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**AGENDA ITEM: *Financial Performance Framework and Guidance* – Definitions of Financial Performance Expectations and Financial Performance Standard**

**Issue**

To better focus the Board's efforts on those charter holders that may currently be experiencing financial difficulties or that may be at a higher risk for financial hardship in the future, staff is proposing the Board base the determination of whether a charter holder meets the Board's financial performance expectations on two years of financial performance information instead of the current process that uses only one year of information.

**Background**

Approximately two years ago, at the beginning of fiscal year 2013, the Board adopted its Financial Performance Framework and Guidance ("financial framework"). The fiscal year 2012 audits were the first audits reviewed using the financial framework. In the fall of 2013, the Board revised the financial framework based on lessons learned during the first year of implementation and charter holder input. The Board's current [financial framework](#) includes six measures that gauge a charter holder's near-term financial health and longer term financial sustainability.

A charter holder that receives at least one "Falls Far Below Standard" rating and/or at least two "Does Not Meet Standard" ratings based on the charter holder's most recent audit does not meet the Board's financial performance expectations. The table below reflects the percent (and number) of charter holders that met and did not meet the Board's financial performance expectations based on the fiscal years 2012 and 2013 audits.

	<b>Fiscal Year 2012</b>	<b>Fiscal Year 2013</b>
<i>Met Financial Expectations</i>	33% (125)	41.8% (161)
<i>Did Not Meet Financial Expectations</i>	67% (254)	58.2% (224)

If a charter holder does not meet the Board's financial performance expectations at the times specified in the financial framework, then the charter holder must submit a financial performance response. During this past fiscal year, financial performance was considered by staff for 106 charter holders through the Board's renewal, interval review, Academic Intervention Schedule, and failing school processes. Overall, 70 charter holders (66%) were required to submit a financial performance response.

**Proposed Revisions**

The proposal presented for Board consideration involves defining a new term and modifying the Board's current definition of financial performance expectations. (Please see Attachment 1, which begins on page 5 of the staff report, for the specific modifications being proposed to the financial framework. The numbers at the bottom of these pages refer to the page numbers where this information may be found in the current version of the financial framework.)

Adding a new term – "Financial performance standard" would reflect a charter holder's financial performance as determined annually. To meet the Board's financial performance standard, the charter holder must receive no "Falls Far Below Standard" ratings and no more than one "Does Not Meet Standard" rating using the most recent audit. A charter holder that receives at least one "Falls Far Below Standard" and/or at least two "Does Not Meet Standard" would not meet the Board's financial performance standard. This is currently the way the Board defines whether or not a charter holder meets its financial performance expectations.

Modifying the current definition – Whether a charter holder meets the Board’s financial performance expectations would be based on two years of financial performance. As proposed, the modified definition would look at the charter holder’s two most recent audits with weight given to the charter holder’s performance based on the most recent fiscal year’s audit. Staff is proposing the change to help focus the Board’s efforts on those charter holders that may currently be experiencing financial difficulties or that may be at a higher risk for financial hardship in the future. The table below shows how the two years of financial performance would be used to determine whether a charter holder meets the Board’s financial performance expectations.

Previous Audit	Most Recent Audit	Meets Board’s Financial Performance Expectations?
<b>MEETS</b> financial performance standard	<b>MEETS</b> financial performance standard	<b>Yes</b>
<b>DOES NOT MEET</b> financial performance standard	<b>MEETS</b> financial performance standard	<b>Yes</b>
<b>MEETS</b> financial performance standard	<b>DOES NOT MEET</b> financial performance standard; <b>no measure receives “Falls Far Below Standard”</b>	<b>Yes</b>
<b>MEETS</b> financial performance standard	<b>DOES NOT MEET</b> financial performance standard; <b>1 or more measures receive “Falls Far Below Standard”</b>	<b>No</b>
<b>DOES NOT MEET</b> financial performance standard	<b>DOES NOT MEET</b> financial performance standard	<b>No</b>

Under the Board’s current definition, the particular ratings received for the measures are not taken into account when determining whether a financial performance response is required; a charter holder that receives only “Does Not Meet Standard” ratings is viewed the same as a charter holder that receives “Falls Far Below Standard” ratings. This would change under the modified definition.

