



**Auditor of State
Betty Montgomery**

**NORTH DAYTON SCHOOL OF DISCOVERY
MONTGOMERY COUNTY**

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Auditor of State Betty Montgomery

INDEPENDENT ACCOUNTANTS' REPORT

North Dayton School of Discovery
Montgomery County
3901 Turner Road
Dayton, Ohio 45415

To the Board of Directors:

We have audited the basic financial statements of North Dayton School of Discovery, Montgomery County, (the Academy), as of and for the year ended June 30, 2004, as listed in the table of contents. These financial statements are the responsibility of the Academy's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the contract service fees incurred by the Academy which totaled \$3,904,376 as indicated in Note 9. Other auditors audited these amounts and have furnished their report thereon to us and we base our opinion, insofar as it relates to the amounts included for Note 9, on the report of the other auditors.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to reasonably assure whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the report of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audit and the report of other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of North Dayton School of Discovery, Montgomery County, as of June 30, 2004, and the changes in financial position and cash flows, for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report date December 1, 2006, on our consideration of the Academy's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. While we did not opine on the internal control over financial reporting or on compliance, that report describes the scope of our testing of internal control over financial reporting and compliance and the results of that testing. That report is an integral part of an audit performed in accordance with *Government Auditing Standards*. You should read it in conjunction with this report in assessing the results of our audit.

Management's Discussion and Analysis is not a required part of the basic financial statements but is supplementary information accounting principles generally accepted in the United States of America requires. We have applied certain limited procedures, consisting principally of inquiries of management regarding the methods of measuring and presenting the required supplementary information. However, we did not audit the information and express no opinion on it.

We conducted our audit to opine on the basic financial statements that collectively comprise the Academy's basic financial statements. The federal awards expenditures schedule is required by U.S. Office of Management and Budget Circular A-133, *Audits of State, Local Governments, and Non-Profit Organizations*, and is not a required part of the basic financial statements. We subjected the schedule of federal awards expenditures to the auditing procedures applied in the audit of the basic financial statements. In our opinion, this information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

A handwritten signature in black ink that reads "Betty Montgomery". The signature is written in a cursive, flowing style.

Betty Montgomery
Auditor of State

December 1, 2006

**NORTH DAYTON SCHOOL OF DISCOVERY
MONTGOMERY COUNTY**

**MANAGEMENT DISCUSSION AND ANALYSIS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004
UNAUDITED**

This section of the annual financial report for the North Dayton School of Discovery (the "Academy") (formerly North Dayton School of Science and Discovery) provides an overview of the Academy's financial activities for the fiscal year ended June 30, 2004. It should be read in conjunction with the financial statements, which immediately follow this section. The Academy implemented Statement No. 34 of the Governmental Accounting Standards Board, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, effective July 1, 2003.

Using This Annual Report

The annual report consists of a series of financial statements and notes to those statements. The Statement of Net Assets and the Statement of Revenues, Expenses and Change in Net Assets on pages 5 and 6 provide information about the activities of the Academy as a whole.

Basic Financial Statements

The basic financial statement include all assets and liabilities and results of operations using the accrual basis of accounting which is similar to the accounting used by most private sector companies.

The statement of net assets and statement of revenues, expenses and change in net assets report the business-type activities for the Academy, which encompass all the Academy's services, including instruction, support services and food services. State aid (based on student count) and state and federal grants finance most of these activities. The Academy has entered into a management agreement with National Heritage Academies, Inc ("NHA") which requires NHA to provide administration, strategic planning and all labor materials, equipment and supervision necessary for the provision of educational services to the students. As part of the consideration received under the management agreement, NHA receives remuneration for its services an amount equal to the total revenue received by the academy from all revenue sources.

The table below provides a summary of the Academy's net assets as of June 30:

	2004	2003
Assets - Current	\$ 515,525	\$ 194,300
Assets - Non-current	179,415	
Total Assets	\$694,940	\$194,300
Liabilities - Current	484,422	179,585
Investment in Capital Assets	179,415	-
Net Assets - Unrestricted	31,103	14,715
Total Net Assets	\$ 210,518	\$ 14,715

The unrestricted net assets can be used to finance day to day operations without constraints, such as legislative or legal requirements. The results of current year operations for the Academy as a whole are reported in the statement of activities, which shows the change in net assets

**NORTH DAYTON SCHOOL OF DISCOVERY
MONTGOMERY COUNTY**

**MANAGEMENT DISCUSSION AND ANALYSIS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004
UNAUDITED
(Continued)**

The table below provides a summary of the Academy's change in net assets for the years ended June 30:

	Business Type Activities	
	2004	2003
Operating Revenues:		
State Aid	\$2,954,571	\$1,767,896
Other State Sources	72,462	66,250
Local Sources	33,843	30,006
Total Operating Revenues	<u>3,060,876</u>	<u>1,864,152</u>
Operating Expenses:		
Contracted Service Fee	3,904,376	3,027,322
Depreciation Expense	21,481	
Total Operating Expenses	<u>3,925,857</u>	<u>3,027,322</u>
Operating Loss	(864,981)	(1,163,170)
Non-operating Revenue:		
Federal and State Grants	747,055	271,905
Private Sources - National Heritage Academies, Inc.	313,729	905,980
Total Non-operating Revenues	<u>1,060,784</u>	<u>1,177,885</u>
Change in Net Assets	<u>\$195,803</u>	<u>\$14,715</u>

As reported in the statement of revenues, expenses and change in net assets, the cost of business-type activities was \$3,925,857. These activities were primarily funded by the Academy's state aid (based on student count) and governments and organizations that subsidized certain programs with grants.

The Academy experienced an increase in net assets of \$195,803 in 2004. Under the terms of the agreement with NHA, NHA provides a spending account to the Board of Directors for discretionary expenditures on an annual basis, and part of the reason for the change in net assets is the timing of these discretionary expenditures. The primary reason is the investment in capital assets.

Budgeting – The Academy is not required to follow the budgetary provisions set forth in Ohio Revised Code Chapter 5705.

General Economic Factors – The Academy depends on the legislative and governmental support to fund its operations. There is current litigation regarding the legality of Ohio's charter school program and its school funding plan. Based on information currently available, no significant changes are expected to occur in the nature of the funding or operations of the Academy in 2005.

Contacting the Academy's Financial Management – The financial report is designed to provide users of the report with a general overview of the Academy's finances and to demonstrate the Academy's accountability for the money it receives. If you have questions about this report, contact the Chief Financial Officer of National Heritage Academies, Inc., 3850 Broadmoor SE, Ste 201, Grand Rapids Michigan 49512.

**NORTH DAYTON SCHOOL OF DISCOVERY
MONTGOMERY COUNTY**

**STATEMENT OF NET ASSETS
AS OF JUNE 30, 2004**

ASSETS

Current Assets:

Cash	\$ 69,384
Due from Other Governments	<u>446,141</u>
Total Current Assets	515,525

Non-current Assets

Capital Assets (Net of Accumulated Depreciation)	<u>179,415</u>
Total Assets	\$694,940

LIABILITIES

Current Liabilities

Due to National Heritage Academies, Inc.	<u>484,422</u>
Total Liabilities	<u>484,422</u>

NET ASSETS:

Invested in Capital Assets	179,415
Restricted for Contractual Services	<u>31,103</u>
Total Net Assets	<u><u>\$210,518</u></u>

See accompanying notes to basic financial statements.

