Education Audit Appeals Panel
State of California

Appeal of 2014-2016 Audit Observation 2 by: California Virtual Academies and Insight Schools of California, Appellant.	EAAP Case No. 17-20 OAH No. 2018-01-0321

Order Adopting Proposed Decision as to Overpayments

The Education Audit Appeals Panel hereby adopts the attached Proposed Decision by the Administrative Law Judge, only insofar as it concludes that Appellants were overpaid $1,978,812 in Common Core funds.

Effective date: Aug. 26, 2019.

IT IS SO ORDERED.

Aug. 26, 2019
Date

Joel Montero, Chairperson
for Education Audit Appeals Panel

BEFORE THE
EDUCATION AUDIT APPEALS PANEL
STATE OF CALIFORNIA

In the Matter of the Audit Appeal of the 2014-2016 Audit Observation 2 by: CALIFORNIA VIRTUAL ACADEMIES AND INSIGHT SCHOOLS OF CALIFORNIA, Appellants, v. CALIFORNIA STATE CONTROLLER, Respondent, CALIFORNIA DEPARTMENT OF FINANCE, Intervenor.	Case No. 17-20 OAH No. 2018010321

PROPOSED DECISION

This matter was heard by Eric Sawyer, Administrative Law Judge (ALJ), Office of Administrative Hearings, State of California, on February 4 and 5, 2019, in Los Angeles.

Kevin M. Troy, Esq., represented appellants.

John E. Dickerson, Staff Counsel, represented respondent.

Alyson R. Parker, Deputy Attorney General, represented intervenor.

The record was held open after the conclusion of the hearing for the parties to submit closing briefs. The post-hearing events and briefs are described in the ALJ's order marked as exhibit B. The record was closed and the matter submitted for decision on May 16, 2019. The parties stipulated to the due date of the proposed decision, as described in the ALJ's order marked as exhibit C.

SUMMARY

Appellants, a group of online charter schools, appeal Observation 2 of a final audit report issued by respondent, which contained a determination that appellants "may have" violated their memoranda of understanding (MOUs) with various authorizing school districts by paying to a vendor previously expired "balanced budget credits." The audit concluded that appellants had violated Common Core funding requirements in connection with the payment of the balanced budget credits and therefore appellants had received an overpayment of $1,995,148 in Common Core funds. The audit recommended the California Department of Education (CDE) seek return of those funds from appellants.

Appellants met their burden of establishing by a preponderance of the evidence that they did not violate the subject MOUs. They demonstrated that the $1,995,148 payment in 2016 to their vendor was not to recoup previously expired balanced budget credits but the result of financial restatements done in October 2016, which caused them to reclassify previously expended funds as Common Core expenses.

Nevertheless, appellants did not establish Observation 2 contained an error of law or fact concerning the conclusion that they had violated Common Core funding requirements. Although they timely incurred eligible Common Core expenses, they failed to timely report those expenses by the requisite deadline.

Appellants' various arguments that the audit was invalid or jurisdiction is lacking to review it were not persuasive. Lastly, appellants established that because iQ Academy California-Los Angeles (iQ Academy) was not a party to the audit (or this appeal), the $16,336 attributed to it should not be included in the Common Core overpayment amount stated in Observation 2.

Under these circumstances, Observation 2 is overturned insofar as it concludes appellants may have violated their various MOUs, but its finding of a Common Core violation is affirmed, except for the $16,336 allocated to iQ Academy.

FACTUAL FINDINGS

Parties and Jurisdiction

1. A. Appellants, together comprising a local education agency (or LEA), are funded by the State of California's public education funds based on their attendance and expenditures reported to CDE. (Ex. 100, p. 6.)

B. On June 17, 2016, CDE executed an interagency audit agreement authorizing respondent to audit appellants' fiscal years 2014/2015 and 2015/2016. (Ex. 3, p. 1550.) The interagency audit agreement recited as the legal basis for the audit Government Code sections 47604.3 and 47604.5. (Ex. 3, p. 1551.)

2. On October 9, 2017, respondent issued its final audit report.[1] (Ex. 100.)

3. Appellants timely requested a hearing to challenge Observation 2.

4. The Department of Finance (intervenor) was allowed to intervene as a party in this matter pursuant to Education Code section 41344.1, subdivision (b).

Appellants' Background Information

5. Appellants are a group of online charter schools that provide an online educational alternative to traditional brick-and-mortar schools. (Ex. 100, p. 5.) The group of charter schools is referred to as "CAVA" (California Virtual Academy) schools. As required by law, each CAVA school is organized as a non-profit corporation. (*Ibid.*) The CAVA schools operate in 45 of California's 58 counties. (*Ibid.*)

6. In fiscal year 2015-2016, CAVA consisted of the following 14 schools, which were involved in the audit: California Virtual Academy @ Fresno; California Virtual Academy @ Jamestown; California Virtual Academy @ Kings; California Virtual Academy @ Los Angeles; California Virtual Academy @ Maricopa; California Virtual Academy High @ Maricopa; California Virtual Academy @ San Diego; California Virtual Academy @ San Joaquin; California Virtual Academy @ San Mateo; California Virtual Academy @ Sonoma; California Virtual Academy @ Sutter; Insight @ Los Angeles; Insight @ San Diego; and Insight @ San Joaquin.[2]

7. K12 California LLC (K12) is a for-profit publicly traded corporation. Appellants purchased their curriculum from K12, as well as management, accounting, operational, and recordkeeping services. (Ex. 100, p. 6.)

8. In accordance with section 4.1 of the Educational Products and Services Agreements (EPSAs) between K12 and each of the CAVA schools operating during the two audited fiscal years, K12 agreed to issue "balanced budget credits" for every year in which a CAVA school ended its fiscal year in a negative net asset position. Balanced budget credits represent the cumulative annual amounts that K12 charged the CAVA schools for educational products and services in excess of available revenues at the end of each fiscal year. K12 expected payment on the balanced budget credits if and when the CAVA school in question had a positive net asset position.

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[1] As a result of the final audit report, CDE, by a letter dated October 9, 2017, demanded appellants remit the amount of $1,995,148 specified in Observation 2 as an overpayment of Common Core funds. (Ex. 11, p. 1720.)

[2] Appellants argue that because the iQ Academy was not part of respondent's audit, the $16,336 attributed to it in the final audit report should not be included in the overpayment demand. This issue is addressed in the Legal Conclusions below.

9. After an investigation of the CAVA schools and their relationship with K12, the People of the State of California, by and through the California Attorney General, filed suit against CAVA and K12 in the Superior Court of the State of California, County of Los Angeles. (Ex. 106.) The Attorney General requested, among many things, limiting the use of the above-described balanced budget credits.

10. On July 8, 2016, the parties settled the matter by reaching a stipulated entry of judgment, which the court approved and entered. (Ex. 106, pp. 1-48.) As part of the stipulated judgment, under the heading "Forbearance," the court ordered, "K12 shall expunge all balanced budget credits incurred by any of the CAVA Schools at the end of every year." (*Id.*, p. 17.) The court further ordered K12 to expunge the approximately $160 million in accumulated "balanced budget credits." (*Ibid.*)

11. As a result of the above-described settlement of the lawsuit, the MOUs between appellants and their authorizing school districts (except for California Virtual Academy @ Fresno) provided that:

> Any contract or arrangement between the Charter School and K12 Inc. for services or materials and equipment shall provide that any charges to or obligation of the Charter School in any fiscal year in excess of the amounts available for payment at the end of such fiscal year will be forgiven by K12 Inc. and shall not be carried over as an obligation in the next succeeding fiscal year.

