter school to remedy identified problems. California State charter school law permits the State board of education to revoke a charter. Authorizers are required to notify the California SEA of charter school renewals, nonrenewals, and revocation decisions before and after they occur. However, authorizers were not required to be evaluated by any State agency.

Florida

SEA

The Florida SEA's monitoring tools were limited regarding their review of charter school activities with CMOs and did not include procedures that would reveal weakness in the internal control areas we reviewed for this audit. The Florida SEA monitoring tools for the Title I and IDEA grants had monitoring procedures to review the programmatic and fiscal aspects of the grants in accordance with Federal regulations, but they included no specific steps to review how LEAs oversaw charter school activities with CMOs. The Florida SEA SIG monitoring tool did not fully incorporate the indicators for charter schools suggested in the OESE's Student Achievement and School Accountability Programs monitoring plan for the SIG program. The CSP monitoring tool contained one procedure that monitored the procurement process that the CMO handled. Part of the procedure included ensuring that the CMO had no financial interest in a selected vendor. However, the step did not indicate if any decision-making employees at the CMO could own or have a financial interest in a vendor that does business with the charter school. The CSP monitoring tool also contained steps to identify conflict of interest, related-party transactions, and segregation of duties. However, these steps were limited to the charter school and its board.

Authorizers

Authorizers in Florida are required to comply with the monitoring requirements found in the State charter school law. As part of the charter application review processes, the authorizer may review the history and background of the charter school's governing board members, including a demonstration of professional experience or competence to operate the charter school, and a description of responsibilities and policies and procedures needed to effectively manage the charter school. Before renewing a charter, the authorizer conducted a program review of the charter school that included a review of the charter renewal application and documentation showing, among other things, the level of success of the current academic program and compliance with terms of the charter. In addition, the authorizer conducted an annual curriculum and compliance review site visits using the Charter School Compliance Management System. The authorizer also reviewed charter school audited financial statements and had the authority to review and audit the financial records at any time. In Florida, the five schools that were part of our case study were operated by three different CMOs and were authorized by the same authorizer.

We found various examples of internal control weaknesses at the charter schools with CMOs that we selected in Florida State. Specifically, we found related-party transactions at four of the five charter schools in our case study in which the charter school leased school facilities or equipment from the CMO or an affiliate of the CMO. The companies associated with three of these instances were disclosed by the CMO to the OIG regional team as entities under the CMO's common control. However, we were unable to determine whether the charter school governing boards were aware of these affiliations before executing the agreements. The authorizer was made aware of the lease agreements for two of the charter schools through an audit the LEA conducted. Two of the related-party transactions identified indicated potential conflicts of interest. We also found instances of insufficient segregation of duties at another two of the five charter schools in our case study. In both instances, the CMO contract gave the CMO the authority to hire and fire charter school personnel. The authorizer, which was the same for both charter schools, was aware of this type of instance. According to an authorizer official, the authorizer was able to include terms in the charter to address perceived weaknesses in the State charter school law; however, charter schools could also negotiate the terms of the charter based on the terms of their contract with the CMO. Table 8 illustrates the examples of internal control weaknesses we found at the selected charter schools in Florida.

Table 8. Examples of Internal Control Weaknesses by Charter School in Florida

Charter School	Examples of Internal Control Weaknesses	Example Detail
FL-1	Related-party transaction between the charter school and CMO	The charter school entered into a 10-year lease agreement with the CMO in 2006 for its facility. The following year, the CMO obtained a loan and used it to expand the charter school facility. In 2008, the lease agreement was changed to last through 2018 and rental payments for the charter school increased. In addition, the charter school and the CMO share the same board.
FL-2	Insufficient segregation of duties between the charter school and CMO	The contract between the charter school and the CMO took away authority from the charter school's board to hire and fire key charter school staff and gave this authority to the CMO. By delegating its operational authority, the charter school board could not be reasonably assured that Federal funds were properly managed and spent.
FL-3	Insufficient segregation of duties between the charter school and CMO	The contract between the charter school and the CMO took away authority from the charter school's board to hire and fire key charter school staff and gave this authority to the CMO. By delegating its operational authority, the charter school board could not be reasonably assured that Federal funds were properly managed and spent.
FL-3	Related-party transaction between the charter school and its former CMO	From July 2008 through June 2013, the charter school leased equipment (such as computers, printers, fax machines, desks, chairs, educational books, and playground equipment) from its former CMO. The CMO provided management services to the charter school from February 2007 through September 2009, and the equipment lease agreement was separate from the management agreement.
FL-4	Conflict of interest between the charter school and a CMO-affiliated entity and related-party transaction between the charter school and a CMO-affiliated entity	The charter school board and operator executed lease and security agreements with a CMO-affiliated entity. The CMO's president, who was also the charter school operator's president, signed the agreement on behalf of the charter school. The former charter school operator's president was the sibling of the CMO's vice president.
FL-4	Related-party transaction between the charter school and a CMO-affiliated entity	The charter school operator entered into a lease agreement with a CMO-affiliated company. The CMO's vice president submitted the articles of incorporation for the CMO-affiliated company and was the sibling of the charter school operator president.
FL-5	Conflict of interest between the charter school and a CMO-affiliated entity and related-party transaction between the school and the CMO's affiliated entity	The charter school board and operator executed lease and security agreements with a CMO-affiliated entity. The CMO's president, who was also the charter school operator's president, signed the agreement on behalf of the charter school. The CMO's vice president, who was also the president of the company that owned the CMO-affiliated entity, signed the agreement on behalf of the CMO-affiliated entity. The former charter school operator's president was the sibling of the CMO's vice president.