**NORTH DAYTON SCHOOL OF DISCOVERY
MONTGOMERY COUNTY**

**COMBINED STATEMENT OF REVENUES, EXPENSES
AND CHANGE IN NET ASSETS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004**

OPERATING REVENUES:	
State aid	\$2,954,571
Other state sources	72,462
Local sources	<u>33,843</u>
Total operating revenues	3,060,876
OPERATING EXPENSES:	
Contracted service fee	3,904,376
Depreciation expense	<u>21,481</u>
Total operating expenses	<u>3,925,857</u>
OPERATING LOSS	(864,981)
NON-OPERATING REVENUE:	
Federal and state grants	747,055
Private Sources - National Heritage Academies, Inc.	<u>313,729</u>
Total Non-operating revenues	1,060,784
NET INCOME	195,803
NET ASSETS - Beginning of Year	<u>14,715</u>
NET ASSETS - End of Year	<u><u>\$210,518</u></u>

See accompanying notes to the basic financial statements.

**NORTH DAYTON SCHOOL OF DISCOVERY
MONTGOMERY COUNTY**

**STATEMENT OF CASH FLOWS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004**

CASH FLOWS FROM OPERATING ACTIVITIES:

Cash received from state sources	\$2,931,778
Cash received from local sources	33,843
Cash paid on behalf of the Academy for goods and services	<u>(3,599,539)</u>
Net cash used in operating activities	(633,918)

CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES -

Federal and state grants received	522,484
Support from private sources - National Heritage Academies, Inc.	<u>313,729</u>
Net cash from noncapital financing activities	836,213

CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES

Payments for Capital Acquisitions	<u>(200,896)</u>
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NET INCREASE IN CASH 1,399

CASH JULY 1, 2002 67,985

CASH JUNE 30, 2003 69,384

**RECONCILIATION OF OPERATING LOSS TO NET CASH
USED FOR OPERATING ACTIVITIES:**

Operating Loss	(864,981)
Adjustments to reconcile operating loss to net cash used for operating activities:	
Depreciation	21,481
Changes in assets and liabilities -	
Due from governmental revenue sources	(95,255)
Due to National Heritage Academies, Inc.	<u>304,837</u>

NET CASH USED IN OPERATING ACTIVITIES (\$633,918)

See accompanying notes to the basic financial statements

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**NORTH DAYTON SCHOOL OF DISCOVERY
MONTGOMERY COUNTY**

**NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004**

1. NATURE OF OPERATIONS

North Dayton School of Discovery (the "Academy") is an Ohio Public School Academy which provides education based on rigorous teaching methods, parental involvement, student responsibility, and basic moral values. The Academy operates under an approved charter received from the Ohio State Board of Education ("Sponsor"), which is responsible for oversight of the Academy's operations. The Academy provides education, at no cost to the parent, to students in kindergarten through sixth grade. Enrollment is open to all appropriately aged children without regard to gender, ethnic background, disability, and/or religious affiliation.

The Academy is exempt from taxation as a governmental entity pursuant to Internal Revenue Code Section 115. The Academy qualifies for public charity status by meeting the requirements of Internal Revenue Code Section 509(1) and 170(b)(A)(ii).

The Academy was approved for operation under contract with the Ohio Department of Education as Sponsor through April 2, 2004. As of that date the Lucas County Educational Service Center became Sponsor. The contract is renewable by the Sponsor. The Academy operates under a five member Board of Directors (the "Board"). The Board is responsible for carrying out the provisions of the contract with the Sponsor which includes, but is not limited to, state-mandated provisions regarding student population, curriculum, academic goals, performance standards, admission standards and qualifications of teachers.

The Academy's primary sources of revenue are provided by the State of Ohio and consist of amounts per student multiplied by weighted average student counts. The State revenue is recognized ratably over the school year and was funded through payments from July 2003 through June 2004.

The Board of Directors of the Academy has entered into a management agreement (the "agreement") with the National Heritage Academies, Inc. (NHA) which requires NHA to provide administration, strategic planning and all labor, materials, equipment and supervision necessary for the provision of educational services to students. As part of the consideration received under the agreement, NHA also provides the facility in which the Academy operates. The agreement will automatically renew on a year to year basis, unless at least 90 days written notice of intent to terminate or renegotiate is given by either the Academy or NHA.

Under the terms of the agreement, NHA receives remuneration for its services an amount equal to the total revenue received by the Academy from all revenue sources. NHA provides a spending account to the Board for discretionary expenditures on an annual basis. Revenues-Private Sources-NHA represents a contribution granted by NHA for the excess of Academy cash expenditures over public revenues available.

The Board of North Dayton School of Discovery serves in the same capacity for Pathway School of Discovery in Dayton, Ohio.

The Academy implemented Statement Number 34 of the Governmental Accounting Standards Board, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, effective July 1, 2003.

**NORTH DAYTON SCHOOL OF DISCOVERY
MONTGOMERY COUNTY**

**NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004
(Continued)**

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting policies of the Academy conform to accounting principles generally accepted in the United States of America as applicable to governmental units. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for establishing governmental accounting and financial reporting principles. As permitted by generally accepted accounting principles, the Academy has elected to apply only applicable Financial Accounting Standards Board statements and interpretations issued on or before November 30, 1989.

A. Basis of Presentation

The Academy's basic financial statements consist of a statement of net assets; a statement of revenues, expenses and change in net assets; and a statement of cash flows.

The Academy uses enterprise accounting to maintain its fiscal records during the fiscal year. Enterprise accounting focuses on the determination of operating income, changes in net assets, financial position and cash flows.

B. Measurement Focus and Basis of Accounting

Enterprise accounting uses a flow of economic resources measurement focus. With this measurement focus, all assets and all liabilities are included on the statement of net assets. Operating statements present increases (i.e. revenues), and decreases (i.e. expenses) in net total assets.

Basis of accounting refers to when revenues and expenses are recognized in the accounts and reported in the financial statements. Basis of accounting relates to the timing of the measurement made.

The accrual basis of accounting is utilized for reporting purposes. Revenues are recognized when earned, and expenses are recognized when incurred.

C. Budget

Unlike other public schools located in the State of Ohio, community schools are not required to follow budgetary provisions set forth in Ohio Revised Code Section 5705, unless specifically provided in the Academy's contract with its Sponsor. The contract between the Academy and its Sponsor requires a detailed school budget for each year of the contract; however, the budget does not have to follow the provisions of Ohio Revised Code Section 5705.

D. Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**NORTH DAYTON SCHOOL OF DISCOVERY
MONTGOMERY COUNTY**

**NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004
(Continued)**

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

E. Cash

Cash as of June 30, 2004 represents bank deposits, which are covered by federal depository insurance. Accordingly, there are no investments which are required to be categorized according to risk.

F. Capital Assets

As of June 30, 2004, the Academy had invested in capital assets with purchases through the Charter School Grant, primarily equipment. Capital assets are substantially provided as part of the management agreement with NHA.

Capital assets, which include equipment and computers, are reported in the government-wide financial statements. Capital assets are defined by the Academy as assets with an estimated useful life in excess of one year. Such assets are recorded at historical cost.