Common Core Funding

12. California Assembly Bill 86, Section 85 (Chapter 48 Statutes of 2013) authorized the appropriation of $1.25 billion from the state's General Fund to school districts, county offices of education, charter schools, and the state special schools in order to "support the integration of academic content standards in instruction adopted pursuant to Sections 60605.8, 60605.85, 60605.10, 60605.11, and 60811.3 of the Education Code." This allocation is generally referred to as the "Common Core State Standards Implementation" or "Common Core" funds. (Ex. 110.)

13. Common Core funds were to be allocated for the purposes of establishing high-quality instructional programs for pupils. (Ex. 112, p. 1.) Appropriated funds were to be expended only for the following specified purposes: (a) professional development for teachers, administrators, and paraprofessional educators or other classified employees involved in the direct instruction of pupils that is aligned to the academic content standards adopted; (b) instructional materials aligned to the academic content standards adopted; and (c) integration of these academic content standards through technology-based instruction for purposes of improving the academic performance of pupils, including, but not necessarily limited to, expenditures necessary to support the administration of computer-based

assessments and provide high-speed, high-bandwidth Internet connectivity for the purpose of administration of computer-based assessments. (*Id.*, pp. 1-2.)

14. The CDE apportioned half of the Common Core funds to eligible LEAs in August 2013 and the second half in October 2013. (Ex. 26, p. 2133.)

15. A school district, county office of education, charter school, or state special school could encumber (the definition of "encumber" is discussed in detail below) funds apportioned pursuant to Common Core at any time during the 2013/2014 or 2014/2015 fiscal year. (Ex. 110, p. 1; AB 86, § 85, subd. (c).)[3] The parties agree the Common Core funds had to be encumbered by no later than June 30, 2015, which marked the end of the 2014/2015 fiscal year. (See, e.g., ex. 9, p. 1694.)

16. "As a condition of receiving [Common Core] funds," a school district, county office of education, charter school, or state special school "shall do both of the following:"

> (1) Develop and adopt a plan delineating how funds allocated pursuant to this section shall be spent. The plan shall be explained in a public meeting of the governing board of the school district, county board of education, or governing body of the charter school, before its adoption in a subsequent public meeting.
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> (2) On or before July 1, 2015, report detailed expenditure information to the State Department of Education, including, but not limited to, specific purchases made and the number of teachers, administrators, or paraprofessional educators that received professional development. The State Department of Education shall determine the format for this report.

(Ex. 110, p. 1; AB 86, § 85, subd. (e).)

17. Common Core funds were subject to audit pursuant to Education Code section 41020. (Ex. 110, p. 1; AB 86, § 85, subd. (h).)

Defining "Encumber" as Used in Common Core

18. Because the word "encumber" is a critical part of the above Common Core funding requirements, the parties provided various definitions of that word. As will become clear, there is little difference between how the parties define the word; the key difference is how the definition is applied to the events in question.

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[3] Although many parts of Assembly Bill 86 amended various parts of the Education Code, section 85 was not included in any statute but was still binding on participants.

19. The California School Accounting Manual (CSAM) defines "encumbrances" in its glossary as "[o]bligations in the form of purchase orders, contracts, salaries, and other commitments chargeable to an appropriation for which a part of the appropriation is reserved." (Ex. 16, p. 2028.) The CSAM elsewhere defines it as "a commitment in the form of a purchase order offer to buy goods or services." (*Id.*, p. 2021.) Conversely, the CSAM defines an "unencumbered balance" as "[t]hat portion of an appropriation or allotment not yet expended or obligated." (*Id.*, p. 2029.) A completed expenditure is by definition an obligation or commitment for goods and services; thus an "expenditure" meets the definition of "encumbrance" under CSAM.

20. Appellant's expert witness, Wade McMullen, testified to his understanding of an encumbrance. Mr. McMullen is a certified public accountant who possesses between 25 and 30 years' experience with planning, directing, and supervising audits of school districts and charter schools in California. Mr. McMullen testified that, in his opinion, a charter school that has expended funds before a certain date has "encumbered" those funds before that date. He further testified that an encumbrance "is a budgetary accounting term. Mainly that's a way to track expenditures that have already been made as well as potential future expenditures so that you don't go over budget. So the word 'encumbrance' has got a little bit different definition, but it essentially is either of those two things, either encumbrance as an expenditure of funds or it's a commitment of funds for a future expenditure in accordance with that budget." (Reporter's Transcript (RT), vol. 1, pp. 34-35.)

21. CDE Education Fiscal Services Consultant Julie Klein Briggs testified that, based on her knowledge from many years of working for the CDE and other state agencies, in order to "encumber" funds before the June 30, 2015 Common Core deadline, a school must have either "spent or encumbered" the funds. She also testified that for purposes of Common Core, an "encumbrance" means "funds that have been obligated for a specific purpose."

22. As set forth in Factual Finding 16, Common Core also had reporting requirements. Ms. Klein Briggs persuasively testified that, in addition to encumbering Common Core funds by June 30, 2015, recipients were also required to report a spending plan to their governing board and their qualifying expenditures to the CDE by the July 1, 2015 deadline. On the other hand, appellants' expert witness, Mr. McMullen, in his direct testimony did not specifically address whether funding had been timely encumbered if not also timely reported to CDE. On cross-examination, Mr. McMullen grudgingly conceded that if a school did not file expenditure reports when due, it "would have been out of compliance." (RT, vol. 1, p. 53.)

Appellants' Receipt and Use of Common Core Funds

23. Common Core funds were disbursed to appellants in August and October 2013.

24. Appellants had recorded the Common Core funding as deferred revenue during the 2013/2014 and 2014/2015 fiscal years, and later recorded the Common Core funds as revenue in the 2015/2016 fiscal year.

25. A. Appellants have consistently maintained during the audit and this litigation that during the fiscal years 2013/2014 and 2014/2015, they incurred eligible expenditures that could be claimed against Common Core revenue, but which had not been so claimed in those two prior fiscal years for accounting purposes.

B. Some question was raised by respondent and intervenor concerning whether Common Core eligible expenses were actually incurred before June 30, 2015, because of an internal e-mail dated June 3, 2016, sent by CAVA Director of Finance Marguerite Violassi. The subject line of the e-mail was "Are we going to spend the Common Core Funding." (Ex. 109, p. 73.) Ms. Violassi wrote in the e-mail, "As of May 31, there remains $845,268 to be spent. . . . [T]his is a large amount and I am not confident it is going to be spent. [¶] The fact that we are at June 1 [2016] without this funding actually spent makes the notion of 'encumbered' as of June 30, 2015 questionable." (*Ibid.*)

C. However, as discussed below, respondent's auditors conceded that Common Core eligible expenditures were actually made before the June 30, 2015 deadline; they concluded the problem was that the expenditures were not categorized as such until after the deadline. (Ex. 4, p. 1587.) Respondent and intervenor also concede in their closing briefs that whether or not Common Core eligible expenditures were actually made prior to the deadline is not at issue in this appeal (ex. 120, p. 11); and that they have no opinion whether appellants spent funds prior to the deadline that could have qualified under Common Core (ex. 20, p. 1 fn. 1).

