



## Arizona State Board for Charter Schools

# Avoiding Common Financial Performance Response Mistakes

The Board considers a charter holder's financial performance as determined by the Board's [Financial Performance Framework and Guidance](#) throughout the term of the charter contract. At those decision points, a charter holder that meets the Board's financial performance expectations is waived from submitting additional information to the Board while a charter holder that does not meet the Board's financial performance expectations is required to submit a financial performance response. If you must prepare a financial performance response, this document includes tips for avoiding common mistakes. Along with this document, you may also want to review "Preparing a Financial Performance Response".

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### General

- ✦ Spend the time upfront to determine why the charter holder did not meet each measure's target. Doing this will help you focus the supporting documentation and the narrative on the relevant cause(s).
- ✦ Identify efforts taken to improve performance in the narrative and show improvement in the supporting documentation. Using your response, complete the calculations, as applicable, to make sure your narrative assertions are supported and that the response includes the information and detail necessary for us to determine your current performance.
- ✦ Provide the basis for your assertions and explanations. Ask yourself how you know each explanation provided or assertion made is true and include those documents (accounting system or management reports, interim financial statements, projections, forecasts, supplemental worksheets, etc.) with your response. If your response doesn't include support for your assertions and explanations, it will be evaluated as "Not Acceptable".
- ✦ Do not assume that resources available to us (audited financial statements, Arizona Department of Education attendance and state equalization reports) will be sufficient to support assertions made in the response. It is often the case that these resources do not show sufficient detail or provide comparable information to support the response. Therefore, you should supplement assertions and explanations, as necessary.
- ✦ Address each measure individually in the narrative portion of the response rather than lumping all of the measures together. This approach will help you ensure that you've addressed all of the financial framework's requirements for an "acceptable" response.
- ✦ Before submitting your response to the Board, consider asking someone who did not participate in preparing the response to review it. This person can provide one last check to make sure that the framework's requirements for the response have been met.

### Going Concern

- ✦ The independent auditor's report, notes to the financial statements, or both will specify the reason(s) for the audit's going concern disclosure. In your response, do not simply restate what was included in the audit. Determine what caused each condition identified in the audit.
- ✦ If "recurring" is used in the audit to describe one or more of the conditions or if multiple years are specifically identified, then the response cannot simply address the condition for the audited year, but must focus on multiple years.

### Unrestricted Days Liquidity

- ✦ The reason for not meeting the unrestricted days liquidity measure is not the measure itself. Determine what caused either cash reserves to decrease, expenses to increase, or both.
- ✦ Other liquidity available to the charter holder (e.g., the delayed transfer of the June 30<sup>th</sup> state equalization payment by a third party to the charter holder, credit lines, general purpose bond reserve account statements) may be included in the response as a way to show improvement, but must be supported. Please note that for these other liquidity sources to be included as part of the financial dashboard, they must be sufficiently disclosed in the annual audit.

### Default

- ✦ The reason for not meeting the default measure is not the measure itself. Determine why the resources were not available to make timely payments or, if applicable, why the charter holder was unable to meet a particular debt covenant.
- ✦ The response should explain and support not only the charter holder's efforts to remedy the default identified in the audited year, but also the charter holder's efforts to prevent a default from occurring in the current or subsequent fiscal year.

### Net Income

- ✦ The reason for not meeting the net income measure is not the measure itself. Consider the statement, "net income did not meet due to high expenses". While it is inarguable that high expenses impact net income, it does not explain why expenses were high. Determine why fewer revenues were received in the audited fiscal year, what unusual or infrequent charges occurred that caused expenses to rise in the audited fiscal year, or both.
- ✦ As part of efforts to improve performance, a charter holder may refer to its marketing plan. If this approach is used, then the response should explain and support the feasibility of the marketing efforts (advertising, flyers, events, etc.) to increase student enrollment, rather than focus on the marketing efforts themselves. Use forecasts to illustrate any financial effects of the marketing efforts and discuss how the efforts will impact the charter holder's performance on this measure and, if applicable, other measures.
- ✦ If the charter holder projects increases in student enrollment, in addition to providing support for the projected enrollment and resulting revenues, the response must also address and support the effect, if any, the increased number of students will have on the charter holder's expenses.
- ✦ Net income and cash flow are not interchangeable.<sup>1</sup> Avoid mixing the two in the same financial worksheet or projection.
- ✦ Any projected or interim income statement (statement of activities) included with the response must include depreciation and amortization. While depreciation and amortization are non-cash expenses, they are used to allocate the initial costs of fixed and other assets over the asset's useful life. As such, the Board's financial framework intentionally does not remove depreciation and amortization from net income.

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<sup>1</sup> The reason net income and cash flow are not interchangeable has to do with how revenue and expenses are recorded "in the books". For instance, a rent expense can be viewed in one of two ways. On the accrual basis, the expense is recognized in the period that the charter holder benefited from it, while the associated cash expense (or outflow) possibly occurred before (as a prepaid expense) or after (when it was invoiced), and may not line up with the time period the charter holder benefited from it. If a charter holder provides support with projected "revenues" and "expenses" spreadsheet without also clarifying the accounting basis, it poses comparability problems with the audited financial statements and interim financial statements submitted by the charter holder, which may limit the spreadsheet's usefulness. This is typically not an issue with reports printed directly from the charter holder's accounting system that show "accrual" on the report.

- ✦ In most cases, accounting system printouts showing comparable information for the time period addressed by the response are sufficient supporting documentation. You do not need to provide receipts and invoices.

### Fixed Charge Coverage Ratio

- ✦ The reason for not meeting the fixed charge coverage ratio measure is not the measure itself. Determine what caused fixed obligations (operating leases, current debt, and interest) to increase, net income to be low relative to fixed obligations, or both.
- ✦ While it is inarguable that a net loss impacts the charter holder's performance on this ratio, before identifying the net loss as the sole reason for not meeting the target, make sure that is actually true. Complete the calculation using \$1 of net income. If \$1 of net income doesn't result in a ratio of at least 1.10, then there is another reason why the charter holder's performance fell short of the target.
- ✦ If the charter holder is in negotiations with a lending institution to refinance debt or with a landlord to change lease terms, provide documents or communications from the lending institution or landlord confirming the terms or supporting that negotiations are in process.

### Cash Flow

- ✦ The reason for not meeting the cash flow measure is not the measure itself. Identify the specific reason why the charter holder didn't meet the target (negative three-year cumulative cash flow, negative cash flow in two fiscal years, or negative cash flow in the audited year) and determine what caused the negative cash flow(s).
- ✦ Cash flow and net income are not interchangeable.<sup>2</sup> Avoid mixing the two in the same financial worksheet or projection.

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<sup>2</sup> The reason cash flow and net income are not interchangeable has to do with how revenue and expenses are recorded "in the books". For instance, a rent expense can be viewed in one of two ways. On the accrual basis, the expense is recognized in the period that the charter holder benefited from it, while the associated cash expense (or outflow) possibly occurred before (as a prepaid expense) or after (when it was invoiced), and may not line up with the time period the charter holder benefited from it. If a charter holder provides support with projected "revenues" and "expenses" spreadsheet without also clarifying the accounting basis, it poses comparability problems with the audited financial statements and interim financial statements submitted by the charter holder, which may limit the spreadsheet's usefulness. This is typically not an issue with reports printed directly from the charter holder's accounting system that show "accrual" on the report.