
AGENDA ITEM: Financial Framework**Background – Financial Performance Standard**

For the first renewal cohort, all charter holders were required to submit a standard detailed business plan with their application.¹ As staff began reviewing the first applications and even before the [Strategic Plan's](#) adoption, Board staff was looking at ways to recognize quality performance and streamline its processes for quality charters. As a result, a revised renewal application was approved and implemented with the second renewal cohort. The current renewal financial standard² has resulted in a diverse group of charter holders with various levels of financial performance being required to submit the financial sustainability section.

In late summer/early fall of 2011, Board staff formed [a work group](#) to help determine if the financial performance standard currently used during the renewal process could be improved to provide a more comprehensive and meaningful evaluation of a charter holder's financial performance. The work group met in late September 2011 and again in early January 2012. Subsequent to the work group's first meeting, the Board received a grant from the National Association of Charter School Authorizers (NACSA), which provided resources to assist the Board in developing a performance framework that addresses academic, operational and financial performance. Between September 2011 and April 2012, staff received input from the charter community as to what they think is important to consider for a financial framework and NACSA provided what it perceives to be "national standards".

May 2012 Financial Subcommittee Meeting

During its [first meeting](#) on May 10th, the Board's Financial Subcommittee, among other actions:

- Adopted seven indicators for inclusion in the Board's financial framework.
- Adopted "Meets Standard", "Does Not Meet Standard" and "Falls Far Below Standard" thresholds for each of the indicators.
- Determined that for renewal and five-year interval review purposes, one or more "Falls Far Below Standard" and/or two or more "Does Not Meet Standard" would require that the charter holder be given the opportunity to provide additional information regarding its financial operations.

Use of Financial Framework

The financial indicators are not intended to be used to measure compliance or noncompliance in and of themselves. Instead, a charter holder's performance as evidenced by the financial framework 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; and/or
- To stipulate the conditions which require the charter holder to provide additional information or clarification that will be used to inform the Board's decision-making.

Since financial health can affect a charter holder's ability to meet the obligations of its charter contract and applicable laws, a charter holder's performance as evidenced by the financial framework may be reviewed when the Board makes decisions related to a charter holder's academic and operational performance.

¹ A.R.S. §15-183(l)(1) requires the renewal application to include a detailed business plan.

² Under the current standard, if one or both of the two previous audits identified a going concern or identified year-end negative equity, the charter holder is required to submit the financial sustainability section of the renewal application.

ACTION ITEM #1 – Revised Financial Framework & Testing Results

Staff has modified the [financial framework document](#) and updated the [testing results for the initial 11 charter holders](#) to reflect the changes adopted by the Subcommittee at its May meeting and to include these charter holders' performance under the Fixed Charge Coverage Ratio indicator.³ The modified financial framework document also includes proposed changes to the framework's Fixed Charge Coverage Ratio, which are discussed in more detail in the "ACTION REQUESTED" section below.

For the 18 charter holders that will be notified of their eligibility to apply for renewal between October 2012 and December 31, 2012, staff has reviewed their fiscal year 2011 audits. The [renewal charter holders' testing results](#) show that based on the fiscal year 2011 audits approximately half will be required to submit additional information with their renewal application packages and approximately half will be waived from submission requirements related to their financial operations.⁴ Staff did not round numbers up when determining a charter holder's performance on an individual indicator.

ACTION REQUESTED

The modified financial framework document included in the meeting materials reflects changes proposed by staff to the Fixed Charge Coverage Ratio (FCCR). (Added information is noted in red and in all caps while removed language has a line through it.)

- Since most of the Board's charter holders are non-profits, staff proposes using "Change in Net Assets" instead of "Net Income After Tax" in the ratio's numerator.
- Based on the testing conducted, staff proposes adding "amortization" to the ratio's numerator. While the audits reviewed by staff included an amount for depreciation, in some instances, the amount included in the audit was for depreciation and amortization.
- The "note" has been removed since the ratio will now be calculated by staff.