D. Based on these circumstances, it was established by a preponderance of the evidence that during the fiscal years 2013/2014 and 2014/2015, appellants actually incurred Common Core eligible expenditures that could be claimed against Common Core revenue, in the amount of $1,995,148, the total identified in the final audit report.

26. A. On September 9, 2016, Ms. Violassi sent the following e-mail to Ruthann Munsterman of CDE, which in turn was forwarded to Ms. Klein Briggs:

> Thank you for taking time to discuss Common Core spending. I appreciate the clarity and understanding you provided. I have summarized our discussion so please let me know if my understanding is accurate:
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> The documentation that we used to prepare and submit our Common Core Expenditure Report to CDE is in essence our encumbrance document. While we have planned spending for the total funding, it is understood that we have flexibility to spend, for example, more on Professional Development and less

> on Technology than we may have originally thought. In other words, there is some flexibility to shift the funds within the allowable expense areas of Technology, Learning Materials and Professional Development. Additionally, I also understood that amounts can flow into this fiscal year or even next as there is no defined cut off.

(Ex. 9, p. 1695.)

B. On October 11, 2016, Ms. Klein Briggs responded to Ms. Violassi's e-mail as follows:

> Thank you for your email below. As clarification, based on Section 85 of Assembly Bill 86 (Chapter 48, 2013) local educational agencies may encumber funds at any time during the 2013-14 or 2014-15 fiscal year. This means that the end date to spend or encumber the Common Core Implementation Funds was June 30, 2015. As of July 1, 2015, all expenditures or encumbrances should have been reported to CDE. While perhaps there might be a little wiggle room for amounts that might be immaterial, we would want to look at unspent amounts for your schools to make a determination. If amounts are material we would most likely issue an invoice to collect the unspent amounts. If you believe you can make adjustments for other 2013-14 and 2014-15 allowable expenditures that were charged to other resources, please let me know.

(*Id.*, p. 1694.)

C. During the hearing, Ms. Klein Briggs persuasively testified that when she referred to the possibility of Common Core funds being restated for prior fiscal years, she meant only "immaterial amounts." (RT, vol. 1, p. 122.) She had previously testified that $10,000 or less would be an immaterial amount.

27. A. In October 2016, appellants restated their 2015/2016 fiscal year financial statements. Common Core revenue totaling $1,995,148 was corrected to shift the recognition of that revenue to fiscal years 2013-2014 and 2014-2015 to match the timing of when the related expenditures were made. Appellants' vendor, K12, received payment for that amount in 2016 as a result of the restatements.

B. Note 8 to appellants' 2015-2016 fiscal year financial restatements explained the reasoning behind correcting the prior fiscal years' recognition of revenue:

> During the year ended June 30, 2016, management noted that the Organization, in prior years, had incurred eligible expenses toward Common Core revenues, which had initially been classified as deferred revenues and amounts due to Federal,

> State, and Local Governments, rather than being recognized as revenues in the period that these eligible costs were expended. Accordingly, a prior adjustment was recorded. . . .

(See, e.g., ex. 1, p. 328.)

C. A chart included in Note 8 to appellants' fiscal year financial restatements shows an increase in monies due to K12, either for the fiscal years ended June 30, 2014 and June 30, 2015 (for CAVA Maricopa, CAVA Los Angeles and CAVA Kings), or the fiscal year ended June 30, 2015 alone (for all other schools.) These increases were pursuant to section 4.1 of the EPSAs, which provided that if school liabilities exceeded school assets in a given fiscal year, K12 would not fully recover the amounts it had invoiced the school for services rendered. With Common Core revenue now recognized in these prior fiscal years, the assets of each school was accordingly increased, and the amount payable to K12 for a particular school in a particular year was accordingly increased as well.

28. The restatements were audited by appellants' independent auditors, Green Hasson Janks, who found the restatements to be proper and necessary. The auditors explained their findings as follows:

> Common Core funds were received in the prior year and unused funds were booked as deferred revenue. . . . There was no time limit spent [sic] on when the funds needed to be spent, however any school with unspent funds at 6/30/15 must encumber the funds and submit a report to the CDE detailing the encumbrances and when the funds would be disbursed.

(Ex. 30, p. 2204.)

29. Green Hasson Janks fully explained its findings in a Common Core Adjustment Memo included in section 9000.30 of its work papers (ex. 30), a Common Core Adjustment Summary in section 9000.35 of its work papers (ex. 31), and a detailed Common Core Expenditure Testing document in section 9000.40 of its work papers (ex. 32). One of the documents included in its work papers contained expenditure information, including the involved school, date, invoice number, check number, check date, Common Core amount per client, Common Core amount per support, balanced budget impact, date balanced budget applied, description, and the allowable cost status of each sampled expenditure. (Ex. 32, p. 2209.) As shown below, some or all of these work papers (exs. 30-32) were presented to respondent's auditors at some point during the audit.

30. Green Hasson Janks' work papers also show the 2014-2015 financial statement of iQ Academy was restated to recognize $16,336 in Common Core funding during that year. (Ex. 1, pp. 246, 248-249.) This $16,336 was included in the $1,995,148 in Common Core revenues recognized as part of the restatements. (*Ibid.*)

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31. The only evidence presented indicating appellants reported their use of Common Core funds to CDE was a list compiled by CDE of the LEAs that "did not submit a Common Core Expenditure Report." Appellants are not on that list. (Ex. 34, p. 4.) However, as pointed out in the testimony of CDE's consultant, Ms. Klein Briggs, that list does not indicate how the LEAs (including appellants) who had timely reported their Common Core expenses did so or what expenses were included in their reports. Therefore, it was not established by a preponderance of the evidence that appellants' Common Core qualifying expenses incurred in fiscal years 2013/2014 and 2014/2015 and restated in October 2016 had ever been presented in a public meeting before appellants' governing board(s) or that they had been reported to CDE as required. (See Factual Finding 16.)

The Audit

32. As indicated in the interagency audit agreement, CDE requested respondent to audit appellants due to "various general concerns" over the CAVA schools' student performance rates, attendance and enrollment reports, possible related-party relationships and transactions with their for-profit vendor K12, and their level of organizational independence from K12. (Ex. 3, p. 1550.)

33. Respondent conducted the audit over the period of July 1, 2014, through June 30, 2016. (Ex. 100.)

34. On February 15, 2017, respondent issued a preliminary audit report to appellants. (Ex. 5.) The preliminary audit report was issued "for discussion purposes only" and focused on the areas of concern specified in the interagency audit agreement. The preliminary conclusions were labeled as "Findings." Respondent found appellants had committed violations of rules applicable to charter schools in each area of concern specified in the interagency audit agreement.

35. A. On February 23, 2017, one of respondent's auditors, Sandra Foster, a certified public accountant, sent an e-mail to a partner of Green Hasson Janks, questioning whether appellants had used Common Core funds to pay previously expired balanced budget credits. (Ex. 7, pp. 1665-1667.)