Equipment and computers are depreciated using the straight-line method over the following useful lives:

Furniture and other equipment	5-20 years
Computers	3-5 years

G. Intergovernmental Revenues

The Academy currently participates in the State Foundation Program and the State Disadvantaged Pupil Impact Aid ("DPIA") Program. Revenues received from these programs are recognized as operating revenues in the accounting period in which all eligibility requirements have been met.

Eligibility requirements include timing requirements, which specify the year when resources are required to be used or the fiscal year when use is permitted; matching requirements, in which the Academy must provide local resources to be used for a specified purpose; and expenditure requirements, in which the resources are provided to the Academy on a reimbursement basis.

Grants and entitlements are recognized as non-operating revenue in the accounting period in which all eligibility and timing requirements have been met.

The Academy also participates in various federal and state programs through the Ohio Department of Education. The programs the Academy participated in during the fiscal year 2004, of which they were still owed for at June 30, 2004, include Title I and Title II, and the Charter School Grant. Revenue received from these programs is recognized as non-operating revenue in the accompanying financial statements.

H. Due to National Heritage Academies, Inc.

The amount of \$484,422 consists of payments due to National Heritage Academies, Inc. for management services rendered in fiscal year 2004.

**NORTH DAYTON SCHOOL OF DISCOVERY
MONTGOMERY COUNTY**

**NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004
(Continued)**

3. DEPOSITS AND INVESTMENTS

The following information classifies deposits by category of risk as defined in GASB Statement Number 3 "Deposits with Financial Institutions, Investments (including Repurchase Agreements) and Reverse Repurchase Agreements."

Deposits: At June 30, 2004, the carrying amount of the Academy's deposits and the bank balance was \$69,384, which was covered by federal depository insurance.

4. INTERGOVERNMENTAL RECEIVABLES

Intergovernmental receivables (Due From Other Governments) at June 30, 2004, consisted of grants and entitlements. All receivables are considered collectible within one year due to the stable condition of State programs, and the fiscal year guarantee of federal funds.

5. CAPITAL ASSETS

	Balance			Balance
	6/30/03	Additions	Deletions	6/30/04
Depreciable Capital Assets				
Furniture	\$ -	\$776	(\$-)	\$776
Equipment	-	130,945	-	130,945
Computers	-	69,175	-	69,175
Total Depreciable Capital Assets	-	200,896	-	200,896
Less Accumulated Depreciation				
Furniture	(-)	(54)	(-)	(54)
Equipment	(-)	(19,915)	(-)	(19,915)
Computers	(-)	(1,512)	(-)	(1,512)
Total Accumulated Depreciation	(-)	(21,481)	(-)	(21,481)
	\$-	\$179,415	\$-	\$179,415

6. DEFINED BENEFIT PENSION PLANS

A. School Employees Retirement System

NHA, on behalf of employees at the Academy, contributes to the School Employees Retirement System ("SERS"), a cost-sharing multiple-employer defined benefit pension plan. SERS provides retirement and disability benefits, annual cost-of-living adjustments, and death benefits to plan members and beneficiaries. Authority to establish and amend benefits is provided by Chapter 3309 of the Ohio Revised Code. SERS issues a publicly available, financial report that includes financial statements and required supplementary information. That report may be obtained by writing to the School Employees Retirement System, 300 East Broad Street, Suite 100, Columbus, Ohio 43215-3476.

**NORTH DAYTON SCHOOL OF DISCOVERY
MONTGOMERY COUNTY**

**NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004
(Continued)**

6. DEFINED BENEFIT PENSION PLANS (Continued)

Plan members are required to contribute 10 percent of their annual covered salary and NHA is required to contribute at an actuarially determined rate of 14 percent for 2004; 9.09 percent was the portion to fund pension obligations with the remainder being used to fund health care benefits. The contribution requirements of plan members and employers are established and may be amended, up to a statutory maximum amount, by the SERS' Retirement Board. NHA's required contribution for pension obligations to SERS for the fiscal year ended June 30, 2004, were \$19,289, of which 100 percent was contributed for fiscal 2004.

B. State Teachers Retirement System

NHA, on behalf of employees at the Academy, participates in the State Teachers Retirement System of Ohio ("STRS Ohio"), a cost-sharing, multiple-employer public employee retirement system. STRS Ohio provides retirement and disability benefits to members and death and survivor benefits to beneficiaries. Authority to establish and amend benefits is provided by Chapter 3307 of the Ohio Revised Code.

STRS Ohio issues a publicly available financial report that may be obtained by writing to STRS Ohio, 275 East Broad St., Columbus, Ohio 43215-3371 or by calling (614) 227-4090.

New members have a choice of three retirement plans, a Defined Benefit ("DB") Plan, a Defined Contribution ("DC") Plan and a Combined Plan. The DB Plan offers an annual retirement allowance based on final average salary times a percentage that varies based on years of service, or an allowance based on member contributions and earned interest matched by STRS Ohio funds times an actuarially determined annuity factor. The DC Plan allows members to place all their member contributions and employer contributions equal to 10.5 percent of earned compensation into an investment account. Investment decisions are made by the member. A member is eligible to receive a retirement benefit at age 50 and termination of employment.

The Combined Plan offers features of both the DC Plan and the DB Plan. In the Combined Plan, member contributions are invested by the member, and employer contributions are used to fund the defined benefit payment at a reduced level from the regular DB Plan. DC and Combined Plan members will transfer to the Defined Benefit Plan during their fifth year of membership unless they permanently select the DC or Combined Plan. Existing members with less than five years of service credit as of June 30, 2001, were given the option of making a one time irrevocable decision to transfer their account balance from the existing DBP into the DCP or CP. This option expired on December 31, 2001.

A DB or Combined Plan member with five or more years credited service who becomes disabled may qualify for a disability benefit. Eligible spouses and dependents of these active members who die before retirement may qualify for survivor benefits.

Members in the DC Plan who become disabled are entitled only to their account balance. If a member dies before retirement benefits begin, the member's designated beneficiary is entitled to receive the member's account balance.

**NORTH DAYTON SCHOOL OF DISCOVERY
MONTGOMERY COUNTY**

**NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004
(Continued)**

6. DEFINED BENEFIT PENSION PLANS (Continued)

Plan members are required to contribute 10 percent of their annual covered salaries. NHA was required to contribute 14 percent and 13 percent was the portion to fund pension obligations. Contribution rates are established by the State Teachers Retirement Board, upon recommendations of its consulting actuary, not to exceed statutory maximum rates of 10 percent for members and 14 percent for employers. Chapter 3307 of the Ohio Revised Code provides statutory authority for member and employer contributions. NHA's required contributions for pension obligations for the fiscal year ended June 30, 2004, were \$119,226, of which 100 percent was contributed for fiscal 2004.

C. Social Security System

Effective July 1, 1991, all employees not otherwise covered by the School Employees Retirement System (SERS) or the State Teachers Retirement System (STRS) have an option to choose Social Security or either SERS or STRS. Although the employees at the North Dayton School of Discovery are members of SERS or STRS, NHA has also opted to enroll the employees in the Federal Insurance Corporation of America (Social Security). Each employee's liability is 6.2 percent of wages paid, and NHA's liability is 6.2 percent of total wages paid.

7. POST-EMPLOYMENT BENEFITS

Comprehensive health care benefits are provided to retired teachers and their dependents through the State Teachers Retirement System (STRS), and to retired classified employees and their dependents through the School Employees Retirement System (SERS). Benefits include hospitalization, physicians' fees, prescription drugs, and reimbursement of monthly Medicare premiums. Benefit provisions and the obligation to contribute are established by the Systems based on authority granted by State statute. Both systems are funded on a pay-as-you-go basis.