CLARIFICATION REQUESTED

Staff's testing of the financial framework has identified items that require Subcommittee review and clarification. These items have been identified below. Based upon the Subcommittee's conclusions, in some instances, changes to the indicators and/or thresholds may be required while in other instances, staff will incorporate the information into the financial framework guidance document that will be developed.

- Default on Material Loan Indicator – Currently, the indicator states that default is defined as in true default on obligations.
 - a. Would this indicator only be concerned with those instances where the lender has issued formal notice of default, or are there other circumstances that should be included? For example, the fiscal year 2011 audit for one charter holder indicated that all accrued interest (\$49,344) and principal (\$176,400) for one of its notes with a non-related party were due on January 1, 2009. If it was determined that this was a "material loan", would this situation result in the charter holder receiving a "Falls Far Below" for this indicator?
 - b. Would this indicator include all loans, or only those with non-related parties?
 - c. How is "material" defined?
- Interest Expense – The FCCR indicator includes interest expense in the calculation. In about 75% of the charter holders' audits tested, there either wasn't interest expense or this information was available in the financial statement notes or on the financial statements themselves. For the remaining 25%, interest expense was not reported out, but the cash flow statement included "interest paid".

³ The document presented at the May meeting required the audit firms to calculate the Fixed Charge Coverage Ratio as part of the annual audits. Following the May meeting, staff determined that the information necessary to calculate the ratio is available through the annual audits. Therefore, the ratio will be calculated by staff.

⁴ Using the existing renewal financial performance standard, approximately one-fifth would have been required to submit additional information as part of their renewal application packages. These charters' "names" are highlighted in blue in the renewal charter holders testing results document.

- a. If interest expense is not available, should staff use interest paid?
 - b. Should staff include any interest identified in the audit (e.g., credit card interest)?
- Current Portion of Long-Term Debt and Capital Leases – The FCCR includes the current portion of long-term debt in the calculation.
 - a. Would outstanding balances on credit lines be included in the current portion of long-term debt?
 - b. Would credit card payables be included in the current portion of long-term debt?
 - c. Would interest payable be included in the current portion of long-term debt?
 - Cash Flow Indicator – Currently, one of the “meets standard” options for the Cash Flow indicator is that the three-year cumulative cash flow is positive, cash flow is positive in two of three years, and cash flow in the most recent year is positive. For 5 of 29 charter holders reviewed, the charter holder failed to meet the standard due to their fiscal year 2011 audits showing negative cash flow. For 2 of the 5 charter holders, the Cash Flow indicator is the only indicator where they received a score of other than “meets” – Charter Holder #11 (initial testing) and Charter J (renewal testing). For 2 of the 5 charter holders, they would be required to submit additional information regardless of their performance on the Cash Flow indicator – Charter Holder #8 (initial testing) and Charter Q (renewal testing). However, for the remaining charter holder – Charter K (renewal testing) – a does not meet on the Cash Flow indicator would be their second does not meet and therefore would require the submission of additional information.
 - a. In determining performance on the Cash Flow indicator, should a certain number of unrestricted days cash in the current year (e.g., 90 days) offset negative cash flow in the current year and result in the charter holder receiving a “meets”?
 - b. Or, since the determination of whether a charter holder is waived from submission requirements is based only on the current audit, should the “meets” threshold remain as is?
 - Financial Statements That Include More Than One Charter Holder Entity – In some instances, due to GAAP requirements, the Board receives consolidated financial statements that cover multiple charter holder entities. In these circumstances, the financial statements submitted break out the financial information for each charter entity (e.g., Charter D in the renewal testing results). However, the financial notes and going concern determinations are for the consolidated financial statements. Therefore, issues could arise when determining a charter holder’s performance under certain indicators. For example, depending upon the detail in the financial statements and notes, staff may not be able to glean all of the financial data necessary to calculate the FCCR for the individual charter holder. Additionally, if the audit identifies a going concern or material default on loan, staff may not be able to determine if the issue pertains to the charter holder being reviewed. In these instances,
 - a. Should staff use the individual charter holder’s financial data or the financial data from the consolidated financial statements?
 - b. Should the going concern and material default on loan determination for the consolidated entity apply to the charter holder under review for financial framework purposes?
 - c. What should staff do when all of the financial data necessary to calculate the FCCR is not available for the charter holder under review?