B. Specifically, Ms. Foster wrote that it appeared to her that the $1,995,148 involved in the October 2016 restatements was actually "balance[d] budget credits for the prior years [that] were reclassified as common core expenses in October [2016]." (*Id.*, p. 1666.) She questioned whether such actions violated appellants' MOUs with their authorizing school districts and appellants' settlement with the Attorney General, and indicated this issue now would be included in the audit. (*Ibid.*)

C. Appellants were advised that this new issue arose "during a quality control review of Green, Hasson, and Janks working papers." (Ex. 6, p. 1620.) Joel James, respondent's Financial Audits Bureau Chief, testified that one of respondent's auditors

discovered the situation after an internet search revealed the settlement of the Attorney General's litigation described above. Presumably, the auditor in question was Ms. Foster.

36. A. On February 27, 2017, respondent issued a revised preliminary audit report. (Exs. 6 & 7.) This revised preliminary audit report included the new issue addressed by Ms. Foster in her above-described e-mail, which was added to Finding 1 from the earlier preliminary audit report. (Ex. 7, pp. 1634-1636.)

B. Specifically, the revised preliminary audit report concluded appellants did not ensure that all obligations to K12 were forgiven at the end of each school year, i.e., balanced budget credits, despite agreeing in MOUs that they would do so. (*Id.*, p. 1634.) It was suggested that such actions violated the MOUs and the settlement agreement with the Attorney General. (*Ibid.*)

37. On March 7, 2017, appellants' counsel responded to the preliminary audit report. (Ex. 7.) With regard to the new issue concerning the balanced budget credits and possible violation of the MOUs and settlement agreement with the Attorney General, appellants' counsel wrote, in part:

> Prior period adjustments were not done to recoup balanced budget credits. During fiscal year 2016 financials, CAVA discovered that in fiscal [y]ear 2015, CAVA had common core expenditures that it could claim against common core revenue. CAVA recorded that revenue in fiscal year 2016. At the recommendation of the auditor, the revenue was pushed from fiscal year 2016 to fiscal year 2015. Larger deficits were recorded in fiscal year 2016 and smaller deficits were recorded in fiscal year 2015. The only manner in which K12 even remotely arguably benefited from this adjustment, is that had CAVA not effectuated this adjustment, it is possible that the Common Core funds would have been recouped by the State rather than utilized appropriately toward the requirements of the Common Core program and had that eventuality occurred, the balance[d] budget credit to be expunged would have been greater.

(*Id.*, p. 1634.)

38. A. On May 4, 2017, respondent issued a draft audit report. (Ex. 8.) For the first time, Common Core funding requirements were specifically addressed in the audit, intertwined with the balanced budget credit discussion contained in the revised preliminary audit report. This discussion was placed in the newly created "Observation 2." (*Id.*, p. 1691.) This issue was labelled as an "Observation" rather than a "Finding" because respondent wanted to indicate the issues were not part of the scope of the audit outlined in the interagency audit agreement, but rather was based on information discovered during the course of the audit.

B. Observation 2 concluded, "The [CAVA] schools['] restatement of prior years' financial statements may have violated the schools' memoranda of understanding and the settlement agreement between the schools and the California State Attorney General." (*Id.*, p. 1690.)

C. Under the sub-heading "Allowable Use of Common Core Funds" was:

> The prior-period adjustment was made in October 2016, when closing out FY [fiscal year] 2015-16 financial statements. The adjustment reduced prior years' balanced budget credits for all 14 schools and increased the payables to K12 Inc. by $1,995,148. CAVA did not provide support that it had encumbered the Common Core funds by June 30, 2015, a prerequisite to being eligible to spend such funds. Therefore, these funds were no longer available to be applied against FY 2013-14 and FY 2014-15 balanced budget credits. Common Core funds not encumbered by June 30, 2015, are required to be returned to the CDE.

(*Id.*, p. 1691.)

D. Because the October 2016 restatement resulted in appellants' payment of $1,995,148 to K12 in 2016, based on expenses incurred in prior fiscal years, Observation 2 concluded such payments honored the expired balanced budget credits from prior years that should have been expunged. Accordingly, Observation 2 noted that appellants "may have" violated both the terms of their MOUs with various authorizing school districts and the settlement agreement with the Attorney General. It was also recommended that CDE take action to recover the $1,995,148 in Common Core funds involved. (Ex. 8, pp. 1690-1692.)

39. On May 15, 2017, counsel for appellants responded to the draft audit report. (Ex. 1, pp. 121-147). Counsel explained:

> During fiscal year 2016 audit, CAVA discovered that in fiscal years 2015 and 2014, CAVA had Common Core expenditures that it could claim against Common Core revenue. CAVA originally had recorded that revenue in fiscal year 2016. During the fiscal year 2016 audit, the timing of recognition of the Common Core revenues was corrected to shift them to fiscal years 2015 and 2014 to match the timing when the related expenditures were incurred (in accordance with GAAP). The correction was audited by CAVA's independent auditors and they agreed with the prior period restatement. Larger deficits were recorded in fiscal year 2016 and smaller deficits were recorded in fiscal years 2015 and 2014. Such Common Core

> funds were spent by June 30, 2015 and thus did not have to be encumbered at June 30, 2015.

(*Id.*, p. 144.)

40. A. On June 2, 2017, respondent issued a revised draft audit report. (Ex. 10.) Observation 2 as discussed above remained, except it now included the following discussion:

> In preparing this observation, we reviewed the audit work papers prepared by the external auditors who prepared CAVA's audited financial statements. Those work papers show that CAVA did not encumber the Common Core funds by the deadline and prior expenses were not classified as being funded with Common Core funds until CAVA adjusted its books in October 2016. The external auditors' work papers also show that CAVA increased its payable to K12 Inc. in October 2016 in order to reduce balanced budget credits. Increasing the payable to K12 Inc. after the end of the school year appears to have violated the terms of the MOUs between CAVA and its authorizing entities.

(*Id.*, p. 1715.)

B. The sub-heading involving Common Core funds again included, "CAVA did not provide support that it had encumbered the Common Core funds by June 30, 2015, a prerequisite to being eligible to spend such funds." (*Id.*, p. 1716.) The remainder of Observation 2 was substantially similar to that contained in the initial draft audit report.

41. A. On June 12, 2017, appellants' counsel responded to the revised draft audit report. (Ex. 1, pp. 149-158.) Counsel explained:

> Common Core Implementation funds were properly spent during the audit period, and thus there is no issue of whether they were timely encumbered as they were appropriately spent prior to June 30, 2015 in alignment with the requirements for Common Core Implementation funds. As explained below, this conclusion has been affirmed by an independent auditing firm and their opinion is attached hereto.

(*Id.*, p. 153.)

B. Counsel further provided a definition of "encumbrance" drawn from the CSAM indicating that an expenditure of funds meets the definition of "encumbrance;" a formal June 8, 2017 letter from Green Hasson Janks affirming the procedures it undertook to audit the proper expenditure of Common Core funds; and a June 12, 2017 letter from a second, independent auditor (Mr. McMullen) supporting and confirming the opinion of Green Hasson Janks. (*Id.*, pp. 149-158.)

42. A. On October 9, 2017, respondent issued the final audit report. (Ex. 100.)

B. Observation 2 remained in the final audit report, which stated, "The restatement of prior years' financial statements may have violated the schools' memoranda of understanding with the authorizing entities."

