LarsonAllen LLP

CPAs, Consultants & Advisors
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December 21, 2010

Members of the Board of Education
Charter School No. 4118
Kaleidoscope Charter School
Otsego, Minnesota

This Executive Audit Summary and Management Report presents information which we believe is important to you as members of the school board. We encourage you to review the sections of this report, the audited financial statements and the auditors' reports.

We would be pleased to furnish additional information with respect to these suggestions and discuss this memorandum with you at your convenience. We wish to express our appreciation to the School for the courtesies, cooperation and assistance extended to us during the course of our work.

**LarsonAllen LLP**

Dennis Hoogeveen, CPA
Principal

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# KALEIDOSCOPE CHARTER SCHOOL
# CHARTER SCHOOL NO. 4118

## EXECUTIVE AUDIT SUMMARY (EAS)

## YEAR ENDED JUNE 30, 2010

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**EXECUTIVE AUDIT SUMMARY (EAS)**
**FOR**
**KALEIDOSCOPE CHARTER SCHOOL**
**YEAR ENDED JUNE 30, 2010**

## AUDIT FINDINGS AND RESULTS

**The Audit Process** – We found the School's records to be in good order (organized, available, complete, etc.). We appreciated the time that staff took to work with us to complete the engagement.

**Audit Opinion** – The financial statements are fairly stated. We issued what is known as a "clean" audit report.

**Yellow Book Opinion** – No compliance issues were noted in our review of laws, regulations, contracts and grants that could have significant financial implications to the School.

**Internal Controls** – No "control deficiencies" in internal control were noted. However management should continuously seek opportunities to improve internal controls and to segregate duties.

**Legal Compliance** – No significant compliance issues were reported with respect to Minnesota Statutes related to charter schools and UFARS accounting.

**Fund Balance** – The fund balance of the School's General Fund ended at a surplus of $1,047,996 at June 30, 2010. This represents 34% of total expenditures. We recommend that a charter school develop a plan that will eventually result in a target fund balance that is 20% to 25% of annual expenditures. There are occasions when it is appropriate for the fund balance to exceed that general target when planning for capital items, program expansion, etc. Fund balance is an important aspect in the School's financial well being since a healthy fund balance represents things such as cashflow, as a cushion against unanticipated expenditures, enrollment declines, funding deficiencies, state aid metering changes, and aid prorations at the state level and similar problems.

**Budget to Actual** – Total revenues for the General Fund were $3,417,948, which was $19,778 (or 0.6%) lower than the budgeted amount while total expenditures were $3,080,073, which was $28,350 (or .9%) lower than had been budgeted. We recommend that budget variances in a charter school environment (which is more volatile than in a traditional school environment but on a much smaller scale) be limited to 1% to 2% on either side of zero. Sometimes the timing of grant expenditures limits the School's ability to accurately budget revenues and expenditures, however, your budget development and monitoring procedures are sufficiently sophisticated to be well within the range of variances we've indicated—whether the variance is positive or negative on a net basis. We recommend that you continue making at least one mid-year budget amendment to update budget assumptions.

**Other Findings** – During the audit, we identified substitute payroll support as an area where improvement could be made. Established rates should be maintained for all substitute positions of the School.

**Food Service Fund** – The School's food service program operated at a deficit of $4,708 for fiscal year 2010. However, with the transfer from the General Fund, the full amount of the current year operating deficit was covered leaving a fund balance of $0 for fiscal year ended June 30, 2010. It is not uncommon for charter schools to operate a subsidized food service program in which a portion of general education funds are utilized (via an annual operating transfer from the General Fund to the Food Service Fund) to ensure that all students have access to a nutritious meal as part of a healthy learning environment. It is basically a board-level decision as to whether or not the intent of the School is to run a food service program on a break-even basis (which may necessitate higher meal prices for students that pay for full-price meals) or on a subsidized basis (where the conclusion is that it is not practical to operate the type of program you want to have without a subsidy). Under UFARS (Uniform Financial Accounting Reporting Standards), the School is required to eliminate a deficit either through operations during the next fiscal year or through an operating transfer from the General Fund. We recommend that the budget of the School's General Fund and Food Service Fund continue to reflect the extent to which the Board has approved subsidizing the child nutrition program.