Authorizer Requirements in Florida Charter School Law

Florida State charter school law describes the role and responsibility of authorizers regarding the approval, renewal, and revocation of a charter. Specifically, Florida charter school law states that authorizers are responsible for monitoring and reviewing charter school financial and academic performance and ensuring that charter schools operate in accordance with the terms of their charter and applicable laws and regulations. Florida charter school law requires authorizers to collect charter school annual accountability reports. Florida State charter school law also requires authorizers to monitor charter schools through monthly financial statements and to notify charter school governing boards within 7 days of determining a deteriorating financial condition. Authorizers in Florida are able to make a corrective action plan in conjunction with charter school governing boards if the schools need improvement. The Florida State charter school law required these corrective action plans to be shared with the Florida SEA. In addition, the Florida SEA is required by law to provide a report to the State that includes an analysis and

comparison of the performance of charter school students versus comparable traditional public school students.

Michigan

SEA

The Michigan SEA's monitoring procedures for the Title I and IDEA grants were designed to review the programmatic and fiscal aspects of the grants in accordance with Federal regulations. The Michigan SEA stated that it did not have a monitoring tool for the SIG grant. The Michigan SEA monitored the CSP SEA grant by conducting a desk review of a charter school's audited financial statements, Single Audit reports, and budgets. The Michigan SEA indicated that they monitored the relationship between charter schools and CMOs, including related-party transactions between charter school boards and CMOs during desk reviews. However, the desk reviews did not include steps to check whether any decision-making employees at the CMO had companies that did business with the charter school.

The Michigan SEA's "[Public School Academies] Subgrants—Planning Subgrant Application [and] Awards" procedure manual had some steps with respect to conflict of interest, related-parties, and segregation of duties.³⁸ The monitoring section of the manual indicated that members of the charter schools board and key individuals at the CMO were checked through the online Excluded Parties List System, which is available through the U.S. General Services Administration. The Michigan SEA stated it reviewed the contracts charter schools had with vendors to ensure there were no conflicts of interest or related-parties. The Michigan SEA contract review tools indicated that the Michigan SEA requested copies of leases and a description of staff responsibilities. Despite these procedures, we found several cases of related-party transactions and conflicts of interest at the seven schools that were part of our case study.

Authorizers

Authorizers in Michigan are required to monitor charter schools they authorized. To monitor charter schools, the authorizers we visited in Michigan (1) employed field representatives that served as a liaison between the authorizer and the charter school, made regular site visits to the charter school during the year, and attended charter school board meetings; (2) monitored charter schools' compliance with various reporting requirements; (3) required charter schools to submit academic and financial information during the year; (4) had a process for conducting annual reviews of employees at charter schools and confirming teacher certifications; and (5) provided charter schools with an annual performance report regarding academic and financial performance. Of the seven selected charter schools in Michigan, one was authorized by the board of a community college and the remaining six were authorized by the governing board of State public universities.

We found that all seven selected charter schools had at least one reportable issue. Six of the charter schools had at least one potential conflict of interest. At one charter school, we found that the CMO's sole employee and the director of the charter school it managed were husband and wife. Four of the charter schools selected used the same external auditors as their CMOs and two charter schools used the same attorney as their CMOs. At another charter school we found that their legal counsel was also the sister-in-law of the charter school board president.

³⁸ Charter schools in Michigan State are referred to as public school academies.

Related-party transactions were found at five of the seven charter schools reviewed in Michigan. Of the charter schools reviewed, four leased school facilities from their CMOs. One charter school leased its facilities from an entity that provided contracted services to both the charter school and the CMO.

Table 9 illustrates the examples of internal control weaknesses we found in the selected charter schools in Michigan.

Table 9. Examples of Internal Control Weaknesses by Charter School in Michigan

Charter School	Examples of Internal Control Weaknesses	Example Detail
MI-1	Potential conflicts of interest between the charter school and CMO	The CMO and the charter school board used the same auditor.*
MI-1	Related-party transaction between the charter school and CMO	The charter school leased school facilities from the CMO.
MI-2	Potential conflicts of interest between the charter school and CMO	The CMO and the charter school board used the same auditor.*
MI-2	Related-party transaction between the charter school and a CMO-affiliated entity	The charter school board leased school facilities from a CMO-affiliated entity.
MI-3	Potential conflicts of interest between the charter school and CMO	The CMO and the charter school board used the same auditor.*
MI-3	Related-party transaction between the charter school and CMO	The charter school board leased school facilities from the CMO.
MI-4	Related-party transaction between the charter school and CMO	The charter school board leased school facilities from the CMO. In addition, the charter school board members were recruited by the CMO.
MI-5	Potential conflicts of interest between the charter school and CMO	The CMO and the charter school board used the same auditor.*
MI-5	Related-party transaction between the charter school and CMO	The charter school board leased school facilities from the CMO.
MI-6	Potential conflicts of interest between the charter school and CMO	The CMO's president and the charter school director were husband and wife.
MI-6	Potential conflicts of interest between the charter school and CMO	The CMO and the charter school board used the same attorney.*
MI-7	Potential conflicts of interest between the charter school and CMO	The CMO and the charter school board used the same attorney.*

* The OIG guidance lists various conflicts of interest for CSP grantees to use to determine whether a charter school is independent of its for-profit CMO. One of those factors is whether the charter school has a separate auditor and attorney from its for-profit CMO.

With respect to the potential conflicts of interest found in these case studies, we found no evidence that the authorizers were aware of the issue or that the monitoring tools they used could have enabled them to become aware of the issue. As for the related-party transactions, charter schools are required to submit lease agreements to its authorizer. This requirement should make authorizers aware of the related-party transactions found in lease agreements.