STRS retirees who participated in the Defined Benefit Plan or the Combined Plan and their dependents are eligible for health care coverage. The State Teachers Retirement Board has statutory authority over how much, if any, of the health care costs will be absorbed by STRS. All benefit recipients pay a portion of the health care cost in the form of a monthly premium.

By law, the cost of coverage paid from STRS funds shall be included in the employer contribution rate, currently 14 percent of covered payroll. For fiscal year 2004, the Board allocated employer contributions equal to 1 percent of covered payroll to the Health Care Stabilization Fund. For NHA, this amount was \$5,642. STRS pays health care benefits from the Health Care Stabilization Fund. The balance in the Fund was \$3.1 billion at June 30, 2004. For the fiscal year ended June 30, 2004, net health care costs paid by STRS were \$268,739,000, and STRS had 111,853 eligible benefit recipients.

For SERS, coverage is made available to service retirees with ten or more years of qualifying service credit, and to disability and survivor benefit recipients. All members must pay a portion of their health care premium. The portion is based on years of service, Medicare eligibility, and retirement status. A safety net is in place for retirees whose household income falls below federal poverty levels. Premiums are reduced by 50 percent for those who apply.

**NORTH DAYTON SCHOOL OF DISCOVERY
MONTGOMERY COUNTY**

**NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004
(Continued)**

7. POST-EMPLOYMENT BENEFITS

For the fiscal year ended June 30, 2004, employer contributions to fund health care benefits were 4.91 percent of covered payroll. In addition, SERS levies a surcharge to fund health care benefits equal to 14 percent of the difference between a minimum pay and the member's pay, pro-rated for partial service credit. For fiscal year 2004, the minimum pay was established at \$24,500. The amount to fund health care benefits, including the surcharge, was \$25,949 for fiscal year 2004.

The surcharge, added to the unallocated portion of the 14 percent employer contribution rate, provides for maintenance of the asset target level for the health care fund. The target level for the health care reserve is 150 percent of annual health care expenses. Expenses for health care at June 30, 2004, were \$223,443,805, and the target level was \$335.2 million. At June 30, 2004, SERS had net assets available for payment of health care benefits of \$300.8 million. SERS has approximately 62,000 participants currently receiving health care benefits.

8. RISK MANAGEMENT

The Academy is exposed to various risks of loss related to general liability. Commercial insurance policies to cover certain risks of loss have been obtained through Indiana Insurance Company. General liability coverage provides \$1,000,000 per occurrence and \$2,000,000 in the aggregate with no deductible. The Indiana Insurance Company also provides umbrella liability coverage of \$1,000,000 per occurrence, as well as, in the aggregate.

9. CONTRACTED SERVICE FEE

NHA receives as remuneration for its services an amount equal to the total revenue received by the Academy from all revenue sources per the agreement (See Note 1). During fiscal year 2004, the NHA received a total of \$3,904,376 for the services provided. NHA has informed the Academy that the contracted service fee includes payment for the following:

Instruction:	
Basic instruction	\$1,335,260
Added needs	254,372
Special education	154,533
Support services:	
Pupil services	75,469
Instructional staff	153,465
Board of education	39,605
Executive administration	225,860
Office of the Principal	304,179
Business support services	47,764
Operations and maintenance	946,178
Central services	151,189
Food services	<u>151,843</u>
Total contracted service fee	3,839,717
Unexpended resources at June 30, 2004	64,659
Total	<u><u>\$3,904,376</u></u>

**NORTH DAYTON SCHOOL OF DISCOVERY
MONTGOMERY COUNTY**

**NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004
(Continued)**

10. OPERATING LEASE

North Dayton School of Discovery entered into a sub-lease for classroom facilities with National Heritage Academies, Inc. located at 3901 Turner Road, Dayton, Ohio, 45415. The term of the lease was for one year commencing on July 1, 2003 and ending on June 30, 2004. For fiscal year 2004, the rental amount for the lease was \$662,594 annually, payable in equal monthly installments of \$55,216 each. In addition, the lease terms required North Dayton School of Discovery to be responsible for all costs associated with the facilities including property taxes and maintenance costs.

11. RELATED PARTIES

The Board of North Dayton School of Science and Discovery serve in the same capacity for Pathway School of Discovery in Dayton, Ohio. National Heritage Academies, Inc. is also Pathway School of Discovery's management company.

12. CONTINGENCIES

A. Grants

Amounts received from grantor agencies are subject to audit and adjustment by the grantor. Any disallowed costs may require refunding to the grantor. Amounts, which may be disallowed, if any, are not presently determinable. However, in the opinion of the Academy, any such disallowed claims will not have a material adverse effect on the financial position of the Academy.

B. State Funding

The Ohio Department of Education conducts reviews of enrollment data and FTE calculations made by the schools. These reviews are conducted to ensure the schools are reporting accurate student enrollment data to the State, upon which state foundation funding is calculated. The results of this review could result in the State funding being adjusted. The Academy does not anticipate any material adjustments to State funding for fiscal year 2004, as a result of such a review.

**NORTH DAYTON SCHOOL OF DISCOVERY
MONTGOMERY COUNTY**

**SCHEDULE OF FEDERAL AWARDS EXPENDITURES
FOR THE FISCAL YEAR ENDED JUNE 30, 2004**

Federal Grantor/ Pass Through Grantor Program Title	Pass Through Entity Number	Federal CFDA Number	Receipts	Disbursements
U.S. DEPARTMENT OF AGRICULTURE				
(Passed through Ohio Department of Education)				
School Breakfast Program	041950 (2003-2004)	10.553	\$2,250	\$2,250
National School Lunch Program	041950 (2003-2004)	10.555	<u>81,483</u>	<u>81,483</u>
Total U.S. Department of Agriculture - Nutrition Cluster			83,733	83,733
U.S. DEPARTMENT OF EDUCATION				
(Passed through Ohio Department of Education)				
Title I - Grants to Local Educational Agencies	143529-C1S1-2003	84.010	14,046	
	143529-C1S1-2004		<u>229,490</u>	<u>269,207</u>
Total Title 1 Grants			243,536	269,207
Title VI-B, Special Education Grants to States	143529-6BSA-2003	84.027	26,956	30,902
Charter School Grant	143529-CHSI-03	84.282	105,000	111,499
	143529-CHSI-04		<u>50,000</u>	<u>166,928</u>
Total Charter School Grants			155,000	278,427
Title V, Innovative Education Program Strategies	143529-C2S1-2003	84.298	426	
	143529-C2S1-2004		<u>468</u>	<u>1,300</u>
Total Title V Grants			894	1,300
Title II-D, Technology Literacy Challenge Grant	143529-C2S1-2003	84.318	2,584	
	143529-C2S1-2004		<u>2,879</u>	<u>3,517</u>
Total Title II-D Grants			5,463	3,517
Title II-A, Improving Teacher Quality	143529-TRS1-2003	84.367	4,685	
	143529-TRS1-2004		<u>3,650</u>	<u>7,060</u>
Total Title II-A Grants			8,335	7,060
Total U.S. Department of Education			<u>440,184</u>	<u>590,413</u>
Total Federal Assistance			<u><u>\$523,917</u></u>	<u><u>\$674,146</u></u>

See accompanying notes to the schedule of federal awards expenditures.