**Kaleidoscope Building Company** – The School's financial statements include the activity of the Building Company as a component unit. No separate financial statements are issued for the Building Company; however, a separate Form 990 is filed.

**Building Company Debt Covenant Compliance** – We want to take this opportunity annually to remind the Board that there are some general debt covenants that were agreed to as part of the Loan and Trust Agreements made between Kaleidoscope Charter School, the KCS Building Company, and Wells Fargo Bank, N.A. (as trustee). Some examples include the submission of audited financial statements within a certain timeframe, the submission of quarterly enrollment, current budget and financial information, and the submission of quarterly long-term budget model forecasting information. We are not aware of any non-compliance with such requirements through the date of our audit report, but it is important that the Board continue to monitor, review and accept responsibility for ensuring the ongoing compliance with all covenants that were agreed to as part of the financing arrangements related to the purchase of the building and subsequent improvements.

## OTHER AUDIT AND ACCOUNTING MATTERS

**Keeping the Charter School in Sound Financial Condition** – LarsonAllen works with a number of Minnesota charter schools and we often provide training opportunities for charter school staff which are aimed at helping charter schools to stay on top of business and financial management issues that, if not handled correctly, may result in a charter school that is not viable in the long-term. In response to the question of what it takes to keep a charter school in sound financial condition, we'd like you to discuss the following characteristics as a school board and rate your school on each.

Below is a partial list of criteria that will help to assess if a charter school is in sound financial condition:

- Having enough cash on hand to pay current bills and those that are due shortly
- Having sufficient revenues to support expenditures on an ongoing basis with minimum reliance on the school's savings/fund equity
- Has demonstrated that it can meet long-term debt obligations and maintain a good credit rating
- Has demonstrated that it can provide education services at a level that meets the needs of all students demonstrated by student results that meet or exceed State standards
- Has an administrative staff that has demonstrated a commitment to professional development and continuing education
- Has a long-range fiscal plan that is compared frequently to actual progress and adjusted to meet dynamic environmental conditions
- Has maintained its buildings in a condition that avoids unexpected major renovation costs or has worked with the building owner to ensure an environment that provides a safe and educationally appropriate setting
- Has filed all state and federal reports and aid claims in a timely and accurate manner and has few or no major post-filing adjustments
- Has engaged an experienced auditing firm that encourages business staff to discuss changes in school accounting requirements as they arise, throughout the year
- Has frequent interaction that occurs between the school board and the administration relating to discussions of the school's fiscal status and trends

At least one board member should be considered "financially literate". This person understands financial statements and financial risks, understands the impact of business decisions on financial statements and can identify balance sheet risks while also understanding revenue recognition issues on the operating statement. This person should also serve as a liaison with the auditor.

**Responsibilities of Charter School Board Members** – Because of the changing oversight environment that has resulted from the failure of some boards of directors of public-held companies to properly exercise their responsibilities to the organization and to the shareholders, we felt it was appropriate to review the responsibilities of charter school board members. This information has been summarized based on materials prepared by PCPS, the AICPA's Alliance for CPA Firms.

There are four "duties" of charter school board members that we'd like to review.

**Duty of Care**: The care that "an ordinary prudent person would exercise in a like position and under similar circumstances". Characteristics that demonstrate such duty of care include:

- ✓ Attending board meetings regularly
- ✓ Showing independent judgment
- ✓ Being informed about organizational resources
- ✓ Delegating only to responsible individuals
- ✓ Following up regularly

**Duty of Loyalty**: Keeping in mind that by agreeing to participate in a charter school board that the interests of the school are of the utmost importance. Duty of loyalty manifests itself when:

- ✓ Members give undivided allegiance to the organization when making decisions that affect the organization
- ✓ Personal, family or business interests are not put above the organization's interests
- ✓ Conflicts of interest are avoided in both fact and in appearance