Authorizer Requirements in Michigan Charter School Law

Michigan State charter school law describes the role and responsibility of authorizers regarding the approval, renewal, and revocation of a charter. Specifically, Michigan State charter school law requires authorizers to develop and implement a process to ensure charter schools are accountable for meeting academic performance standards and implementing corrective actions when the standards are not met. Michigan State charter school law specifies corrective action measures to avoid revocation of a charter. Michigan charter school law required the Michigan SEA to submit an annual report to the legislature that included detailed information regarding the overall charter school program, as well as individual charter school data. However, this requirement was repealed on March 28, 2012. The last legislative report was for the 2009–2010 school year. The Michigan SEA has limited authority to monitor and oversee its 37 authorizing agencies. Although authorizers in Michigan are able to participate in an assurance and verification process, participation is voluntary and monitoring results are not reported to outside parties.

New York SEA

The New York SEA officials indicated that procedures regarding the awarding and monitoring of Title I and IDEA grants to charter schools are the same as the process for traditional public schools. The New York SEA monitoring tools for the Title I and IDEA grants had monitoring procedures to review only the programmatic and fiscal aspects of the grants in accordance with Federal regulations. The New York SEA SIG monitoring tool did not fully incorporate the indicators for charter schools suggested in OESE’s Student Achievement and School Accountability Programs monitoring plan for the SIG program. Starting in the 2012–2013 school year, the New York SEA provided a draft audit guide, applicable to charter schools, that requires independent auditors to review charter school contracts with CMOs, ensure the authorizers approved the CMO contracts, and evaluate the reasonableness of the fees that charter schools paid to CMOs. The draft audit guide also includes steps to review related-party transactions, conflicts of interest, and segregation of duties to mitigate the risk for fraud.

Authorizers

Authorizers in New York are required to comply with the monitoring requirements found in the State charter school law. Authorizers in New York monitor charter schools annually. The level of monitoring depends on the status year of the charter contract and on the academic success of the charter school in the prior year. Authorizers perform more comprehensive reviews when charter renewal approaches. Authorizers require annual accountability reports from all charter schools. A higher education institution authorized three of our selected charter schools, the New York SEA authorized one, and an LEA authorized another.

We identified one related-party transaction where the charter school board leased facilities from a CMO-affiliated company. We did not identify conflicts of interest or insufficient segregation of duties in the five charter schools with CMOs that were part of our case study.

Table 10 illustrates the example of internal control weakness found in the selected charter schools in New York.

Table 10. Example of Internal Control Weakness by Charter School in New York

Charter School	Example of Internal Control Weakness	Example Detail
NY-5	Related-party transaction between the charter school and the CMO	The charter school board leased facilities from the CMO. The building was owned by a CMO-affiliated company. In addition, the charter school board ceded authority over charter school operations to the CMO.

The authorizer was aware of the lease agreement and deemed it an acceptable risk.

Authorizer Requirements in New York Charter School Law

New York State charter school law describes the role and responsibility of authorizers regarding the approval, renewal, and revocation of a charter. Specifically, New York State charter school law requires authorizers to provide oversight sufficient to ensure that charter schools comply with all applicable laws and charter provisions (which include performance benchmarks). If authorizers determine State charter school law requirements were not met, they may put a charter school on probation to implement a remedial plan. The authorizers may revoke the charter if requirements have not been met after a period of due process was given to the charter to correct the issues. By law, one of the three New York State authorizers, the State Board of Regents, is required to provide an annual report to the governor, temporary State senate president, and speaker of the house.

Pennsylvania

SEA

The Pennsylvania SEA officials stated that procedures regarding the awarding and monitoring of Title I, IDEA, and SIG grants to charter schools are the same as the process for traditional public schools. The Pennsylvania SEA monitoring tools for Title I, IDEA, and SIG did not have steps to review conflicts of interest, related-party transactions, or insufficient segregation of duties. In addition, the SIG monitoring tool did not fully incorporate the indicators suggested in OESE’s Student Achievement and School Accountability Programs monitoring plan for the SIG program. The Pennsylvania SEA did not administer the CSP SEA grant during our audit period.

Pennsylvania SEA officials stated that their charter school office had oversight responsibility of virtual charter schools, and authorizers had oversight responsibility of brick-and-mortar charter schools. The officials stated that they were unaware of any monitoring the authorizers performed at those charter schools. In addition, the officials stated that the charter school law does not delegate the authority of monitoring charter schools to the SEA but to the authorizers. According to officials, each charter school’s independent auditor files a budget for the charter school with the Pennsylvania SEA and an annual financial report with the governor’s office. The governor’s office reviews the annual financial report for compliance with generally accepted accounting principles and to confirm the charter schools received funds.

Authorizers

Charter school monitoring in Pennsylvania varied depending on the authorizer. Authorizers in Pennsylvania approve and renew charter applications, which could include a review of curriculum requirements. The authorizers we reviewed in Pennsylvania have procedures to conduct site visits of charter schools and review financial aspects of charter school operation,

such as management fees, charter school leases, and fiscal stability. In addition, these authorizers conducted periodic enrollment reconciliation procedures that could be used to determine funding. In Pennsylvania, the five charter schools that were part of our case study were authorized by LEAs.

We found that three charter schools in our case study had four instances of conflicts of interest, one related-party transaction, and two instances of insufficient segregation of duties, as illustrated in Table 11.

