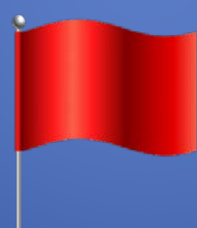
POLICY REPORT #2 IN A SERIES
MARCH 21, 2018

RED FLAGS: NET LOSSES



Warning Signs in the Financial Data of Arizona's Public Charter Schools and Recommendations for Ensuring Sustainability

Policy Report #2 in a Financial Analysis of Twenty+ Years of Charter School Governance and Finances in Arizona

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The Essential Questions Explored in these Policy Reports

"What have the promoters of charter schools done with the freedom over their budgets, staffing, curricula and other operations granted to them by the Arizona Legislature?"

"What is the result of eliminating the substantial conformity of governance and finance rules for operating charter schools (financed from taxpayers' dollars) on the governance and finances of these entities?"

Executive Summary

Charter schools have been authorized in Arizona since 1996. Today Arizona enrolls a greater portion of K-12 students in charter schools than any other state in the nation. In 2016-2017, the annual growth in enrollment at charters exceeded that at district schools.

Part of the proliferation of charter schools can be attributed to the minimal fiscal oversight defined by law for these private businesses. The Grand Canyon Institute's (GCI) initial report in this series, *Following the Money,* noted questionable expenditures in three-quarters of charters. These transactions involved more than half a billion dollars. The recommendations in that report called for charters to be subject to state public procurement laws similar to those district schools must follow.

Red Flags: Net Losses is the GCI's next policy paper reflecting on the current state of charter school governance and finances. This paper focuses on the charters that have been authorized by and report to the Arizona State Board for Charter Schools (ASBCS). Charter schools continue to open, but they also close. The data on closures shows that over 40 percent of the charter school entities authorized by ASBCS since 1994 have subsequently closed. In 2014-2015, one in four charter holders lost more than $100,000 and more than half either did not meet the financial performance expectations of the ASBCS or had cash flow problems.

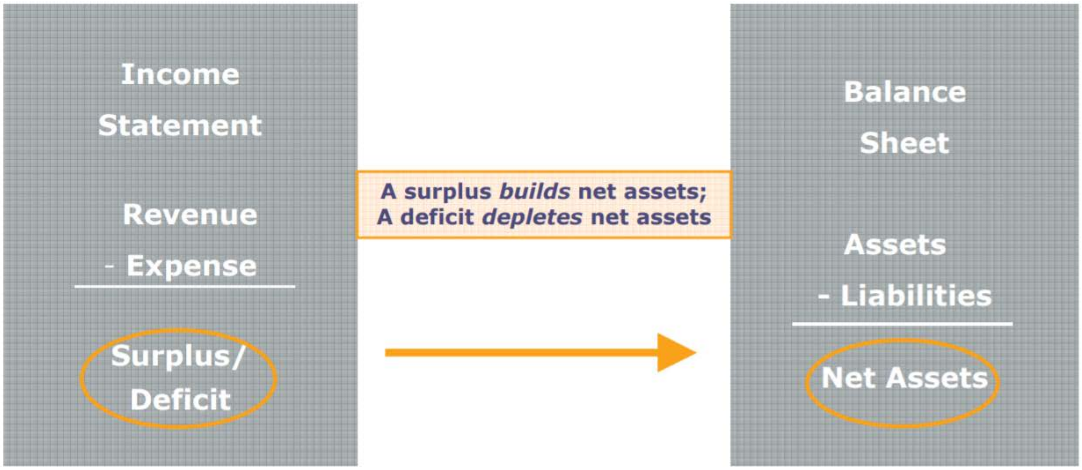
In the last two months, the ASBCS has revoked or moved to revoke the charters for two multi-million dollar financially failed charters with problematic academic performance as well. In both cases, Discovery Creemos and StarShine academies, the charter holder appears to have grained tremendously financial benefits from the inability of the ASBCS to take more proactive action. In both cases, the ASBCS had previously renewed the schools' charters for 20 years despite known problems due to limits in its statutory authority. Discovery Creemos suddenly closed on January 30, 2018. The ASBCS began an intent to revoke StarShine's charter on March 20, 2018, after notice under Chapter 11 bankruptcy proceedings of failure to make payments and possible fraud by the United States Trustee in the Department of Justice (StarShine declared bankruptcy in February 2016).

Red Flags: Net Losses is the first of two papers detailing the financial warning signs that present themselves in charter audits, IRS 990s, and Annual Financial Reports. Where appropriate, a forensic accounting method was utilized to analyze the data.[1]

Red flags show up in the data as multiple years of net losses (expenditures exceeding revenues). A cumulative picture of a charter's financial status is reflected in the net assets (deficits) section of the audits. This paper will purposely put this accounting language into laymen's terms.

The two are conceptually related as schools that consistently run net losses must pull from their assets or go into deeper long-term debt in order to sustain themselves.

[1] Forensic accounting involves a more in-depth look beyond numbers directly presented to analyze basis, consistency and comparisons.

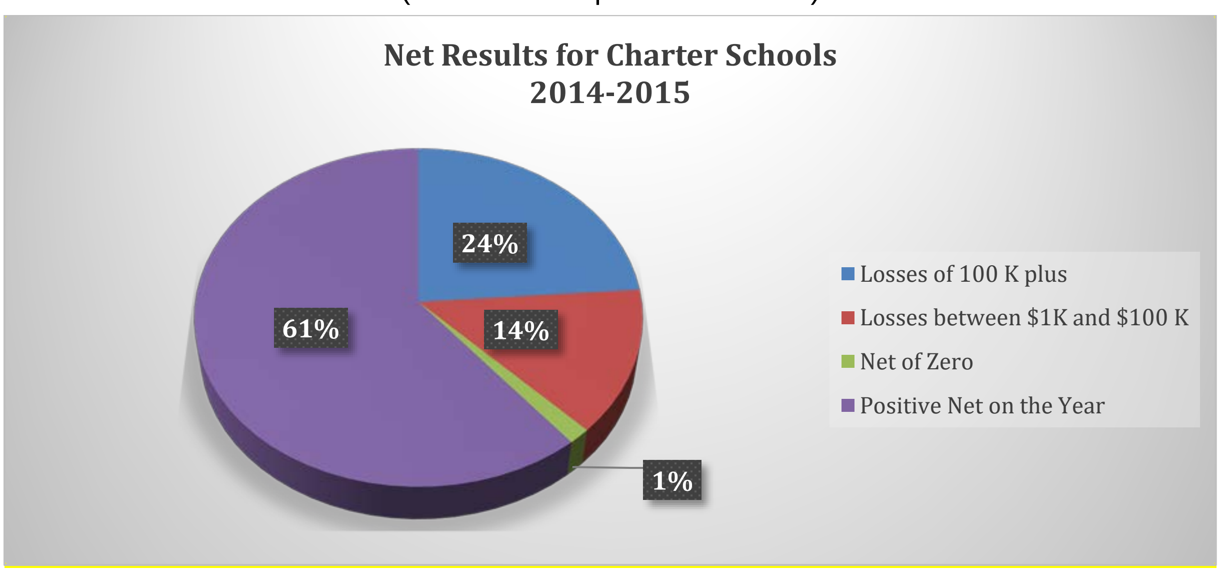


The recent "sudden" closure of Discovery Creemos Academy (formerly the Bradley Academy of Excellence) in the middle of the 2017 – 2018 school year and a similar closure in October of 2016 at Hillcrest Academy in Gilbert as well as the latest action by the ASBCS regarding StarShine Academy are symptomatic of the issues underlying charter financial losses and catastrophic financial failures. This paper examines some underlying causes of financial stress in the charter sector. We will show that more than one-third of charter operators have net losses and that these losses have occurred over multiple years.

In sharp contrast to the more laissez-faire charter school fiscal oversight are the strict financial checks and balances the state imposes upon districts that are in the red. Murphy Elementary School District is running a reported $2 million budget deficit, which exceeds the state-imposed revenue control limit by more than 5 percent. Consequently, the state can intervene proactively and take over the school district. While GCI is not advocating that the ASBCS take over financially troubled charters, they have no legal authority to close charters for financial reasons, which opens the door for "sudden" closures to occur.

Net Losses in 2014-2015

(Revenue – Expenditures = Net)



The red flags referred to in this report were abundantly clear in financial data of Hillcrest as well as Discovery Creemos and StarShine academies in the years leading up to their financial collapse.

Charter schools that have reported negative net assets to the ASBCS range from those with questionable academic outcomes to those whose graduates are among the top in the nation. Many of these charters share red flags in their underlying financial practices that appear to be unsustainable; others might recover but should have heightened oversight.

Without more proactive oversight, deeply in debt charter schools are forced to prioritize guaranteed payments to bondholders over classroom resources. GCI recommends changes to the financial oversight of charter schools that it believes will safeguard the public's investment in education while providing transparency regarding how tax dollars are being spent.

To its credit, ASBCS, the government agency responsible for governing the state's charter schools, created a Financial Framework to guide and monitor charter school financial practices in 2012. GCI applauds this effort to define the board's expectations regarding specific aspects of a charter school's financials. One-third of charters currently *do not meet* the board's financial performance expectations. This report goes beyond classifying the issues by probing the reasons behind the financial difficulties the board's rating system identifies.

Currently, the ASBCS cannot close schools for financial reasons. This report does not focus on academic closures or academically failing charter schools. *A charter school's academic underperformance has consequences* and the ASBCS, to its credit, has closed schools based on academic underperformance. However, our analysis of 2014 academic performance reveals that there is no causal link between academic performance or academic underperformance and financial success. Likewise, there isn't a clear causal link between financial failures and academic performance. This seems counterintuitive because one would assume parents would be choosing schools based on academics and those schools would be thriving financially.

Utilizing the data from FY 2014 cases like the following illustrative sample appear consistently in the data.[2] The sample data on financial performance is posted next to the FY 2014 academic score and is illustrated below.

These Glendale charter schools show a wide range of combinations of financial performance and academic scores in FY2014.

If there is not a clear connection between an educational business' academic and financial success, then what other factors are causing financial distress at our publicly-funded charter schools?

[2] The full list of FY2014 financial performance and academic scores is available at http://grandcanyoninstitute.org/wp-content/uploads/2018/03/AZ-Charters-Academic_and_Financial_for_2014.xlsx.

Illustrative sample of financial and academic performance[3] of charter schools in Glendale

Charter Entity	FY 14 Financial Rating	2014 Academic Score
Arizona Community Development	Meets ASBCS Financial Performance Expectations	53.75
Blueprint Educ.	Meets ASBCS Financial Performance Expectations	54.38
Camelback Academy	Does Not Meet Liquidity Falls Far Below	65.62
Challenge Charter Schools	Does Not Meet ASBCS Financial Expectations	85.62
Choice Academies	Meets ASBCS Financial Performance Expectations	80.88

Average Daily Membership[4] (ADM) statistics drive the distribution of state funding to the charter industry, the primary source of revenue for charter schools. State funding shows up as revenue from the state to the charter group. How the group allocates and spends the money is defined on the expenditure side of the audits.

While ADM at charters is increasing yearly, the top ten charter groups captured almost three-quarters of the student increases. The top five of that ten capture 60 percent.