ACTION ITEM #2 – Financial Performance Level for Expansion Eligibility

During its May meeting, the Subcommittee tabled its discussion, at staff’s request, on the conditions related to expansion request that would require a charter holder be given the opportunity to provide additional information regarding its financial operations. “Expansion” currently includes the following amendment requests, notification requests and applications:

- Adding grade levels
- Adding a site
- Adding an Arizona Online Instruction program

- Increasing enrollment cap
- Replication applications
- Non-school site transfer applications

Expansion requests may be received from charter holders that have been operating for several years or from charter holders that are just starting out.

ACTION REQUESTED

The Subcommittee must determine the conditions related to expansion requests that would require a charter holder to provide additional information regarding its financial operations. The Subcommittee may choose to adopt the same conditions as were adopted for renewal and five-year interval review purposes. However, in defining the conditions that will apply for expansion requests, the Subcommittee needs to determine what will happen when a charter holder does not have three audits that staff can review.

- Cash Flow Indicator – Performance under the Cash Flow indicator is determined by assessing the charter holder’s three-year cumulative cash flow. Performance criteria need to be developed for charter holders for which staff only has one or two audits available to review.
- No Audit Data – It is possible that a charter holder could submit expansion requests prior to the Board receiving the charter holder’s first audit. The Subcommittee could decide that when no audit data is available for review, the charter holder will be required to submit additional information regarding its financial operations. (The submission requirements will be determined under “ACTION ITEM #3 – Charter Holder Submission Requirements” – see below.)

Additionally, related to expansion requests, one work group member stated, “For some charter schools who may appear to have marginal financial viability based on the Board’s criteria, expansion of grade levels or students served may actually help the school become more viable. My suggestion is that the Board consider these factors and not just dismiss or reject an amendment request solely due to certain financial criteria not being met.”

ACTION ITEM #3 – Charter Holder Submission Requirements

Currently, charter holders that fail to meet the renewal financial performance standard must submit the following:

- A completed [Renewal Budget Plan](#) that includes one year of actual financial information and three years of projected financial information.
- A one-page narrative explaining the charter holder’s current financial situation and describing the specific steps taken by the charter holder to improve its financial situation and ensure the continued financial sustainability of the charter school(s).
- Evidence supporting the specific steps taken by the charter holder to improve its financial situation as identified in the narrative.

ACTION REQUESTED

With the new financial framework, the Subcommittee must determine if and how the submission requirements should be revised. For Subcommittee consideration, staff prefers that the submission requirements be:

- Standardized across all areas (renewal, interval reviews, and expansion eligibility) to the extent possible. This would be particularly true for submissions required as part of the renewal and five-year interval review processes. It may be necessary to differentiate the submission requirements for expansion requests, especially when the requests involve charter holders that have not yet had three audits completed.
- Not be dependent upon which indicator(s) the charter holder’s performance scored something other than “Meets Standard”. As such, to the extent possible, the submission requirements would not be

specific for each particular indicator. This would be particularly true for submissions required as part of the renewal and five-year interval review processes.

Additionally, the Subcommittee may want to consider whether as part of the submission requirements, the Board should ask the charter holder to provide its break-even ADM.

ACTION ITEM #4 – Financial Information for Staff Reports

For those charter holders currently required to submit the renewal application’s financial sustainability section, the staff report prepared for the Board meeting summarizes certain financial information from the charter holder’s previous five audits and information submitted as part of the renewal application. The staff report also includes the charter holder’s recent ADM history.