Table 11. Examples of Internal Control Weaknesses by Charter School in Pennsylvania

Charter School	Examples of Internal Control Weaknesses	Example Detail
PA-1	Insufficient segregation of duties between the charter school and the CMO	The CEO of the CMO had the ability to write and issue checks without the charter school board’s approval. We found that the CEO of the CMO wrote checks to himself totaling about \$11 million during the 2008–2009 school year. According to the charter school’s legal counsel, the charter school established procedures to prevent this weakness in internal controls, including the requirement that the charter school board approves payments to the CMO. However, the charter school could not provide written procedures to support the change.
PA-3	Conflict of interest between the charter school and CMO	Four officers of the CMO were also members of the charter school board. The CMO had four of the nine charter school board member positions.
PA-3	Conflict of interest between the charter school and CMO	The CMO contract was signed by two people, one representing the charter school board. The charter school representative was the CMO’s president, and the CMO representative was a charter school board member.
PA-3	Related-party transaction between the charter school and a CMO-affiliated company	The charter school made vendor payments to a CMO-affiliated company.
PA-4	Conflict of interest between the charter school and CMO	The CMO appointed the first three members of the charter school’s board, and then those three members appointed the remaining charter school board members.
PA-4	Insufficient segregation of duties between the charter school and the CMO	The charter school board did not have an opportunity to review, validate, and approve CMO monthly invoices. The CMO compensation was capped at about \$1.3 million annually. The CMO was paid without the approval of the charter school board.

We brought these issues to the attention of the authorizers; however, the authorizers did not provide a response.

Authorizer Requirements in Pennsylvania Charter School Law

Pennsylvania State charter school law describes the role and responsibility of authorizers regarding the approval, renewal, and revocation of a charter. Specifically, Pennsylvania charter school law requires authorizers to annually review charter schools to ensure that charter schools complied with the terms of its charter and conduct a more comprehensive review before granting a 5-year renewal to ensure that charter schools. All charter schools are required to provide annual reports to their authorizer and the State secretary of education.

Texas

SEA

Texas SEA officials stated that procedures regarding the awarding and monitoring of Title I, IDEA, and SIG grants to charter schools are the same as the process for traditional public schools. Monitoring of Federal grants at the Texas SEA is an agency-wide activity. The Texas SEA has established a coordinated system to ensure collaboration, the sharing of information across the agency and preventing the duplication of effort. Several departments, divisions, and units carried out the Texas SEA monitoring system; depending on the monitoring outcome, these different offices can refer matters to other departments, divisions, or units for follow-up monitoring activities.

Texas SEA officials stated that they monitored charter schools with CMOs through the charter school's submission of its Annual Financial Review, an accreditation review, Charter Financial Integrity Rating System accountability ratings, academic accountability ratings, and the annual governance forms. The Texas SEA accreditation review and Charter Financial Integrity Rating System procedures were to monitor and evaluate the academic performance and financial health of charter districts. The Texas SEA reviewed charter schools annual financial and compliance reports that can disclose conflicts of interest and related-party transactions. The Texas SEA reviewed the charter school annual governance forms; however, the Texas SEA review was not sufficient to ensure that the charter holders and charter schools were complying with the conflicts of interest regulations found in the State law.³⁹ We found various cases where the charter schools were not complying with State law. We sent a letter to advise the Texas SEA of these noncompliance issues.

Authorizers

The Texas SEA authorized the selected charter schools and performed all aspects of oversight and monitoring. The Texas SEA annually monitored and evaluated the academic performance of all charter schools under the Texas State accountability system and financial ratings through the Charter Financial Integrity Rating System. In addition, the Texas SEA accreditation review was based on annual examinations of the financial and academic condition of the charter schools and may have included performance in other areas, including program effectiveness, program compliance, and data integrity.

We found examples of internal control weaknesses related to conflict of interest at five of the six charter schools in our case study.⁴⁰ We found a conflict of interest at one of the six charter schools whose board member owned a legal services company. The board member for the CMO did not file a conflict of interest affidavit to note his substantial interest in the legal services company, as required in the Texas State law.

Another two of the six charter schools contracted two vendors that were affiliated with charter school officials. The former superintendent for the two charter schools was the owner of one of the two vendors (Vendor 1) and was also the former assistant superintendent's father. The husband of the former assistant superintendent was the owner of the second vendor (Vendor 2)

³⁹ The six charter schools selected in Texas were managed by charter holders; which, for the purpose of our audit, met our definition of a CMO.

⁴⁰ We counted examples of internal control weaknesses by charter holder; therefore, conflicts of interest examples that occurred at a charter holder applied to both charter schools under that charter, unless the evidence supported that an example was at a specific charter school.

that provided services to the two charter schools. In addition, the charter school board president, who is also the CMO board president, and a charter school board member are the uncle and aunt of the former assistant superintendent. Table 12 illustrates the total amount that the two charter schools paid to the two vendors.

Table 12. Amounts Paid to Vendors 1 and 2

School Year	Vendor 1	Vendor 2
2010–2011	\$8,280	\$193,845
2011–2012	\$90,114	\$209,015
2012–2013	\$48,375	\$120,175

The charter school board president, CMO board member, former superintendent, and former assistant superintendent did not complete and file a conflict of interest affidavit in the 2010–2011 and 2011–2012 school years, as required by Texas State law. Subsequently, in October 2012, the charter school board president, board member, and former assistant superintendent filed conflict of interest affidavits that documented their substantial interest in Vendor 1 or Vendor 2. According to the current superintendent, the former superintendent retired in January 2012 and did not file an affidavit.

In the last two of the six charter school cases studied in Texas, the CEO of the CMO entered into a contract with an educational development company he owned. The two charter schools paid \$6,000 per month to use the affiliated company’s learning tools. The contract was amended in April 2013, to pay the affiliated company \$10,000 annually per school over 6 years. The CEO did not complete and file a conflicts of interest affidavit prior to a vote or decision by the charter school board. The charter school board was also the CMO board.

We identified six conflicts of interest, as illustrated in Table 13.

