



Berkeley Unified School District

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February 2, 2018

VIA ELECTRONIC MAIL -- victor@realmcharterschool.org
Victor Diaz, Executive Director
REALM Charter School
1222 University Ave, Berkeley, CA 94702

Dear Mr. Diaz:

This document constitutes a Notice of Violation ("NOV") issued by the Berkeley Unified School District (the "District") to REALM Middle School ("Charter School") under Education Code § 47607(d). Staff is presenting the NOV to the Board at the February 7, 2017 board meeting, with the recommendation that the Board approve the NOV.

I. LEGAL BASIS FOR ACTION

A. Purpose of Notice of Violation

As is noted in more detail below, the purpose of the NOV is to commence a process under which the District sets forth findings in support of the NOV, as well as a remedy period. At the end of the remedy period, Charter School shall respond in writing to the findings in the NOV, and identify measures taken to remedy the violations set forth therein. At that time, the District will assess Charter School's response and remedies and will determine whether to pursue revocation of the Charter School's charter through issuance of a Notice of Intent to Revoke.

B. Education Code Provisions

The revocation of a charter is governed by Education Code § 47607. Education Code § 47607(c) sets forth the grounds for revocation:

A charter may be revoked by the authority that granted the charter under this chapter if the authority finds, through a showing of substantial evidence, that the charter school did any of the following:

- (1) Committed a material violation of any of the conditions, standards, or procedures set forth in the charter;

- (2) Failed to meet or pursue any of the pupil outcomes identified in the charter;
- (3) Failed to meet generally-accepted accounting principles, or engaged in fiscal mismanagement; or
- (4) Violated any provision of law.

The charter-authorizing agency precedes revocation with a Notice of Violation and a reasonable opportunity to remedy the violation under Education Code § 47607(d):

Prior to revocation, the authority that granted the charter shall notify the charter public school of any violation of this section and give the school a reasonable opportunity to remedy the violation, unless the authority determines, in writing, that the violation constitutes a severe and imminent threat to the health or safety of the pupils.

Prior to revocation, the charter-authorizing agency provides the charter school with a Notice of Intent to Revoke, and conducts a public hearing on the potential revocation (Education Code § 47607(e)):

Prior to revoking a charter for failure to remedy a violation pursuant to subdivision (d), and after expiration of the school's reasonable opportunity to remedy, without successfully remedying the violation, the chartering authority shall provide a written notice of intent to revoke and notice of facts in support of revocation to the charter school. No later than 30 days after providing the notice of intent to revoke a charter, the chartering authority shall hold a public hearing, in the normal course of business, on the issue of whether evidence exists to revoke the charter. No later than 30 days after the public hearing, the chartering authority shall issue a final decision to revoke or decline to revoke the charter, unless the chartering authority and the charter school agree to extend the issuance of the decision by an additional 30 days. The chartering authority shall not revoke a charter, unless it makes written factual findings supported by substantial evidence, specific to the charter school, that support its findings.

The charter school may appeal the revocation to the County Board. (Education Code § 47607(f)(1).)

C. California Code of Regulations

Cal. Admin. Code tit. 5, § 11968.5.2, sets forth additional procedures for a school district's revocation of a charter. Subsection (a) of the regulation provides the charter school 72 hours' notice before the board considers issuing a Notice of Violation:

At least 72 hours prior to any board meeting in which a chartering authority will consider issuing a Notice of Violation, the chartering authority shall

provide the charter school with notice and all relevant documents related to the proposed action.

Subsection (c) describes the charter school's obligations once a Notice of Violation is served:

Upon receipt of a Notice of Violation, the charter school's governing body as described in the school's charter, if it chooses to respond, shall take the following actions:

- (1) Submit to the chartering authority a detailed, written response addressing each identified violation which shall include the refutation, remedial action taken, or proposed remedial action by the charter school specific to each alleged violation. The written response shall be due by the end of the Remedy Period identified in the Notice of Violation.
- (2) Attach to its written response supporting evidence of the refutation, remedial action, or proposed remedial action, if any, including written reports, statements, and other appropriate documentation.