Overall, charter school ADM has grown by 29,549 from FY2014 to FY2017. Most of that gain is captured by a few large charter organizations. Most of the remaining charters have either stagnant or declining enrollment. The chart below considers the amount of ADM captured by the top 10 charter organizations (i.e. the 10 with the highest ADM growth over 4 years)

New ADM Distribution over Four Years (FY 2014 through FY 2017)

Gain Represented by Top 10 Charter Companies	**84 Sites**
% ADM Overall Gain to Top 10 Charter Companies:	**73%**
ADM Numerical Gain Posted by Top Ten:	**21,703**
ADM Gain Shared by Remainder (417 Charter Corporations):	**7,846**
Total Numerical Gain of ADM FY 14 to FY 17 ALL CHARTERS	**29,549**

Why this matters

Charter schools frequently borrow money based on projected future enrollment growth. When that ADM growth fails to occur, long-term leases and loan payments that were premised on that

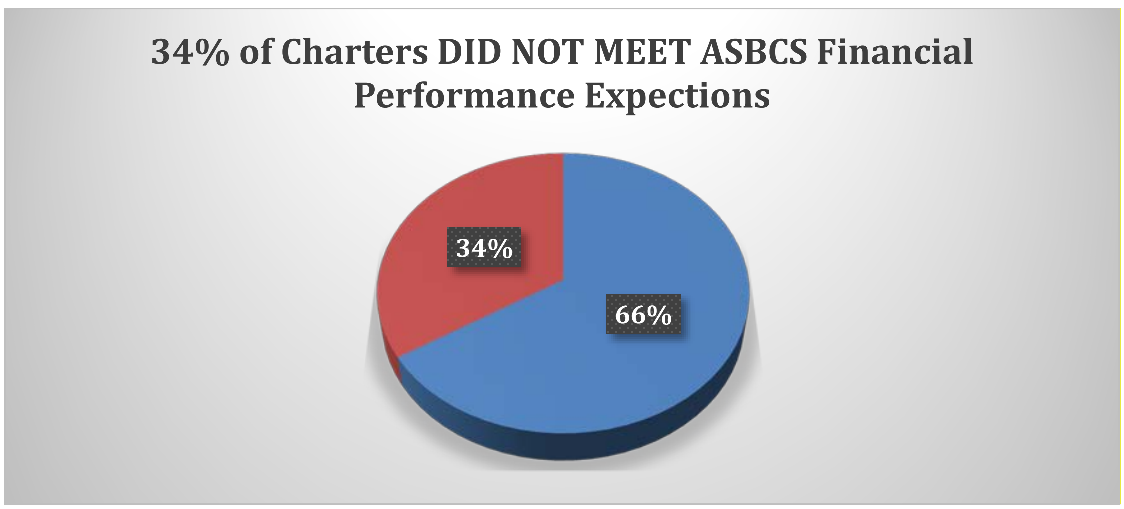
[3] Color coding in both frameworks is consistent. The colors move from Green to Red. On the academic side a 100 is a perfect score. The Challenge Charter School with a pink 'Does Not Meet' in the financial area has a dark green in the academic area, which is the highest range. Great academics do not ensure great financials.
[4] ADM which stands for **Average Daily Membership** is represented with up to three decimal point calculations. It is the number of days ACTUALLY attended by students at the school. Example: If a student misses six days due to illness the ADM is drawn down by 6 for that student. Kindergarten is reimbursed at 0.5 in the ADM calculation. SPECIAL EDUCATION figures are weighted ADM numbers, which increases the funding for those students so identified.

growth create expenditure requirements that exceed some charters' ability to pay their debt. Long-term lease commitments are typically seen in cases where the property is held by a related-party or affiliated corporate real estate holding subsidiary of the charter.

When debt or lease payments are not based on property-value but on an anticipated income stream (from ADM growth), liabilities can exceed asset value. We believe that the charter marketplace is over-leveraged with properties that are underwater, using a term from the last mortgage crisis. In this case, underwater means the property is not worth the amount owed on the debt and the charter's ADM is not materializing as expected. This topic will be explored in more detail in the second Red Flags report. Like the mortgage crisis in 2007 and 2008 this has been developing over a period of time. Over-leveraged bonds and loans generate negative net assets.[5] Refinancing to reduce debt payments is a short-term solution, but can be detrimental when used in the long term.

The ADM calculations and predictions that Industrial Development Authority (IDA) bonds and other financing loans are premised on for charter organizations *are not being met*. The financial distress caused by debt manifests as net income losses and net (deficits)[6] rather than their opposites, net income gains and positive net assets.

The statistics shown in the 2014-2015 net losses are caused by many factors several of which are addressed by this paper. The next policy paper, *Red Flags: Over-Leveraged Debt*, will delve into the debt and bond structures underpinning charter sector debt and property acquisition. The financial "tells" in the data (net losses and net (deficits)) are the topic of the current paper.



GCI supports a financially healthy and ethically managed charter school sector. It is a tragic loss when an academically performing innovative charter school fails financially. Emphatically stating that charters are being "run as businesses" does not excuse their management from fiscal responsibility for public funds. Charter school closures, especially those that occur during the school year, significantly disrupt the lives of students, teachers and families affected by these closures. Consequently, the ASBCS needs to be empowered to take on a stronger oversight role when charters such as Discovery Creemos Academy show signs of significant financial difficulty

[5] Negative net assets are written as net (deficits) on financial statements with a bracket to indicate the negative amount. This paper uses this convention and red coloring when there are net (deficits) indicated.
[6] The term 'net losses' will refer to 'revenues' that do not equal the company's expenses. 'Net assets' indicates positive net assets. 'Net (deficits)' indicates the company has a deficit (i.e. their net assets are in the red.)

instead of having no power to close a school for financial reasons and ending up renewing its charter authorization for 20 years a mere seven months before it collapsed.

Market corrections, the mechanism that is theorized to correct financial issues in charter schools, are not occurring in a timely manner. GCI's concern is that this problem could magnify without an improvement in oversight from the ASBCS.

Milton Friedman warned about this type of "business suicide" (Friedman 1999). Business suicide occurs when business owners seek out favors and exceptions from the rules that govern the use of the tax dollars that fund their businesses.

Friedman also famously noted:

"One of the great mistakes is to judge policies and programs by their intentions rather than their results." – Milton Friedman

These papers look at the results, not the intent of the free market theories underlying the charter sector. Red flags are a clear and present danger to the charter industry and the taxpayer dollars that fund public education.

In particular, the Grand Canyon Institute recommends:

1. ASBCS be given greater financial oversight power by the Legislature to put charters on probation and, if necessary, revoke charters from schools unable to meet financial improvement plans.

2. ASBCS Financial Performance Dashboard be revised so as to identify charters with financial problems earlier than the current dashboard allows for and that they more closely scrutinize the financial operations of these charters.

Details on these recommendations follow.

Summary of Findings & Recommendations

The ASBCS, as a regulatory body, has the responsibility of providing oversight for the state's charter schools. This responsibility has been evolving in an era where anti-regulation and free-marketplace beliefs have prevailed and dominated the charter economic model (theory of action).

The ASBCS, in its *Financial Performance Framework and Guidance* dated October 2017, states the following:

> *The Board, in its oversight of charter holders and the schools that they operate, strives not to be over-reaching, but also recognizes the need to protect the public's interests. Because charter schools are public schools they must maintain the public's trust that they are implementing their education program as set out in the charter, spending public funds responsibly, and adhering to laws and charter requirements regarding their operations. However, the Board is aware of the delicate balance between appropriate oversight and infringement on autonomy.*

Based on the findings of this report, the ASBCS' efforts—either due to limited legal authority, ideological mindsets or lack of resources—have favored charter holders over taxpayers' interests and the state's children. It is time that the ASBCS' mandate and its ability to proactively oversee charter schools be revisited and strengthened.

1. **Finding:** Average Daily Membership predictions are not being met at the majority of charters.

Change in ADM from FY2014 to FY2017

Gained at least >0.5% ADM	Zero or Lost ADM (<0.5% ADM Change in ADM)
187 Charter Entities	**240 Charter Entities**
44%	**56%**

   a. ASBCS currently can only not renew a charter OR renew it for 20 years, nothing in between.
   b. Charter schools commonly use <u>*Educational Revenue Bonds*</u> through Industrial Development Authorities to finance debt that is premised upon obtaining new students (ADM). These bonds are marketed and rated (normal bond or junk bonds) with greater weight placed on the charter's <u>*projected*</u> ADM counts and less weight placed on the **existing** property value of the charter school. This topic is further explored in the next *Red Flags* report.
   c. New ADM Distribution over Four Years (FY 14 through FY 17)

Gain Represented by Top 10 Charter Companies	**At 84 Sites**
% Gain to Top 10 Charter Companies	**73%**
ADM Gain Posted by Top Ten	**21,703**
ADM Gain Shared by Remainder (417 Charter Corporations)	**7,846**
Total Gain of ADM FY 14 to FY 17 ALL CHARTERS	**29,549**

University sanctioned charters gained 2,414 ADM during this time frame. Which means the remaining charters (outside of the top 10) actually shared a gain of 5,432 ADM.

Recommendation: The Arizona Legislature must grant the ASBCS the authority to place charter holders on financial probation as well as to close them if charter holders do not effectively implement a financial improvement plan within a specified period of time.

2. **Finding:** About 4 in 10 charter holders are showing signs of financial distress—either suffering net losses or otherwise not meeting the financial performance expectations of the ASBCS. However, often it takes two to three years of substandard financial performances to have a 'Does Not Meet' rating from the ASBCS. The ASBCS does not currently closely examine the financial transactions of these charters, including transactions with related-party or affiliated subsidiaries that operate outside public procurement requirements.

   Recommendation: The ASBCS should perform annual financial performance expectation reports rather than the current practice of grading charter organizations based on two years of financial data.

   a. **That a charter entity which 'Does Not Meet' the ASBCS Financial Performance Dashboard Expectations receive a thorough review of the underlying financial decisions behind those weaknesses identified in the Financial Performance Expectations. This would require an in-depth review of the charter organization's audit and supporting financial records as well as possible inconsistencies in related financial documents associated with the charter, i.e. IRS 990s and Annual Financial Reports submitted to the Arizona Dept. of Education. ASBCS should bring any concerns and recommendations to the attention of the charter holder.**

   b. **That any charter entity *that has negative net income and/or net asset (deficits)* be required to submit the audits of any related-party or otherwise affiliated subsidiaries dealing with that charter that operates outside a public procurement process. The current system allows these companies, whose sole source of income comes from taxpayer funding via the charter school they conduct business with, to operate without financial oversight from the ASBCS and the public.**

   c. **That charter school audits be required to include details on revenue and expenditures rather than gross accounting for the Charter Program and Management and Other.**

   d. **That charter organizations that show negative net income and/or net asset (deficits) for consecutive years be placed on financial probation and be required to submit an action plan for correcting the deficits. Continuation of the charter organization's charter should be determined at an ASBCS board meeting after operating for two years on financial probation and a thorough review of the plan’s efficacy.**

3. **Finding:** Red flags emerge in the financials for charter schools well before they fail financially. Failure to intervene allows debt to increase, leading to greater risk to investors and resources being diverted from the classroom to bondholders.