Table 13. Examples of Internal Control Weaknesses by Charter School in Texas

Charter School	Examples of Internal Control Weaknesses	Example Detail
TX-1	Conflict of interest between the charter school board of directors president and an affiliated vendor	The charter school board president had a substantial interest in a business entity that provided legal services to the charter school, but did not disclose the nature and extent of the interest as required by Texas State law.
TX-3 and TX-4	Conflicts of interest between the two charter schools and two affiliated vendors	The board president, CMO board member, former superintendent for two charter schools, and former assistant superintendent had substantial interest in two companies that provided services to the two charter schools. These individuals were also family relatives. All four parties had an interest and did not disclose the nature and extent of the interest as required by Texas State law.
TX-5 and TX-6	Conflict of interest between the two charter schools and a CMO-affiliated vendor	The CEO of the CMO owned a business entity that developed education software programs. The two charter schools contracted the affiliated company. However, the CEO did not disclose the nature and extent of the interest as required by Texas State law.

The authorizer was not aware of these examples. However, as a result of our case study, the authorizer for the charter schools stated that they would send policy letters to charter schools regarding conflicts of interest required in State and local law. In addition, the authorizer stated they initiated special accreditation investigations of the charter schools identified to determine whether any State laws were violated.

Authorizer Requirements in Texas Charter School Law

Texas State charter school law describes the role and responsibility of authorizers regarding the approval, renewal, and revocation of a charter. Specifically, Texas charter school law requires authorizers to annually evaluate performance and financial indicators at charter schools. The Texas charter school law allows the authorizer to audit the records of an open-enrollment charter school, a charter holder, and a management company. However, the audit must be limited to matters directly related to the management or operation of an open-enrollment charter school, including any financial and administrative records. Authorizers are able to take actions when charter schools do not meet applicable laws and regulations, including the terms of the charter. The actions that authorizers can take include placing charter schools on probation, withholding funding, suspending the charter school's permission to operate, and revoking the charter.

APPENDIX 2: Auditee Comments



UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF THE DEPUTY SECRETARY

September 16, 2016

TO: Patrick J. Howard
Assistant Inspector General for Audit
Office of Inspector General

FROM: Joseph Conaty
Senior Policy Advisor
Office of the Deputy Secretary

SUBJECT: Response to Draft Audit Report "National Assessment of Charter and Education Management Organizations." OIG Control Number ED-OIG/A02M0012

Thank you for providing the Office of the Deputy Secretary with an opportunity to review and respond to the findings and recommendations in the Office of Inspector General's (OIG) draft audit report entitled "National Assessment of Charter and Education Management Organizations" OIG Control Number ED-OIG/A02M0012 (CMO Audit). Staff from multiple offices have reviewed the draft audit and provided input for these comments.

This memorandum provides general comments on the draft, a corrective action plan, and an attachment that includes a number of technical edits and comments. During the work on this audit, OIG informally informed the U.S. Department of Education (ED) of developments relevant to its findings, and the charter school sector within the realm of the Department's programs is otherwise an area in which ED keeps a careful watch, so that ED has been aware of some of the developments in the charter school sector. ED believes that the joint cooperation on this audit, with OIG sharing information in real-time as the audit work is done, could serve as a model for future audits. This form of collaboration, while not threatening the OIG independence, helps ED better manage its programs and helps OIG better understand the related programmatic issues.

GENERAL COMMENTS

Charter schools continue to be among the most dynamic sectors in K-12 education. Between school years (SYs) 2003–2004 and 2013–2014, the percentage of all public schools that were public charter schools increased from 3.1 percent to 6.6 percent, and the total number of public

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charter schools increased from 3,000 to 6,500.¹ During that same time period, the number of students enrolled in public charter schools increased from approximately 800,000 to 2.5 million. By definition in the Elementary and Secondary Act, and for the purposes of our work on charter schools, “public charter schools” are publicly-funded schools that typically are governed under a charter (*i.e.* performance contract), with a charter school authorizing entity, such as a state or relevant school district. “As specified in state and local law, the contract or charter typically exempts the school or the charter school sector in that area from certain state or local rules and regulations.”²

Along with the growth of charter schools and charter school enrollments, the development and roles of non-profit Charter Management Organizations (CMOs) and for-profit Education Management Organizations (EMOs) have also increased. In school year 2015-2016, 59 percent of charter schools were independent, single-site schools, 26 percent were managed by CMOs, and 15 percent were managed by EMOs.³ This is a substantial increase since 2007-2008 when 78% of charter schools were freestanding, 10% were managed by CMOs and 16% were managed by EMOs.⁴ Although the CMO Audit does not distinguish between CMOs and EMOs (and instead refers to both types of organizations as “CMOs”), we believe the distinction is important because for-profit entities, including EMOs, are not eligible to receive direct grants from the Department under the programs covered by the CMO Audit.⁵ While recipients of Federal funds may enter into contracts with for-profit entities for the provision of goods or services (including, but not limited to, EMOs), Federal regulations require that the Federal grant recipient directly administer or supervise the administration of the grant.⁶ In addition, any costs charged to the grant must be necessary, reasonable, and allocable to the grant.⁷

Charter schools provide an opportunity to scale successful innovations, within a region and across the nation to serve more children. One important attribute of charter schools is the governance of public schools by self-sustaining non-profit boards of trustees that typically are comprised of community leaders; experts in areas such as law, finance, program evaluation, fundraising and strategy; educators; and parents. The advent of charter schools introduced new

¹ Kena, G., Hussar W., McFarland J., de Brey C., Musu-Gillette, L., Wang, X., Zhang, J., Rathbun, A., Wilkinson-Flicker, S., Diliberti M., Barmer, A., Bullock Mann, F., and Dunlop Velez, E. (2016). The Condition of Education 2016 (NCES 2016-144). U.S. Department of Education, National Center for Education Statistics. Washington, DC. Retrieved [August, 2016] from <http://nces.ed.gov/pubsearch>. http://nces.ed.gov/programs/coe/indicator_cgb.asp

² Ibid. Page 78.