**Duty to Manage Accounts**: A major component of the Board's responsibility is to oversee financial management, including financial planning, budgeting, accounting, payroll, taxes and annual government filings. These are often accomplished through delegation but the ultimate responsibility remains with the Board, therefore, it is the Board's duty to manage accounts by:

- ✓ Overseeing the organization's executive director or equivalent position
- ✓ Checking that resources are used prudently
- ✓ Implementing procedures to ensure accurate records
- ✓ Ensuring that no one person has control over finance
- ✓ Accurate decision making is documented using board meeting minutes

**Duty of Obedience**: The State relies on this conceptual "duty of obedience" to know that state aids (as well as donors with their gifts) will be used appropriately and to ensure that the organization remains obedient to its central purpose. This is accomplished by establishing accountabilities which are also tools to keep the organization focused on its purpose. Central purposes are spelled out in articles of incorporation, by-laws, adopted mission statements, charter school sponsorship agreements and other governing documents. The school board demonstrates a duty of obedience through:

- ✓ Policies
- ✓ Programs
- ✓ Performance
- ✓ Process
- ✓ Value
- ✓ Outcomes and Effectiveness
- ✓ Efficiency and Economy
- ✓ Planning, Allocating and Managing

# APPENDIX A

## FORM 990 CHANGES

### Prepare for the New Form 990

The Internal Revenue Service has completely redesigned Form 990—the information return filed by charities and other tax exempt organizations. We want to review the basics of the new requirements to make sure you understand the new form, including new policy disclosures and reporting requirements.

The Form 990 consists of an 11-page core form and 16 related schedules. All tax-exempt organizations must complete the core form, which contains questions intended to increase the transparency of tax-exempt organizations and present the IRS and stakeholders with a realistic picture of entities and their operations. The 16 schedules are required only if your organization participates in certain activities. For example, Schedule C will only be completed by those organizations participating in political and lobbying activities.

The form requires exempt organizations to report information never requested before. It also requires greater accounting detail than the current form. Here are some of the highlights.

### Governance

The form asks questions about organizational policies such as conflicts of interest, whistleblowers, document retention, and joint ventures. The form also requests information about the composition and independence of the governing body and unrelated business income, documentation of board and committee actions, compensation practices for key individuals, and the board's review of the Form 990 itself.

### Compensation

The form requests information about compensation of directors, officers, key employees, highly compensated employees, and independent contractors. A significant change is that compensation—including that from related organizations—will now be reported on a calendar-year basis through W-2s and 1099s.

Schedule J requires a description of specific types of compensation, including first-class travel, companion travel, gross-up payments to cover taxes, housing allowances, club dues, and personal services, such as maid or chauffeur services. Organizations must describe the process of approving executive compensation, including specific information about nontaxable benefits and deferred, incentive, and other compensation.

### Revenue and Expense Reporting

The revenue and expense reporting format has changed. Organizations will now be required to disclose amounts paid for services such as management, legal, accounting, lobbying, professional fundraising, and investment management.

**Public Charity Status**

Schedule A is now limited to information concerning 501(c)(3) public charity status and details regarding supporting organizations. In addition, the public support calculation method must be the same method used within the tax filing. For example, an accrual-basis organization will complete the public support schedule on an accrual basis. And, for publicly supported organizations that are not meeting the 33⅓% public support test, the form requires an explanation of how the organization meets the 10% facts and circumstances test.

**Schedule of Contributors**

Schedule B remains unchanged from the current version; however, the instructions clarify the method of reporting contributions and the definition of "contributor."

**Supplemental Financial Statements**

Schedule D requires detailed information concerning donor-advised funds, conservation easements, art, historical treasures, trust, escrow and custodial arrangements, endowments, and investments. Organizations also must report footnotes to the organization's financial statements that describe potential liability for uncertain tax positions.

**Fundraising and Gaming**

Schedule G is required for reporting fundraising and gaming revenue, expenses, and activities. It also requires information about payments to professional fundraisers and a list of the states in which the organization solicits contributions.

**Tax-Exempt Bonds**

Schedule K requests information regarding identification of bond issues, proceeds, private use, and arbitrage.

**Transactions with Interested Persons**

Schedule L requires organizations to report excess benefit transactions, loans, grants, and business transactions with directors, officers, and key employees.