Once the charter school responds to the Notice of Violation, the District will determine whether to proceed with the revocation process. As set forth in Cal. Admin. Code tit. 5, § 11968.5.2, sections (d) and (e):

- (d) After conclusion of the reasonable opportunity to remedy, the chartering authority shall evaluate the response of the charter school's governing body as described in the school's charter response to the Notice of Violation and any supporting evidence, if submitted, and shall take one of the following actions:
 - (1) If the chartering authority has substantial evidence that the charter school has failed to refute, to the chartering authority's satisfaction, or remedy a violation identified in the Notice of Violation, the district shall continue revocation of the school's charter by issuing a Notice of Intent to Revoke to the charter school's governing body as described in the school's charter; or
 - (2) Discontinue revocation of the school's charter and provide timely written notice of such action to the charter school's governing body as described in the school's charter.
- (e) If the chartering authority does not act, as specified in subdivision (d), within 60 calendar days of the conclusion of the Remedy Period

specified in the Notice of Violation, the revocation process is terminated and the Notice of Violation is void.

If the District proceeds to issue a Notice of Intent to Revoke, the Board will hold a public hearing no later than 30 days thereafter, and take action on a Final Decision in open session within 30 days of the public hearing:

On the date and time specified in the Notice of Intent to Revoke, the chartering authority shall hold a public hearing concerning revocation. No more than 30 calendar days after the public hearing (or 60 calendar days by written mutual agreement with the charter school), the chartering authority shall issue a Final Decision.

The charter school must file any appeal to the County Board within 30 days of Board action. (Cal. Admin. Code tit. 5, § 11968.5.4(a).)

II. BACKGROUND

Budgeted projections at 2017-18 First Interim indicate the REALM Middle School will have a surplus for 2017-18. However, the surplus will not negate the projected negative ending fund balances for 2017-18 and the subsequent two years.

In addition, despite projected surpluses at the 2017-18 First Interim reporting period, the District remains concerned about the fiscal health of the Charter School and commitments made during the renewal process in 2015, have not materialized.

A. December 9, 2015 Renewal Staff Report:

In the Staff Report evaluating the petition to renew the Charter School, issued in connection with the Board's December 9, 2015 renewal action, the District noted that the Charter School's unaudited actuals for 2014-2015 showed that the Charter School was deficit spending in the sum of \$760,000, and maintaining a negative fund balance of \$849,000. The Staff Report also noted that the Charter School adopted budget for 2015-2016 did not call for sufficient ongoing reductions in expenditures to sufficiently address its negative fund balance. (Exhibit A, p. 20.)

Although the Board voted to renew the Charter School on December 9, 2015, it did so with significant fiscal conditions upon the Charter School, including the following:

- Resubmission of multi-year projections for the Charter School.
- Reductions in expenditures in excess of \$673,000 to reduce the Charter School's deficit spending and negative fund balance.
- Submission of monthly budgets to the District, including updates and cash flow, until resolution of the negative fund balance and a 3% reserved was achieved.

- Response to District concerns and request for information expressed in prior fiscal oversight letters.
- No further advances on the payment of REALM's in lieu property taxes under Education Code section 47635. (See, Exhibit A, p. 25.)

B. January 26, 2017 Notice of Violation:

REALM's fiscal mismanagement, however, continued, even after the Board renewed the Charter School with conditions to remedy its fiscal mismanagement. The Charter School's continued fiscal problems led the Board to approve a Notice of Violation against it on January 26, 2017. The Notice of Violation was based upon the Charter School's negative fund balance of \$1,146,107, as shown in the 2015-2016 audit report, and failure to reduce expenditures sufficient to eliminate deficit spending. (Exhibit B, p. 11.)