**NORTH DAYTON SCHOOL OF DISCOVERY
MONTGOMERY COUNTY**

**NOTES TO THE SCHEDULE OF FEDERAL AWARDS EXPENDITURES
FOR THE FISCAL YEAR ENDED JUNE 30, 2004**

A. Basis of Presentation

The accompanying schedule of federal award expenditures is presented in accordance with the U. S. Office of Management and Budget ("OMB") Circular A-133 and is prepared using the cash basis of accounting.



**Auditor of State
Betty Montgomery**

**INDEPENDENT ACCOUNTANTS' REPORT ON INTERNAL CONTROL OVER
FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS
REQUIRED BY *GOVERNMENT AUDITING STANDARDS***

North Dayton School of Discovery
Montgomery County
3901 Turner Road
Dayton, Ohio 45415

To the Board of Directors:

We have audited the financial statements of the business-type activities of the North Dayton School of Discovery, Montgomery County, (the Academy), as of and for the year ended June 30, 2004, and have issued our report thereon dated December 1, 2006, which indicated that the amounts presented in Note 9 were audited by other auditors. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in the Comptroller General of the United States' *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Academy's internal control over financial reporting to determine our auditing procedures to express our opinion on the financial statements and not to opine on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Academy's ability to record, process, summarize, and report financial data consistent with management's assertions in the financial statements. Reportable conditions are described in the accompanying schedule of findings as items 2004-002 thru 2004-004.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts material to the financial statements we audited may occur and not be timely detected by employees when performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered material weaknesses. We consider reportable condition 2004-003 listed above to be a material weakness.

In a separate letter to the Academy's management dated December 1, 2006, we reported other matters involving internal control over financial reporting we did not deem reportable conditions.

Compliance and Other Matters

As part of reasonably assuring whether the Academy's financial statements are free of material misstatement, we tested its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could directly and materially affect the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express an opinion. The results of our tests disclosed instances of noncompliance and other matters that we must report under *Government Auditing Standards* which are described in the accompanying schedule of findings as item 2004-001, 2004-003, 2004-005, and 2004-006. In a separate letter to the Academy's management dated December 1, 2006, we reported other matters related to noncompliance we deemed immaterial.

We intend this report solely for the information and use of the management, Board of Directors, federal awarding agencies and pass-through entities. It is not intended for anyone other than these specified parties.

A handwritten signature in black ink that reads "Betty Montgomery". The signature is written in a cursive, flowing style.

Betty Montgomery
Auditor of State

December 1, 2006



Auditor of State Betty Montgomery

INDEPENDENT ACCOUNTANTS' REPORT ON COMPLIANCE WITH REQUIREMENTS APPLICABLE TO MAJOR FEDERAL PROGRAMS AND ON INTERNAL CONTROL OVER COMPLIANCE IN ACCORDANCE WITH OMB CIRCULAR A-133

North Dayton School of Discovery
Montgomery County
3901 Turner Road
Dayton, Ohio 45415

To the Board of Directors:

Compliance

We have audited the compliance of the North Dayton School of Discovery, Montgomery County, (the Academy), with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) Circular A-133, *Compliance Supplement* that apply to each of its major federal programs for the year ended June 30, 2004. The summary of auditor's results section of the accompanying schedule of findings and questioned costs identifies the Academy's major federal programs. The Academy's management is responsible for complying with the requirements of laws, regulations, contracts, and grants applicable to each major federal program. Our responsibility is to express an opinion on the County's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to reasonably assure whether noncompliance occurred with the types of compliance requirements referred to above that could directly and materially affect a major federal program. An audit includes examining, on a test basis, evidence about the County's compliance with those requirements and performing other procedures we considered necessary in the circumstances. We believe our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on the County's compliance with those requirements.

As described in items 2004-004 through 2004-009 in the accompanying schedule of findings and questioned costs, the Academy did not comply with the requirements regarding activities allowed or unallowed, allowable costs/cost principles, equipment and real property management, and procurement applying to its Charter School Grant and the Title I Grant to Local Educational Agencies. Compliance with those requirements is necessary, in our opinion for the Academy to comply with the requirements applicable to those programs.

In our opinion, except for the noncompliance described in the preceding paragraph, the Academy complied, in all material respects, with the requirements referred to above that apply to each of its major federal programs for the year ended June 30, 2004.

Internal Control Over Compliance

The Academy's management is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the County's internal control over compliance with requirements that could directly and materially affect a major federal program to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect the Academy's ability to administer a major federal program in accordance with applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items 2004-004 and 2004-006 through 2004-009.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts and grants caused by error or fraud that would be material in relation to a major federal program being audited may occur and not be timely detected by employees when performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered material weaknesses. We consider items 2004-006 through 2004-009, to be material weaknesses.

We intend this report solely for the information and use of management, the Board of Directors, federal awarding agencies and pass-through entities. It is not intended for anyone other than these specified parties.



Betty Montgomery
Auditor of State

December 1, 2006

**NORTH DAYTON SCHOOL OF DISCOVERY
MONTGOMERY COUNTY**

**SCHEDULE OF FINDINGS AND QUESTIONED COSTS
OMB CIRCULAR A -133 - .505
FOR THE FISCAL YEARS ENDED JUNE 30, 2004**

1. SUMMARY OF AUDITOR'S RESULTS

(d)(1)(i)	Type of Financial Statement Opinion	Unqualified
(d)(1)(ii)	Were there any material control weakness conditions reported at the financial statement level (GAGAS)?	Yes
(d)(1)(ii)	Were there any other reportable control weakness conditions reported at the financial statement level (GAGAS)?	Yes
(d)(1)(iii)	Was there any reported material non-compliance at the financial statement level (GAGAS)?	Yes
(d)(1)(iv)	Were there any material internal control weakness conditions reported for major federal programs?	Yes
(d)(1)(iv)	Were there any other reportable internal control weakness conditions reported for major federal programs?	Yes
(d)(1)(v)	Type of Major Programs - Compliance Opinion	Qualified
(d)(1)(vi)	Are there any reportable findings under § .510?	Yes
(d)(1)(vii)	Major Programs (list):	Title 1 – CFDA# 84.010 Charter School Grant CFDA# 84.282
(d)(1)(viii)	Dollar Threshold: Type A\B Programs	Type A: > \$ 300,000 Type B: all others
(d)(1)(ix)	Low Risk Auditee?	No

**2. FINDINGS RELATED TO THE FINANCIAL STATEMENTS
REQUIRED TO BE REPORTED IN ACCORDANCE WITH GAGAS**

FINDING NUMBER - 2004-001

State Employees Retirement System Contributions

Ohio Rev. Code 3309.23(A)(2) provides, in pertinent part, that employees of an existing or newly created employer unit supported in whole or in part by the state or any political subdivision thereof and wholly controlled and managed by the state or any subdivision thereof shall be contributors to the school employees retirement fund.

Fifteen percent, or three out of twenty transactions, of the federal payroll transactions tested for the employees of the North Dayton School of Discovery that were determined to be members of the State Employees Retirement System (SERS) did not have SERS consistently deducted on every pay of the audit period.

National Heritage Academy should implement procedures to ensure state employees retirement withholdings are being deducted from each applicable employee's pay.