³ National Alliance for Public Charter Schools “A Closer Look at the Charter School Movement: Schools, Students, and Management Organizations, 2015-16. National Alliance 2/3/2016 <http://www.publiccharters.org/publications/charter-school-movement-2015-16/>.

⁴ National Alliance for Public Charter Schools “CMO and EMO Public Charter Schools: A Growing Phenomenon in the Charter School Sector: Public School Dashboard Data from 2007-08, 2008-09, and 2009-10. http://www.publiccharters.org/wp-content/uploads/2014/01/NAPCS-CMO-EMO-DASHBOARD-DETAILS_20111103T102812.pdf

⁵ See: <http://www2.ed.gov/programs/charter/finalsignedcsp.pdf>.

⁶ See 34 C.F.R. 75.701.

⁷ 2 C.F.R. 200.403.

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challenges for the monitoring and oversight of Federal funds by state and local education officials who have the primary responsibility to provide oversight and monitoring for the schools in their states and districts.

A core tenet of the charter school model is increased autonomy in exchange for increased accountability for educational outcomes. While this increased autonomy has enabled charter schools to employ innovative school models, practices, and pedagogical methods to reach, in many instances educationally disadvantaged and other students who have not been successful in traditional public schools, ED is well aware of the challenges and risks posed by CMOs and, in particular, EMOs, that enter into contracts to manage the day-to-day operations of charter schools that receive Federal funds. We recognize that the proliferation of charter schools with these relationships has introduced potential risks with respect to conflicts of interest, related-party transactions, and fiscal accountability, particularly in regard to the use of federal funds. Given these potential risks, ED has provided States and charter schools with non-regulatory guidance and technical assistance offering factors to consider when determining whether a charter school is independent from its management organization.

In addition, over the last 12 months, ED has taken a number of steps to work with States to reduce and mitigate the risks to Federal funds. For example:

2015 Dear Colleague Letter Reminding States of Their Responsibilities Regarding Charter Schools Under Federal Programs

- In September 2015, the leaders of the Office of Elementary and Secondary Education (OESE) and the Office of Special Education and Rehabilitative Services (OSERS), which oversee ED's largest programs that provide funding for charter schools, and the Office of Innovation and Improvement (OII), which oversees the Federal Charter School Program (CSP), among other relevant programs, issued a joint Dear Colleague Letter (DCL) reminding State educational agencies (SEAs) of their key role in helping to ensure that Federal funds used by public charter schools in state-administered programs are used for their intended, appropriate purposes. <http://www2.ed.gov/programs/charter/finalsignedcsp.pdf>
- That letter specifically addressed funds awarded to charter schools under the programs covered by the CMO audit. As public schools, public charter schools are eligible to receive assistance from a wide range of Federal education programs. For example, under the Elementary and Secondary Education Act of 1965, as amended (ESEA) by the No Child Left Behind Act as well as the Every Student Succeeds Act (ESSA), eligible charter schools that qualify as local educational agencies (LEAs) may apply for funds under Titles I and III (the latter assists students who are English learners). Similarly, charter schools that qualify as local educational agencies (LEAs) may be eligible to receive funds from the formula grant awards made to States under Part B of the

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Individuals with Disabilities Education Act (IDEA) to assist in providing a free appropriate public education (FAPE) to eligible students with disabilities. Additionally, students at charter schools within other LEAs may also receive benefits or services under these programs.

- Additionally, ED provides support specifically targeted to charter schools through its CSP, which has invested over \$1 billion since 2009 in grants to SEAs, CMOs, other non-profit charter school operators, and, in some cases, charter schools to support the planning, initial implementation, replication, and expansion of charter schools and to disseminate information about successful charter schools and best practices in charter schools.
- The DCL highlighted specific areas where SEAs may play a key, helpful role, in particular to provide operational oversight and ensure strong authorizing practices. Specific to the topic of the CMO Audit, the letter explicitly highlighted the need for transparency with regard to the contractual relationship of charter schools to CMOs and EMOs. The DCL stated the following: “The relationship of charter schools to management organizations (**especially EMOs and other organizations that provide fee-generating management services to charter schools**) requires effective oversight to ensure that charter schools provide the best quality services and benefits to their students. By increasing transparency and oversight regarding these relationships, and ensuring that appropriate corrective actions are taken when conflicts of interest arise, States can help ensure that charter schools use their public funds—including Federal funds—properly” (emphasis added).
- The DCL lists a number of ways that each of the three Department offices can provide help to States to exercise effective monitoring and oversight of charter schools.

Other Relevant Communications and Actions Taken Regarding Charter Schools

- ED’s Office for Civil Rights issued a Dear Colleague Letter in 2014 reminding SEAs of their obligation to ensure that any public charter school to which it provides a charter, money (regardless of whether the SEA provides Federal or State funds), or other significant assistance, is not discriminating on the basis of race, color, national origin, sex, or disability. States can designate other agencies—in addition to SEAs and charter school authorizers—to take, investigate, and resolve complaints of discrimination by charter schools. ED’s Office for Civil Rights’ Dear Colleague Letter concerning the applicability of Federal civil rights laws to charter schools is available at: <http://www.ed.gov/ocr/letters/colleague-201405-charter.pdf>.
- ED has provided guidance to assist SEAs in ensuring that Federal funds accessed by public charter schools are used for their intended, appropriate purposes. In a letter, dated August 4, 2016, to CSP SEA Project Directors, ED highlighted responsibilities related to fiscal monitoring of Federal funds and provided information for prospective CSP SEA grantees. The areas addressed by the letter include monitoring and oversight of CSP subgrantees and

