

STATE BOARD OF ACCOUNTS
302 West Washington Street
Room E418
INDIANAPOLIS, INDIANA 46204-2769

SPECIAL COMPLIANCE REPORT

OF

MUNCIE COMMUNITY SCHOOL CORPORATION

DELAWARE COUNTY, INDIANA

January 1, 2014 to September 5, 2018



FILED
09/28/2018

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SCHEDULE OF OFFICIALS

<u>Office</u>	<u>Official</u>	<u>Term</u>
Treasurer	Mark Burkhart	07-01-13 to 06-30-14
	Chip Mehaffey	07-01-14 to 12-31-14
	Cheri Scott (interim)	01-01-15 to 05-31-15
	Deborah A. Williams, CPA	06-01-15 to 01-10-17
	Bruce Perry	01-11-17 to 03-07-17
	(Vacant)	03-08-17 to 05-10-17
	Robert Coddington	05-11-17 to 01-31-18
	(Vacant)	02-01-18 to 06-30-18
	Robert Coddington	07-01-18 to present
Superintendent of Schools	Tim Heller	07-01-13 to 06-30-15
	Dr. Steven Baule	07-01-15 to 12-31-17
Emergency Manager	Stephen Edwards	01-01-18 to present
President of the School Board	Anthony Costello	01-01-14 to 12-31-14
	Robert A. Warrner	01-01-15 to 12-31-15
	Michael Long	01-01-16 to 12-31-16
	Deborah D. Feick	01-01-17 to 12-31-17
	(Vacant)	01-01-18 to 06-30-18
	James Williams	07-01-18 to 06-30-22



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TO: THE OFFICIALS OF THE MUNCIE COMMUNITY SCHOOL CORPORATION, INDIANA

As authorized under Indiana Code 5-11-1, we engaged private examiners under our review to perform certain procedures to the accounting records and related documents of the General Obligation Bonds, Series 2014 (Bonds) issued by Muncie Community School Corporation (School Corporation), Delaware County, for the period January 1, 2014 to September 5, 2018, to determine compliance with applicable Indiana laws and uniform compliance guidelines established by the Indiana State Board of Accounts.

The Results and Comments contained herein describe the identified reportable instances of noncompliance found as a result of these procedures. These procedures were not designed to identify all instances of noncompliance; therefore, noncompliance may exist that is unidentified.

Any Official Response to the Results and Comments, incorporated within this report, was not verified for accuracy and represents the opinions of those writing them. Any Official Response received and incorporated does not represent the opinion of the State Board of Accounts.

Michael H. Bozyski, CPA
Deputy State Examiner

September 18, 2018

MUNCIE COMMUNITY SCHOOL CORPORATION
RESULTS AND COMMENTS

BACKGROUND

Pursuant to Indiana Code section 5-11-1-7, the State Examiner engaged private examiners to conduct forensic analysis and audit and compliance procedures relating to General Obligation Bonds, Series 2014 (hereinafter the Bonds) issued by the Muncie Community School Corporation (hereinafter the School Corporation). This special compliance report is being issued pursuant to Indiana Code section 5-11-5-1 based on the analysis performed and other available information.

BOND ISSUANCE FOR CONSTRUCTION PROJECTS

On May 28, 2014, the School Corporation issued ten million dollars (\$10M) in Bonds. The Bonds were issued for the purpose of making specified repairs and upgrades to School Corporation buildings and facilities. Those specific projects were detailed in the Official Statement filed by the School Corporation with the Municipal Securities Rulemaking Board, which was signed by then School Board President Tony Costello.

The "Construction Program" of the Official Statement indicated that construction bids for the Projects were to be received on June 8, 2014, construction of the Projects was to begin in October 2014, and construction was anticipated to be completed by August 2015.

Procedures performed regarding the expenditures of the bond proceeds confirmed that the School Corporation had not taken substantial steps, as of the end of field work to move forward with projects relating to more than ninety percent of the bond funds.

The Internal Revenue Service has numerous rules governing the issuance of tax-exempt bonds and the allocation and expenditure of the proceeds of those bond issues, including rules contained in IRS Publication 4079, *Tax-Exempt Governmental Bonds*. These rules contain procedures that must be observed and deadlines for following those procedures. These rules are complex and subject to exceptions in certain instances based on the facts and circumstances of each situation.

To avoid being considered a hedge bond that would not be tax exempt, the issuer of a governmental bond must reasonably expect that eight-five percent (85%) of the spendable proceeds of the issue will be used to carry out the qualified purpose within the three (3) year period beginning on the issuance date. IRS Publication 4079.