**Noncash Contributions**

Schedule M requests information about noncash gifts, gift acceptance policies, the number of Form 8283 filed, and the use of third parties or related organizations to process noncash gifts.

**Related Organizations**

Schedule R requires organizations to identify and provide information about "disregarded" entities, such as single-member LLCs, related tax-exempt organizations, partnerships, and taxable entities.

# Weathering the Recession as a Charter School

## Weathering the Recession

Within the past year our consultants have written a white paper and offered complimentary training sessions on how charter schools can weather the recession. We'd like to present a summarized version of that information here. If you would like the full white paper or would like to discuss training opportunities for your administrative team or school board in the areas of charter school finance, governance, roles and responsibilities, strategic planning or similar areas please don't hesitate to contact us to discuss your needs.

## Meeting Challenges Head On

Most charter school leaders are weary of waking up every morning braced for what the day will bring. Government funding will be different in three or six months than it is today. How big will the change be, and which of your programs will it affect? Private giving will change as foundations, corporations, and individuals adjust to dramatic changes in investment values, personal income, and general business conditions. What will the impact be on your school?

While you may not yet know the answers to these questions, by now it's no doubt clear that:

- Business as usual won't do it anymore. It's time to adapt and transform.
- Active engagement with today's challenges increases your likelihood of emerging from the recession with important educational programs intact.
- Going it alone won't work. It is in working with others that leaders find the best ways to generate solutions and hope for the future.

It's time to adopt new tools and approaches for responding proactively and nimbly to changes in income. Such tools will be critical to your ability to continue delivering as much mission-related benefit to your students as possible within available resources, and adapt to the future as it unfolds.

## Make the Most of What You Have

You may already have organizational assets (financial and non-financial) that you can make more productive. Use this approach as you look for ways to increase revenue and decrease costs.

1. Examine the balance sheet. What assets might produce income if better activated or directed to a different purpose?

    - Are existing assets appropriately protected? Are your investments appropriately diversified and insured? Are other assets appropriately insured?
    - Are you making the best possible use of physical space and equipment? Is there a way to make this fixed investment available to others and earn some income or expense relief from it? Is occupancy expense an appropriate share of the budget you expect to be able to fund in the next few years?

2. Move to your activities. What is the bigger story told by your statement of revenue and expense?

   - Are you obtaining every possible dollar from entitlement-based revenue streams? Are your state and federal aid rates as high as those of similar schools with comparable student populations? If not, what can you do to raise them?
   - Do your school's leaders know which programs operate at a surplus, which operate near breakeven, and which require varying levels of subsidy? How recently has the board discussed the implications of this "portfolio" of activities, and whether the mix of subsidies appropriately reflects and carries out your school's mission?

3. Don't forget your non-financial assets. Are the right people doing the right things? Talented, motivated, productive staff and volunteers are the most essential asset of all. Without them it is not possible to do good work. Are you applying the best human capital to all aspects of your mission?

**Contingency Plans**

Prepare or revise your operating budget in a way that acknowledges uncertainty in the funding environment and builds in processes that will allow you to respond quickly and wisely through the year.

1. Identify trigger points. Develop a contingency planning tool that allows each program to envision and model multiple income scenarios and adjust spending to live within the income projected in each scenario. Then articulate the "trigger points" or conditions under which your school must implement one or more programs' contingency plans. It can be helpful to define — in objective terms — what a financial crisis would look like for your school, in order to come up with these conditions.

2. Cautiously consider an intentional deficit. Determine whether your school has sufficient net assets and cash that you can afford to incur an intentional deficit.

   This is a risky departure from good financial management practice and should only be considered by schools that a) have strong cash and net assets positions, and b) have committed to making whatever fundamental changes they must in order to get back to balanced budgets in subsequent years. It is an interim strategy that buys your school and those it serves some time, and it must never be used to deny the reality of a need to adapt to the external environment.

   Put smart, clear boundaries around the amount of deficit to be budgeted, and monitor actual financial results against the detailed budget even more carefully than in balanced-budget times.