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authorizers, including expectations for monitoring and oversight in the context of charter school closures. Among the topics addressed in the letter were SEA procedures for monitoring charter school compliance with Federal procurement requirements related to agreements between subgrantees and third-party contractors, including CMOs and EMOs. This letter is available at: <http://innovation.ed.gov/files/2016/08/CSP-Letter-to-SEA-on-Uniform-Guidance-FINAL-08.04.2016.pdf>

- In addition to these steps, ED is taking an important new step to increase accountability and oversight of CMOs and EMOs. Effective for SY 2016-2017, ED will begin collecting new charter school data elements from SEAs as part of the *EDFacts* Submission System. One of the purposes of these new data elements is to increase public transparency of charter school contracts and charter school affiliations with management organizations. Together, these elements will assist ED, states, and other oversight entities in providing stronger oversight and accountability over federal funds awarded to charter schools. For each management organization (as defined by the directory file specifications) operating in a state, SEAs will be required to report the following: management organization name; Employer Identification Number (EIN); management organization location and mailing address; and management organization type (EMO, CMO, or “Other”). Using this new management organization directory, states will be required to report (link) each charter school to its management organization, if applicable. SEAs will be required to assign each charter contract a new “Charter Contract Identification Number,” and provide the contract approval date and charter contract renewal date. Potential uses for these new data elements include: performing queries to determine the scope and nature of management organization affiliations with charter schools; possibly cross-referencing EINs with other databases, including those maintained by other governmental agencies; monitoring actions of authorizers with respect to charter renewals; and understanding how individual charter schools are linked with discrete charter contracts. Together, these new data elements will assist ED, States, and other oversight entities in providing stronger oversight and accountability over Federal funds awarded to charter schools.
- We are planning to add more information on oversight of charter schools under ED programs in the OMB Compliance Supplement, so that single auditors will be able to provide more information and oversight on charter schools.

The actions described above demonstrate how ED, in ways that are appropriate to the Federal role, has been addressing and will continue to address issues related to charter schools that contract with CMOs and EMOs to provide management services, including issues raised by the CMO Audit. The Department will continue to provide monitoring and oversight of its direct grantees, such as SEAs, CMOs, and charter schools in States that do not have CSP SEA grants. By statute, SEAs bear primary responsibility for ensuring that Federal funds that they award to charter schools through the Department’s State-administered programs (*e.g.*, Title I of the ESEA, Part B of IDEA, and the CSP SEA program) are expended properly. ED authority is limited

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under the Department of Education Organization Act, the General Education Provisions Act, and ESSA, and we do not have the resources to monitor directly each and every one of the over 6,400⁸ charter schools in the nation. For these reasons, it is incumbent on ED, SEAs, charter school authorizers, and charter schools to work together to ensure that charter schools that receive Federal funds and enter into contractual relationships with CMOs and EMOs take seriously their public accountability responsibilities. Among other things, this should entail making public and transparent all of their governance arrangements, contracts for goods and services, and the uses of Federal funds.

Because of these limitations on ED's authority and resources, and our ongoing efforts to work with grantees to facilitate a smooth transition to the ESSA, including issuing regulations and non-regulatory guidance on a number of topics and resolving implementation issues, it would be premature for ED to make significant commitments of resources in response to the recommendations in this report. ED can appropriately commit to, as outlined below, that ODS will lead an internal working group made up of representatives of OESE, OSERS, and OII, tasked with developing an internal briefing paper that assesses the level of risks to Department programs posed by charter schools with CMOs and EMOs, and the possible actions steps the Department could take to address these issues consistent with its limited authority. The group will include also representatives from the Office of the Chief Financial Officer's Post Audit Group (PAG), the Office of the Deputy Secretary's Risk Management Division (RMS), the Office of Planning, Evaluation, and Program Development, and the Office of the General Counsel (OGC). As noted above, we will also explore adding information to the compliance supplement to address some of the issues discussed in this audit report, as appropriate.

SUGGESTIONS AND COMMENTS ON THE DRAFT AUDIT RECOMMENDATIONS⁹

We are providing suggestions for alternative wording of and comments on the draft recommendations with all of the considerations above in mind; we will ensure that the working group will consider the areas covered by the recommendations in their initial year of work.

Recommendation 1.1 The Delegated Deputy Secretary should convene a formal oversight group including high level representatives from the following offices: Office of the Deputy Secretary, Office of Elementary and Secondary Education, Office of Special Education, the Office of the Chief Financial Officer. The oversight group would determine the most appropriate manner to conduct an analysis and assessment of the risks to Department programs posed by charter schools with CMOs and EMOs. The assessment would consider actions appropriate to ED's federal role to assist SEAs, LEAs and charter school authorizers to fulfill their obligations for

⁸ Source: National Center for Education Statistics, Digest of Education Statistics: 2014, April 2016, Table 216.20.

⁹ A table of technical edits was shared earlier in the review process.

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oversight of federal funding. Such actions would include, but not be limited to the recommendations that follow:

Comment: As evident in this response, ED has been working collaboratively in and across multiple offices on issues related to charter school oversight and monitoring, including risk factors. ODS will convene an internal working group that primarily consists of OESE, OSERS, and OII, that will among other things, develop a briefing paper that considers how best to assess possible risks to Department programs posed by charter schools with CMOs and EMOs, and how best to address them. The group will also include representatives from the Office of the Chief Financial Officer's Post Audit Group (PAG), the Office of the Deputy Secretary's Risk Management Division (RMS), and the Office of the General Counsel (OGC).

Recommendation 1.2 Working with external partners and interest groups to help SEAs and other authorizers consider risk to federal funds in their evaluation of proposals for charter schools including the consideration of what is an acceptable level of risk related to the charter school relationship with the CMOs.