We recommend that the School Corporation consult with legal counsel and relevant regulatory agencies to obtain guidance as to actions the School Corporation should take to ensure compliance with these tax rules.

USAGE OF RESTRICTED FUNDS

As indicated in Report B48786, the financial statement for the School Corporation included eleven (11) funds with overdrawn cash balances totaling \$16,929,868 at June 30, 2016, that were not related to a reimbursable grant fund. A similar comment appeared in the prior Report B46278.

MUNCIE COMMUNITY SCHOOL CORPORATION
RESULTS AND COMMENTS
(Continued)

The cash balance of any fund may not be reduced below zero. Routinely overdrawn funds could be an indicator of serious financial problems which should be investigated by the unit. (Accounting and Uniform Compliance Guidelines Manual for Indiana Public School Corporations, Chapter 1)

Report B48786 also indicated that the School Corporation reported a total balance of all funds in the amount of \$8,307,696 at June 30, 2016. However, less than one million dollars of the \$10M Bond had been spent, and it had a corresponding debt of \$9,695,000 at the time.

Contrary to the dates listed in the Official Statement, more than ninety percent of proceeds from the bond issuance have not been spent for the purpose of the issue. Instead, proceeds from the bond issuance received were commingled in a bank account with other School Corporation funds and ultimately were utilized to pay regular operating expenses and to assist in keeping cash balances in the singular commingled bank account out of a deficit balance. Interviews and analysis conducted confirmed that bond proceeds were used for cash flow to cover operating expenses, thereby allowing deficits to be created within certain dedicated funds.

Former School Corporation Chief Financial Officer Mark Burkhart submitted a memo to the School Board in February 2014 entitled "Proposed Facility Improvement Bond Issue." The memo referenced cash flow concerns among the reasons he encouraged board members to act promptly to approve and move forward with the bond issuance process.

During some portions of this audit period, School Board members were only presented with expense reports. During other portions of this audit period, School Board members were presented with monthly financial statements that indicated that the only way operating expenses could have been covered was to utilize proceeds obtained from the bond issuance that should have been restricted for the specified projects in the Official Statement and no other purposes.

Results of our review show that school financial personnel utilized proceeds from the bond issuance for operating expenses. School financial personnel confirmed that, through their commingling of proceeds from the bond within a singular bank account for the School Corporation, the fund balances reflected by the School Corporation as being available in the General Fund actually overstated amounts available for expenditure from funds shown in the financial statement.

By maintaining money in a commingled bank account school financial personnel were easily able to utilize proceeds from several sources, including but not limited to restricted money, to satisfy expenses of other funds. This effectively allows a unit to disregard the usage restrictions by accessing and using a singular commingled account for any purpose so long as an amount remains in the bank account, if appropriately designed and implemented internal controls are not in place, as described in the subsequent audit report comment.

Commingling and using money in this manner resulted in the failure by the School Corporation to actually set aside the moneys for the Bond projects.

Fund accounting enables governmental entities to easily monitor and report compliance with spending purposes (fund restrictions), spending limits (budget), and other fiscal accounting objectives. Fund accounting is an accounting system organized on the basis of funds. Each fund is considered to be a separate accounting entity. The operations of each fund are accounted for with a separate set of

MUNCIE COMMUNITY SCHOOL CORPORATION
RESULTS AND COMMENTS
(Continued)

self-balancing accounts that are comprised of receipts, disbursements, and its investment and cash balance. Resources are allocated to and accounted for in individual funds based upon purpose for which they are to be spent and the means by which spending activities are controlled. *Accounting and Financial Reporting Regulation Manual, Part II, Page 6.*

A fund represents moneys set aside for specific activities of a school corporation. *Accounting and Uniform Compliance Guidelines Manual for Indiana Public School Corporations, Chapter 4, Funds and Fund Accounting.*

INTERNAL CONTROL DEFICIENCIES

We noted deficiencies in the internal control system concerning Bond proceeds and associated projects. These deficiencies included, but were not limited to, lack of sufficient controls to ensure adherence to assertions made in the Official Statement and commitments made to bondholders; lack of sufficient controls to maintain adherence to the bid issuance, bid review, and vendor selection schedule; and lack of sufficient controls to ensure expenditure of Bond proceeds was only done in relation to the projects and consistent with required or represented timeframes.

The oversight body (School Board of Trustees) and management (Superintendent and the Treasurer or Chief Financial Officer) work together and share responsibility for the development and implementation of internal controls for a political subdivision.