**Restructure, Reorganize, Engage**

Many schools have already spent several years cutting expenses in response to funding cuts. For these organizations it will be impossible to continue producing the current level of services in the same way with less revenue. In these settings leaders need to find new ways of operating; waiting it out until things get back to normal is not an option. Consider the full continuum of options, including:

1. Restructure. Consider spinning off activities that don't truly fit the mission or that require a level of subsidy your school can no longer afford. This could start out as a "foster care" arrangement of sorts with another other organization picking up the program for a period of time before final arrangements are agreed upon.

2. Reorganize. Merge programs with an organization that has a vision, mission and values similar to your schools. Often seen as the very last resort, this strategy must be viewed through students' eyes. Merger may be the best way to keep vital services in place for the students you were founded to serve — to maintain your mission.

3. Engage with Others. Identify peer schools or other organizations that are more efficient than your school in certain aspects of service delivery; explore how to restructure and combine forces so that students get the best of all efforts within the resources available. This might mean combining forces with another school to accomplish portions of the administrative work load or facility operations. Carefully analyze and compare the costs and benefits of all of these options before proceeding.

**Communicate, Communicate**

Develop an active "intelligence" function to keep leaders informed about internal and external changes.

1. Funders and Legislators. Keep your key funders and legislative representatives informed about the impact and quality of your school's programs; monitor developments in government aid levels, grant guidelines, and funder priorities. Participate in advocacy efforts as appropriate to the funding stream.

2. Staff. Keep employees informed about your school's economic realities and what you as leaders are doing about it. Fear can be your worst enemy in difficult times. It saps the energy of even the most talented staff and diverts their time and talent into unproductive speculation. Share good news and even small successes with staff; find ways to help them remain hopeful about the future.

3. Board of directors. Keep your board informed, engage members wherever possible in contingency and communications plans, and be specific with them about what you need them to do. Tap board members' financial savvy and their ability to think strategically about your school's short- and long-term success. A board that actively partners with staff leaders is an important asset when the school must make difficult choices.

4. Others in the charter school sector. Learn about strategies that do and don't work from the leaders of schools similar to yours, as well as from other parts of the sector.

## How Do You Minimize the Risk Of Fraud?

With the downturn in the economy we felt it was important to reemphasize the importance of maintaining vigilance against opportunities to take advantage of charter schools. These are not based on specific concerns we have about your particular school. They are intended as general, thought-provoking things to keep in mind as board members to help protect against unwelcome news coverage. If you are serious about protecting your school, consider some or all of the following steps:

- Implement control policies and procedures and monitor them (segregation of duties, proper approvals, documentation requirements for purchases, cash receipts, review of bank statements, etc.).
- Conduct periodic internal audits.
- Accept the idea that fraud is commonplace and can happen in any school.
- Assure the message coming from top management is one of integrity and low tolerance for fraud. Create work environments that encourage honesty (don't put employees in situations that encourage them to lie or deceive).
- Set a high standard for moral and ethical conduct and job performance which includes treating employees with respect and fairness, including fair pay.
- Use due care in hiring practices with thorough background checks. Try to hire people of integrity.
- Invest in proper training of staff.
- Consistently enforce standards through appropriate discipline ranging from reprimand to dismissal.
- Utilize and work closely with a qualified external auditor who is familiar with charter school finance and accounting and internal control procedures. Realize that the cheapest audit is not always the most effective. Follow through on implementing their management recommendations.
- Consider a finance committee (there may be certain members of your board that are more interested in school finances than others).
- Have a fidelity bond for employees.
- Ask your employees to identify ways in which someone could commit fraud at your school and the ways to avoid it.
- Have periodic reviews of the effectiveness of internal controls. Adopt a "trust, but verify" code.
- Consider surprise fraud audits which are beyond a typical audit and include reviews of "high risk" areas.
- Investigate unexplained financial variances or other "red flags" (altered or missing documents, large or out-of-the-ordinary adjustments, excessive refunds or credits, employees not taking vacations, reduction in income, no addresses for vendors or employees, etc.). If something seems odd, whether it is a disbursement to an unfamiliar vendor or unexpected costs, consider the possibility of fraud.
- Establish realistic expectations for periodic reporting of financial results both in terms of timeliness as well as completeness. Ensure that budgets are adhered to. Investigate variances and seek out satisfactory explanations.