- Under the third scenario (see table above), a charter holder could not meet the Board’s financial performance standard in the current year, but still meet the Board’s financial performance expectations so long as the charter holder did not receive any “Falls Far Below Standard” ratings based on the most recent audit and met in the prior year.

Within the financial framework, there is an interplay that exists between certain measures. As a result, a charter holder’s strategic decision or an unexpected event could negatively affect a charter holder’s performance on multiple measures in a particular fiscal year. A lesson learned from reviewing the financial performance responses submitted last year is that one year of not meeting the Board’s financial performance standard does not necessarily indicate the charter holder may be at a higher risk for financial hardship in the future.

Therefore, since no measure received a “Falls Far Below Standard” rating under the third scenario, the Board would wait for another year of data to determine whether the most recent audited year’s performance is an outlier or the beginning of a downward trend in the charter holder’s financial performance. If it turns out that the most recent year’s performance was the start of a downward trend, under the fifth scenario (see table above), the charter holder would

be required to submit a financial performance response at the specified times based on the performance identified in the next year's audit.

- Under the fourth scenario (see table above), a charter holder that did not meet the Board's financial performance standard in the current year due in total or in part to the charter holder receiving one or more "Falls Far Below Standard" ratings based on the most recent audit would not meet the Board's financial performance expectations. This scenario is different from the previous one as in this case the most recent audit, through the going concern measure, has identified concerns about the charter holder's viability and/or the current audit has identified that the charter holder has fewer than 15 days of liquidity available, the charter holder has defaulted on a material loan, or both.

The modified definition of financial performance expectations would be used to determine whether a charter holder is required to submit a financial performance response at the times specified in the financial framework. If only one audit is available, a charter holder seeking to expand its operations must meet the Board's financial performance standard in order to be waived from submitting a financial performance response.

### Projected Effect of Changes

Based on the financial performance information for fiscal years 2012 and 2013, 46 charter holders that would be required to submit a financial performance response under the Board's current financial performance expectations definition would not be required to submit a financial performance response under the modified definition's third scenario. These 46 charter holders represent approximately 12% of the Board's portfolio that submitted fiscal year 2013 audits.

Using financial performance information based primarily on the fiscal years 2012 and 2013 audits, the table below projects the impact of the modified definition on charter holders eligible for renewal, undergoing an interval review, with one school site designated as a failing school, or required to submit information as prescribed by the Board's Academic Intervention Schedule. The "Status Quo" section represents the number and percent of charter holders that would be waived from submitting a financial performance response or required to submit a response if no changes are made. The "Modified Definition for Financial Performance Expectations" section shows the effect modifying the definition could have.

Process	Status Quo		Modified Definition for Financial Performance Expectations	
	Waived	Required	Waived	Required
Renewal	16 (50%)	16 (50%)	19 (59.4%)	13 (40.6%)
Interval Reviews	7 (50%)	7 (50%)	10 (71.4%)	4 (28.6%)
Failing Schools	4 (44.4%)	5 (55.6%)	4 (44.4%)	5 (55.6%)
Academic Intervention Schedule	37 (34.9%)	69 (65.1%)	55 (51.9%)	51 (48.1%)
<b>TOTAL</b>	<b>64 (39.8%)</b>	<b>97 (60.2%)</b>	<b>88 (54.7%)</b>	<b>73 (45.3%)</b>

The 161 charter holders reflected in the table above represent 40.9% of the Board's portfolio expected to submit fiscal year 2014 audits.

### **Implementation of Changes**

These changes present no additional burden to any charter holder and will reduce the burden to certain holders. These changes will also reduce the number of financial performance responses to be reviewed, allowing staff to repurpose the time.