The Notice of Violation directed the Charter School to provide the following information in response:

- An explanation of why the ending balance for 2015-16 did not meet the projected ending fund balance included in the petition for renewal.
- An explanation of the budget to actual variance for fiscal year 2015-2016.
- A demonstration of how the Charter School reached its LCFF calculations for the unaudited actuals, including actual ADA numbers.
- Proof of subsequent receipts of all receivables, by providing the District with the dates, reference numbers and amounts of subsequent receipts.
- A schedule to support Long Term Liabilities totaling \$1.9 million, so the District can ascertain the validity of the amount reported.
- Any additional information on why it engaged in deficit spending as shown in its First Interim Report for Fiscal Year 2016-2017.
- The LCFF calculations for the First Interim Report for Fiscal Year 2016-2017, and which should be submitted with each interim report. (Exhibit B, pp. 16.)

By the end of the remedy period provided in the January 26, 2017 Notice of Violation, the Charter School had failed to cure the fiscal mismanagement set forth in the Notice. Specifically, as noted in the District's August 31, 2017 memorandum to the Charter School:

Based on the projections included in the petition renewal, REALM Middle School projected a surplus of \$70,000 but ended up deficit spending in

2016-17 by \$(174,000). Their fund balance dropped from a negative \$(1,165,000) to a negative \$(1,320,000). This is certainly the definition of fiscal insolvency. (Exhibit C, p. 2.)

The District's August 31, 2017 memorandum to the Charter School concluded it had not "achieved a balanced budget by June 30, 2017" and that "violations still exist and fiscal solvency has not been achieved. (Exhibit C, p. 3.)

III. VIOLATIONS GIVING RISE TO THIS NOTICE

A. Failure to Follow Generally Accepted Accounting Principles and Fiscal Mismanagement (Education Code section 47607(c)(1)(C)) Violation of Terms of the Charter (Education Code section 47607(c)(1)(A))

The District's oversight responsibility includes monitoring the fiscal condition of the Charter School through review of legally-required financial reports, including the Charter School's adopted budget, interim budget reports and unaudited and audited financial statements.

The Charter School is obligated under the law to avoid fiscal mismanagement and use Generally Accepted Accounting Principles. (Education Code section 47607(c)(1)(C).) Appendix I of the REALM Middle School Charter requires the Charter School to maintain fiscal solvency and a positive ending fund balance, as do conditions of the Board's December 9, 2015 renewal of the charter. (Exhibits A, D)

In accordance with Education Code Section 47604.33, the District reviewed and evaluated the Unaudited Actuals for Fiscal Year 2016-2017 for REALM Middle School in an October 20, 2017 letter to REALM. (Exhibit E.)

B.

REALM Middle School:

1. Fiscal Year 2016-2017: Unaudited Actuals

The District's October 20, 2017 written evaluation concluded that "the middle school charter continues to show an insolvent fiscal position. A review of the Unaudited Actuals for 2016-17 indicates that revenues were \$2.7M and expenditures were \$3.1M, reflecting a deficit of \$(374K), leaving a negative ending fund balance of \$(1,520,000)." (Exhibit E, p. 3.) The District also found that "based on the projections included in the charter petition renewal for the combined unrestricted and restricted general fund, REALM projected a surplus of \$301K for 2016-17 when in fact they ended up deficit spending by \$(374K),

down from the 2016-17 Estimated Actuals submitted with the Adopted Budget in June of \$(174K). In effect, REALM Middle missed the projection by \$(675K)." (Exhibit E. p. 3.) Therefore, the District concluded, "the charter school has not met the conditions of the charter petition renewal by making additional reductions that would balance the negative balance by the end of 2016-17." (Exhibit E, p. 3)

The District concluded that the Charter School took none of the steps identified in its 2015-2016 audited financial statements to continue as an ongoing concern, including:

- "Staffing cuts during 2016-17 to balance the budget and establish a 3% reserve [did not occur]
- Submitting monthly financial budgets to the District to maintain a correct and accurate course of action [did not occur]
- Apply for, and receive, additional multi-year grants. [no evidence this occurred]" (Exhibit E p. 4.)