C. The explanation for Observation 2, in pertinent part, follows:

> The schools restated prior-year financial statements for FY [fiscal year] 2013-14 in the amount of $261,954 and for FY 2014-15 in the amount of $1,733,194 by applying $1,995,148 in unspent deferred revenues against Common Core expenses that were included in balanced budget credits. Balanced budget credits represent the cumulative annual amounts that K-12 Inc. charged the schools for educational products and services in excess of available revenues at the end of each fiscal year. This restatement may have violated the MOUs of 12 of the 13 schools in FY 2014-15 and 13 of the 14 schools in FY 2015-16.
>
> In preparing this observation, we reviewed the audit work papers prepared by the external auditors who prepared CAVA's audited financial statements. Those work papers show that CAVA did not encumber the Common Core funds by the deadline and prior expenses were not classified as being funded with Common Core funds until CAVA adjusted its books in October 2016. The external auditors' work papers also show that CAVA increased its payable to K12 Inc. in October 2016 in order to reduce balanced budget credits. Increasing the payable to K12 Inc. after the end of the school year appears to have violated the terms of the MOUs between CAVA and its authorizing entities.
>
> **Allowable Use of Common Core Funds**
>
> The prior-period adjustment was made in October 2016, when closing out FY 2015-16 financial statements. The adjustment reduced prior years' balanced budget credits for all 14 schools and increased the payables to K12 Inc. by $1,995,148.
>
> CAVA did not provide support that it had encumbered the Common Core funds by June 30, 2015, a prerequisite to being eligible to spend such funds. Therefore, these funds were no longer available to be applied against FY 2013-14 and FY 2014-15 balanced budget credits. Common Core funds not

> encumbered by June 30, 2015, are required to be returned to the CDE.

(Ex. 100, pp. 22-23.)

D. The final audit report also quoted at length from appellants' counsel's response to the revised draft audit report (ex. 100, pp. 24-25), and provided, under a section entitled "SCO's Comment," the following:

> We disagree with CAVA's position. CAVA did incur expenses prior to June 30, 2015, but these expenses were not categorized as Common Core until October 2016. As CAVA did not classify these funds as Common Core prior to the June 30, 2015 deadline, it was improper for CAVA to subsequently claim them as valid expenditures.
>
> In preparing this observation, we reviewed the work papers in which Green Hasson Janks analyzed this issue in preparing CAVA's audited financial statements. Those work papers show that CAVA did not actually encumber the Common Core funds by the deadline; CAVA's expenses were not classified as being used for Common Core until CAVA adjusted its books in October 2016.

(*Id.*, p. 25.)

43. Before the final audit report was issued, respondent's staff held an in-person exit conference with appellants' representatives to review the results of the audit and to give them an opportunity to correct any errors and provide any missing documentation. (RT, vol. 2, pp. 47-50, 91-93.)

44. In December 2017, respondent completed a quality control review of Green Hasson Janks working papers for the firm's audits of California Virtual Academy @ Los Angeles, California Virtual Academy @ San Diego, and California Virtual Academy @ San Joaquin. (Ex. 27.) A quality control review is meant to determine whether audits were performed in accordance with standards for financial and compliance audits. (*Id.*, p. 2139.) In this case, while respondent found some problems with other aspects of the firm's audits, respondent did not raise an issue regarding the propriety of Green Hasson Janks' treatment of the October 2016 restatements. Respondent's Financial Audits Bureau Chief, Mr. James, credibly testified that the purpose of the quality control review was not to re-audit the audit, or to determine the propriety of appellants' restatements, but simply to verify the quality of the firm's audit.

Other Relevant Facts

45. Ms. Klein Briggs was the only CDE employee to testify at hearing. She has worked for CDE for 18 years, 12 of which have been as an educational fiscal services

consultant. She has significant experience with educational funding issues, including Common Core. Ms. Klein Briggs testified that under AB 86, LEAs receiving Common Core funds were required to have spending plans approved by their governing boards and thereafter report their Common Core expenditures to the CDE, all by July 1, 2015. Her understanding is that under AB 86, if a receiving LEA did not timely encumber or report Common Core expenditures, that LEA was subject to paying back to CDE the Common Core funds received but not timely encumbered or reported. In that sense, Ms. Klein Briggs opined that even if an LEA timely incurred a Common Core expense or became obligated to pay such an expense before June 30, 2015, technically those funds were not properly encumbered under Common Core if they had not been also timely reported to a governing board and CDE. Ms. Klein Brigg's testimony was credible as it relates to how AB 86 functioned.

46. Appellants' expert witness, Mr. McMullen, testified that an expenditure becomes an encumbrance when incurred, regardless of how it is accounted for by the LEA in question at the time it was incurred or thereafter. (RT, vol. 1, p. 38.) Focusing solely on GAAP and other well established accounting principles, but not on how AB 86 functioned, Mr. McMullen's testimony was credible.

47. During the hearing, Mr. Supan credibly testified that the reporting deadline in AB 86 is in place to promote order and allow the state to predict fiscal liabilities each year related to Common Core. Specifically, Mr. Supan opined that it would be financial chaos, to the tune of hundreds of millions of dollars of potential liabilities, if LEAs receiving Common Core funds could simply restate their financial statements after June 30, 2015, and thereby lay claim to funds that they were required to previously encumber and report by the deadline. (RT, vol. 1, pp. 154-155.)

LEGAL CONCLUSIONS

Burden and Standard of Proof

1. LEAs may appeal a final audit report. (Ed. Code, §§ 41344, 41344.1.) Appeals are conducted pursuant to the Administrative Procedure Act and corresponding regulations. (Ed. Code, § 41344.1, subd. (b); Gov. Code, § 11500 et seq.)

2. During an audit appeal, the final audit report is presumed correct and proper, and the appellant has the burden of proof to present evidence or arguments to overturn the findings of the final audit report. (Ed. Code, § 41344, subd. (d).)

3. Since this case does not involve discipline of a professional license, and no statute or law requires otherwise, the standard of proof is the preponderance of the evidence. (*Imports Performance v. Department of Consumer Affairs, Bureau of Automotive Repair* (2011) 201 Cal.App.4th 911, 916–918; see also Evid. Code, § 115.)

4. A. The statute governing this appeal, Education Code section 41344, subdivision (d), provides:

> [A] local educational agency may appeal a finding contained in the final report, pursuant to Section 41344.1. . . . [A] hearing shall be held at which the local educational agency may present evidence or arguments if the local educational agency believes that the final report contains any finding that was based on errors of fact or interpretation of law, or if the local educational agency believes in good faith that it was in substantial compliance with all legal requirements.

B. Thus, in this case, appellants bear the burden of establishing by a preponderance of the evidence that the final audit report contains a finding that was based on errors of fact or interpretation of law.[4]

5. A government agency's interpretation of its governing statutes and regulations is entitled to great weight and deference. (*Calderon v. Anderson* (1996) 45 Cal.App.4th 607, 612-613; *Department of Health Services v. Superior Court* (1991) 232 Cal.App.3d 776, 782.) "[A]n agency's interpretation of its own regulations is the "ultimate criterion . . . which becomes of controlling weight unless it is plainly erroneous or inconsistent with the regulation.' [Citation.]" (*Calderon v. Anderson, supra,* 45 Cal.App.4th at p. 613.) However, an agency's "vacillating position" is entitled to no deference, irrespective of any institutional capacities or expertise to which it may subsequently lay claim. (*Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 13.)