**2. FINDINGS RELATED TO THE FINANCIAL STATEMENTS
REQUIRED TO BE REPORTED IN ACCORDANCE WITH GAGAS**

FINDING NUMBER - 2004-001 (Continued)

State Employees Retirement System Contributions (Continued)

Officials' Response

NHA acknowledges that employees initially hired during the audit time period may not have had SERS deductions consistently deducted from every paycheck. Assignment of the SERS deduction code is done manually and initial deductions were not made. However, NHA had controls in place to detect the oversight and in fact did correct the errors in a timely manner: Audits were done by the Payroll Administrator and Payroll Supervisor to verify that these deduction codes were assigned to new employees and that proper deductions were being withheld from all pay checks. In a few instances where deductions were not initially withheld, employees were notified immediately and additional deduction arrangements were made to eliminate the missing amount. As a final control, all salaries and withholdings were reported to SERS and a reconciliation between reported withholdings and remitted withholdings was performed. There were no errors in this comparison. Based on the foregoing, we believe there were adequate preventive and detective controls in place to ensure SERS withholdings were proper.

FINDING NUMBER - 2004-002

Reportable Condition - Retirement Systems

As of the report date, the employees of National Heritage Academies, Inc. (NHA), North Dayton School of Discovery's for-profit management company, that were employed at the North Dayton School of Discovery, Dayton, Ohio, were members of the state retirement systems, the State Teachers Retirement System of Ohio (STRS), the State Employees Retirement System of Ohio (SERS), and the Federal Insurance Corporation of America (Social Security). Deductions were being made from employees' wages and remitted to both systems.

26 USCS § 401 identifies exceptions for withholding Social Security. One of those exceptions is if there is a plan established and maintained by the government of any State or political subdivision thereof. Since the STRS/SERS are the decision makers regarding the required retirement system, and the "rules" determine who is a member of their systems, it becomes a "duties" test, and those performing the work of STRS/SERS members must have the deductions taken for the duties defined. These employees fall under the Ohio umbrella for pension systems.

Further, Ohio Rev. Code Section 3309.23(D) states that "In all cases of doubt pertaining to contributors on an individual basis or the status of existing or newly created employer units, the decision shall be made by the retirement board and such decision shall be final. STRS and SERS have determined that employees at North Dayton School of Discovery are required to pay into their systems

Payment into more than one system is an unnecessary expenditure. The end result of the deduction and payment into two systems would be that the employee would not be allowed to receive the full benefit from social security although the full benefit amount for social security was being deducted and paid from the employee's salary. In addition, federal grant money (Title I) was being used to pay a portion of these benefits and the payments would not be considered an allowable cost.

**2. FINDINGS RELATED TO THE FINANCIAL STATEMENTS
REQUIRED TO BE REPORTED IN ACCORDANCE WITH GAGAS**

FINDING NUMBER - 2004-002 (Continued)

Reportable Condition - Retirement Systems (Continued)

Officials' Response:

The Auditor considers this a reportable condition in the Independent Accountants' Report on Internal Control over Financial Reporting and on Compliance and Other Matters Required by *Government Auditing Standards* on the basis of the assertion that National Heritage Academies, Inc. (NHA) is not required to withhold and pay social security taxes on the wages it pays to its employees working in the North Dayton school because those employees also participate in one of the State of Ohio's retirement programs. NHA believes and it has been confirmed by its attorneys that governing law requires it to withhold Social Security.

The Supremacy clause of the United States Constitution provides that federal law will overrule any inconsistent state law. U.S. Const. Art. VI. Social security taxes are federal taxes imposed by an act of the United States Congress. See Internal Revenue Code (IRC) Section 3101 et seq. As a consequence, NHA will only be exempted from withholding/paying social security taxes on the wages of its employees who work at the North Dayton School if federal law provides an exemption.

IRC Section 401 provides the rules for determining whether or not a retirement plan qualifies for tax exemption, i.e., is it a qualified plan. IRC Section 414(d) defines the term "governmental plan". The rules under IRC Section 401 and 414(d) do not determine whether an entity is exempted from paying/withholding social security taxes.

IRC Sections 3101 and 3111 impose social security taxes on wages received or paid with respect to **employment**. IRC Section 3121(b) defines the term employment for purposes of the social security tax and provides an extensive list of employment relationships that are excepted from the definition of employment. One exception excludes from the definition of employment services, service performed in the employ of a State, or any political subdivision thereof, or any wholly owned instrumentality of a State or political subdivision. IRC Section 3121(b)(7) Consequently NHA's employment of its employees working in the North Dayton school will only be excluded from the definition of employment and thereby exempted from paying Social Security tax if NHA qualifies as a wholly-owned instrumentality of the State of Ohio or one of its political subdivisions.

The six-factor test for determining whether an entity is a wholly-owned instrumentality of the State or a political subdivision is set forth in Rev. Rul. 57-128, 1957-1 C.B. 311. The six factors are: 1) whether the entity is used for governmental purposes and performs a governmental function; 2) whether performance of its function is on behalf of one or more states or political subdivisions; 3) whether there are any private interests involved, or whether the states or political subdivisions involved have the powers and interests of an owner; 4) whether control and supervision of the organization are vested in public authority or authorities; 5) if express or implied statutory or other authority is necessary for the creation and/or use of such an instrumentality and whether such authority exists; and 6) the degree of financial autonomy and the source of its operating expenses.

Although an entity is not required to satisfy all six factors to be considered a wholly-owned instrumentality, the Internal Revenue Service places particular attention to the third and fourth factors in analyzing the issue. The fact that NHA is a private, for-profit corporation probably guarantees that IRS would not consider it to be a wholly-owned instrumentality.

**2. FINDINGS RELATED TO THE FINANCIAL STATEMENTS
REQUIRED TO BE REPORTED IN ACCORDANCE WITH GAGAS**

FINDING NUMBER - 2004-002 (Continued)

Reportable Condition - Retirement Systems (Continued)

Auditor Analysis:

NHA has indicated their belief that they are required to pay Social Security taxes, despite the fact that NHA also makes contributions to two qualified retirement plans (STRS and SERS) on behalf of their employees. NHA has not produced a revenue ruling or documentation from the IRS supporting their interpretation of the relevant IRS provisions. Regardless, it is inappropriate to pay into both the state and federal pension systems, as employees can not collect from both systems. NHA has recourse in Ohio courts if they believe the Ohio retirement boards to be in error regarding the Ohio systems' determination that NHA employees are members of the Ohio retirement systems. The legal arguments NHA raises must be made in a court of competent jurisdiction and cannot be resolved by the Auditor of State.

FINDING NUMBER 2004-003

Reportable Condition – Material Weakness – Payment of Taxes

Ohio Rev. Code Section 3314.082 states, in pertinent part, that it is the intent of the general assembly that no state moneys paid to a community school under Section 3314.08 of the Ohio Revised Code be used by the school to pay any taxes the school might owe on its own behalf, including, but not limited to, local, state and federal income taxes, sales taxes, and personal and real property taxes.

For the fiscal years ended June 30, 2004 and June 30, 2005, \$34,910.63 and \$143,517.45, respectively, were paid in property taxes to the Montgomery County Treasurer. In addition, Michigan sales tax was paid in the amount of \$12,812 for supplies/materials while North Dayton School of Discovery maintains an Ohio tax exempt status. The payment of unnecessary taxes results in the reduction of funds available for expenditures that could be used in a more prudent manner.