There was a lack of understanding and governance by individuals who served in these capacities as related to the Bond and projects.

Governmental units should have internal controls in effect which provide reasonable assurance regarding the reliability of financial information and records, effectiveness and efficiency of operations, proper execution of management's objectives, and compliance with laws and regulations. Among other things, segregation of duties, safeguarding controls over cash and all other assets and all forms of information processing are necessary for proper internal control. (*Uniform Internal Control Standards for Indiana Political Subdivisions*)

The control deficiencies noted indicate that significant deficiencies existed in the components that make up the internal control system.

The Indiana State Board of Accounts (SBOA) is required under Indiana Code 5-11-1-27(e) to define the acceptable minimum level of internal control standards. To provide clarifying guidance, the State Examiner compiled the standards contained in the manual, *Uniform Internal Control Standards for Indiana Political Subdivisions*. All political subdivisions subject to audit by SBOA are expected to adhere to these standards. The standards include an adequate control environment component. According to this manual:

"The control environment is the basic commonality for all and comprises the integrity and ethical values of the political subdivision established by the oversight body and management. The standards, processes, and structures which form the control environment pervasively impact the overall system of internal control. The oversight body and management convey leadership expectations, and overall tone which are reinforced by all officials and management throughout the various offices and departments.

MUNCIE COMMUNITY SCHOOL CORPORATION
RESULTS AND COMMENTS
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The standards also include an adequate control activities component. According to this manual:

"Control activities are the actions and tools established through policies and procedures that help to detect, prevent or reduce the identified risks that interfere with the achievement of objectives. Detection activities are designed to identify unfavorable events in a timely manner, whereas prevention activities are designed to deter the occurrence of an unfavorable event. Examples of these activities include reconciliations, authorizations, approval processes, performance reviews, and verification processes.

The standards also include an adequate monitoring activities component. According to this manual: "Evaluations are used to determine whether each of the five components of internal control is present and functioning. The criteria used are developed by the oversight body and management."

MUNCIE COMMUNITY SCHOOL CORPORATION
EXIT CONFERENCE

The contents of this report were discussed on September 18, 2018, with James Williams, President of the School Board, and Stephen Edwards, Emergency Manager.

The contents of this report were discussed via phone on September 20, 2018, with Anthony Costello, former President of the School Board.

The contents of this report were discussed via phone on September 24, 2018, with Tim Heller, former Superintendent of Schools.

The contents of this report were discussed separately via phone on September 25, 2018, with Bruce Perry, former Treasurer; Mark Burkhart, former Treasurer; Dr. Steven Baule, former Superintendent of Schools; and Deborah A. Williams, CPA, former Treasurer.

TO: Mr. Paul Joyce
State Examiner
Indiana State Board of Accounts

FROM: David Day
Church, Church, Hittle + Antrim
General Counsel
Muncie Community Schools

DATE: September 25, 2018

RE: Response to Special Compliance Report – September 2018

We are submitting this response on behalf of Muncie Community Schools (MCS) to the Special Compliance Report made by the Indiana State Board of Accounts (ISBOA) in September 2018. MCS appreciates the work of the ISBOA in this matter and pledges its best efforts to address and correct the issues raised in the report.

As a preliminary matter, MCS notes that the issues in the report date back to a time prior to the appointment of an emergency manager for MCS by the Indiana Distressed Unit Appeal Board. In addition, the issues arose prior to the actions of the 2018 Indiana General Assembly to change the governance of MCS to a school board appointed by Ball State University. The newly-appointed board took office effective July 1, 2018.

Additionally, MCS notes that the report does not find any instance of monies being received by MCS and not used to pay MCS expenses. In other words, there does not appear to be any misappropriation of funds and no circumstances of misfeasance by any MCS board member or employee. The ISBOA is making no requests for reimbursement of funds by any person and there is no referral of any matters to the Indiana Attorney General or the local prosecuting attorney.

Nevertheless, the report raises significant issues that, as detailed below, MCS has been addressing and will continue to address until they are corrected.

The first items in the report concerns the bonds issued by MCS in 2014. MCS is aware of the rules that apply to the expenditure and allocation of those bond proceeds and the deadlines that must be met. The application of those rules is very fact-sensitive, and the rules are subject to several interpretations and exceptions.

Since the new board took office, the board and administration has been working with general counsel and bond counsel to review the issues to be sure that MCS follows the applicable rules. MCS will continue to consult with counsel to take any necessary remedial or mitigation actions to comply with its obligations.