Last month, staff began notifying charter holders of their eligibility to apply for renewal. Using the modified definition, two of the three charter holders that have already been notified of their requirement to submit a financial performance response as part of their renewal application would be waived from submitting a response. Should the Board choose to adopt the proposed changes the motion options presented below include language to make the approval of the changes retroactive to September 1, 2014.

### **Board Options**

Option 1: I move to approve the changes to the *Financial Performance Framework and Guidance* as presented today. Since these changes present no additional burden to any charter holder and will reduce the burden to certain charter holders, I further move to approve these changes retroactive to September 1, 2014.

Option 2: I move to approve the changes to the *Financial Performance Framework and Guidance* as presented with the inclusion of the modifications discussed (may require specific reference depending upon whether clarification of discussion is needed). Since these changes present no additional burden to any charter holder and will reduce the burden to certain charter holders, I further move to approve these changes retroactive to September 1, 2014.

Option 3: Take no action and maintain the *Financial Performance Framework and Guidance* as it is currently being implemented.

## **Attachment 1**

## Evaluation and Intervention

The established targets are used to determine whether the charter holder is meeting each measure based on the available existing data. The evaluation is completed annually using the charter holder's most recent audit reporting package [and a determination is made as to whether the charter holder met the Board's financial performance standard for the audited fiscal year](#). A charter holder that receives two or more "Does Not Meet Standard" and/or one or more "Falls Far Below Standard" based on the charter holder's most recent audit reporting package does not meet the Board's financial performance [standard expectations](#).<sup>2</sup>

A charter holder's financial performance will be used by the Board during the term of the charter:

- To stipulate the conditions which waive the charter holder from any submission requirements related to its financial operations.
- To stipulate the conditions which require the charter holder to submit additional information or clarification that will be used to inform the Board's decision-making.

A charter holder's financial performance will be considered by the Board as follows:<sup>3</sup>

- Renewal
- Five-year interval reviews
- New School Site Notification Requests
- Arizona Online Instruction Program of Instruction Amendment Requests
- Replication
- Transfer of the charter contract from another sponsor to the Board
- Academic Intervention Schedule
- Failing School designations

[As shown in the table below, a charter holder's financial performance for the most recent audited fiscal year and the prior audited fiscal year are used to determine whether the charter holder meets the Board's financial performance expectations.](#)

Previous Audit	Most Recent Audit	Meets Board's Financial Performance Expectations?
<b>MEETS</b> financial performance standard	<b>MEETS</b> financial performance standard	<b>Yes</b>
<b>DOES NOT MEET</b> financial performance standard	<b>MEETS</b> financial performance standard	<b>Yes</b>

<sup>2</sup> In those instances where the Board receives financial statements that cover multiple and different charter holder entities, the charter holder's performance will be evaluated under the financial framework using the charter holder specific financial information and the financial information for the consolidated/combined entity. Failure of the individual charter holder or the consolidated/combined entity to meet the Board's financial performance expectations will result in the charter holder being required to submit a financial performance response.

<sup>3</sup> At the time of consideration by the Board, the most current audited financial information will be provided.

<b>MEETS</b> financial performance standard	<b>DOES NOT MEET</b> financial performance standard; <b>no measure receives “Falls Far Below Standard”</b>	<b>Yes</b>
<b>MEETS</b> financial performance standard	<b>DOES NOT MEET</b> financial performance standard; <b>1 or more measures receive “Falls Far Below Standard”</b>	<b>No</b>
<b>DOES NOT MEET</b> financial performance standard	<b>DOES NOT MEET</b> financial performance standard	<b>No</b>

A charter holder that meets the Board’s financial performance expectations will be waived from submitting a financial performance response at the times identified in the bullets above. A charter holder that does not meet the Board’s financial performance expectations at the times identified in the bullets above will be required to submit a financial performance response. [If only one audit is available, a charter holder seeking to expand its operations must meet the Board’s financial performance standard in order to be waived from submitting a financial performance response.](#) Please see Appendix B regarding what the charter holder must do and how that information will be used by the Board. For more information regarding the financial performance response, please see the “Financial Performance Response” section of this document.