   Recommendation: The ASBCS Financial Performance Dashboard currently has no "falls far below" criteria for its three sustainability measures. GCI recommends that two "falls far below" criteria be developed for these sustainability measures.

   a. **The ASBCS should replace the Fixed Charge Coverage Ratio (FCCR) with the Debt Service Coverage Ratio (DSCR).[7] The FCCR measures how much net income a business has relative to what it needs to cover debt payments and obligations, but does not make exceptions for one-time costs or (noncash) depreciation. Because net income is also tracked and includes these costs, DSCR, which excludes these, is a better overall measure of the long-term ability of a charter holder to service debt. Industrial Development Authority (IDA) charter bonds typically have a DSCR requirement, but make no mention of a FCCR.**

   b. **If the FCCR is used, the current 1.10 ASBCS standard is appropriate. However, if the FCCR falls below 1.0, then the business must rely on cash reserves or maneuvers that delay debt payments in order to meet this obligation or simply take on more debt. Hence, falling below 1.0 should be classified as 'Falls Far Below.'**

   c. **If the DSCR is used, charter IDA bonding agreements typically require a minimum ratio of 1.15 (DSCR will be equal larger than the FCCR). That should be the standard. Falling below 1.0 is considered a sign of likely default and should be the "Falls Far Below" standard.**

   d. **Net income. Net income is related to net assets, as when net income is negative (a net (deficit)) it reduces the firm's net assets. The ASBCS currently has a standard that if net income is negative then the charter school 'Does Not Meet' the standard, but does not define a standard for 'Falls Far Below.' Since the ASBCS has no formal criteria regarding net assets, GCI recommends that if net income <u>and</u> net assets are negative that the charter holder be deemed as 'Falls Far Below' the standard. Alternatively, if net income is negative and 5 percent or more of expenses, it should also be noted as 'Falls Far Below', as normally negative net income greater than 3**

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[7] The Fixed Charge Coverage Ratio (FCCR) = (Net Income excluding interest + Fixed Charges)/(Fixed Charges + Interest). Fixed Charges are expenses that do not vary based on the number of students in a charter context such as insurance and lease/property costs. Net income is the overall profit or loss of the operation. An FCCR of 1 means a charter has just enough overall income to meet its debt and interest payments. The Debt Service Coverage Ratio (DSCR)=(Net Income excluding debt payments + noncash expenses like depreciation + one-time charges not paid in cash)/(interest and principle payments). The DSCR focuses on items paid for in cash. So Net income gets to add back depreciation and is divided by the debt payment. A DSCR of 1 means you have just enough cash to make your debt payment. For example, take a charter with round numbers and rough categorization. Net Income=$700,000. Fixed Charges (management fees, insurance, legal, accounting, occupancy)=$6,500,000. Interest=$2,200,000. FCCR= ($700,000+2,200,000+$6,500,000)/($6,500,000+$2,200,000)=1.08. To calculate DSCR, include depreciation=$250,000. Debt amortization (principle)=$200,000. Noncash loss on disposal of assets=$50,000. DSCR=($700,000+$2,200,000+$200,000+$250,000+$50,000)/($2,200,000+$200,000)=1.42. As this example illustrates, the DSCR will always be greater than the FCCR because it excludes noncash expenses. In this case 1.42 compared to 1.08.

percent of expenses is the threshold for serious cause for concern. Likewise, 5 percent parallels the 5 percent threshold for state takeovers of district schools.

4. **Finding:** Raising standards of financial accountability need to be enforced in order to be impactful.

   Recommendation: The Arizona Legislature should allocate adequate resources to the ASBCS so that it can fulfill its obligations as the regulatory body overseeing the majority of the state's charter schools and ensure that it is sufficiently staffed to meet the technical tracking needed to effectively meet the recommendations in this report.

Introduction

Red Flags: Net Losses is the second policy report in a series of papers produced by the Grand Canyon Institute (GCI) to analyze the current financial and governance structures of Arizona's charter school sector.

The title of this report, *Red Flags: Net Losses*, refers to the financial warning signs manifest in the data on charter schools. The data used for these reports is publicly available and includes information taken from charter school Audits submitted to the Arizona State Board for Charter Schools (ASBCS), Annual Financial Reports (AFRs) submitted to the Arizona Department of Education (ADE) and 990 forms filed with the IRS by non-profit organizations.

This policy report and the upcoming *Red Flags: Over-Leveraged Debt* that will follow later this year will demonstrate that the financial practices in this marketplace are similar to the deregulated, overextended, and overleveraged mortgage industry prior to and during the last real estate and financial market crash in 2007-2008. Red flags were present in that marketplace and ignored by the companies profiting from the debt markets.

Forty-three percent of Arizona's charter schools have gone out of business since 1996. This figure is not out of line with other states that have embraced a free market approach to public education. However, as the number of Arizona children relying on charter schools for their education rises, so does the responsibility to tighten oversight of possible disruptions to their learning environment. By highlighting the red flags, GCI's hope is that public policy can be adjusted to eliminate the financial dangers to our system of public school financing[8]. We support the concept of free public charters and salute those players in the current marketplace who run their charters in an honorable and financially sustainable way. These charter champions invest their own resources and private funding to ensure the success of their schools. The red flags in the data are a warning sign for the best charters and the public school systems (districts). In a state that prides itself on fiscal conservatism we cannot afford avoidable losses to our taxpayer-funded public education efforts.

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[8] The statistic used here is generated using data from a 2014 ASBCS print out provided to the author in December of that year, data on the ASBCS webpage on closed charters, and extended information available from the pro-charter think tank The Center for Educational Reform. These listings have been shared with the ASBCS leadership team and are available on request from the GCI.

Free market theory applied to a public good

The free market economic theories of Fredrick Hayek (Hayek 1941, Hayek 1944) and Milton Friedman (Friedman 1962, Friedman and Friedman 1980, Friedman and Friedman 1982) have been cited as reasons and justifications for supporting charter and private schools with public funds.

The stated purpose for this use of public funding paid directly to charter companies was to allow parents to choose where to send their child for their publicly-funded education (choice). Open enrollment, a first step in offering choice in Arizona, allowed parents to send their children to any public district or charter school in the state.

Privatization of a public good through direct payments to charter corporations from publicly raised funds (taxation) has been theorized to lead to competition, innovation, individual *choice* and improved academic performances.

The economic theories were written into laws that allowed charter holders to own the building and assets of publicly-funded, privately-held, businesses. At the same time, charter owners were exempted from the procurement practices regulating public districts, a *de facto* deregulation of one sector of “public schools”. The “competition” - district schools - continue to follow the policies and regulations that were in place when public charters were allowed to enter the market.

A recent ousting of a district Chief Financial Officer in Scottsdale, Arizona, for engaging in related-party purchases resulted in community outrage and multiple stories in the local and state press regarding this impropriety. Rightfully so.

In the free markets of charter schools, related-party transactions are not only legal but engaged in at over 77 percent of the charters evaluated. The other 23 percent of charters either do not engage in the practice or do so in a manner that saves the school money and provides efficiencies. The practice is banned in school districts, no matter what the rationale is.

An economic theory applied to a public good

Economic theories have driven and guided the financial and governance practices seen in the Arizona charter school movement since their inception in 1994. The theories imply that taxpayer funds, euphemistically termed “backpacks full of cash”, follow students to their “public school of choice”. Once the state pays the charter its ADM funds they ***become the property of the charter holders to use as they and their boards, (corporate and governing), see fit.***

The caveat is that they must produce academic results.

While there are financial performance expectations articulated by the ASBCS as the governing agency, the board maintains a hands-off approach regarding how charters manage their finances. Currently, <u>*the ASBCS does not have the authority to close a charter school for poor financial performance, nor does it have the authority to require a financial correction plan. This paper will argue that, as the governing agency, the charter board should have that authority.*</u>

This deregulation of public school financing has created an opportunity for charter schools to apply business models that ensure the business maximizes its profits.

This paper asks, <u>*which business*</u>?

Is it the charter school business where the children are actually educated or the for-profit, subsidiary (often related-party) firms set up as management groups, employment agents, and service providers that do business with the charter schools that they are subsidiary to?

This business method, using subsidiaries, creates the opportunity for charter holders to ensure profits for themselves and their boards. By creating subsidiary related-party companies that sell services (and at times goods) to the related charter entity, the firms can command a premium for providing related-party services outside of public procurement processes and without sufficient public disclosure. That 'premium' is paid for with taxpayer dollars.

The plethora of red flags in the data are a “tell” that these services are not a means for the charter (i.e. the actual charter school) to save money by increasing efficiency which is the logic used when the industry defends the practice.

The usual rhetorical response involves citing an example that DOES fit these criteria, (indeed 23 percent of the market DOES increase efficiency and save money with these types of transactions).

In fact, in the other 77 percent of cases, these practices are ***the antithesis of money saving and efficiency for the charter school entity paying for their services***. The result is the net losses and net (deficits) on the charter school’s financials and reflected in the audits.

The now defunct Discovery Creemos (aka Bradley Academy of Excellence) had related-party transactions involving Daniel Hughes, the operator of the charter, amounting to half a million dollars. This occurred at the same time, the charter was spiraling into deeper and deeper debt. Likewise, Hillcrest Charter which went under in October of 2016 used Management Contracts and Leased Teachers with a related party corporate subsidiary as part of its financial strategy. The financing for Hillcrest was investigated by FINRA and the financing agency lost its license to broker bonds (See Appendix).

When charters are losing money and at the same time funneling large portions of their money to for profit subsidiaries that do not report to the ASBCS those transactions undermine effective financial oversight and transparency regarding how taxpayer funding is being spent.

Often charter schools believe they can grow their way out of their financial problems, an option pursued by StarShine Academy. That charter went a further $12.7 million in debt to build a new larger campus, but struggled financially when huge projected enrollment growth never materialized.[9] StarShine was forced to declare bankruptcy under Chapter 11 in February 2016, but remained open. Last week the United States Trustee overseeing the bankruptcy found further malfeasance and filed an emergency motion in bankruptcy court “to stem the tide of the state’s assets being squandered for Ms. McCarty’s personal use.”[10]

GCI thinks increasing the ASBCS’ authority is critical in tracking what occurs with taxpayer money when a charter school shows signs of financial problems. The ASBCS lacks the authority to

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[9] Pima County Industrial Development Authority Bond, Education Facility Revenue Bonds (StarShine Academy Project) Series 2013, Official Statement Dated May 30, 2013, and StarShine FY2017 Audit by Holcomb and Shreeve PC, Mesa, AZ.

[10] Arizona State Board for Charter School Special Meeting, March 20, 2018, transcribed audio, https://asbcs.az.gov/board-staff-information/meeting-dates-materials.

request the audits of related-party subsidiaries even when a nonprofit charter holder reports multiple years of negative net income and negative net assets. The StarShine case illustrates the need for more careful review of the financial management of charters that do not meet financial performance expectations. Taxpayers should not have to rely on bankruptcy courts to discover malfeasance, if it occurs.

Where has that Expected ADM Increase Gone?

Statistics on the growth of the charter school sector appear positive with nearly 30,000 additional students from FY2014 to FY2017.

FY 14 to FY 15	*FY 15 to FY 16*	*FY 16 to FY 17*	**4 Yr. Gain**
10,949.69	**3,281.51**	**15,318.28**	**29,549.49**

The devil is in the details regarding where that growth went. Who is choosing and who is losing[11]?

We will show that the ADM distribution is far from even. One charter operator, BASIS, has captured nearly 20 percent of that growth alone. One reason is their academic prowess and outstanding programs. Another is their ability to fund new entities.

Four Years of ADM at BASIS Inc.

FY2014	**FY2015**	**FY2016**	**FY2017**
6,517.20	**8463.779**	**10405.614**	**12200.023**

From FY 2014 to FY 2017, BASIS' ADM grew, by 5,682.82 students to 12,200.023. Equalized Valuation Payments, the state government funding provided to public schools, is based on ADM. These new students were housed in 18 separate BASIS sites; an increase of 8 sites since FY2014 and up from just 2 sites in FY2010. There is market demand for their product[12].

The data on ADM for four years (FY 14 through FY 17) shows that the growth for the entire charter sector is uneven at best as73 percent of charter growth went to 10 charter groups.

After 20 plus years the charter free market is consolidating around the largest charter groups.

Charters that had a Gain of >0.5% on ADM
187.00
Charters that had a Gain of <0.5% on ADM
240.00

Negative or Growth Less than 0.5% may lead to financial problems as many charters have built debt payments around projected growth in ADM.

[11] Who Chooses, Who Loses was the title of an early review regarding charter schools and vouchers (Fuller, 1997 #283).

[12] The market is driving this growth along with BASIS' strategic placement of new sites. This company's business model is sound. The issue being discussed is not BASIS' growth but the lack of growth at charters that premised their debts on ADM that did not materialize.

427.00 Total Charter Count FY 17

The dark side of related-party transactions, net losses, and net (deficits) shows up at charters that fail when expected ADM predictions do not materialize.

