



Dave Yost • Auditor of State

Audit Division Advisory Memo 2017-01

TO: Audit Division Staff and Independent Public Accountants

FROM: Center for Audit Excellence

DATE: January 19, 2017

RE: **Impact of Ohio Department of Education (ODE) Full-Time Equivalency (FTE) Determinations for E-Schools, 2015-2016 School Year on Audits**

CFAE Conclusions

While the criterion used in our evaluation is explained later in this memo, our conclusions are summarized below:

For ECOT and the other community schools that had a 2016 FTE Review by ODE:

- The ECOT case is still under appeal with the State Board, the liability is not probable, and therefore it would not meet the GASB requirement for accrual in the financial statements. However, if ECOT or any of the other schools that ODE reviewed choose to settle prior to the state board decision and prior to the audit report being issued, then the liability would become probable and known, requiring the liability to be accrued.
- Even though the liability would not be accrued on the financial statements, GASB does require the government to disclose the potential for the liability within its footnotes, if material.
- In addition, auditors would then include an Emphasis of Matter in the Independent Auditor's Report as a result of this material disclosure. A possible opinion modification would be required for any schools not properly disclosing a material contingent liability in their footnotes.

For community schools that have reached an approved settlement agreement with ODE Prior to Issuance of the Audit Report:

- Schools that have settled with ODE prior to issuance of the audit report would meet the GASB requirements for reporting a liability in the financial statements. If the

January 19, 2017

Re: Impact of Ohio Department of Education (ODE) Full-Time Equivalency (FTE) Determinations for E-Schools, 2015-2016 School Year on Audits

Page 2

liability is material, the school should recognize a liability on the face of the financial statements and make a note disclosure regarding the FTE Review and terms of the settlement agreement with ODE.

- Auditors should include an Emphasis of Matter in the Independent Auditor's Report as a result of this material disclosure.

For community schools that did not receive a 2016 FTE Review by ODE but for which the durational requirements for participation are material:

- Since HB 2 requires e-schools to maintain evidence of participation for each student and ODE is requiring student durational data as part of its FTE Review procedures for e-schools and brick and mortar schools with blended learning, we feel there is potential for ODE to issue future FTE Review determinations resulting in potential claw backs of funding for both blended learning and online community schools, if the schools are not maintaining durational FTE data. However, HB 2 was not in effect during the 2016 school year and ODE has completed the 2016 FYE reviews and does not plan to revisit 2016 in any upcoming reviews. Therefore, potential claw back of funding would impact FYE 2017 on.
- Since few of the online and blended learning community schools maintained durational student participation data during the 2015-2016 school year, we believe the GASB contingent liability disclosure requirements have been met with the current funding footnote. Auditors need to review the sufficiency of any durational participation data maintained by the community school and determine the necessity of a material noncompliance citation.

Background

ODE conducted a FTE Review pursuant to Ohio Rev. Code §3314.08 over the Electronic Classroom of Tomorrow's (ECOT) full-time equivalency of students for the five year period ended, June 30, 2016. During the course of this review, ECOT filed a preliminary injunction against ODE which the courts subsequently rejected. The courts ruled that ODE is entitled to consider durational data in reaching a funding decision for a community school, pursuant to Ohio Rev. Code §3314.08(H)(3). The court also found that ODE has the authority to develop guidance in the form of the FTE Manual so long as such guidance does not expand upon the underlying statutes. In this case, the court ruled that the FTE review manuals do not enlarge the scope of the rule or statute from which they derive. These manuals are procedural guidelines and it is appropriate for the FTE reviewers to follow them when conducting an FTE review. Lastly, while the court did not find ODE retroactively changed its FTE requirements, the court acknowledged that ODE would have the authority to do so pursuant to an Ohio Supreme Court case ruling (*See Toledo City School Dist. Bd. Of Educ. v. State Bd. Of Educ. Of Ohio, 2016-Ohio-2806*).

January 19, 2017

Re: Impact of Ohio Department of Education (ODE) Full-Time Equivalency (FTE) Determinations for E-Schools, 2015-2016 School Year on Audits

Page 3

ODE made a final determination that ECOT's FTE for the 2015-2016 school year was 6,312.62, which is 58.8 percent less than the 15,321.98 FTE reported by ECOT.

ECOT filed an appeal to this determination with the State Board of Education and has also filed a lawsuit against ODE, challenging ODE's authority to establish FTE rules and retroactively apply them to earlier periods. These appeals and the lawsuit are not likely to be ruled upon until spring and fall of 2017, respectively.

ODE also conducted FTE Reviews of several other e-schools around the State for the same period and made similar findings, resulting in a claw back of funding from these schools in amounts ranging from 45% to 100% of their FY 2016 State Foundation settlement amounts. With one exception, all schools have filed an appeal with ODE regarding these determinations. Unless the schools and ODE agree to settle, ODE expects the State Board to rule on these matters sometime in the spring of 2017.