Legal Authority for the Audit

6. The final audit report provides that "[t]he legal authority to conduct this audit is provided by interagency [audit] agreement CN 150487 between the CDE and the SCO dated June 17, 2016." (*Id.*, p. 1571.) The interagency audit agreement in turn recites Education Code sections 47604.3 and 47604.5. In their closing brief, appellants argue neither of these provisions authorized CDE to initiate an audit of a charter school and therefore CDE had no authority to contract with respondent to conduct the audit. Appellants are wrong.

7. CDE may audit any charter school as part of its responsibility to oversee such school's financial stability, including revoking a school's charter if any financial mismanagement is uncovered. (Ed. Code, § 47604.5.) Charter schools also are required to cooperate with any investigation of their finances initiated by CDE. (Ed. Code, § 47604.3.) Those are the two Education Code statutes referenced in the interagency audit agreement between CDE and respondent. Here, CDE had general concerns regarding appellants' performance as charter schools and thus initiated an audit, as it was entitled to do under the

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[4] Since appellants argue Observation 2 is in error, and that they met their legal requirements, they are not making a "substantial compliance" argument.

two statutes in question. Therefore, CDE had the authority to initiate and hire respondent to perform an audit of appellants. The primary issue investigated in Observation 2 related to appellants' financial management, i.e., the alleged payment of prohibited balanced budget credits; the second issue noted in Observation 2 pertaining to a Common Core funding violation similarly related to appellants' financial management. In addition, all local educational agencies, including appellants, are subject to annual audits for any Common Core funds apportioned under AB 86. (Ex. 110, p. 1, subd. (h); see also Ed. Code, § 41020.) Observation 2 of the final audit report involved the receipt and use of Common Core funds. Thus, when respondent's staff discovered anomalies concerning appellants' receipt and use of Common Core funds, it had the legal authority to include that issue in the audit.

8. In addition, respondent has broad audit authority grounded in the payment and use of state funds. For example, article XVI, section 7, of the California Constitution states that "money may be drawn from the Treasury only through an appropriation by law and upon a Controller's duly drawn warrant." The term "duly" means "as is right and fitting." (71 Ops.Cal.Atty.Gen. 275 (1988).) "It signifies correctness, propriety, validity, and that which is legally required. [Citations.] A duly drawn warrant, therefore, is one that is drawn for a lawful amount." (*Ibid.*) The Supreme Court stated that the purpose of the constitutional requirement of a "duly drawn warrant" is to "insure the Controller's concurrence in the expenditures of state funds." (*Flournoy v. Priest* (1971) 5 Cal.3d 350.) If the expenditure is "authorized and approved by the Controller," the constitutional requirement is met. (*Id.*, p. 354.) This signifies that respondent had expansive audit authority over the use and receipt of state money, including the ability to audit receipt and use of Common Core funds received by appellants when that issue was discovered during the course of the audit.

9. A. In their opening brief filed before the hearing, appellants offered various arguments that there is no jurisdiction "to review Observation 2." (Ex. 35, pp. 10-18.) Those arguments were not raised in their closing briefs submitted after the evidence in this case was presented. Nonetheless, these jurisdiction arguments have been considered, but none is supported by fact or law and the arguments are therefore not persuasive. They are best described as scatter-shot, but seem to group in three common themes discussed below.

B. First, appellants make the semantic argument that Education Code section 41344 only allows an appeal from a "finding" in an audit, but does not contain the word "observation." However, it is clear that Observation 2 contained formal findings that appellants may have violated the MOUs with their authorizing school districts and did violate Common Core funding requirements. The fact that Observation 2 was not labelled a "finding" is of no moment.

C. Second, appellants argue that because Observation 2 is not a finding and goes outside the scope of the interagency audit agreement between CDE and respondent, it violated a number of accounting standards. However, appellants cite no legal authority and failed to present any expert witness testimony in support of their claim that respondent lacked legal authority to include the purported violations of appellant's MOUs or Common Core funding requirements in the audit. As discussed above, the Education Code allows

audits of charter school financial management and Common Core funding; when respondent discovered those anomalies, its staff was entitled to proceed.

D. Finally, appellants point to several extraneous documents issued by CDE summarizing the audit results, such as CDE's demand letter and a press release. Yet it is not apparent from appellants' argument how those documents impact respondent's legal authority to conduct the audit or for the review the final audit report.

Observation 2 Concerning the MOUs

10. A. The initial conclusion stated in Observation 2 is that appellants may have honored previously expired balanced budget credits when they paid K12 $1,995,148 in 2016 as a result of the October 2016 restatements. Doing so would have been prohibited by the terms of appellants' settlement of the Attorney General's lawsuit, as well as the terms of the MOUs between appellants and their authorizing school districts.

B. Appellants made various arguments in their closing brief concerning how that conclusion was in error. (Ex. 37, pp. 30-38.) Interestingly, respondent and intervenor decided not to address this issue in their closing briefs, arguing that the issue is unnecessary to the resolution of this appeal if the Common Core funding violation conclusion contained in Observation 2 is affirmed. (See, e.g., exs. 119 & 120, pp. 13-14.) Respondent and intervenor argue this issue is also unnecessary because it is unconnected to a dollar repayment recommendation. (*Ibid.*) However, appellants urge in their reply brief that respondent [and intervenor] "concedes that no repayment demand can follow from this [aspect of the] observation. (Citation omitted.) Procedurally, however, this observation still needs to be set aside, as the CDE may nevertheless seek repayment." (Ex. 40, p. 20.)

C. Appellants are correct. This conclusion was the primary part of Observation 2. As concluded above, Education Code section 41344 allows an appeal from a finding contained in a final audit report. The finding contained in Observation 2 that appellants may have violated their MOUs is such a finding from which an appeal can be made.

11. A. Appellants are also correct that their payment to K12 as a result of the October 2016 restatements did not constitute a payment of previously expired balanced budget credits.

B. It is not true that the payment of $1,995,148 to K12 in 2016 that resulted from the October 2016 restatements constituted appellants honoring previously expired balanced budget credits from the fiscal years ending in 2014 and 2015. Instead, and as discussed in more detail below, the October 2016 restatements were a recognition by appellants that they had incurred Common Core eligible expenses in the fiscal years ending in 2014 and 2015. The restatements did not result in an obligation being carried over from one fiscal year and offset against income of a succeeding year. Rather, an increased amount of revenue was recognized in a prior fiscal year, and thus the amount payable to K12 by the

schools was increased. A mistaken, erroneous calculation was being fixed. The restatements simply acknowledged that the full amount of the earlier years' balanced budget credit was not appropriate in the first place, because revenue in that year was actually higher than what had been originally reported.

C. Since the payment to K12 was not a recoupment of previously expired balanced budget credits, the MOUs were not violated, and in turn, the terms of the settlement of the Attorney General's lawsuit were not violated. In this regard, the conclusion of Observation 2 that appellants may have violated the MOUs with their authorizing school districts was based on errors of fact or interpretation of law and therefore appellants met their burden of establishing that this aspect of Observation 2 should be overturned pursuant to Education Code section 41344, subdivision (d).

Observation 2 Concerning Common Core Funding

12. In discussing how appellants may have violated their MOUs, the auditors concluded in the second part of Observation 2 that appellants violated Common Core funding requirements. All parties in their briefs devoted primary attention to this aspect of Observation 2, presumably because attached to this conclusion is the recommendation that CDE seek repayment of $1,995,148 from appellants for a Common Core overpayment.

13. A. As discussed in the Factual Findings, receipt of Common Core funds came with two specific and distinct requirements.