## Cashflow Concerns

The State of Minnesota is balancing its budget through the withholding of state aid payments to school districts and charter schools. For fiscal 2010, there was 17% less state aid paid out by the end of the fiscal year. For fiscal 2011 the holdback will increase an additional 3%. Traditional school districts can borrow to meet cashflow needs through the issuance of aid anticipation certificates while charter schools do not possess that ability. As a result, we anticipated that there will be a number of charter schools experiencing significant cashflow difficulties during fiscal 2010 and continuing into future fiscal years.

Cash flow is considered the financial lifeblood of business – for-profit and nonprofit alike. It is a time-dependent term that means having sufficient resources when needed to meet costs as they are due. Technically, it's the difference between cash receipts and cash disbursements over a given period of time. But for all practical purposes, cash flow means that a school is able to stay solvent – that it is able to pay debts and claims as they come due. Schools need to anticipate, plan, and balance the flow of cash in and out of the organization. This allows schools to have enough cash when they need it and to make the most of excess cash.

Many schools have trouble distinguishing cash flow problems from operating deficits, though they are very different circumstances. Negative cash flow occurs when a school's demand for cash is higher than the amount of cash on hand – a situation that, although disruptive to smooth operations, shouldn't be confused with running a deficit. Negative cash flow assumes that, within the course of the year, there will be enough money to handle all budgeted financial obligations. The problem is that the receipt of funds will be slower than the time period in which bills must be paid. It's a timing issue.

A deficit, on the other hand, occurs when schools overspend their operating income. Naturally, when schools spend more annually than they receive, there will be cash flow problems. But in such cases, negative cash flow is a symptom of the deeper deficit problem.

By the time you are reading this, your school may already have dealt with the consequences of insufficient cashflow. However, to the extent your school has time to plan and implement its strategy we encourage you to consider the following:

1) Have a board-level discussion regarding the ending fund balance and the period of time over which you'd like to reach your goal. We have found that school's that have been able to attain an ending fund balance that is between 20% and 25% of expenditures are best equipped to deal with financial issues that come up including a slowdown in the metering of state aid payments.
2) Ensure that the school is maximizing all opportunities to generate cashflow—e.g. is the school's lease aid application is submitted timely and completely?, is the school claiming reimbursement for federal expenditures in a timely and complete manner?, is the best data available for enrollment being used by the Department to generate aid entitlements?, etc.
3) Is the School able to work with individual vendors to adjust the timing of amounts owed?

# APPENDIX B

## STATEMENT ON AUDITING STANDARDS NO. 114 LETTER

Board of Education
Charter School No. 4118
Kaleidoscope Charter School
Otsego, Minnesota

We have audited the financial statements of the governmental activities and each major fund of Kaleidoscope Charter School (the School) for the year ended June 30, 2010, and have issued our report thereon dated December 21, 2010. Professional standards require that we provide you with the following information related to our audit.

**Our Responsibility under U.S. Generally Accepted Auditing Standards and *Government Auditing Standards***

As stated in our engagement letter dated June 15, 2010, our responsibility, as described by professional standards, is to express opinions about whether the financial statements prepared by management with your oversight are fairly presented, in all material respects, in conformity with U.S. generally accepted accounting principles. Our audit of the financial statements does not relieve you or management of your responsibilities.

As part of our audit, we considered the internal control of the School. Such considerations were solely for the purpose of determining our audit procedures and not to provide any assurance concerning such internal control.

As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the School's compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our tests was not to provide an opinion on compliance with such provisions.

1. Our responsibility is to plan and perform the audit to obtain reasonable, but not absolute, assurance that the financial statements are free of material misstatement.
2. We are responsible for communicating significant matters related to the audit that are, in our professional judgment, relevant to your responsibilities in overseeing the financial reporting process. However, we are not required to design procedures specifically to identify such matters.
3. We are also responsible for communicating Minnesota legal compliance issues.