Also, the budget for the Charter School depended upon \$388,785 of borrowed cash during the month of June 2017 used to prop up its cash balance, and also depended upon selling receivables as a way of generating cash. (Exhibit E., p. 5.) As has been noted above, the Charter School had significant consolidated (*i.e.*, shared jointly between REALM High School and REALM Middle School) accounts payable of \$734K, 80% of which (approximately \$589K) were overdue. The Charter School's unaudited actuals also do not reflect payment to the District of \$136,765 for maintenance and services, so the amount of accounts payable is in fact much higher. The District also received notice of nonpayment by the Charter School from a number of local vendors, and the County of Alameda will cease providing counseling services due to non-payment of bills by the Charter School over the past two years. REALM High School and REALM Middle School also jointly hold balances of \$161,339, \$60,000 and \$1,836,446 on two notes payable, a balance of \$1,836,446 of factored receivables, as well as a \$97,103 balance on a line of credit with Wells Fargo Bank. (Exhibit E, p. 5.)

The District also had concerns regarding the accuracy of the Charter School's 2017-2018 adopted budget. For example, the budgeted deficit as of the 2016-17 Second Interim report was \$(149K), whereas the actual deficit was \$225K larger, a total of \$(374K), once the books were closed. (Exhibit E, p 4.)

2. Fiscal Year 2017-2018: Adopted Budget

Even though the 2017-2018 adopted budget for the Charter School projected an operating surplus of \$309K, it still contained a negative ending fund balance of \$1M. (Exhibit E, p. 1.) The Charter School had projected an operating surplus for Fiscal Year 2016-2017 as well, and ended up deficit spending by \$(374K), missing its projection by \$(675K). (Exhibit E, p. 2.) In sum, the District found the following:

- “2016-17 estimated deficit spending of \$(174,000)
- June 30, 2017 estimated ending balance of \$(1,320,000)
- In the MYP, LCFF revenues increased 29% and 13% in the two out years, in an environment of declining enrollment and small levels of gap funding and COLAs. There is no documentation provided to explain these huge increases in LCFF funding.
- Ending fund balances in 2017-18 of (1,010,000) and in 2018-19 of \$(566,000) show improvement with no explanation regarding the turn-around related to the large surpluses that are shown each year.” (Exhibit E, p. 2.)

The Charter School's adopted budget for 2017-2018 projected a drop in salaries/benefits in the sum of \$482K, and an unexplained drop in rents, leases and professional fees in the sum of \$348K. However, there is no detailed explanation for significant decrease in expenditures, and, even with the decrease, the budget still projects a negative ending fund balance. (Exhibit E. p. 2.)

All of the findings contained in the District's October 20, 2017 written fiscal evaluation sent to REALM, and contained in Exhibit E, are incorporated by reference as if set forth explicitly herein.

3. Fiscal Year 2017-2018: First Interim Report

The District issued a written evaluation of REALM Middle School's First Interim Report on December 19, 2017. (Exhibit F.) The District noted that the Charter School's First Interim Report projected a negative ending fund balance of \$1.25 million. (Exhibit F., p. 1.). The District noted, “the charter school has not met the conditions of the charter petition renewal by making additional reductions that would balance the negative balance by the end of 2016-17. In fact, their multi-year projection fails to eliminate the negative fund balance by June 2020.” (Exhibit F. p. 1.) The June 30, 2017 audit report stated that “the Schools experienced an operating deficit, cash flow difficulties, and did not have adequate cash reserves or accounts receivable to meet its current obligations without obtaining additional financing or funding. The Schools increased the deficit for the year ended June 30, 2017 and required substantial financing to meet its current obligations. These factors cause substantial doubt about the Schools' ability to continue as a going concern.” (Exhibit F, p. 2.)

The District's December 19, 2017 evaluation noted that “there are concerns as to the accuracy of the submitted budget for 2017-18 as well as the ability of the School to stay within budget.” (Exhibit F, p. 3.) While it is encouraging that the first interim report reflects a surplus for the year, the Charter has a history of ending the year in a worse financial position than projected in the interim reports. Last year, the Charter projected ending with a \$301K surplus, yet ended the year with a \$(374K) deficit.