B. First, the funds had to be encumbered during the 2013/2014 and/or 2014/2015 fiscal years, or no later than June 30, 2015. (AB 86, § 85, subd. (c); Factual Finding 15.) In this case, appellants established by a preponderance of the evidence that they had incurred expenses eligible under Common Core before June 30, 2015, totaling $1,995,148, the amount identified in the final audit report. By the generally accepted accounting definition of the word encumber, meaning an expense incurred or obligated, appellants had encumbered the amount in question on a timely basis, i.e., by or before June 30, 2015. (Factual Findings 12-22, 46.)

C. The second requirement related to reporting Common Core expenditures in a timely manner. Initially, an LEA receiving Common Core funds was required to develop and adopt "a plan delineating how funds allocated pursuant to this section shall be spent. The plan shall be explained in a public meeting of the governing board of the . . . charter school, before its adoption in a subsequent public meeting." (AB 86, § 85, subd. (e)(1); Factual Finding 16.) This language indicates the spending plan was to be prospective, i.e., made before the funds were spent. This construction of subdivision (e)(1) would give governing boards the ability to approve or reject such plans before funds were spent. In this case, appellants did not demonstrate that they had developed a plan delineating how the funds in question would be spent or that they presented such a plan to their governing board(s).

D. (i) In addition, AB 86 required an LEA to report to CDE, by or before July 1, 2015, detailed expenditure information for Common Core funds, including specific purchases made and the number of teachers, administrators, or paraprofessional educators that received professional development. (AB 86, § 85, subd. (e)(2); Factual Finding 16.) This language indicates the report to CDE was intended to be retrospective, i.e., made to CDE after the expenses were incurred. This construction of subdivision (e)(2) would allow CDE to monitor how the funds were being used, intervene when necessary, or facilitate decisions on who to audit after. As Mr. Supan credibly testified, timely reporting also provided financial stability to the Common Core program, and ignoring the timely reporting requirement would lead to "financial chaos." (Factual Finding 47.)

(ii) Appellants failed to establish by a preponderance of the evidence that they had reported the $1,995,148 in question to either their governing board(s) or CDE by July 1, 2015. (Factual Finding 31.) This conclusion is bolstered by the fact that appellants had not decided to link the expenses incurred in the two fiscal years in question to Common Core funding until they issued their financial restatements in October 2016, which was well more than one year after the reporting deadline. If appellants had not linked those expenditures to Common Core funds until after the deadline, it is not apparent how they could have timely reported the expenditures before the deadline. This was also the conclusion reached by the auditors in the final audit report. (Factual Findings 38-42.)

E. There also is significant circumstantial evidence corroborating the conclusion that appellants failed to timely report the expenditures in question to their governing board(s) prospectively or to the CDE retroactively, and that, instead, the expenditures were not linked to the Common Core funding until well after the applicable deadlines. Examples include the June 3, 2016 e-mail sent by Ms. Violassi questioning whether a large amount of unspent Common Core funds as of June 2016 could still be deemed encumbered as of June 30, 2015 (Factual Finding 25.B); the September 9, 2016 e-mail from Ms. Violassi, indicating her mindset that appellants had flexibility on Common Core spending and that "amounts can flow into this fiscal year or even next as there is no defined cut off" (Factual Finding 26); and the statement of external auditors from Green Hasson Janks that "there was no time limit . . . on when funds needed to be spent," and intimating that unspent funds, as of June 30, 2015, could still be timely encumbered and reported to CDE (Factual Finding 28).

F. Finally, Ms. Klein Briggs of CDE persuasively opined that the lack of timely reporting of Common Core expenditures to CDE also meant the underlying expenses were not timely encumbered. As a CDE representative, Ms. Klein Briggs' interpretation of how AB 86 functioned is entitled to great weight and deference. Moreover, her opinion on that topic was not effectively rebutted by appellants' lone witness, Mr. McMullen. (Factual Findings 45-46.)

14. As discussed above, the final audit report is presumed correct and proper, and appellants have the burden of overturning it. Here, based on the above, it was established by a preponderance of the evidence that appellants failed to meet one of the two funding

requirements for Common Core, i.e., timely reporting to their governing board(s) and CDE pursuant to AB 86, section 85, subdivision (e). Since they failed to meet a funding requirement for the $1,995,148 in question, appellants are subject to repayment of that amount to CDE. Under these circumstances, appellants failed to rebut the presumption that the audit was correct and prove that Observation 2 should be overturned with regard to Common Core funding. (Factual Findings 1-47.)

Appellants' Arguments Concerning the Common Core Funding

15. Appellants argue the Common Core funding violation contained in Observation 2 is in error legally and factually for several reasons. All have been considered, but none are persuasive, as explained below.

A PARTICULAR ACCOUNTING TREATMENT

16. Appellants argue Observation 2 is in error because respondent required appellants to give their Common Core "expenditures a particular accounting treatment prior to June 30, 2015." (Ex. 37, p. 6.) Appellants correctly note that nothing in AB 86 requires any particular accounting treatment or recordation for Common Core funds. However, the final audit report does not find that appellants violated AB 86 due to how they internally recorded or treated their Common Core expenditures as an accounting function. The final audit report concluded appellants did not classify or categorize their pre-deadline expenditures as Common Core eligible until after the reporting deadline. It is clear from that language that the problem was appellants' failure to timely report their expenditures to their governing board(s) and CDE as required by AB 86, section 85, subdivision (e), as opposed to their use of a particular accounting method.

DUE PROCESS

17. A. Appellants argue that during the hearing respondent and intervenor urged the final audit report was correct because respondent's auditors had requested encumbrance documents from appellants during the audit that were not provided. Appellants contend the final audit report does not discuss such a situation or conclude that the absence of information was a basis for Observation 2. Appellants conclude their due process rights would be violated if Observation 2 is affirmed for that reason, because in doing so the Education Audit Appeals Panel (EAAP) would effectively make *and* uphold such findings. (Ex. 37, pp. 8-13 & 22-28.)

B. Appellants correctly point out that under Government Code section 11425.10, subdivision (a)(4), "the adjudicative function shall be separated from the investigative, prosecutorial, and advocacy functions with the agency." However, respondent and intervenor do not argue in their closing briefs that Observation 2 should be affirmed because appellants failed to provide encumbrance documentation during the audit. Respondent and intervenor used that evidence in their closing briefs only to support the auditors' conclusion in the final audit report that the pre-deadline expenses claimed by

appellants were not timely reported to CDE and not even linked to Common Core funds until well after the deadline. In any event, there has been no evidence presented indicating any member of the EAAP has been involved in any aspect of the investigation or prosecution of this matter, which is the sort of activity prohibited by section 11425.10, subdivision (a)(4).

18. A. Appellants also argue that the final audit report does not discuss a lack of reporting pursuant to AB 86, section 85, subdivision (e), as a basis for Observation 2. (Ex. 37, pp. 28-30.) Appellants seem to argue their due process rights have thereby been violated, because they were not given notice of the actual reason for the overpayment conclusion in Observation 2.