Related to these matters, the Center for Audit Excellence was asked to evaluate:

- Whether and at what point ODE's final determination of ECOT's FTE should be accrued as a liability on ECOT's financial statements;
- Whether other blended learning brick and mortar community schools and online e-schools that have had a 2016 ODE FTE Review Determination should accrue receivables or liabilities, as applicable, on their financial statements; and
- Whether schools that did not receive an ODE FTE Review for the 2015-2016 school year need to disclose within the footnotes to their financial statements the possibility that a future review could result in a claw back of funding.
- Finally, what would be the potential impact on the auditors' procedures and reports in these instances

CFAE Evaluation Criteria

For ECOT and the other community schools that had a 2016 FTE Review by ODE:

In evaluating ECOT and the other community schools that received a FTE review for the 2015-2016 school year and are contesting the decision, we applied the GASB guidance for determining (1) what constitutes a contingency and, (2) when a contingency would become a recognizable liability.

GASB section C50, (Claims and Judgments) paragraph 151 defines a contingency, "as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (referred to as a gain contingency) or loss (referred to as a loss contingency) to a government that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability."

January 19, 2017

Re: Impact of Ohio Department of Education (ODE) Full-Time Equivalency (FTE) Determinations for E-Schools, 2015-2016 School Year on Audits

Page 4

For ECOT and the other community schools, ODE initiated its FTE review prior to the June 30, 2016 fiscal year end for these schools. The FTE reviews covered the 2015-2016 school year. At the conclusion of those reviews, ODE concluded that ECOT and the other e-schools selected for the FTE review owed back excess funding; as such the definition of a contingency was met.

To determine if the contingency met the definition of an accruable liability we applied GASB C50.155-.158 which further discusses classifications and possible accrual of loss contingencies. Paragraph .157 says a loss contingency should be accrued if two conditions are met. The first being the information is available prior to issuance of the financial statements that indicates that a liability had been incurred at the date of the statements, or that it is probable that one or more future events will occur confirming the fact of the loss. The second is the amount of loss can be reasonably estimated.

Paragraph 158 goes on to clarify that the purpose of the two conditions is to require accrual of losses when they are reasonably estimable and relate to the current or a prior period. The condition that the amount of loss can be reasonably estimated, does not delay accrual of a loss until only a single amount can be reasonably estimated. If there is a range of amounts and some amount within that range appears to be a better estimate it should be accrued, if no amount is a better estimate the minimum should be accrued.

Ohio Rev. Code §3314.08 (K)(1) indicates that ODE can complete the reviews as necessary and paragraph (K)(2) outlines that if the review results in a finding that the community school owes money back to the state the following procedures will apply,

- Within 10 business days of the notice the school may appeal the determination to the state board of education
- The board shall conduct an informal hearing upon receipt of the appeal within 30 days and shall issue a decision within 15 days of the conclusion of the hearing.
- Any decision made by the board is final.

Since the State Board can overturn ODE's FTE review and decision and the Board decision is final, the contingency doesn't meet the GASB requirement that it is probable.

For community schools that have reached an approved settlement agreement with ODE Prior to Issuance of the Audit Report:

For schools that have settled and not contested the FTE review to the state board, the conditions have been met to accrue a liability.

January 19, 2017

Re: Impact of Ohio Department of Education (ODE) Full-Time Equivalency (FTE) Determinations for E-Schools, 2015-2016 School Year on Audits

Page 5

In the event that the two conditions have not been satisfied to accrue the contingency, GASB section 1500 (Reporting Liabilities) paragraph 125 directs that, "contingent liabilities not requiring accrual should be disclosed in the notes to the financial statements." The disclosure in these cases would be detailed to include the amounts reported by ODE to be returned and that the decision is being contested with the state board which holds the final decision and could either overturn or uphold ODE's review and if upheld a liability would be required to be posted to the financial statements.

For community schools that did not receive a 2016 FTE Review by ODE but for which the durational requirements for participation are material:

For schools that have not had an ODE FTE review, based on the court ruling that the statute has a durational component measured in terms of actual participation, there is a potential for blended learning and online community schools to also have noncompliance, if the schools are not maintaining durational FTE data. No potential liability/contingency exists for the 6-30-16 FYE since ODE confirmed they will not require repayment of lack of durational data in a year they do not perform a FTE review. The existing contingency footnote disclosure for funding is sufficient for the 6-30-16 FYE.

Audit Report Impact

The current version of the OCS requires us to review the durational data at these blended learning and online community schools. Since the judgment in the ECOT lawsuit supported the ODE requirement to provide durational data in support of FTE figures reported to the ODE and because there is a potential for a material impact on the financial statements, auditors finding durational FTE data has not been maintained, should report material non-compliance. However, we do not feel that this would meet the requirements of AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*, for reporting a financial statement misstatement control deficiency since ODE's past practice in its FTE reviews was not to require durational data.

For ECOT and the other community schools that received an FTE review by ODE, if the amounts in question would be considered quantitatively or qualitatively material to the financial statements then a note disclosure would be required. Additionally an Emphasis of Matter should be included in the Independent Auditors Report along with the note disclosure. If the school fails to make the proper disclosure, auditors should modify their opinion.

For the e-schools and other blended learning schools that have not recently received an FTE review by ODE and have not maintained durational participation data, only the usual contingency footnote for funding is required.