The other two items concern usage of restricted funds and deficiencies in internal controls. As these two items are somewhat related, MCS will address them together.

Following the appointment of the emergency manager, MCS has been tracking its funds and its cash flow carefully. MCS provides a monthly fund report for its chief administrators and the school board that details monthly revenue and expenditures by fund and provides a cash balance for each fund at the end of the month. In addition, MCS prepares a monthly cash flow worksheet for its chief administrators and school board. This worksheet shows actual and projected revenues and expenditures in a variety of funds, along with the state-approved appropriation in each fund where applicable.

Each month the chief financial officer presents a financial report to the school board during a public board meeting that includes the information in the cash flow worksheet.

Along with the reports described above, MCS has in place additional financial internal controls as described on the attached document.

MCS has posted the position of chief financial officer and is receiving applications for review at this time. It intends to move forward with the employment of a new chief financial officer as quickly as possible and will bring up the issues raised in this audit report during job interviews to emphasize the importance of these matters for the new administrator.

FINANCIAL INTERNAL CONTROLS FOR THE SCHOOL BOARD & SUPERINTENDENT

9/20/18

As the governing body with the ultimate responsibility for the financial well-being of the Muncie Community School Corporation, these are the minimum internal controls for the oversight of the fiscal management and stability of the school corporation.

Requisitions to Purchase:

Each Requisition must have a minimum of two (2) of the following signatures-

1. Building administrator;
2. Grant administrator;
3. Business Office Administrator (CFO).

Fund Report:

A Fund Report will be given to the Superintendent, the Chief Financial Officer and the School Board each month. The Report will detail all funds monthly and yearly revenue and expenditures, with a cash balance of each fund at the end of the reporting period. This report will be presented to the School Board each month by the CFO.

Cash Flows:

A detailed Cash Flow worksheet will be given to the Superintendent, the Chief Financial Officer and the School Board each month. The worksheet will be constructed on a calendar year basis and will show actual and projected revenue and expenditures in the following funds:

1. Education Fund
2. Debt Service Fund
3. Operations Fund
4. Cafeteria Fund
5. Major Grants
 - a. Title I, Title II, Adult Basic Ed, IDEA-Special Ed.
6. GO Construction Bond
7. All Other Funds

These funds will show the State approved Appropriations where applicable. The CFO will present the cash flows to the School Board each month.

Payroll:

The HR department of the Muncie School Corporation enters all employee information on the personnel side of Komputrol (Financial Software). The Assistant Treasurer/Payroll pulls all information from HR into the payroll side of Komputrol. The use of two departments provides the check and balance for payroll.

General Comments:

Historically, the YOC fund, Special Ed fund and the Vocational Ed fund stood alone and consistently ran in the red. Those funds were moved and tracked starting January 1, 2018, to the General/Education Fund.

Response to the Exit Conference on September 25, 2018 regarding the Special Compliance Report regarding the General Obligation Bonds, Series 2014 issued by the Muncie Community Schools.

Bond Issuance for Construction Projects

In the third paragraph of the first section labelled, Bond Issuance for Construction Projects, the report states that the School Corporation “had not taken substantial steps, as of the end of the field work on September 5, 2018, to move forward with projects relating to” the construction projects. That is inaccurate. In fact, MCS developed a facilities committee to determine what work needed to be accomplished and prioritize the same, beginning in October 2016 along with determining which buildings should remain open. In January 2017, the MCS Board began the process of issuing RFPs for two large projects at Muncie Central High School and Southview Elementary School. This would have been approximately \$4.5 million of the funds. Bids were solicited and presented to the Board on March 28, 2017. The Board was unable to accept those bids and begin the projects as the Fact Finder assigned by the Indiana Educational Employment Relations Board determined that work was not required to be done at the time and it could wait until the summer of 2018. MCS felt that the Fact Finder erred in her decision and ignored a significant financial liability MCS had to address. The IEERB then upheld the decision in a June 2017 appeal. At that appeal, key testimony came from the State Board of Accounts that identified addressing the misuse of bond funds by properly aligning the balance sheets for all MCS funds, as recommended by counsel, “was not an expense” but a transfer. Therefore, the transferring of nearly \$10 million dollars to show an accurate balance in the MCS General Fund was effectively opposed by the State Board of Accounts in June 2017.

The MCS Staff would later address the need to properly spend the GO Bond funds with both the Distressed Unit Appeals Board and the Emergency Management Team along with other state officials. In all cases, the appeals fell on deaf ears. Except in the case of Steve Wittenauer, who specifically told me that “the State will need to come up with that \$10 million.” MCS sent a final amended plan on how to fund and complete the construction projects to the Distressed Unit Appeals Board on December 4, 2017. No response was ever received.