Because financial health can affect a charter holder’s ability to meet the obligations of its charter contract and applicable laws, a charter holder’s financial performance may also be reviewed at other times when the Board makes decisions related to a charter holder’s academic and/or operational performance. In these situations, a charter holder will be able to address its financial performance at the Board meeting, but an opportunity will not be built in to the process for the charter holder to provide a written response in advance of the meeting.

## FINANCIAL PERFORMANCE RESPONSE<sup>5</sup>

As indicated in the “Evaluation and Intervention” section of this document, a charter holder that does not meet the Board’s financial performance expectations will be required to submit a financial performance response at specified times (see also Appendix B). The Board has not prescribed the specific information that must be submitted, but the charter holder’s financial performance response should minimally focus on each measure where the charter holder received a “Does Not Meet Standard” or “Falls Far Below Standard” based on the most recent audited fiscal year presented in the financial performance dashboard(s). The charter holder’s financial performance response should not address all measures in the financial framework unless the charter holder failed to meet the standard for all measures. Board staff will evaluate the financial performance response using the evaluation criteria found in Appendix C. In preparing the financial performance response that will be submitted to the Board, the charter holder should evaluate its own financial situation and, for those measures where the charter holder failed to meet the standard, determine the information that will best explain the charter holder’s situation and efforts to improve. For more information on the financial performance response, please see Appendix C.

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<sup>5</sup> This section and Appendix C may also be useful to charter holders as part of their ongoing efforts to monitor financial performance. For example, a charter holder may use the information in this section to improve its financial performance, so that by the time it must undergo a five-year interval review or apply for renewal, its financial performance will be such that it will be waived from being required to submit a financial performance response.



## Appendix C

# Financial Performance Response & Evaluation

### Financial Performance Response

A charter holder that does not meet the Board’s financial performance expectations will be required to submit a financial performance response at specified times (see Appendix B). For those charter holders required to submit a financial performance response, the table below includes examples of items that the charter holder may want to consider addressing. The Board has not prescribed the specific information that must be submitted, but the charter holder’s financial performance response should minimally focus on each measure where the charter holder received a “Does Not Meet Standard” or “Falls Far Below Standard” based on the most recent audited fiscal year presented in the financial performance dashboard(s). The charter holder’s financial performance response should not address all measures in the financial framework unless the charter holder failed to meet the standard for all measures.

In preparing the financial performance response, the charter holder should evaluate its own financial situation and, for those measures where the charter holder failed to meet the standard, determine the information that will best explain the charter holder’s situation and efforts to improve. Although listed separately in the table, to some extent, certain measures may relate to one another. Therefore, in the financial performance response, it may be appropriate for the charter holder to refer to its performance under a measure that met the standard when addressing a measure that did not meet or fell far below the standard.

Please note that the examples included in the table below are just that. The information in the table is not meant to be exhaustive, but serves as a starting point to assist charter holders. By including the table, the Board is not intending to limit what a charter holder may address in its response.

Measure	For Ratings of “Does Not Meet” or “Falls Far Below” Consider Demonstrating...
<b>1a.</b> Going Concern	❖ The issue resulting in the auditor’s “going concern” designation has been resolved or is in the process of being resolved.
<b>1b.</b> Unrestricted Days Liquidity	❖ The charter holder has access to other sources of liquidity, including related parties, to augment liquidity needs. ❖ The charter holder expects a receipt of cash from a grant, etc.
<b>1c.</b> Default	❖ The charter holder is no longer in default. ❖ The charter holder’s efforts to resolve the lender’s concerns, so that the default status can be lifted.
<b>2a.</b> Net Income	❖ The net loss was from non-recurring events that will not occur in future periods. ❖ The charter holder has reduced expenses to meet the minimum requirement in future periods. ❖ Student counts for the charter holder will increase in future periods to result in positive change in net assets.
<b>2b.</b> Cash Flow	❖ The charter holder meets the other financial requirements and had positive cash flow for the most recent year. ❖ The charter holder has sufficient cash to fund cash deficiencies for the foreseeable future. ❖ The charter holder has increased revenue or reduced expenses that will result in positive cash flow in the next fiscal year.
<b>2c.</b> Fixed Charge Coverage Ratio	❖ The charter holder has sufficient cash to augment cash flow to fund fixed charges for the foreseeable future. ❖ The charter holder’s income is expected to improve which will result in “Meets” for the Fixed Charge Coverage Ratio in the next fiscal year. ❖ The charter holder’s fixed charges are expected to decline which will result in a “Meets” for the