Comment: The internal working group will consider the need and appropriateness of having the Department convene a forum, comprised of representative from SEAs and national organizations with expertise in charter schools, to help develop an approach for determining an acceptable level of risk related to charter school contractual relationships with CMOs and EMOs.

Recommendation 1.3 Providing further guidance to SEAs that offers a general strategy for performing a minimum level of monitoring, risk assessment, and mitigation procedures related to charter school contractual relationships with CMOs and EMOs.

Comment: Through the working group described in the comment to Recommendation 1.1, OESE, OSERS, and OII will consider providing further guidance to SEAs that offers a general framework for performing a minimum level of monitoring, risk assessment, and mitigation procedures related to charter school contractual relationships with CMOs and EMOs. Those procedures may address financial risk, lack of accountability, and program performance risk.

Recommendation 1.4 Developing modifications to program monitoring protocols for Title I, Title II, Title III, IDEA and other programs to assist federal grantees in meeting their monitoring and oversight responsibilities with respect to CMOs and EMOs;

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Comment: ED agrees that there may be risks to Federal programs associated with charter schools that are affiliated with management organizations, particularly for-profit EMOs. To address these possible risks we have communicated expectations for evaluating these relationships through various means, such as non-regulatory guidance (e.g. CSP non-regulatory guidance may be found at: <http://innovation.ed.gov/what-we-do/charter-schools/charter-school-program-state-educational-agencies-sea/funding-and-legislation/>), webinars, national conferences, and project directors' meetings. ED agrees that we should continue to offer guidance and technical assistance to states and consider further guidance so that they are able to assess the risks for all Federal programs, and will consider if further written guidance is appropriate.

Recommendation 1.5 Collaborating and coordinating with the Office of the Chief Financial Officer's Post Audit Group to update the OMB Circular A-133 Compliance Supplement to include procedures to determine whether the SEA and LEA, as appropriate, have internal controls to ensure that charter schools with relationships with CMOs have effective controls to mitigate financial risks, provide for accountability over Federal funds, and mitigate performance risk.

Comment: The internal working group will consult with the Office of the Chief Financial Officer's Post Audit Group to determine the feasibility of updating the Office of Management and Budget Circular A-133 Compliance Supplement to include procedures to determine whether the SEA and LEA, as appropriate, have internal controls to ensure that charter schools with contractual relationships with CMOs and EMOs have effective controls to mitigate financial and performance risks and to provide accountability over Federal funds.

At the end of each calendar year, the oversight group would prepare a summary of its activities and efforts to reduce the risks associated with charter school CMOs and EMOs.

CONCLUSION

ED appreciates the work OIG has put into this audit and has benefited from its collaborative nature. ED agrees that there may be increased risks to Federal programs associated with charter schools that are affiliated with certain management organizations. These risks may be most acute in those cases where a non-profit charter school contracts with a for-profit management organization that may exert significant control or influence over the day-to-day operations of the charter school and how Federal funds are used. To address these potential risks, for some programs we have communicated expectations for entering into and evaluating these contractual relationships through various means, such as non-regulatory guidance, webinars, conferences, and meetings. ED agrees that, when appropriate, its programs will continue to offer guidance and technical assistance and to disseminate to states useful information on successful charter schools and best practices in charter schools, so that SEAs may be better able to assess and

ameliorate the risks for all Federal programs. In response to this guidance, a state could voluntarily elect to develop a robust set of public disclosure requirements that can help States ensure public accountability of charter schools that are affiliated with CMOs and EMOs. For example, charter schools could publicly disclose independent financial statements, form 990s, and substantial contracts with providers of goods and services, including CMOs and EMOs.

Charter school performance, overall, has significantly improved in recent years. One 2013 national study found that 25 percent and 29 percent of charter schools outperform traditional public schools in ELA and math, respectively. Certain groups of students—students in poverty, African American students, and English learners—enrolled in charter schools post significantly higher learning gains compared to their peers in non-charter public schools.¹⁰ In addition, a study of 41 urban areas found that, on average, charter schools in those regions achieved significantly greater student success.¹¹ The performance of certain CMOs has been even more impressive, with students attending charter schools managed by these entities achieving math growth that was 0.21 standard deviations higher than traditional public school students and results in reading that were 0.13 standard deviations above traditional public school students.¹² The Department’s CSP and, in particular, the CSP Replication and Expansion grant program, has been instrumental in supporting states in their efforts to provide at scale high-quality educational opportunities for all students, particularly educationally disadvantaged students, through the creation, replication, and expansion of high-quality charter schools. Non-profit CMOs have been, and will continue to be, a key strategy that states and communities can adopt in order to expand these high-quality educational opportunities for all students.

We appreciate OIG providing us with this draft report and identifying the potential risks to Federal programs posed by CMOs and EMOs. As we progress in implementing ESSA, we will continue to review the need and appropriateness of assisting states to strengthen their public education systems through work on charter schools’ relationships with EMOs and CMOs, and to explore proper roles with States and other entities to help identify and mitigate the risks that such relationships pose to Federal program funds. We believe the multi-office working group described above will provide meaningful input on all areas covered by the audit report.

¹⁰ Center for Research on Education Outcomes, *National Charter School Study, 2013*, Stanford, CA: Stanford University, 2013. <https://credo.stanford.edu/documents/NCSS%202013%20Executive%20Summary.pdf>

¹¹ Center for Research on Education Outcomes, *Urban Charter Schools Study, 2015*, Stanford, CA: Stanford University, 2015. <http://urbancharters.stanford.edu/index.php>

¹² Center for Research on Education Outcomes, *Charter School Growth and Replication, 2013*, Stanford, CA: Stanford University, 2013. <https://credo.stanford.edu/pdfs/CGAR%20Growth%20Volume%20II.pdf>