ACTION REQUESTED

With the new financial framework, staff requests the Subcommittee’s input on the information it would like included in staff reports prepared for when the Board considers requests (e.g., renewal, expansion) from charter holders that fail to meet the financial framework or for when the Board considers whether to take disciplinary action against a charter holder.⁵ As discussed below, staff has prepared [four options](#) for Subcommittee consideration.

- Full Financial Information – This option includes the raw financial data used in the financial performance indicators as well as other raw financial data (current assets, fixed assets, and current liabilities). It also includes the indicator data related to the charter holder’s performance under the framework (e.g., how many days unrestricted days cash the charter holder has).
- Modified Financial Information – The only difference between this option and the “Full Financial Information” option is that this option includes the raw financial data used in the financial performance indicators. It does not include any additional financial data.
- Indicator Data Only – This option does not include any of the raw financial data used in the financial performance indicators. It includes the indicator data related to the charter holder’s performance under the framework (e.g., how many days unrestricted days cash the charter holder has).
- Indicator Ratings Only – This option does not include any of the raw financial data or the indicator data. It only includes the rating (e.g., Meets Standard).

In addition to determining the specific data and the level of detail to be included in the staff reports, the Subcommittee needs to determine the number of fiscal years the information should cover. Staff requests that the staff reports include no more than five fiscal years of financial data.

Whatever the Subcommittee decides, staff proposes that this information would replace the current summary written by staff for the staff reports. Staff would continue to include the charter holder’s multi-year ADM trend in the applicable staff report prepared for the Board.

ACTION ITEM #5 – Revisions to Existing Renewal Application Instructions & Documents

A.R.S. §15-183(I) requires the Board notify a charter holder of its eligibility to apply for renewal at least 18 months prior to the contract’s expiration. For the current renewal cohort, staff notified the last charter holder of its eligibility in June 2012. The next charter holder will be notified in October 2012. Should the Subcommittee and full Board wish to make changes to the renewal application, this approximately four-month window provides the opportunity to do just that.

⁵ The matching funds associated with the NACSA grant are dedicated to updating ASBCS Online to ensure the Board has the information it needs to make data-driven decisions about the charter holders in its portfolio. After the full Board approves the financial framework, staff will work with the system developers to ensure that the necessary financial data is tracked and available.

ACTION REQUESTED

Since review of the Board's financial performance standard began approximately a year ago due to the current renewal financial standard resulting in a diverse group of charter holders with various levels of financial performance being required to submit the financial sustainability section, staff asks that the Subcommittee direct staff to do the following:

- Update the Renewal Application Instructions to reflect that one or more "Falls Far Below Standard" and/or two or more "Does Not Meet Standard" will require that a charter holder to provide additional information regarding its financial operations.
- Update the Renewal Application Instructions to incorporate the submission requirements as agreed to during today's meeting for charter holders required to submit additional information with their renewal application packages.
- Make any other changes necessary to align the existing renewal application and related documents to the financial framework.
- Complete the changes so that the updated renewal documents can be presented to the full Board for approval at either the August 13th or September 10th meeting.

Action Items for Subcommittee Consideration

Item 1: Approve the indicators and thresholds as presented at the meeting with the inclusion of the modifications discussed (may require specific reference depending upon whether clarification of discussion is needed).

Item 2: Approve the conditions related to expansion requests that would require a charter holder to provide additional information regarding its financial operations.

Item 3: For charter holders required under the financial framework to provide additional information regarding their financial operations, determine what information the Subcommittee would ask be submitted as part of the renewal and interval review processes and expansion requests.

Item 4: Determine the financial information that the Subcommittee would like included in staff reports for when the Board considers requests (e.g., renewal, expansion) from charter holders that fail to meet the financial framework or for when the Board considers whether to take disciplinary action against a charter holder.

Item 5: Direct staff to make the necessary changes as outlined in the staff report and discussed during today's meeting to the Renewal Application Instructions and related documents so that they can be presented to the full Board for approval at either its August 13th or September 10th meeting.