	Fixed Charge Coverage Ratio.
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### Evaluation Criteria for Financial Performance Response

The following criteria will be used to evaluate the financial performance response submitted by the charter holder. Charter holders are submitting the financial performance response based upon those measures that received a “Does Not Meet Standard” or “Falls Far Below Standard” based on the most recent audited fiscal year presented in the financial performance dashboard(s). Each charter holder’s financial performance response will be unique.

#### GOING CONCERN

Provide evidence demonstrating:		
❖ The issue resulting in the auditor’s “going concern” designation has been resolved or is in the process of being resolved.		
ACCEPTABLE	NOT ACCEPTABLE	
Meets	Does Not Meet	Falls Far Below
The financial performance response explains the reason(s) for the going concern designation identified in the audited fiscal year and the charter holder’s efforts to cure the situation in the current or subsequent fiscal year. The information and analysis included supports and helps explain the statements made by the charter holder in the financial performance response.	The financial performance response explains the reason(s) for the going concern designation identified in the audited fiscal year or explains the charter holder’s efforts to cure the situation in the current or subsequent fiscal year, but not both. The information and/or analysis included provide limited support for the statements made by the charter holder in the financial performance response.	The financial performance response does not address the measure or only restates the sentence from the table found in the “Financial Performance Response” section of Appendix C or similar information.

#### UNRESTRICTED DAYS LIQUIDITY

Provide evidence demonstrating:		
❖ The charter holder has access to other sources of liquidity, including related parties, to augment liquidity needs. ❖ The charter holder expects a receipt of cash from a grant, etc. ❖ Other information specific to the charter holder’s situation.		
ACCEPTABLE	NOT ACCEPTABLE	
Meets	Does Not Meet	Falls Far Below
The financial performance response explains the reason(s) for the charter holder having fewer than 30 days of cash or other liquidity in the audited fiscal year and the charter holder’s efforts to improve in this area in the current or subsequent fiscal year. The information and analysis included supports and helps explain the statements made by the charter holder in the financial performance response.	The financial performance response explains the reason(s) for the charter holder having fewer than 30 days of cash or other liquidity in the audited fiscal year or explains the charter holder’s efforts to improve in this area in the current or subsequent fiscal year, but not both. The information and/or analysis included provide limited support for the statements made by the charter holder in the financial performance response.	The financial performance response does not address the measure or only restates the sentence from the table found in the “Financial Performance Response” section of Appendix C or similar information.

## DEFAULT

Provide evidence demonstrating: <ul style="list-style-type: none"> <li>❖ The charter holder is no longer in default.</li> <li>❖ The charter holder's efforts to resolve the lender's concerns, so that the default status can be lifted.</li> </ul>		
ACCEPTABLE	NOT ACCEPTABLE	
Meets	Does Not Meet	Falls Far Below
The financial performance response explains the reason(s) for the charter holder's default identified in the audited fiscal year and the charter holder's efforts to cure the situation in the current or subsequent fiscal year. The information and analysis included supports and helps explain the statements made by the charter holder in the financial performance response.	The financial performance response explains the reason(s) for the charter holder's default identified in the audited fiscal year or explains the charter holder's efforts to cure the situation in the current or subsequent fiscal year, but not both. The information and/or analysis included provide limited support for the statements made by the charter holder in the financial performance response.	The financial performance response does not address the measure or only restates the sentence from the table found in the "Financial Performance Response" section of Appendix C or similar information.