What happened to those properties and the properties of the other charters that have failed over the years?

Private property

Property and equipment (assets) owned by charter schools are privately held by the charter holder(s).

Despite the phrase, "public charter schools" in the jargon, the property and assets of these schools are considered privately owned assets. A school's student counts (ADM, Average Daily Membership), the primary source of revenues used to operate charter schools, are considered assets in this marketplace. The term "Educational Revenue Bonds" is a reference to the source guaranteeing those bonds, revenue following the children attending the charter school.

Arizona Law spells out this ownership of property and assets.

AZ 15-183: Sections S and T spell out the use of charter school property for credit purposes and then states who owns the property accumulated by the charter school.

> S. Charter schools may pledge, assign or encumber their assets to be used as collateral for loans or extensions of credit.
>
> T. All property accumulated by a charter school shall remain the property of the charter school[13].

Note that assets in the charter school world go beyond physical assets, i.e. they include projected future ADM growth, i.e., growth in future revenues[14] from the state. Prior to items S and T, items O and P of the same Charter Law (AZ 15-183) are designed to limit the liability of the taxpayers, (State) and the sponsors of the charter schools (i.e. the charter authorizers, which in most cases is the ASBCS). Items O and P discuss liability of the sponsoring agencies and the state.

> O. A sponsor, including members, officers and employees of the sponsor, is immune from personal liability for all acts done and actions taken in good faith within the scope of its authority.
>
> P. Charter school sponsors and this state are not liable for the debts or financial obligations of a charter school or persons who operate charter schools.

In addition, Charter Companies generally organize their businesses as Limited Liability Corporations (LLCs), Limited Partnerships and/or C Corps (and S Corps) as a way of shielding

[13] The charter holder(s) are the owners of most charter schools.
[14] The fact that the IDA calls these loans Educational Revenue Bonds and other financial groups use the same terminology is a tell that the physical assets are only part of what provides collateral for the loans. Our students and the funding that follows them are the justification used for these risky loans.

the charter holder(s) and their corporate boards and governing boards from personal financial losses in the event that the company fails. Many businesses in the private sector use these corporate classifications to prevent personal losses due to bankruptcies and business debts. It is common business practice when organizing a corporate structure. The governing board, ASBCS, is not liable for actions taken in good faith. A difficult thing to prove.

Missing the warning signs

This paper will show that as of December 2017 a total of 66 charters had red marks on at least one Financial Performance Standard on their Arizona State Board for Charter School Financial Performance reviews[15]. A red mark, as will be shown, indicates a GOING CONCERN on the ASBCS financial performance framework.

In 2012 ASBCS developed and implemented a financial performance framework. GCI applauds this effort and the board's recent upgrade of the Financial Framework.

The current ASBCS Financial Performance Framework is often cited as proof that the financials of charters are being monitored.

That theory of action is tested in this paper. We will show that the audited financials that the Finance Performance Framework relies on for data only tell a part of the story in the charter industry. Too many transactions in the charter marketplace are invisible to the taxpayers funding public educational spending.

Hidden figures

Hidden from public scrutiny and auditing by the governing agency are multiple "for profit" related party subsidiaries of non-profit (and for profit) charter corporations.

These subsidiary companies are set up to accept direct payments from the related charter school. The subsidiaries then sell "services" back to those schools. All of the subsidiary companies' revenues come from the charter school companies[16].

Red Flags: Net Losses looks at the financial risks to the public from the funding of these privately held properties and assets with guaranteed payments from taxpayer sources. This paper analyzes the Negative Results in the metadata collected in two, three and sometimes 10 years of audits. Additional sources for this data are Arizona Department of Education Annual Financial Reports (AFRs) and Superintendent's Reports from the same two to ten year period and IRS 990 Data from 2011 to 2016. In addition, researchers looked at IRS Form 990s and public information sources regarding the privately held subsidiaries used by so many charter companies and the use of taxpayer funds to support these deregulated privately held companies.

Properties and assets accumulated by private firms utilizing guaranteed payments from taxpayer sources should be subject to the same scrutiny as similar purchases made by district schools.

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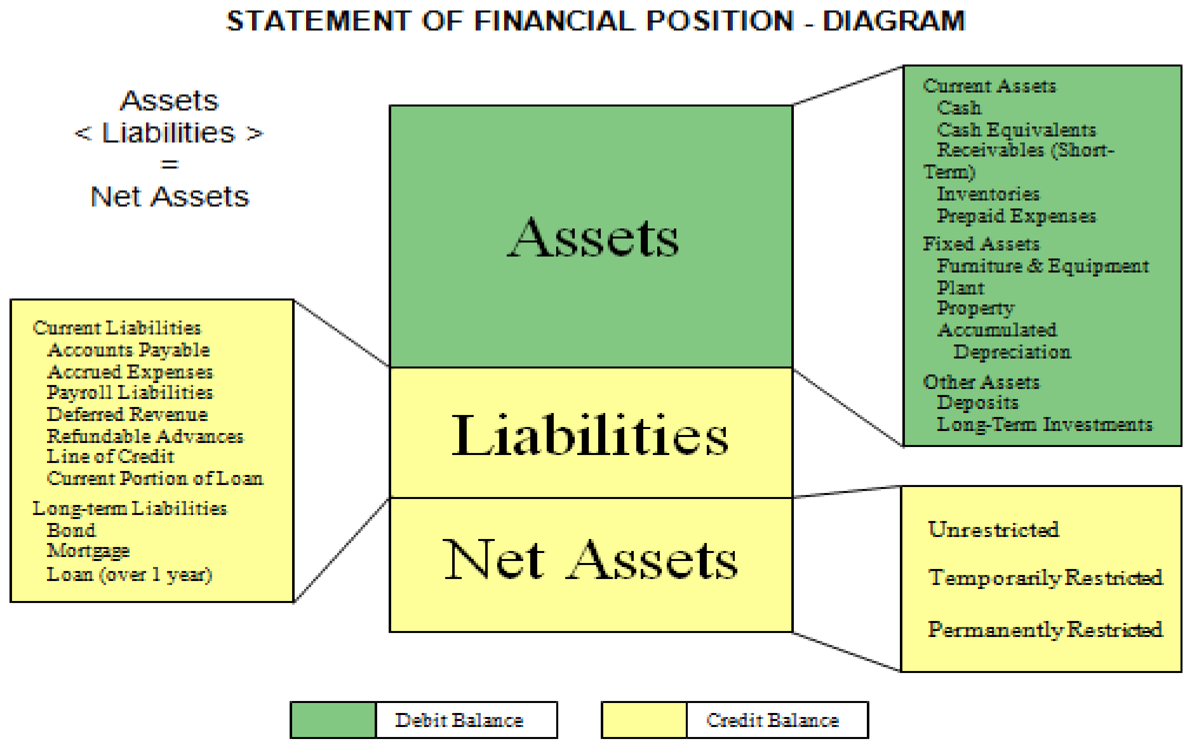
[15] (Source: *Currently listed financial performance reports* for 2015-2016 and 2016-2017).

[16] Intercepts, a topic in the next paper in this series involves direct payments of debt to the bond holders from the Department of Education. The debt is "Guaranteed" by those Equalized Valuation Payments on ADM.

This report focuses on the nets, the difference between Revenues and Expenditures, (sometimes referred to as a profit) in four years of data. Most readers will find this information easy to understand and will be able to relate the figures provided to their household budgets. Negative spending in that arena involves mortgage debts, credit cards, and re-financing of your personal debt to make ends meet.

Net assets (deficits) of charters in Arizona are a long-term look at the finances of the business in question. The business in the diagram on the following page has net assets, which means that there is a balance between its current and long-term liabilities and assets.



The antithesis of this healthy balance (when LIABILITIES exceed ASSETS) is termed net (deficits). This report goes into depth regarding the current state of nets and net (deficits) in the charter marketplace. When the liabilities are greater than the assets, a net (deficit) is the result.

The deregulation of public school financing has created an opportunity for charter schools to apply business models that ensure the business maximizes its profits. As Milton Friedman would say this is the purpose of a business, to make a profit (Friedman, 1982; Friedman, 1990). GCI does not take issue with a business making a profit. However, the same economist warned about "business suicide" (Friedman, 1999), which happens when a business seeks exceptions from the government to support their efforts to capture additional funding from the government. We will argue that the current structure is giving businesses too much leeway, which heightens the danger of a financial collapse.

“Red Skies in the Morning, Sailor take Warning”

Mariner’s saying

“Financial red flags in schools are only ignored by fools”

Advice given at a symposium on school finances

Public Money

Topic I. Charter School Revenue & ADM

Money from public sources

In Arizona, the state provides the bulk of the money that funds public education. Charter schools and public district schools receive Base Support Level (BSL) funding, which is computed based on a weighted student count multiplied by the statutory base level. The amount districts receive is prorated based on their community's equalized funding rating based on property values. Additional money from donations etc. will be covered in another section of this report.

Charter schools also receive *Additional Assistance*—a per-pupil dollar amount set by the legislature and multiplied by the simple, non-weighted student count. Additional Assistance is intended to fund capital and transportation costs for charter schools given that they do not have the opportunity to raise funds through bond elections. Charter schools can use this money flexibly and are not limited to using it for capital or transportation expenditures.

Charter schools receive $4,963 in BSL funding and $1,706 for Additional Assistance for a total of $6,669 per year per pupil in FY 2016 for grades K-8 and about $2,000 additional for grades 9-12 or about $6,960 per pupil. The additional assistance is adjusted for inflation each year and for FY2018 (this year) is $1,775 for K-8 and $2,069 for grades 9-12.[17]

The public funding a charter school receives for BSL and Additional Assistance is determined based on a school's Average Daily Membership (ADM), or physical student count, on October 1 each year. A charter school's ADM determines its revenue for the year. It is a number that is critical to a school's day-to-day operations as well as long-term spending decisions.

Total ADM among Arizona's charter schools was 179,669 in 2016-17. The industry points to positive growth in the charter sector with 51,242 ADM added to this sector since the 2011-12 school year, representing a 40 percent growth rate.[18]

In FY2017, charter school total revenue was more than $1.5 billion. The amount primarily comes from the state (85%). About 8 percent comes from local sources. These can vary from food service charges, school activity fees, as well as contributions and donations from private sources, including parents.[19]

[17] For more details go to Joint Legislative Budget Committee Staff, "Overview of K-12 Per Pupil Funding for School Districts and Charter Schools," June 6, 2017, https://www.azleg.gov/jlbc/districtvscharterfunding.pdf, Arizona State Senate Research Staff, "Arizona's School Finance System," Arizona State Senate Issue Brief, Oct. 20, 2016, https://www.azleg.gov/briefs/Senate/ARIZONA'S%20SCHOOL%20FINANCE%20SYSTEM.pdf, and ADI Staff, "Arizona Charter Schools Have Fewer Students, More Funding," Arizona Daily Indepenent, August 8, 2017, https://arizonadailyindependent.com/2017/08/08/arizona-charter-schools-have-fewer-students-more-funding/.
[18] FY 2017 Superintendent's Report. http://www.azed.gov/finance/reports/
[19] Auditor General, "Uniform System of Financial Records for Arizona Charter Schools,, " https://www.azauditor.gov/sites/default/files/USFRCS.pdf.

FY2017 Charter School Revenue[20]

Source	Amount	% of Total
Local	$123,650,011	8.08%
Intermediate	$2,245,378	0.15%
State	$1,296,340,157	84.66%
Federal	$109,015,964	7.12%
Total	**$1,531,251,510**	**100%**

Measuring charter school financial performance

The Arizona State Board for Charter Schools (ASBCS) is the government regulatory body responsible for providing oversight to 407[21] of the state's charter school organizations with an overall portfolio of more than 500 schools (charter entities). The ASBCS is the largest independent, state-based charter school authorizing body in the United States. The number of charter organizations represented by the 407 figure excludes University, District, and County Charters and also excludes some Native Charters.