Board of Education
Charter School No. 4118
Kaleidoscope Charter School

**Other Information in Documents Containing Audited Financial Statements**

Our audit opinion, the audited financial statements, and the notes to financial statements should only be used in their entirety. Inclusion of the audited financial statements in a client prepared document, such as an annual report, should be done only with our prior approval and review of the document. Our responsibility for other information in documents containing the School's financial statements and report does not extend beyond the financial information identified in the report. We do not have an obligation to perform any procedures to corroborate other information contained in such documents.

**Planned Scope and Timing of the Audit**

We performed the audit according to the planned scope and timing previously communicated to you in our email about planning matters on July 2, 2010.

**Significant Audit Findings**

***Qualitative Aspects of Accounting Practices***

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the School are described in Note 1 to the financial statements. No new accounting policies were adopted and the application of existing policies was not changed during the year ended June 30, 2010.

We noted no transactions entered into by the School during the year for which there is a lack of authoritative guidance or consensus. There are no significant transactions that have been recognized in the financial statements in a different period than when the transaction occurred.

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimates affecting the financial statements were:

- Due from Minnesota Department of Education
- Due from Federal through the Minnesota Department of Education
- Estimated useful lives of depreciable capital assets

Management's estimate of Due from Minnesota Department of Education (MDE) is based on amounts anticipated to be received from the state for various aid entitlements for fiscal 2009-10. The most significant of these is the aid portion of General education revenue. General education revenue and certain other revenues are computed by applying an allowance per student to the number of students served by the School. Student attendance is accumulated in a statewide database - MARSS. Because of the complexity of student accounting and because of certain enrollment options, student information is input by other school districts and the MARSS data for fiscal year 2010 is not finalized until well into fiscal year 2011. MDE calculates amounts owed to the School for special education excess cost tuition billing and adds the amount to the School's special education aid. Because the tuition amounts are based on estimated information, final entitlements are not expected to be known until well into the following fiscal year. Management expects any differences between estimated and actual data will be insignificant.

Management's estimate of due from Federal through the Minnesota Department of Education is based on amounts anticipated to be received through the state for various federal aid entitlements for fiscal 2009-10. Many federal entitlements require that supporting financial reporting information be provided both in the UFARS accounting system and also the SERVS reporting system. To the extent that these two separate systems are not in agreement and reported in a timely manner, the estimated aid entitlement may be adversely affected. Management expects any differences between estimated and actual data will be insignificant.

Management's estimate of the useful lives for depreciable assets is based on guidance recommended by the Minnesota Department of Education and other sources. The useful life of a depreciable asset determines the amount of depreciation that will be recorded in any given reporting period as well as the amount of accumulated depreciation that is reported at the end of a reporting period.

We reviewed and tested management's procedures and underlying supporting documentation in the areas discussed above and evaluated the key factors and assumptions used to develop the estimates noted above in determining that they are reasonable in relation to the financial statements taken as a whole. We concluded that the accounting estimates and management judgments appeared to consider all significant factors and resulted in appropriate accounting recognition.

***Difficulties Encountered in Performing the Audit***

We encountered no significant difficulties in dealing with management in performing and completing our audit.

***Corrected and Uncorrected Misstatements***

Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. Management identified one uncorrected financial statement misstatement for the amortization of bond issuance costs and bond discount which would have increased the beginning net asset balance by $43,992.

***Disagreements with Management***

For purposes of this letter, professional standards define a disagreement with management as a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the financial statements or the auditors' report. We are pleased to report that no such disagreements arose during the course of our audit.

***Management Representations***

We have requested certain representations from management that are included in the management representation letter dated December 21, 2010.

***Management Consultations with Other Independent Accountants***

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the School's financial statements or a determination of the type of auditors' opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

Board of Education
Charter School No. 4118
Kaleidoscope Charter School

***Other Audit Findings or Issues***

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the School's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our audit.

This information is intended solely for the use of the Board of Education and management of the School and is not intended to be and should not be used by anyone other than these specified parties.

LarsonAllen LLP

**LarsonAllen LLP**

Minneapolis, Minnesota
December 21, 2010