## NET INCOME

Provide evidence demonstrating: <ul style="list-style-type: none"> <li>❖ The net loss was from non-recurring events that will not occur in future periods.</li> <li>❖ The charter holder has reduced expenses to meet the minimum requirement in future periods.</li> <li>❖ Student counts for the charter holder will increase in future periods to result in positive change in net assets.</li> <li>❖ Other information specific to the charter holder's situation.</li> </ul>		
ACCEPTABLE	NOT ACCEPTABLE	
Meets	Does Not Meet	Falls Far Below
The financial performance response explains the reason(s) for the charter holder's negative net income in the audited fiscal year and the charter holder's efforts to attain positive net income in the current or subsequent fiscal year. The information and analysis included supports and helps explain the statements made by the charter holder in the financial performance response.	The financial performance response explains the reason(s) for the charter holder's negative net income in the audited fiscal year or explains the charter holder's efforts to attain positive net income in the current or subsequent fiscal year, but not both. The information and/or analysis included provide limited support for the statements made by the charter holder in the financial performance response.	The financial performance response does not address the measure or only restates the sentence from the table found in the "Financial Performance Response" section of Appendix C or similar information.

## CASH FLOW

Provide evidence demonstrating:

- ❖ The charter holder meets the other financial requirements and had positive cash flow in the most recent year.
- ❖ The charter holder has sufficient cash to fund cash deficiencies for the foreseeable future.
- ❖ The charter holder has increased revenue or reduced expenses that will result in positive cash flow in the next fiscal year.
- ❖ Other information specific to the charter holder's situation.

ACCEPTABLE	NOT ACCEPTABLE	
Meets	Does Not Meet	Falls Far Below
The financial performance response explains the reason(s) for the charter holder not meeting the cash flow measure's targets in the audited fiscal year and the charter holder's efforts to improve in this area in the current or subsequent fiscal year. The information and analysis included supports and helps explain the statements made by the charter holder in the financial performance response.	The financial performance response explains the reason(s) for the charter holder not meeting the cash flow measure's targets in the audited fiscal year or explains the charter holder's efforts to improve in this area in the current or subsequent fiscal year, but not both. The information and/or analysis included provide limited support for the statements made by the charter holder in the financial performance response.	The financial performance response does not address the measure or only restates the sentence from the table found in the "Financial Performance Response" section of Appendix C or similar information.

## FIXED CHARGE COVERAGE RATIO

Provide evidence demonstrating:

- ❖ The charter holder has sufficient cash to augment cash flow to fund fixed charges for the foreseeable future.
- ❖ The charter holder's income is expected to improve which will result in "Meets" for the Fixed Charge Coverage Ratio in the next year.
- ❖ The charter holder's fixed charges are expected to decline which will result in a "Meets" for the Fixed Charge Coverage Ratio.
- ❖ Other information specific to the charter holder's situation.

ACCEPTABLE	NOT ACCEPTABLE	
Meets	Does Not Meet	Falls Far Below
The financial performance response explains the reason(s) for the charter holder's fixed charge coverage ratio being less than 1.10 in the audited fiscal year and the charter holder's efforts to improve in this area in the current or subsequent fiscal year. The information and analysis included supports and helps explain the statements made by the charter holder in the financial performance response.	The financial performance response explains the reason(s) for the charter holder's fixed charge coverage ratio being less than 1.10 in the audited fiscal year or explains the charter holder's efforts to improve in this area in the current or subsequent fiscal year, but not both. The information and/or analysis included provide limited support for the statements made by the charter holder in the financial performance response.	The financial performance response does not address the measure or only restates the sentence from the table found in the "Financial Performance Response" section of Appendix C or similar information.