The ASBCS has adopted its Financial Performance Framework and Guidance as one component of the Board's Performance Framework. The board's primary mission is to ensure Academic Performances are the primary factor used to determine charter renewals or closures by the State Board for Charter Schools.

The ASBCS's purpose in developing the financial framework was to communicate its expectations for ensuring that charter holders in its portfolio are viable organizations with strong fiscal management practices. The public can search ASBCS' database to review a particular charter school's dashboard at http://online.asbcs.az.gov/search .

According to the ASBCS, 'the annual statutorily required audits conducted by independent certified public accountants provide the information necessary to determine a charter holder's financial performance.'[22] Specific audit documents used to inform the Financial Performance Framework include:

- Independent Auditor's Report on the financial statements[23]
- Audited statement of financial position
- Audited statement of activities and changes in net assets
- Audited statement of cash flows
- Notes to the audited financial statements
- Applicable compliance questionnaire

A review of the ASBCS "Financial Performance Framework and Guidance" document notes:

[20] FY 2017 Superintendent's Report, volume 1, page 39.
[21] This number does not include the University Associated Charters, District or County Charters OR Native Charters. The number of ALL charters was 427 in 2016-2017.
[22] https://asbcs.az.gov/sites/default/files/documents/files/Financial%20Guidance%20Document%20Approved%2010-2017.pdf
[23] Author's note: There are 33 different accounting firms, 7 from out of state, that perform audits at our AZ Charters.

"It is important to note that the financial framework excludes measures of how a charter holder manages and expends its funds as the financial framework is not designed to evaluate a charter holder's spending decisions."[24]

More detailed information is available on the ASBCS' Financial Performance Framework and Guidance pages at http://online.asbcs.az.gov. This statement reflects the Board's adverseness to monitoring spending by charter schools noted on their audits.

The data shows that this hands-off approach, which is grounded in a free market business theory of action, is not intervening sufficiently. Since 1994 the Arizona charter industry has experienced a 43 percent failure rate (closed charter entities).[25]

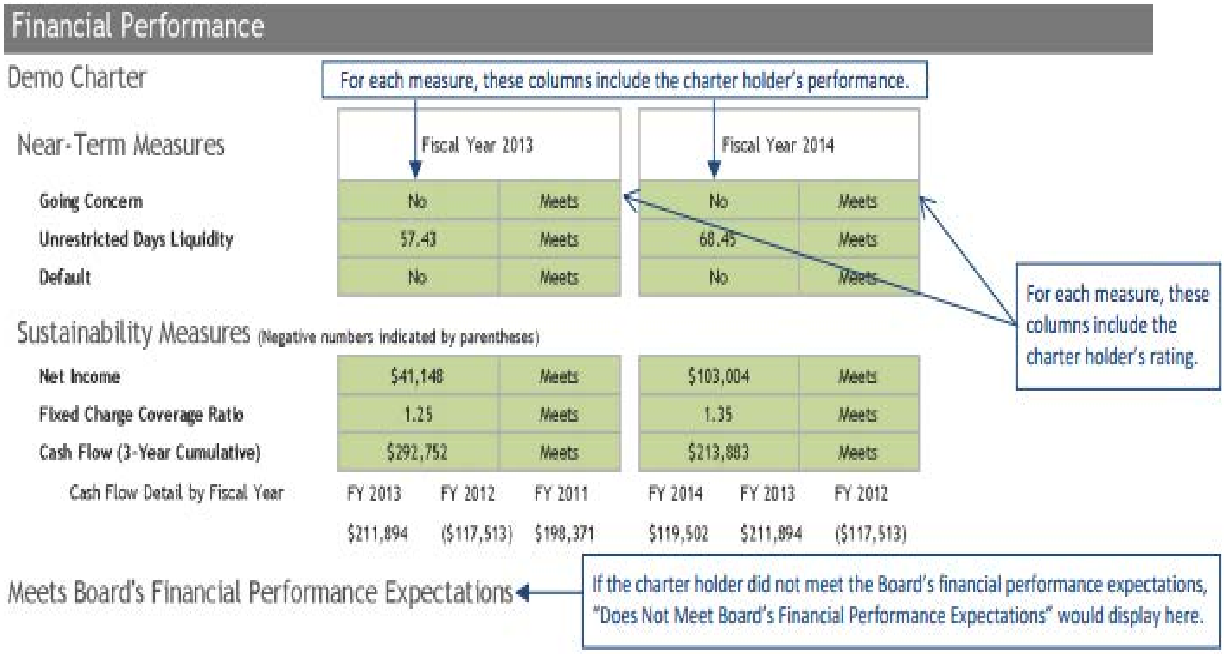
The Arizona State Board for Charter Schools (ASBCS) began movements in a more proactive manner when they began to monitor finances starting in Fiscal Year 2013 and have adjusted their financial dashboard since then. Their primary motivation was to evaluate the financial capacity of academically troubled charters to meet academic improvement plans. Those plans include discussions regarding how the charter in question will finance the improvements being made to their programs.

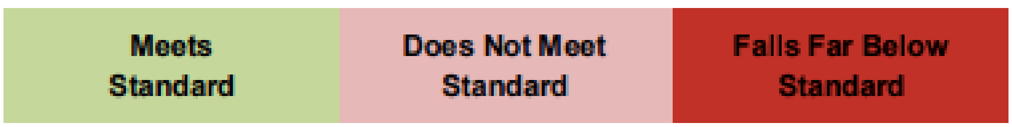
The ASBCS' financial performance framework uses indicators designed to evaluate each charter holder's near-term financial health ("Near-Term Indicator") and longer-term financial sustainability ("Sustainability Indicator").

The ASBCS has developed a Financial Dashboard that reflects a school's two most recent audited financial reports. This data is used to summarize a charter holder's performance on each measure. Three ratings are used to indicate how a charter organization is performing on each of the indicators including 'Meets', 'Does Not Meet', and 'Falls Far Below' standards. The following images provide a view of what the Financial Dashboard and the ratings provided to charter organizations and/or schools.

[24] Arizona State Board for Charter Schools, "Financial Performance Framework and Guidance," revised October 10, 2017, p. 8. https://asbcs.az.gov/sites/default/files/documents/files/Financial%20Guidance%20Document%20Approved%2010-2017.pdf

[25] Data on charter school failures since 1994 collated from the AZSBCS and EdReform.





Each of these six measures is further defined.

ASBCS Financial Framework Measures[26]

Measure	Description of Measure	Performance Target
Near-Term Indicators		
Going Concern	Charter holder will continue to engage in its activities for at least the next year.	No going concern issue identified in the annual audit If identified, falls far below standard.
Unrestricted Days Liquidity	Indicates how many days a charter holder can pay its expenses without an influx of cash. Reserve cash or other liquidity for managing unexpected expenses.	At least 30 days of Liquidity If 15-29 does not meet standard Less than 15 days falls far below standard
Default	Whether or not a lender has issued formal notice of default to the charter holder	No default on material loans If default then fall far below standard
Sustainability Indicators		

[26] Arizona State Board for Charter Schools, "Financial Performance Framework and Guidance," revised October 10, 2017, p. 8. https://asbcs.az.gov/sites/default/files/documents/files/Financial%20Guidance%20Document%20Approved%2010-2017.pdf

Measure	Description of Measure	Performance Target
Net Income	Identifies whether a charter holder operates at a surplus (total revenues exceed total expenses) or a deficit (total expenses exceed total revenues).	Greater than or equal to $1 Zero or loss then does not meet standard Does not have falls far below criteria.
Cash Flow	Shows the change in a charter holder's cash balance from one fiscal year to another.	Three year cumulative cash flow is positive (NOTE by ASBCS This target is effective beginning with the FY 2016 audits)
Fixed Charge Coverage Ratio	Considers the amount of cushion in the charter holder's cash flow to cover fixed obligations or charges. These charges occur regardless of changes in revenue or other circumstances that may affect the charter holder's financial situation. For this ratio, fixed charges would include lease payments, loan payments, and interest.[27]	Greater than or equal 1.1 Less than 1.1 then does not meet standard. Does not have falls far below criteria

GCI recognizes and applauds these efforts by ASBCS to identify and improve financial expectations. GCI also believes additional refinements and authority would enhance the work of the ASBCS.

GCI recommends that the analysis is done yearly as the data to do so currently exists. GCI will demonstrate that the current system will award a 'Meets' expectations even when the current year being looked at can show four or more areas in the "does not meet categories. ***A false positive is the result***.

The two year review process uses the following criteria to determine if a charter fails to meet the overall dashboard:

[27] The fixed-charge ratio, also known as the solvency ratio, is often used by lenders when determining if a company has sufficient cash flow for debt repayment. A low ratio means reduced earnings could threaten the sustainability of the organization, which is a concern for lenders. Fixed-charge coverage ratio is used to determine a company's ability to take on additional debt. A company with a higher ration can cover its fixed charges at a faster rate and is more likely borrowing for growth rather than hardship.

Previous Audit	Most Recent Audit	Meets Board's Financial Performance Expectations?
MEETS financial performance standard	**MEETS** financial performance standard	**Yes**
DOES NOT MEET financial performance standard	**MEETS** financial performance standard	**Yes**
MEETS financial performance standard	**DOES NOT MEET** financial performance standard; **no measure receives "Falls Far Below Standard"**	**Yes**
MEETS financial performance standard	**DOES NOT MEET** financial performance standard; **1 or more measures receive "Falls Far Below Standard"**	**No**
DOES NOT MEET financial performance standard	**DOES NOT MEET** financial performance standard	**No**
Note: Charter can NOT MEET STANDARD for ONE of the SIX financial performance measures and be classified as **MEETS** above, if it does not "fall far below standard."		

In order to receive a "No" on the board's financial performance expectations, a charter with a 'Does Not Meet' standard for all six categories in the most recent year would still meet the Board's financial performance expectations if in the prior year they had no more than one standard that did not meet the standard. Yet such a dramatic decline in financial performance would strike most observers as a serious red flag for immediate need for greater oversight.

Manipulating financials to improve ASBCS status

The current two-year system can also lead to data manipulation. An example of overt manipulation of the data is illustrated by Phoenix Education Management, LLC. Note the company, based out of the country of Lebanon, has a net (deficit) of ($25.6 Million).

Charter Holder Corporate Name	Net Assets (Deficits) ASBCS Audit 14-15
Phoenix Education Management, LLC SABIS Inc.	**-$25,567,324**

Since net asset deficits aren't tracked by the ASBCS dashboard, deeper analysis shows that this number was controlled to produce a non-negative **net income** result. SABIS "achieved" its $1 net by listing the operating loss to the operating company as "forgiven." The $1 drove its rating into the 'Meets' range on the NET INCOME and liquidity segment of the Financial Performance Analysis. The timing of the manipulation in FY2015 was also likely not coincidental, as their FY2016 audit states as their charter was expiring after 2015. “The contract was renewed on June 15, 2015 for an additional twenty years ending June 30, 2035” despite the questionable items on their accounting statements.

Nets FY 2014	Nets FY 2015	Nets FY 2016	Nets FY 2017
$(1,857,175.00)	$ 1.00	$ 1.00	$ 1.00

The extent of related-party dealing is significant with essentially in this case the parent company subsidizing a school that operates continually in the red. But in the meantime, the charter holder has accumulated an ongoing debt to the parent company which it is not paying off. The related-party here forgives just enough expense to yield a $1 net. If this charter’s financials improve it will likely start paying off these debts, before putting more dollars in the classroom.