As of first interim, revenues were lower than the adopted budget by \$67K due to lower-than-projected enrollment. (Exhibit F, p. 3.) Projected expenditures were increased over

adopted budget, but most significantly, almost \$200K of Restricted expenditures were reclassified as Unrestricted, materially reducing the unrestricted projected surplus. Although the Charter School is projecting a surplus for the year, the ending fund balance is still negative. (Exhibit F, p. 3.) Due to decreased revenue and increased expenditure, plus a drop in the beginning fund balance once the books were closed, the projected ending fund balance as of first interim was lower by \$435K than that projected in the adopted budget. (Exhibit F, p. 3-4.)

REALM Middle School projects enrollment growth of 60 next year, and 25 in the following year, even though it has declined in enrollment by 125 students in the past 3 years. (Exhibit F, p. 4.) If this projected growth does not materialize, LCFF revenues could be overstated by \$1.2 million in the MYP. (Exhibit F, p. 4.)

The District's December 19, 2017 evaluation noted that actual cash balance was \$157K, as opposed to the \$305K projected in the adopted budget. (Exhibit F, p. 5.) REALM Middle School also continues to rely upon selling receivables, as well as maintaining significant accounts payable, notes payable and a line of credit. (Exhibit F, p. 6.) The district also noted that the Charter School's 2017-18 first interim report shows a negative ending fund balance for fiscal years ending 2018 and 2019. (Exhibit F, p. 6.)

4. Summary

The District continues to have serious concerns about the fiscal health of REALM Middle School and its ability to meet financial obligations and continue as a going concern. The Charter School has also not met the conditions of the charter petition renewal by making additional reductions that would balance the negative ending balance by the end of fiscal year 2017-18 and the Charter School has not provided monthly budget and cash flow reports. The District acknowledges that the projected surplus in REALM's 2017-18 First Interim is a step in the right direction toward financial recovery. However, the projected negative ending fund balance for 2017-18 and subsequent two years concerns the District.

In addition, if projected growth does not materialize, revenues could be overstated by \$1.2 million in the Multi Year Projections.

IV. REMEDIES TO BE TAKEN BY REALM

The District provides the Charter School with a **remedy period ending April 11, 2018** in which to provide a written response to this Notice of Violation. In their written response, the Charter School must address the violations addressed herein and identify remedial steps in all of the areas raised in the Notice of Violation, including but not limited to responses to the following directives made to REALM Middle School:

- Submission of all financial reports required by law, including but not limited to those listed in Education Code section § 47604.33, showing that the Charter School, during the current and future fiscal years, will ensure that revenues exceed expenditures, that the Charter School will finish the Fiscal Years with a positive fund balance, and that Charter School will avoid deficit spending.
- Demonstrate that the Charter School has made the cuts necessary to reduce ongoing expenditures on a multi-year basis.
- Demonstrate that the Charter School will be able to achieve fiscal solvency such that they no longer need to rely upon selling their receivables.
- Demonstrate that the Charter School will have paid off all promissory notes, lines of credits, and all other means of financing and financial obligations by the end of the current Fiscal Year. The District will also take into consideration significant gains to achieving these goals.
- Provide an adopted budget for Fiscal Year 2018-2019, as well as financial plans and cash flow for the following three (3) fiscal years, demonstrating positive ending fund balances, the absence of deficit spending, and realistic and supported cuts in expenditures, ADA and attendance levels, and revenue sources. The District will also take into consideration significant gains to achieving these goals.

Please take notice that the District reserves the right to pursue revocation if the Charter School fails to remedy any or all of the violations listed above. Therefore, the District intends to issue a Notice of Intent to Revoke in the event that the Charter School fails to remedy any or all of the violations set forth in this notice.

Under Cal. Admin. Code tit. 5, §11968.5.2(c) and (d), the District will evaluate the Charter School's written response to this Notice of Violation, and, in light of Charter School's identified remedial measures, will consider whether to proceed with the revocation of the Charter School's charter.

Sincerely,

A handwritten signature in blue ink, appearing to read "Donald Evans", with a stylized flourish at the end.

Donald Evans Ed.D.
Superintendent
Berkeley Unified School District