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

In an effort to increase the quality of the Board’s portfolio of charter schools, the Board is developing a performance-based framework for the purposes of monitoring and measuring a charter holder’s academic, operational and financial performance. The Board is establishing a standard for each performance area (academic, operational and financial). Where the contract and law support compliance with the standard(s) or individual indicator(s) within the standard(s), the Board will intervene, as appropriate and necessary, through corrective action or other disciplinary action. Corrective action plans may be required as part of the annual or five-year interval review processes, or as necessary through other monitoring/oversight processes. Minimally, a charter holder’s performance under the performance framework will be considered by the Board during five-year interval reviews and when making decisions about eligibility for expansion and ultimately renewal of the charter.

**Background – Financial Performance Standard**

For the first renewal cohort, all charter holders were required to submit a standard detailed business plan with their application.<sup>1</sup> 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.

For the second renewal cohort, the detailed business plan section was scaled back and criteria were set for determining which charter holders would be required to submit the financial sustainability section of the application based upon whether one or both of the two previous audits identified a going concern or identified year-end negative equity. The current renewal criteria have resulted in a diverse group of charter holders with various levels of financial performance being required to submit the financial sustainability section.<sup>2</sup>

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.

**Proposed Financial Indicators**

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”.

At the September work group meeting, members spent a significant amount of time discussing the purpose for and the Board’s use of the financial performance standard. Support was expressed for using financial performance to help determine whether charter holders will be able to fulfill their contractual obligations or

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

<sup>2</sup> Current financial sustainability section submission requirements: 1) a completed Renewal Budget Plan that includes one year of actual financial information and three years of projected financial information; 2) 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); and 3) evidence supporting the specific steps taken by the charter holder as identified in the narrative.

should be allowed to expand their operations (e.g., adding a site). Concerns were raised too. Some members expressed concern that with a financial standard the Board may try to involve itself in schools' day-to-day financial decisions and operations or may try to prevent charters from failing financially. Those present at the September meeting also believed strongly that charter holders should be allowed to provide additional information or clarification to the Board if their performance did not meet the Board's financial standard.

During the January work group meeting, which was facilitated by NACSA, members reviewed and provided input on several possible financial indicators related to the following:

- Audit Opinion
- Going Concern
- Year-End Equity
- Debt to Asset Ratio
- Cumulative Net Loss Over 3 Years
- Total Margin
- Net Cash – Operating Activities
- Cash Flow
- Debt Service Coverage Ratio
- Current Ratio
- Unrestricted Days Cash
- Payment of Obligations
- Default on Loan(s)
- Loan Covenants and Debt Service Payments
- Budgeted to Actual Enrollment Variance

For Subcommittee consideration, staff has prepared a [discussion document](#) that includes possible financial indicators and performance thresholds.<sup>3</sup> In creating the discussion document, Board staff considered feedback provided during the two work group meetings, information shared by NACSA, and suggestions made by two Board members. In the discussion document, staff was unable to address one major item raised during the work group meetings. During discussions, some work group members noted the variety of charter schools that currently operate in Arizona (e.g., small versus large, new versus established, “mom and pop” versus EMO/CMO managed) and raised concerns about a one-size-fits-all financial standard. Board staff asked NACSA whether it has peer comparison data/tables that could be used to inform the thresholds in the Board's standard. NACSA indicated that it does not have access to such information.

In its current form, the discussion document does not include an indicator that specifically addresses a charter holder's average daily membership (ADM), which determines to a large extent the charter holder's funding. Instead of developing a separate ADM-specific indicator, the charter holder's multi-year ADM trend will be included in the applicable staff report prepared for the Board, as is currently done when the Board considers renewal application packages.

For Subcommittee consideration, staff has also included [testing results](#) showing 11 charter holders' performance against six of the proposed financial indicators.<sup>4</sup> Staff selected 10 charter holders to be included in the testing. Based on discussions with NACSA, an eleventh charter holder was added. NACSA reviewed the fiscal years 2009 through 2011 audits for the 11 charter holders and developed the testing results report. The colors included in each report's “Financial Health Indicators” section correspond to the colors used in the discussion document for the “Meets Standard”, “Does Not Meet Standard” and “Falls Far Below Standard” categories.

### **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:

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<sup>3</sup> The audit opinion indicator has not been included in the financial framework as it will be addressed through the operational framework.

<sup>4</sup> Please see the “Related Changes to Fiscal Year 2012 Audit Documents” section of this document for additional information regarding the “Debt Service Coverage Ratio” indicator.

- 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 provide the charter holder the opportunity to offer 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.

**Related Changes to Fiscal Year 2012 Audit Documents**

If the Subcommittee chooses to propose including the “Debt Service Coverage Ratio” and/or the “Unrestricted Days Cash” indicators in the financial framework, the following will need to be incorporated into the fiscal year 2012 audit documents, which include the audit guidelines and compliance questionnaires:

- Debt Service Coverage Ratio (DSCR) – Early on during the testing conducted by NACSA, questions arose regarding whether the information necessary to calculate the DSCR is available through the annual audits. One of the charter holders included in the testing is not in compliance with numerous debt service requirements and is unable to meet ongoing debt service requirements as a result of being jointly liable for bond debt with another charter school that ceased operations. Although the charter holder has received notice of default from the bond trustee, the DSCR calculated using information from the fiscal year 2011 audit implied that the charter holder was able to service its debt.

*Potential Impact on Audit Fee* – The information used to calculate the DSCR is readily available to the audit firm and the calculation itself is relatively simple. Therefore, asking the audit firms to calculate and disclose the DSCR in the audit reporting package is expected to have a nominal impact on the audit fee.

- Unrestricted Days Cash – Classroom Site Fund (CSF) monies provided to charter and district schools must be used in accordance with A.R.S. §15-977. Because the law limits how CSF monies may be spent, if a charter holder does not spend all of the CSF monies it received during the fiscal year, then at the end of the year, the charter holder needs to have enough cash in the bank to cover the unspent portion from current and prior years (“carryover”). Since the CSF carryover monies may only be used for the purposes specified in statute, any year-end CSF cash carryover balance should be removed when determining the charter holder’s unrestricted cash. The simplest way to obtain this information for each charter holder is to require its disclosure in the compliance questionnaire.<sup>5</sup>

*Potential Impact on Audit Fee* – In order to answer Question #7 in the “Classroom Site Fund” section of the compliance questionnaire, the audit firm must know the CSF cash carryover balance at year-end. Therefore, asking the audit firms to disclose the CSF cash carryover balance in the compliance questionnaire will not increase the audit fee.

**Items for Subcommittee Consideration**

Item A: Discussion regarding and approval of the financial indicators to be included in the financial framework that will be presented to the full Board.

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<sup>5</sup> In reviewing the testing results for the “Unrestricted Days Cash” indicator, please note that the Classroom Site Fund cash carryover balance at year-end may not have been removed for this calculation due to the balance not being disclosed in the audit.

- Item B: If the financial indicators approved in Item A include the Debt Service Coverage Ratio, Unrestricted Days Cash, or both, direct Board staff to make the necessary changes as outlined in the staff report and discussed during today's meeting to the fiscal year 2012 audit documents that will be presented to the full Board at its June 11<sup>th</sup> meeting.
- Item C: Discussion regarding and approval of the conditions which: 1) will waive the charter holder from any submission requirements related to its financial operations; and/or 2) will provide the charter holder the opportunity to offer additional information or clarification that will be used to inform the Board's decision-making.