PHOENIX EDUCATION MANAGEMENT, LLC
DBA SABIS INTERNATIONAL SCHOOL
Notes to Financial Statements
June 30, 2016

Note 5 – Related Party Transactions (continued)

Balance due to related party - SABIS, June 30, 2015	$ 25,955,459
Increases:	
Management fees	241,472
Proprietary information fee	321,964
Book purchases	353,009
Other transactions	112,951
Advances	211,575
Building lease	1,128,384
Total increases	2,369,355
Decreases:	
Payments on account	(267,447)
Related party expense forgiveness	(2,296,043)
Total decreases	(2,563,490)
Balance due to related party - SABIS, June 30, 2016	$ 25,761,324

See note 8 for lease commitments to Phoenix Property Management, LLC

FY 14 through FY 17 net (deficits) at SABIS AKA Phoenix Educational Management

FY2014	FY2015	FY2016	FY2017
$(25,567,325.00)	$(25,567,324.00)	$(25,567,323.00)	$(25,567,325.00)

Today Phoenix Educational Management 'Meets' the financial dashboard thanks to their data manipulation that enabled FY2016 to only have one area that did not meet, fixed charge coverage ratio. Recall that charters are allowed one criteria that does not meet standard each year as long as none fall far below, but there is no falls far below standard for the three sustainability measures. Consequently, though SABIS does not meet in FY2017, they meet in FY2016 and consequently pass the overall financial dashboard. However, with GCI's recommendations of one year reviews due to falling short in FY2017, SABIS would be placed on financial probation. Here the manipulation also leads to a 1.00 Fixed Charge Coverage Ratio, but they are not able to manipulate the number to fix this result.

Financial Performance

Phoenix Education Management, LLC

Interpreting the Financial Performance Dashboard

	Fiscal Year 2016			Fiscal Year 2017		
Near-Term Measures						
Going Concern	No	Meets		No	Meets	
Unrestricted Days Liquidity <30, but ≥15: Does Not Meet <15: Falls Far Below	41.78	Meets		45.37	Meets	
Default	No	Meets		No	Meets	
Sustainability Measures*						
Net Income ≤0: Does Not Meet	$1	Meets		$1	Meets	
Fixed Charge Coverage Ratio <1.10: Does Not Meet	1.00	Does Not Meet		1.00	Does Not Meet	
Cash Flow (3-Year Cumulative) Negative: Does Not Meet**	$18,056	Meets		($137,372)	Does Not Meet	
Cash Flow Detail by FY	FY 2016	FY 2015	FY 2014	FY 2017	FY 2016	FY 2015
	($141,908)	($77,428)	$237,392	$81,964	($141,908)	($77,428)

Meets Board's Financial Performance Expectations

* Negative numbers indicated by parentheses.
** Target effective beginning with FY16 audits.

How are Arizona's charter schools performing on the ASBCS financial standards?

As of December 2017 a total of 66 charters 'Did Not Meet' at least one Financial Performance Expectation on their ASBCS Financial Performance reviews.[28]

Note: GCI will provide four years of this type of data in its next report. Currently the ratings for 2016-2017 are not all in as the date for FY 2017 submissions is March 31, 2018. The limitations of reporting financial data are the data relies on the inputs provided by the charters to the ADE and the ASBCS. We commend both of those agencies for updating their sites as soon as they receive this data.

[28] Source: Currently listed financial performance reports for 2015-2016 and 2016-2017.

The following information comes from 2014-15 financial ratings from ASBCS. An additional 90 charter schools did not meet the ASBCS CASH FLOW standard. I.e. the charter received a score that registered in the pink range. As of this writing, February 17, 2018 the rankings between 2014 and 2016 show that there were 66 cases of a red rating (GOING CONCERN) in the financial performance rankings OVER 4 Years, FY 2014 to FY 2017.

The chart below shows one set of two years' scoring. The board rates financial performance over two years, i.e. if you go to the ASBCS website you will find 2015 and 2016 posted or 2016 and 2017 (Annual Audits are due by March 31 of each year for schools doing consolidated audits for multiple locations. The deadline is earlier for single-site audits).

Charter Group MEETS ASBCS Financial Performance Expectations	Charter Group DOES NOT MEET ASBCS Financial Performance Expectations
269	138

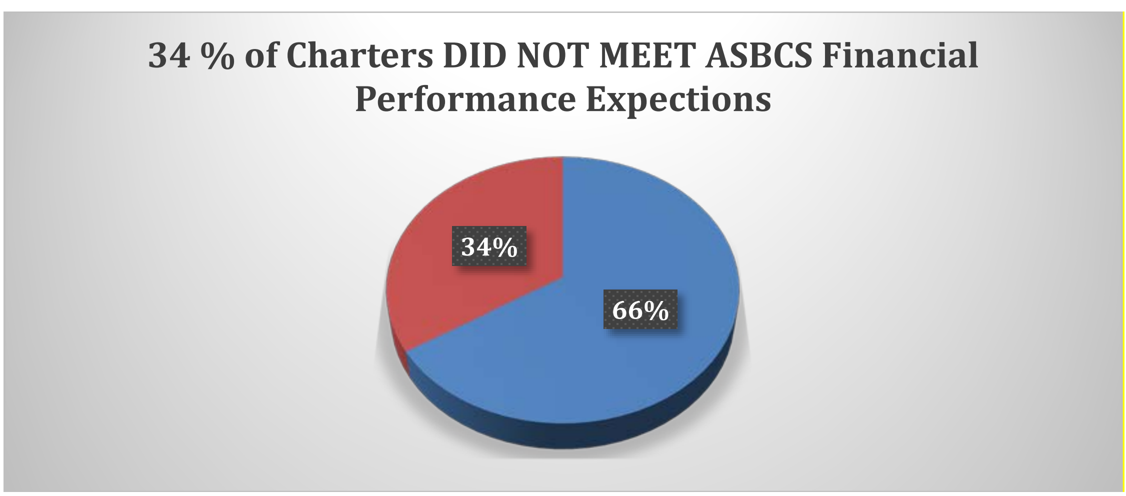
Total Rated Charter Groups
407

Percentage of charter groups that:

MEET ASBCS Overall Financial Performance Expectations	DO NOT MEET ASBCS Overall Financial Performance Expectations
66%	34%

<u>Meaning of the Data</u>:
34% of charter groups were struggling financially according to the ASBCS' Expectations for Financial Performance

Financial Performance Monitoring by ASBCS



Topic II: Net Losses & Negative Net Assets

What is not reported on the ASBCS' Financial Performance Dashboard

The ASBCS' Financial Performance Framework is often cited as proof the financials of charters are being monitored. That theory is tested in this paper by a deeper look at the data underlying the framework's scoring criteria. While the ASBCS' annual Financial Performance Framework provides some insight into the financial well-being of charter schools, the audited financials that these Performance Expectations rely on for data only tell a part of the financial story in the charter industry.

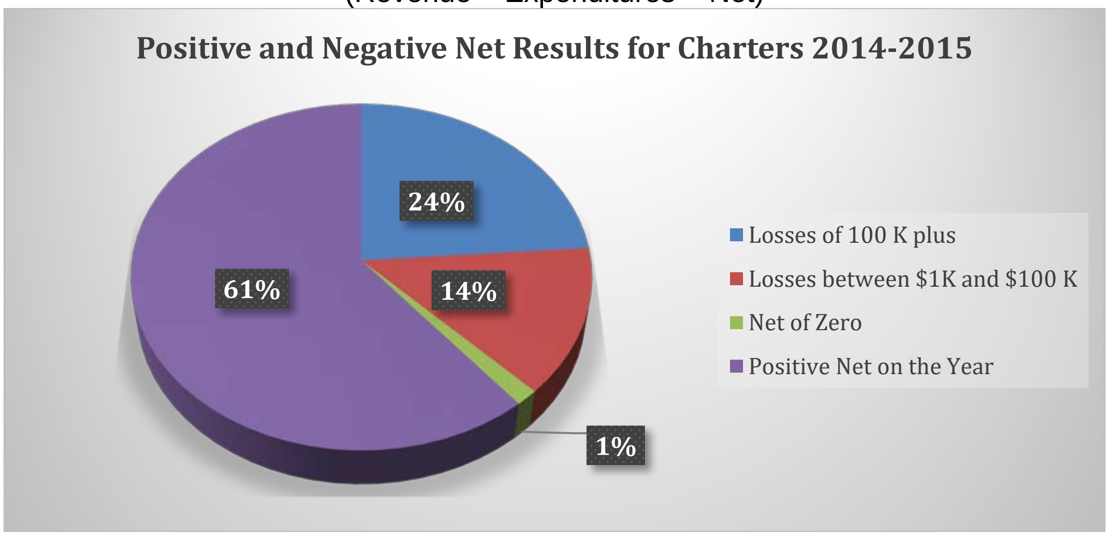
In 2014-2015, 153 charters (39 percent) reported a zero net or net losses.

Issue: Those charters were not subject to the same rigorous financial corrections that public school districts[29] are obliged to take when they have a deficit in a fiscal year (that is when revenues were less than expenditures resulting in a loss). The ASBCS has a mechanism to hold a portion (10%) of a charter's financial support. There is no evidence of this type of disciplinary action being undertaken in the data available in the audits. When Bradley, aka Discovery Creemos, had 10 percent of its financial support withheld it had nothing to do with financial issues but the composition of its board of directors based on the resolution that renewed its charter for 20 years that was passed unanimously by the charter board in June 2017.[30] The school failed at the end of January 2018.

Net losses are a growing problem as will be shown in the sample data sets provided in this report.

Net Losses in 2014-2015

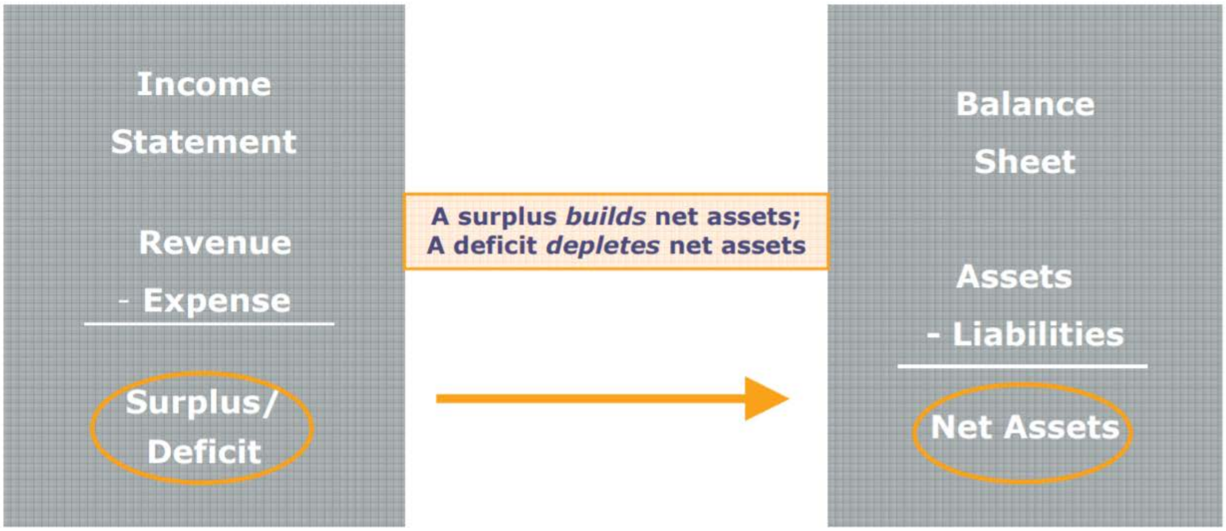
(Revenue – Expenditures = Net)



[29] There are AZ Districts with net losses. They are subject to financial rules when this type of loss occurs.
[30] Transcript of the meeting can be found under "The Arizona State Board for Charter Schools Renewed the Charter for the Defunct Bradley Academy for 20 Years … But Never Questioned Spending Practices that Netted CEO Daniel Hughes Millions," Arizonans for Charter School Accountability, http://www.azcsa.org/.