Officials' Response

The Auditor asserts that Ohio Revised Code (ORC) Section 3314.082 prevents NHA, a for-profit Michigan business corporation, from paying sales and personal property taxes on property NHA purchases and uses to fulfill its contractual obligations to North Dayton. Furthermore, the auditor asserts that \$191,240.08 in state monies were illegally expended to pay property and sales taxes.

First, it should be noted that ORC Section 3314.082, arguably, is not the outright prohibition on a community school's payment of taxes that the Auditor claims it is. The relevant portion of the statute reads,

"It is the intent of the general assembly that no state moneys paid to a community school under Section 3314.08 of the Revised Code be used by the school to pay any taxes the school might owe **on its own behalf**, including but not limited to local, state, and federal income taxes, sales taxes, and personal and real property taxes."

This statute can be read as an expression of a goal that the General Assembly has established for community schools but has not imposed as a mandatory obligation.

**2. FINDINGS RELATED TO THE FINANCIAL STATEMENTS
REQUIRED TO BE REPORTED IN ACCORDANCE WITH GAGAS**

**FINDING NUMBER 2004-003
(Continued)**

**Reportable Condition – Material Weakness – Payment of Taxes (Continued)
Officials’ Response (Continued)**

Assuming *arguendo* that ORC 3314.082 does prohibit community schools from paying taxes with per-pupil funds, it is clear that North Dayton has not accrued nor has it paid any tax with per-pupil funds. NHA, a for-profit management company that is organized as a Michigan business corporation, paid the questioned taxes on its own behalf for goods it purchased and which are titled in its name.

Although part, if not all, of these funds came from North Dayton and were paid pursuant to ORC Section 3314.08, North Dayton paid the per pupil monies to NHA as a North Dayton School of Discovery management fee due under their management contract. Upon payment to NHA these funds ceased to be per-pupil monies and became the private funds of NHA. See *Yovich v. Board of Education*, 1992 Ohio App. LEXIS 3323 (holding that Yovich had not been paid with public funds because funds lost their public character when paid to a private corporation that contracted to provide services to the Board of Education), 1997 Ohio Op. Atty. Gen. No. 8 (in which then Attorney General Montgomery opined that public monies paid to a private corporation as reasonable compensation for services rendered to the public entity become the property of the private entity and may be used by the private entity for any purpose for which the private entity could lawfully expend its money), and 1989 Ohio Op. Atty. Gen. No. 10 (holding that private fire department that contracted with township to provide fire protection and was paid with a special tax assessment could expend these funds for any lawful purpose).

In Article V, Section C of the management contract, the Academy acknowledged that it had no further right or claim to the amounts paid to NHA pursuant to the contract. In addition, ORC Chapter 3314 places no restrictions on the funds paid to management companies. From the foregoing it logically follows that because neither the law nor the Academy had placed any restrictions on NHA’s use of the funds, NHA could expend its private funds to pay these taxes and its payment of the taxes was not a violation of ORC Section 3314.082.

Ohio’s community school law also implicitly authorizes for-profit management companies. See ORC Section 3314.02(E). Ohio community school law also requires that management companies who receive more than 20% of a community school’s gross revenues must provide a detailed accounting to the community school including the nature and costs of the services it provides. See ORC Section 3314.024.

This information is subject to audit during the audit of the school. See ORC Section 3314.024. Consequently, the community school statute also implicitly approves the total performance contract with for-profit management companies. The sales and property tax laws provide certain exemptions from tax but do not exempt for-profit school management companies. See ORC Chapter 5709 and Section 5739.02. In light of ORC Section 3314.024, one must assume that the Ohio General Assembly is aware that there are for-profit management companies who receive 100% of school funding as their management fee, and are obligated to provide equipment, supplies, and a facility to the school.

**2. FINDINGS RELATED TO THE FINANCIAL STATEMENTS
REQUIRED TO BE REPORTED IN ACCORDANCE WITH GAGAS**

FINDING NUMBER 2004-003 (Continued)

Reportable Condition – Material Weakness – Payment of Taxes (Continued)

Officials' Response (Continued)

The legislature does not bar these comprehensive contracts, nor has it provided that Ohio community schools must retain title to the equipment and other assets that are used to fulfill their contracts. Again, in light of these facts and the language of ORC Section 3314.082, the Ohio General Assembly, by its failure to act, has authorized these arrangements and clearly does not intend to bar for-profit management companies from fulfilling their obligations to pay the real, personal property and sales taxes on the property they purchase and/or own.

The Ohio Department of Education and its agents who grant community school charters (the sponsors) have expressly approved the contractual arrangements that NHA and other for-profit management companies have with their schools. This includes the approval of the purchase of property by the for-profit management companies with their fees and their retaining title to such property. This action by the State Auditor is an attempt to alter the terms of the contract negotiated by and between the school and the management company that was blessed by the sponsor and ODE, an impairment of the obligation of the contract in violation of U.S. Const. Art. I, Section 10.

Auditor Analysis:

The Auditor of State does not assert ORC section 3314.082 prevents NHA to pay sales and property taxes, rather we reported that the intent of the general assembly for state monies provided to community schools would be used for educational purposes. The school has utilized their option to contract for services with a management company, including services for purchasing items such as buildings and supplies. However, if the School (with an Ohio tax exempt status) were to make purchases in the school's name rather than contract to have the management company make the purchases for them, the school would not be required to pay such taxes.

**2. FINDINGS RELATED TO THE FINANCIAL STATEMENTS
 REQUIRED TO BE REPORTED IN ACCORDANCE WITH GAGAS
 AND
 3. FINDINGS AND QUESTIONED COSTS FOR FEDERAL AWARDS**

Finding Number	2004-004
CFDA Title and Number	Title 1 – CFDA# 84.010
Federal Agency	U. S. Department of Education
Pass-Through Agency	Ohio Department of Education

Activities Allowed/Unallowed and Allowable Costs/Cost Principles - Medicare

26 USC §3121 and Circular E, Publication 15 states that there is no wage base limit for Medicare taxes and all covered wages are subject to Medicare tax.

Deductions for Medicare were calculated on employees’ net gross wages (gross wages less retirement deductions) rather than actual gross wages.

Failure to withhold Medicare on the gross wages could result in additional liabilities, including fines and penalties, which National Heritage Academies, Inc. would be required to cover. Medicare should be withheld on total gross wages prior to any deductions. This matter will be forwarded to the Internal Revenue Service.

Officials’ Response

The deduction code was improperly calculated by the payroll service, Automatic Data Processing (ADP). A full audit has been conducted of all paychecks for its Ohio employees and amounts owed have been self-reported to the Internal Revenue Service and remitted for all missed contributions, and procedures have been put in place to ensure the error does not occur in the future.

Finding Number	2004-005
CFDA Title and Number	Title 1 – CFDA# 84.010 Charter School Grant – CFDA# 84.282
Federal Agency	U. S. Department of Education
Pass-Through Agency	Ohio Department of Education

Activities Allowed/Unallowed and Allowable Costs/Cost Principles - Sales Taxes

34 CFR Subpart C, Section 80.36 requires that when procuring property and services under a grant or subgrant, procurement procedures should reflect applicable state and local laws and regulations. **Ohio Rev. Code Section 3314.082** states that no state moneys paid to a community school are to be used by the school to pay any taxes the school might owe including, but not limited to, local, state, sales taxes, and personal and real property taxes.