B. A person or entity subject to administrative adjudication is entitled to notice and an opportunity to be heard, including the right to present and rebut evidence. (Gov. Code, § 11425.10, subd. (a)(1).) This means that a person must at least be given notice of the impending deprivation and the facts on which it is based and some opportunity to present an argument against the proposed action. (*Skelly v. State Personnel Bd.* (1975) 15 Cal.3d 194.) In *Tafti v. County of Tulare* (2011) 198 Cal.App.4th 891, 901, the appellant was told, in essence, that, if he requested a hearing, it would merely allow him to challenge the merits of the allegations of an enforcement order; in reality, the hearing reopened the issue of the extent of civil penalties, subjecting appellant to liability for monetary penalties greatly exceeding what was determined in the enforcement order. The *Tafti* court held that, as a result of the inadequate notice, the portion of the civil penalties imposed by respondent above the amount it previously determined in the enforcement order must be vacated. (*Ibid.*) However, a variance between the proof and the pleadings is not deemed material unless it actually misleads a party to his prejudice; a variance may be disregarded when the action has been fully and fairly tried on the merits. (*Cooper v. State Bd. of Medical Examiners* (1975) 49 Cal.App.3d 931, 941-942.)

C. (i) In this case, it was not established that appellants' due process rights were violated. It must be remembered that the pleading at issue is an audit report, written by accountants, not lawyers. In that parlance, Observation 2 clearly concluded appellants had timely incurred eligible expenses, but connected the encumbrance issue with appellants' failure to link the pre-deadline expenditures to Common Core funds until well after the reporting deadline. A reasonable person reading the audit report, knowledgeable of AB 86 and the Common Core funding requirements, would or should have understood the deficiency noted in the final audit report related to a reporting issue.

(ii) Appellants also had the requisite notice of the reporting issue because that issue was noted in draft versions of the audit report provided to appellants, each version prompting a response from appellants, which in turn prompted a response from respondent, as well as in an exit conference. The fact that appellants offered evidence during the hearing that they had reported expenditures to CDE also undercuts their argument. Appellants concede in their closing briefs that they knew respondent and intervenor were making this argument in this case before, during, and after the hearing. But appellants at no time argued they were misled to their prejudice by the fact that the final audit report does not

specifically reference AB 86, section 85, subdivision (e), or include the word "reporting," nor did they make a proffer that they have evidence of timely reporting under AB 86, section 85, subdivision (e). This is not a situation like the *Tafti* case, where appellants were subjected to greater liability than as stated in the final audit report. Finally, the record in this matter, comprised of copious briefing before and after the two-day hearing, and thousands of pages of exhibits, indicates that even if there is a variance between the pleading and evidence, this action has been fully and fairly tried on the merits, and any such variance may therefore be disregarded.

COMMON CORE ELIGIBLE EXPENSES WERE TIMELY ENCUMBERED

19. A. Observation 2 concludes that "CAVA did not encumber the Common Core funds by the deadline and prior expenses were not classified as being funded with Common Core funds until CAVA adjusted its books in October 2016." Appellants seize on the word encumber, and focus on the fact that they did in fact incur eligible expenses before the deadline. Therefore, they argue, they did timely encumber Common Core expenses, and the audit was in error to conclude otherwise. (Ex. 37, pp. 13-20.)

B. Under all the various accounting standards appellants presented in this case, an expense is encumbered when incurred or obligated. Appellants' expert witness, Mr. McMullen, persuasively testified that, from a general accounting standpoint, the expenses in question had been timely encumbered before the deadline. Viewing this situation from that narrow focus, appellants are correct.

C. However, appellants' argument completely ignores the other funding requirement of AB 86, i.e., the reporting requirement of section 85, subdivision (e). It is not enough to timely encumber Common Core eligible expenses. A recipient of Common Core funds must also timely report its planned expenditures to its governing board, and report actual expenditures to CDE. As respondent and intervenor correctly point out, it would do violence to AB 86 to focus only on the encumbrance requirement but ignore the reporting requirement. Timely encumbrances without timely reporting would also lead to financial chaos, as Mr. Supan testified. Here, appellants failed to present evidence showing they timely satisfied the reporting requirement. In addition, CDE expert Ms. Klein Briggs persuasively opined that for purposes of how AB 86 functioned, the proper view is that an eligible Common Core expense still is not timely encumbered if it is not also timely reported. Since the issue in question is more fairly one of the funding requirements mandated by AB 86, and not general accounting standards, Ms. Klein Briggs' opinion is more persuasive than the opinions offered by Mr. McMullen, who ignored AB 86 and focused solely on general accounting issues.

CDE ADVISED PRIOR YEARS' EXPENSES COULD BE RESTATED

20. Finally, appellants argue they cannot be faulted for the results of their October 2016 financial restatements because Ms. Klein Briggs advised Ms. Violassi in her October 2016 e-mail that they could "restate their financials to recognize Common Core expenditures

actually made (but not previously accounted for as such) without losing Common Core funding." (Ex. 37, p. 20.) Appellants focus solely on the last sentence of the e-mail and a small part of Ms. Klein Briggs' hearing testimony. In fact, it is clear by reading her entire e-mail and considering her entire hearing testimony that Ms. Klein Briggs was referring to only "an immaterial amount" of unspent Common Core funds being restated, which she had previously testified would be $10,000 or less. (Factual Finding 26.C.) Ms. Klein Briggs did not advise appellants to do what they did. In any event, no evidence suggests Ms. Violassi followed up with Ms. Klein Briggs and advised her that appellants intended to restate almost $2 million of previously unreported Common Core expenses one year after the deadline; nor did Ms. Violassi or anyone else on behalf of appellants testify that Ms. Klein Briggs' October 2016 e-mail was the reason for the October 2016 financial restatements.

Amounts Attributed to iQ Academy

21. A. The final issue raised by appellants in their closing brief concerns the amount of the Common Core overpayment attributed to iQ Academy. No evidence was presented providing a breakout of what restated Common Core funds were attributable to which audited CAVA school. However, iQ Academy's October 2016 restatement involved $16,336 in recognized Common Core revenues, which was included in the $1,995,148 of total Common Core funds recognized in all the CAVA schools' restatements.

B. As appellants point out, it is reasonable to assume that in making the recommendation that "CDE take appropriate action related to $1,995,148 in Common Core funds" (ex. 4), respondent's auditors drew from the aforementioned $1,995,148 sum included in the Green Hasson Janks work papers. (Factual Finding 30.) The same is true with regard to CDE's demand that "CAVA must remit $1,995,148 to CDE." (Ex. 11.) However, iQ Academy was not a party to the audit and is not an appellant in this case. Appellants therefore argue that the $16,336 attributable to iQ Academy should not be included in the overpayment calculation. Respondent and intervenor take no position on this argument in their closing briefs.

C. Appellants' argument is plausible and supported by evidence. Respondent and intervenor offered nothing in response. Under these circumstances, appellants established by a preponderance of the evidence that the final audit report contained a finding that was based on an error of fact, i.e., that the amount attributed to iQ Academy in its restatement should be included in the overpayment amount attributed to the Common Core funding violation. Therefore, the total overpayment amount should be reduced to $1,978,812.

ORDER

The conclusion in Observation 2 of appellants' 2014-2016 Audit that appellants may have violated MOUs with their authorizing school districts is overturned.

The conclusion in Observation 2 of appellants' 2014-2016 Audit that appellants were overpaid Common Core funds totaling $1,995,148 is modified to reduce that amount to $1,978,812.

In all other respects, Observation 2 of appellants 2014-2016 Audit is affirmed.

DATED: June 21, 2019

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ERIC SAWYER
Administrative Law Judge
Office of Administrative Hearings