Net losses in perspective

What are NET LOSSES?
Net losses occur when a company's *revenue sources* do not equal or surpass the same company's *expenditures* in a given year, *i.e. the company did not live within its budget*. This is a poor business practice by any CEO in any industry.



Aren't Net Losses Normal in a Business Environment?
Losses in the first three to five years of a business' existence are not unusual in a free marketplace. It is also often normal for losses to occur when a business acquires another property or a competing entity. These "startup costs" are a factor whenever a business sets up in a capitalistic marketplace. The ASBCS should work with start-up charters to ensure they have this type of cushion built into their financials.

These losses, which are normal in a growth phase, *have been accommodated for in this report*.

Start-up costs are one reason why charters often borrow more money than they need when acquiring a property to operate in.

The danger occurs when the charter's projected revenues do not materialize due to lower than expected student enrollment (ADM). Going out and re-borrowing does not solve this type of ADM shortage. The debt, which is premised on ADM[31], then becomes unsustainable. The charter is overleveraged and overextended. These reports will identify those red flags using multiple years of data. ADM counts are also dealt with in detail.

Understanding Net Losses at Charter Schools. The meta-data was probed for underlying reasons for the net losses identified in this report. It consisted of all AFRs submitted to the ADE from 2014 through 2017 and all available audits submitted to the ASBCS from the same time period.

[31] IDA loans which are the typical finance tool used by charters for construction are termed, Educational Revenue Bonds, a nod to the fact that the "backpacks full of cash" following students to a charter are guaranteeing the loans. This study finds that the majority of these tax free bonds are financed in the junk bond markets.

The analysis showed that businesses became overextended when *multiple years of losses are recorded with ever increasing debt loads*[32] *covering those losses. The report identifies these frailties in the financial performances recorded in the audits.*

The data show that often these losses are being caused by excessive payments to related-party or affiliated corporate subsidiaries. The harm caused to the charter's financials show up as a loss on the charter's audits. Note: The losses at the charter do not necessarily mean the related-party businesses associated with that charter lost money on their operations.

The audits of the subsidiaries are not available to the public nor are they required by the financial oversight rules of the ASBCS. GCI recommends that these audits be collected by the ASBCS and evaluated when charters have net losses given that all of these businesses are receiving money that originated from taxpayer sources. The scope of the diversion of funds to subsidiaries is a growing issue in the charter sector.

The practices surrounding the financing of charter debt are similar to debt secured by second mortgages that are held on properties that are underwater. A financial time bomb (balloon payments and excessive debt) exists and is identified in the data. The next report, RED FLAGS: Debt, will provide detailed analysis of these loans.

Discovery Creemos Academy: The price of inaction

Discovery Creemos Academy (formerly known as Bradley Academy) closed suddenly on January 30, 2018 due to claims of "financial hardship" by Daniel Hughes, its CEO and charter holder. Discovery Creemos Academy had a $3.3 million net (deficit) in its FY2016 audit.

This closure which occurred during the school year provides a textbook example of what is not working with the ASBCS' current Financial Performance Framework and its breadth of authority to truly regulate the charter schools for which it has responsibility.

The company's net for FY 2014, 2015 and 2016 are included here.

$(716,832.00)	**$(1,011,727.00)**	**$(1,946,771.00)**

The net (deficits) for the same time period was equally dismal.

$(382,915.00)	**$(1,394,642.00)**	**$(3,341,413.00)**

Discovery Creemos/Bradley had not met the ASBCS Financial Performance Standards in FY2014, FY2015, or FY2016, which under a more thorough financial review process should have at minimum placed the school under financial probationary status—something that currently does not exist, but GCI is recommending. Under GCI's recommendations that level of oversight would have started after FY2014.

[32] These refinanced loans often have 'refinancing fees' built in based on penalties charged for refinancing prior to the loan's maturity dates. These penalties can run into millions of dollars. Examples will be provided in the data here and in more detail in the second RED FLAGS report in the spring of 2018.

In the dashboard you find no red areas in the Sustainability area-because charters currently never receive red areas in the Sustainability area, only pink, because the ASBCS has no criteria set for falling far below standards. In FY2014, the Discovery Creemos/Bradley's loss of $717,000 represented nearly 20 percent of expenses. In FY2015, the $1 million loss represented almost 25 percent of expenses, and in FY2016, the nearly $2 million loss represented one-third of expenses. GCI, following guidelines for nonprofits, suggests any time net losses exceed 5 percent of expenses the charter would be rated as falls far below the standard. Any person familiar with basic finances could see this school was going bankrupt. Yet parents and students weren't notified. The opposite occurred.

Financial Performance

Bradley Academy of Excellence, Inc.

Interpreting the Financial Performance Dashboard

	Fiscal Year 2015		Fiscal Year 2016	
Near-Term Measures				
Going Concern	No	Meets	Yes	Falls Far Below
Unrestricted Days Liquidity <30, but ≥15: Does Not Meet <15: Falls Far Below	39.55	Meets	13.77	Falls Far Below
Default	No	Meets	No	Meets
Sustainability Measures*				
Net Income ≤0: Does Not Meet	($1,011,727)	Does Not Meet	($1,946,771)	Does Not Meet
Fixed Charge Coverage Ratio <1.10: Does Not Meet	0.17	Does Not Meet	(0.62)	Does Not Meet
Cash Flow (3-Year Cumulative) Negative: Does Not Meet**	$363,356	Does Not Meet	$157,723	Meets

Cash Flow Detail by FY	FY 2015	FY 2014	FY 2013	FY 2016	FY 2015	FY 2014
	$401,450	($23,319)	($14,775)	($220,408)	$401,450	($23,319)

Fiscal Year 2014

- Fixed Charge Coverage Ratio FY 14
- 0.24
- FY 2014
- Cash Flow
- Net Income
- Liquidity
- Going Concern Falls Far Below

Does Not Meet Board's Financial Performance Expectations

* Negative numbers indicated by parentheses.
** Target effective beginning with FY16 audits.

The charter also had weak and deteriorating academic performance. It also received an "F" on the preliminary grades for FY2017 for academics, though that may not have been accessible to the charter board in June 2017 when they considered the renewal of its charter.

Academic Performance

Discovery Creemos Academy

	2012 Traditional Elementary School (K-8)		2013 Traditional Elementary School (K to 8)		2014 Traditional Elementary School (K to 8)	
Overall Rating	Overall Rating		Overall Rating		Overall Rating	
Scoring for Overall Rating 89 or higher: Exceeds Standard <89, but > or = to 63: Meets Standard <63, but > or = to 39: Does Not Meet Standard Less than 39: Falls Far Below Standard	55.31	100	50.62	100	37.19	100

In June 2017, the ASBCS renewed Discovery Creemos Academy's charter for 20 years. Daniel Hughes, had taken over leadership of the school in 2016. At the time that the school's charter was renewed, it was documented in audits, Annual Financial Reports and IRS 990 filings that the school had:

- Spent 5 times more on administration in 2016 compared to the year before the current CEO took over.

- Spent $1.8 million to run a single school of 441 students.
- Bought $574,000 worth of goods and services from four separate companies that the CEO and his wife formed to do business with the school.
- Created a revolving fund used by the CEO to buy unspecified goods and services for the school totaling $477,000.[33]

However, the ASBCS is clear that it does not look at how a charter school spends its money, rather it focuses solely on the information presented in its Financial Dashboard. During a June 2017 State Charter Board meeting, to their credit, several ASBCS board members expressed their concerns to Daniel Hughes when discussing the renewal of Discovery Creemos Academy's charter. (Source: Transcript of Meeting)

The school's 2014 Academic Performance was an overall **37.19,** equivalent to a "D" rating, which could have provided an academic reason for closure. *But as Discovery Creemos served a lower-socio-economic student population and academic performance frequently correlates with socio-economic performance, the current ASBCS use of academics often can lead to a bias toward not intervening or renewing charters. By adding financial criteria to the ASBCS closure abilities, the ABSCS would be able to move itself outside this cloud of ambiguity and require financial improvement plans, and, if necessary, withdraw the charter. With those rules in place the ASBCS would have been properly empowered to not renew the school's charter in June 2017 and the school-year disruptions could have been avoided.*

Instead the charter was renewed despite the school's academic and financial deficiencies.

A school closure like this during the academic year is an avoidable disruption to a child's education if the financial issues underlying the closure are identified and acted upon. The data below is derived from the ASBCS' closure reports and data from EdReform, a pro-charter organization.[34]

The numbers reflect ALL charter entities open or closed since 1995.

Open	Closed
554	**427**
56.47%	**43.53%**

Of those closures, 67 occurred during the academic year, like the October 2016 closure of Hillcrest Academy and the January 2018 closure of Discovery Creemos Academy.

Schools that CLOSED During the Academic Year as of October 15, 2016	**67 School Year Closures School Year Closings are Defined as between October and March of the School Year**

[33] "The Arizona State Board for Charter Schools Renewed the Charter for the Defunct Bradley Academy for 20 Years… *But Never Questioned Spending Practices that Netted CEO Daniel Hughes Millions" Hall, Jim,* Arizonans for Charter School Accountability. http://www.azcsa.org/past-research.html
[34]Consoletti, 2011.

Consequences of charter school closures during a school year

The displacement of students who must then seek open space in either another charter or a district school creates issues for the receiving school(s). The larger the failed school the greater the impact to other charters and districts in the service area of that school.

Charter school closures after the 100th day result in a loss of funding to the receiving school as funding is based on the 100 day count[35]. What this translates to is that the school accepting the student may not receive further funding as the charter school that closed has already collected the maximum allocated taxpayer funds for the year. The school accepts the students without compensation. The money that has been paid in advance to the closed charter school is usually unrecoverable by the state. The state discontinues payments beyond the closure date. I.e. February's payment was not made to Discovery Creemos.

Unless a catastrophic event occurs (fire, flood, etc.) districts **never** close schools during a school year to avoid disrupting the children's educations. However, there have been district site closures due to the disruption caused by a glut of charter seats in specific municipalities. This overbuilding hurts performing public districts *and established* academically performing *charters* in the area.

Net losses: Overspending of revenues, a common problem

Charters with over -$100,000 of Net LOSSES according to ASBCS' audits for 2014-2015 are listed on the following pages.

Charter Name	***Fiscal 2014-2015 NET INCOME Reported to ASBCS***
Hillcrest Academy, Inc. (Failed in 2016) See CASE STUDY	-$4,084,353
BASIS System wide Information	-$3,074,317
Edkey Schools	-$1,265,948
Imagine Prep Coolidge, Inc.	-$1,129,412
Legacy Traditional School- Gilbert	-$1,117,552
Discovery Creemos Academy/Bradley Academy of Excellence, Inc. (Failed Jan. 2018)	-$1,011,727
The Odyssey Preparatory Academy, Inc.	-$963,135
Juniper Tree Academy	-$818,515
StarShine Academy (bankruptcy 2016, move to revoke 2018)	-$803,397
AZ Compass Schools, Inc.	-$779,454
CAFA Inc. Consolidated Reporting	-$773,894
Challenge School, Inc.	-$668,379
Salt River Pima-Maricopa Community Schools	-$586,107
Telesis Center for Learning, Inc.	**-$550,248**
Legacy Traditional School- Laveen	**-$516,257**

[35] The 100-day count is the student count (Average Daily Membership rate) at the 100th day of school. The figure is used to calculate ADM payments which are distributed throughout the year in Arizona by payments from AZDOE.