During the audit period, \$12,812 was paid in sales taxes on purchases from the Federal Charter School grant program (see questioned cost below finding number 2004-007). If sale taxes were paid on all purchases, it could constitute a material impact on the financial statements since the sales tax rate is 7.25 percent.

The payment of unnecessary sales taxes results in the reduction of funds available for expenditure that could be used in a more prudent manner. Since the Academy is tax exempt, this status should be utilized and the dollars that would be expended for sales tax should be used to benefit the Academy.

3.FINDINGS AND QUESTIONED COSTS FOR FEDERAL AWARDS (Continued)

Finding Number	2004-007 (Continued)
CFDA Title and Number	Charter School Grant – CFDA# 84.282
Federal Agency	U. S. Department of Education
Pass-Through Agency	Ohio Department of Education

Officials’ Response (Continued)

also undermines the Auditor’s legal position. In addition, because the State of Ohio, through its agent (the Academy’s sponsor), has approved the management contract and its terms, it has agreed that a for-profit corporation will purchase the school’s equipment. Consequently, it has further implicitly agreed that sales taxes will be paid on the assets used in the school because, under state law, a for-profit corporation must generally pay taxes on its purchases. Therefore, these taxes were paid in accordance with State law.

Auditor Analysis

The Official Response does not directly address the intent of the comment which is that grant agreements should be strictly adhered to when making expenditures unless the grantor’s permission has been obtained to deviate from the itemized budget. The State of Ohio does not approve contracts and is not party to the contract between a sponsor and the school. Per the Ohio Department of Education, they don’t approve individual elements within a contract, only that the contract is valid.

Finding Number	2004-008
CFDA Title and Number	Charter School Grant – CFDA# 84.282
Federal Agency	U. S. Department of Education
Pass-Through Agency	Ohio Department of Education

Questioned Costs

Activities Allowed/Unallowed and Allowable Costs/Cost Principles - Employee Training

National Heritage Academy (NHA) charged the Academy for a five day New Teacher Training Class for twenty-one teachers in the amount of \$29,358.24. Per the Charter School Grant budget, the allowed budgeted amount for training was \$11,120 resulting in charges in excess of the budgeted allowance. Therefore, the difference between the amounts charged and the amount allowed of \$18,238.24 is considered a questioned cost.

Included in the costs allocated for the teacher training were charges for men’s and women’s shirts and parkas with the NHA logo (not North Dayton’s). In addition, expenses allocated included calculators, binoculars, watches, stadium cups, pens, rulers, hats, picture frames, and totes all with the NHA logo. Also, the cost of the NHA newsletter and entertainment (riverboat cruise and a gala event) had been allocated. These expenses are items that would not be allowable costs under this federal grant and those amounts allocated have been included in the questioned costs.

3.FINDINGS AND QUESTIONED COSTS FOR FEDERAL AWARDS (Continued)

Finding Number	2004-008 (Continued)
CFDA Title and Number	Charter School Grant – CFDA# 84.282
Federal Agency	U. S. Department of Education
Pass-Through Agency	Ohio Department of Education

Officials’ Response

The Academy respectfully disagrees with the conclusion, as in fact these are allowable costs as defined under Charter School Grant regulations. The costs directly benefited the staff of the school and the educational program at the school.

Auditor Analysis

The grant agreements should be strictly adhered to when making expenditures unless the grantor’s permission has been obtained to deviate from the itemized budget. The amount allowed in the budget for teacher training had been exceeded and some of the types of expenditures made may not be permissible when made with from federal monies.

Finding Number	2004-009
CFDA Title and Number	Charter School Grant – CFDA# 84.282
Federal Agency	U. S. Department of Education
Pass-Through Agency	Ohio Department of Education

Activities Allowed/Unallowed, Allowable Costs/Cost Principles and Equipment Management

34 CFR Subpart C, Section 80.32, stipulates that title to all equipment acquired with a grant or subgrant will vest upon acquisition with the grantee or subgrantee, and requires that all equipment shall be used by the grantee or sub grantee in the program or project for which it was acquired as long as needed, whether or not the project or program continues to be supported by Federal Funds.

It also states property records must be maintained that include a description of the property, a serial number or other identification number, the source of property, who holds title, the acquisition date, and cost of the property, percentage of Federal participation in the cost of the property, the location, use and condition of the property, and any ultimate disposition data including the date of disposal and sale price of the property. A physical inventory of the property must be taken and the results reconciled with the property records at least once every two years.

All equipment purchased is considered property of the management company rather than as property of the Academy, except for equipment where the cost is over \$5,000 which is transferred back to the Academy. To date, there has been no equipment transferred to the Academy.

The Academy was awarded grants for fiscal years 2004 and 2003 in the amounts of \$300,000 and \$150,000 respectively, for which the major portion was required to be spent for equipment.

Since all property purchased with federal funds is required to be the property of the grantee, or sub grantee, all assets should be transferred to the Academy and reported in its financial statements. In addition, a complete listing of all equipment purchased with a life in excess of one year from the Charter School Grant, or any other federal or state funds, should be prepared and submitted to the Academy. The listing should comply with the federal requirements stated above and include date purchased, a

3.FINDINGS AND QUESTIONED COSTS FOR FEDERAL AWARDS (Continued)

Finding Number	2004-009 (Continued)
CFDA Title and Number	Charter School Grant – CFDA# 84.282
Federal Agency	U. S. Department of Education
Pass-Through Agency	Ohio Department of Education

description, serial number, if applicable, the cost and the revenue source from which the asset was purchased. The Academy should perform a physical inventory which should be reconciled with the property records at least once every two years.

National Heritage Academy compiled an equipment listing of purchases through the Charter School Grant program for fiscal year 2004. This amount, and applicable depreciation, has been recorded on the financial statements.

Officials' Response

The Academy respectfully disputes the facts assertion that the equipment acquired by grants is reported as property of the management company on its fixed asset listing. This infers they are NHA assets. They are not reported on NHA's financial statements. They are reported on the Academy's financial statements. NHA does have a tracking system for capital assets of the Academy, the total of which appears on the Academy's financial statements. Use of a subsidiary ledger or asset tracking system does not determine title. The assets are physically present at the Academy as they appear on the Academy's audited financial statements. There is a list of assets which comply with the requirements and a physical inventory of the Academy's capital assets will be performed within the two year requirement.

Auditor Analysis

Capital assets had not been reported within the Academy's financial statements until requests were made by the AOS to have the school adjust their financial statements for only those assets acquired with Charter School Grant revenues. The management company agreement indicates that all assets purchased with school funds will remain the property of the school; (with the exception of capital items purchased or leased by NHA). Thus, all capital assets purchased with revenues received from North Dayton School of Discovery, including federal grant dollars, should be held by and reported within North Dayton School of Discovery's financial statements.



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NORTH DAYTON SCHOOL OF DISCOVERY

MONTGOMERY COUNTY

CLERK'S CERTIFICATION

This is a true and correct copy of the report which is required to be filed in the Office of the Auditor of State pursuant to Section 117.26, Revised Code, and which is filed in Columbus, Ohio.

Susan Babbitt

CLERK OF THE BUREAU

**CERTIFIED
JANUARY 4, 2007**