Additionally, it is not clear in the report that effectively, the bond funds received in April 2014 were spent in covering previous deficits, etc. prior to August 2014 as noted in materials Chip

Mahaffey, CFO, presented to each Board member and the entire administrative team. These materials were provided to the external auditors.

Usage of Restricted Funds

In this section, the penultimate paragraph articulates that commingling funds “led to the failure of the School Corporation to actually set aside the moneys for the Bond projects.” I would argue that this is again inaccurate. Such a commingling of funds is not best practice nor should it be encouraged, but alone, such a practice did not lead to the misuse of the GO Bond funds.

Internal Control Deficiencies

The third paragraph consisting of a single sentence, “There was a lack of understanding and governance by both parties [Board and management] as relate to the Bond and projects.” Again, this appears inaccurate and effusively generous. Effectively, it is saying that the Board, superintendent, and CFO were ignorant of how to use the funds. The evidence including the February 2014 memo written by Mr. Burkhart to the Board show that is not accurate.

Additionally, the Board president at the time was an architect who by profession would have been well aware of the proper process for bonding, bidding, and completing construction projects.

As mentioned above, Mr. Mahaffey’s documents show that there was not a lack of understanding by the prior management team regarding the Bond funds.

Additionally, if there was truly an intent to use these bond funds appropriately, then why were the projects outlined never bid out on the time table outlined in the Official Statement?

Conclusion

It is essential that the points articulated above are included in any public report on the use of the bond funds. The public has a clear right to understand how the funds were initially intended to be used. How members of two separate management teams tried to address the issue and correct the misuse, and ultimately, how state agencies stymied the attempts to properly address the issue. Particularly concerning is the fact that the Emergency Management Team refused to address the issue or even admit any malfeasance had taken place. This is particularly interested as the DUAB

focused on the fact MCS had not addressed the bond funds when they determined to take over the district under the auspices of SB 567.

Steven M. Baule

9/27/18

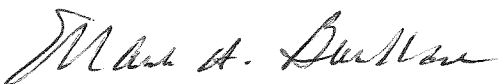
To: IN State Board of Accounts (SBOA)

Re: Special Compliance Report – Muncie Community Schools (MCS) 2014 General Obligation Bonds

In response to the preliminary draft audit comments regarding the above-listed matter, I would offer the following comments, addressing only those points I am familiar with:

- A. I held the position of Chief Financial Officer/Treasurer of the Muncie Community Schools through June 30, 2014, at which time I retired. My fiduciary authority ended on June 30, 2014.
- B. Section 1 – Bond Issuance for Construction Projects – The Official Statement dates listed - June 8, 2014/October, 2014/August, 2015 – were unilaterally inserted by Umbaugh, financial advisors for the bond issue, without any consultation with MCS officials. The project dates that should have been used by Umbaugh (per this SBOA Compliance Report) should have been 18 months after May 28, 2014 (bond closing date) or November 28, 2015, instead of June 8, 2014, and July 27, 2019, instead of August, 2015. Work orders for the first bond issue work at Central H.S. were issued in June, 2014. The likely closing and/or sale of some facilities included in the bond issue was a factor in waiting to schedule other bond issue work.
- C. Section 2 – Usage of Restricted Funds – The issue of overdrawn balances in some funds, while a definite concern, reflects reimbursement situations in most cases. MCS has, historically, operated large transfer tuition programs – Special Ed., Vocational Ed. and Opportunity School. This differentiates MCS from most other Indiana school corporations. These programs operate for 15 months from July 1 through September 30. These annual transfer tuition funds show an overdrawn balance until the final tuition reimbursement payment is received from participating school districts. This process is in compliance with instructions for SBOA Form 515-Transfer Tuition. Also, to say that “ninety percent of the proceeds from the bond issue was never spent for the purpose of the issue” appears to be premature since the spending deadline (7/27/19) has not been reached. In regards to comingled funds or the use of one control checking account for several school funds, this is common practice in public entities throughout Indiana. I do not recall SBOA field examiners ever taking exception to this process. Obviously, if one fund has a negative balance at any point, positive balances in other funds temporarily cover that situation.
- D. Finally, to my knowledge, there has been no default on the 2014 bond payments – the bondholders have been paid timely. It is also my understanding that no MCS bond funds are missing or unaccounted for.

Respectfully Submitted,



Mark A. Burkhart - MCS CFO/Treasurer (through 6/30/14)