Charter Name	***Fiscal 2014-2015 NET INCOME Reported to ASBCS***
Arizona Connections Academy Charter School	**-$495,693**
EAGLE College Prep Maryvale, LLC.	**-$457,501**
Innovative Humanities Education Corporation	**-$448,504**
South Phoenix Academy, Inc.	**-$422,070**
Tucson Youth Development, Inc.	**-$409,605**
Ahwatukee Foothills Prep, Inc.	**-$387,734**
San Tan Montessori School, Inc.	**-$362,223**
American Basic Schools LLC	**-$355,422**
The Paideia Academies, Inc.	**-$352,568**
Noah Webster Schools - Pima	**-$349,939**
Noah Webster Schools- Mesa	**-$349,939**
Consolidated Report for Rose Academies	**-$346,104**
Institute for Transformative Education	**-$310,354**
LEAD Charter Schools	**-$299,735**
Fit Kids, Inc.	**-$291,575**
Incito Schools	**-$289,787**
STEP UP Schools, Inc.	**-$288,450**
Park View School, Inc.	**-$288,156**
Imagine Coolidge Elementary, Inc.	**-$275,153**
Carpe Diem Collegiate High School	**-$265,251**
Heritage Academy Queen Creek, Inc.	**-$258,443**
Ball Charter Schools (Val Vista)	**-$256,230**
Arizona Montessori Charter School at Anthem	**-$254,447**
Arizona Academy of Science & Technology	**-$251,867**
Foothills Academy	**-$251,034**
Desert Heights Charter Schools	**-$248,978**
Friendly House, Inc.	**-$244,126**
Pinnacle Education - Tempe, Inc.	**-$241,122**
Madison Highland Prep.	**-$213,419**
Vector School District, Inc.	**-$207,990**
Premier Charter High School	**-$184,009**
Desert Star Academy, Inc.	**-$174,795**
Teleos Preparatory Academy	**-$169,359**
Omega Alpha Academy	**-$163,004**
PACE Preparatory Academy	**-$150,804**
StrengthBuilding Partners	**-$149,244**
Graysmark Schools Corporation	**-$147,767**

Charter Name	Fiscal 2014-2015 NET INCOME Reported to ASBCS
Presidio School	-$145,064
Concordia Charter School	-$141,037
Reid Traditional Schools' Painted Rock Academy, Inc.	-$139,804
Success School	-$138,789
Pima Prevention Partnership	-$134,608
Genesis Program, Inc.	-$125,094
Valley of the Sun Waldorf Education Association, Inc.	-$124,396
Flagstaff Montessori, L.L.C.	-$121,187
Montessori Day Public Schools, Chartered	-$113,877
Pointe Educational Services	-$105,717
Arizona School for the Arts	-$105,428
West Valley Arts and Technology Academy, Inc.	-$104,261
Academy with Community Partners, Inc.	-$102,273
Espiritu Community Development Corp	-$101,725

- Number of charters with over $100,000 in losses in fiscal year 2014-2015: **97**
- There were an additional **56** charters that had negative nets between $1,000 and $100,000 during fiscal year 2014-2015. GCI will release a four-year study once all of the data from 2016-2017 becomes available.
- Another **6** charters had a net of zero on the year in 2014-2015.
- ***Growing Issue?*** There are **10** more charters that have between $143 and $10,000 of net losses in fiscal 2014-2015 than there were in fiscal 2013 - 2014.

The cash flow performance expectation: The canary in the coal mine

This report also analyzed and considered Cash Flow (one factor in the ASBCS' Financial Performance Expectations) as a primary "tell" regarding potential financial performance issues. During the 2014-2015 school year the ASBCS Performance Expectations show that another 90 charters did NOT MEET the Cash Flow component of the Performance Expectation (90 beyond the 138 that DID NOT MEET the Board's Financial Performance Expectation.) "Expectation" is an indicator that there is not much that the ASBCS can do if the "Expectation" is not met. This finding continues in the new performance ratings.

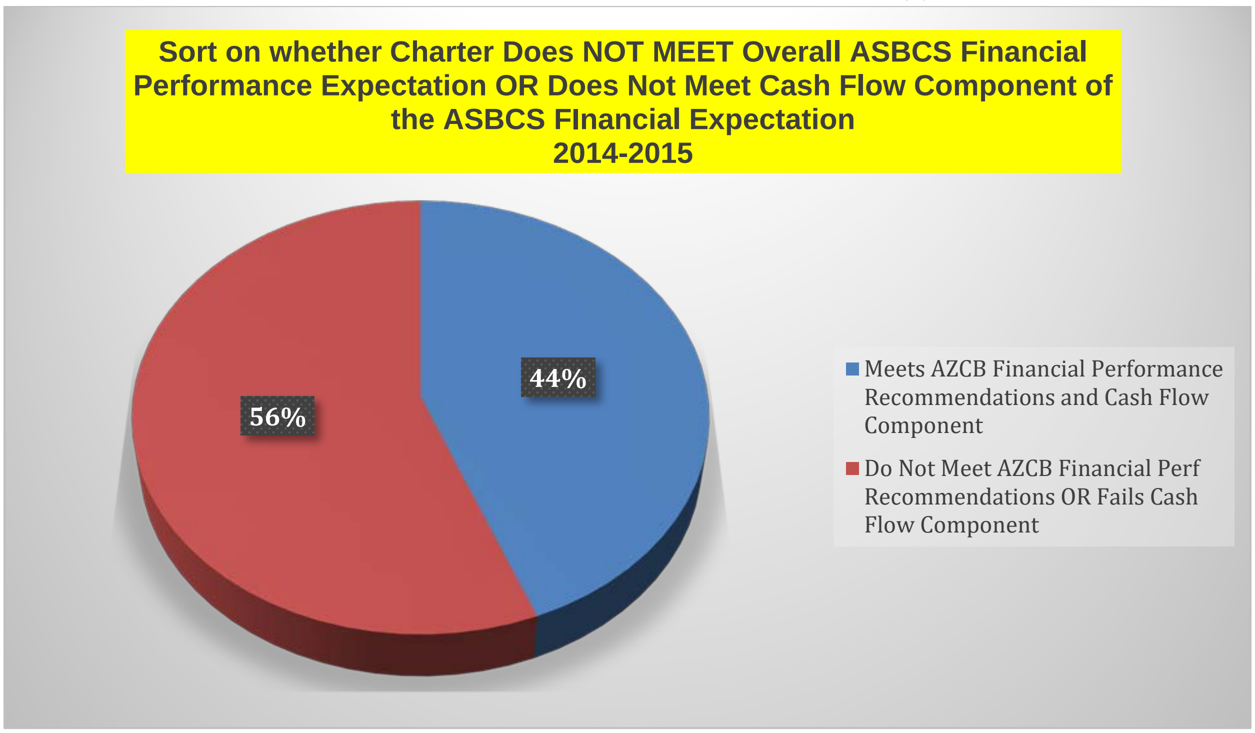
Cash flow is a primary **determinate** when examining a business' fiscal condition. Of the failed charters studied, the majority were exhibiting cash flow issues prior to collapse[36]. The following results examine cash flow as reported on the Financial Performance Expectations for FY 15.

[36] Businesses that are having difficulty paying their taxes, payroll or bills experience cash flow issues. Typical indicators in a failing business are receivables that are over 120 days in arrears. The data revealed several charters that were having difficulty paying their federal payroll taxes according to their annual audits.

Data on Cash Flow (FY 2015)

Charter Group MEETS ASBCS Financial Performance Expectations and Cash Flow Component	Charter Group DOES NOT MEET ASBCS Financial Performance Expectations or Cash Flow Component
179	228
Total Rated Charter Groups	
407[37]	

MEET ASBCS Financial Performance Expectation AND Cash Flow Standard	DOES NOT MEET ASBCS Financial Performance Expectation or Cash Flow Standard
44%	56%



[37] This is the number of charters in FY 2015. It is skewed downward from the number of actual charters because of the use of consolidated reports by some charter organizations, which may include upwards of 25 charter schools in one report.

Topic III: Net Asset (Deficits), Long-Term Losses: Liabilities that Exceed Assets

What are net assets (deficits)?

Each charter organization reports on its ***Assets and Liabilities*** (both long and short term) as part of their annual audits. Similar information is reported on Page 7 of the AFR submitted to the ADE. Nonprofit charter companies also report this information to the IRS on Form 990.

All three reporting formats were analyzed for this study. A **minimum** of two to four years of data were analyzed for this report**. Up to ten years of data were analyzed for larger charter entities in order to discover and review mega-trends.**

GCI recommends that any charter with negative net assets be noted as not meeting the financial performance standards dashboard.

Net asset (deficits) in the charter sector

Statistics on Net Asset (Deficits)

2013-2014 Audits

Number of charters with a net (deficit) over $1 Million

Net Assets (Deficits) ASBCS Audit 13-14
36
Number of charters with a Net (Deficit) between $1 million and -$100,000
Net Assets (Deficits) ASBCS Audit 13-14
54
Number of charters with Net (Deficit) between $100,000 and $10,000
Net Assets (Deficits) ASBCS Audit 13-14
11
Total Number of charters with NET (DEFICITS) FY 2013-2014
101

Source: Charter school audits

The largest deficit[38] was in a company controlled by a charter company based in the country of Lebanon, SABIS, as discussed earlier.

Net assets (deficits) often persist each year and in many cases are growing issues for charters. The results from 2013-2014 and 2014-2015 are illustrated below. For some of the worst cases additional data is provided later in the report.

[38] The company showed a NET of $1 on its audit. This was "achieved" by listing the debt due to the operating company as "forgiven". It appeared this was a "temporary reprieve". The $1 drove its rating into the MEETS range on the LIQUIDITY segment of the Financial Performance Analysis.

Charter Holder Net Assets (Deficits)

2013-2014 and 2014-2015 Audits

Charter Holder Corporate Name	Net Assets (Deficits) ASBCS Audit 13-14	Net Assets (Deficits) ASBCS Audit 14-15
Phoenix Education Management, LLC	($25,567,325)	($25,567,324)
BASIS System wide Information (Consolidated Audit for 13 Charters)	($5,807,354)	($13,312,226)
Ahwatukee Foothills Prep, Inc. (2 Charters)	($9,822,201)	($10,209,935)
Horizon Community Learning Center, Inc.	($9,710,997)	($9,421,012)
Hillcrest Academy, Inc. (failed 2016)	($3,115,086)	($7,199,439)
Legacy Traditional School- Maricopa	($1,916,724)	($6,339,946)
Phoenix Advantage Charter School, Inc.	($4,596,883)	($4,677,407)
Heritage Elementary School	($3,162,104)	($2,961,278)
Bell Canyon Charter School, Inc.	($3,093,950)	($2,829,788)
Calibre Academy, Inc. (Consolidated Audit 2 Charters)	($2,570,519)	($2,681,194)
Pointe Educational Services	($2,359,685)	($2,465,402)
The Odyssey Preparatory Academy, Inc.	($1,349,077)	($2,187,508)
Imagine Prep Coolidge, Inc.	($1,043,993)	($2,173,405)
StarShine Academy (bankruptcy 2016, move to revoke 2018)	($1,194,016)	($1,997,412)
Imagine Elementary at Tempe, Inc.	($1,731,236)	($1,595,924)
Milestones Charter School	($1,591,308)	($1,586,987)
Legacy Traditional School- Laveen	($1,063,315)	($1,579,572)
San Tan Montessori School, Inc.	($1,157,189)	($1,519,412)
Reid Traditional Schools' Painted Rock Academy, Inc.	($1,349,162)	($1,488,966)
EdKey, Inc.	($208,655)	($1,474,613)
Discovery Creemos Academy/Bradley Academy of Excellence (failed 2018)	($382,915)	($1,394,642)
AZ Compass Schools, Inc.	($558,254)	($1,337,708)
South Phoenix Academy, Inc.	($867,672)	($1,289,742)
Career Success Schools	($630,385)	($1,273,854)
Legacy Traditional School- Gilbert	($90,517)	($1,208,069)
Legacy Education Group dba East Valley HS	($1,500,633)	($1,201,712)
Park View School, Inc.	($891,605)	($1,179,758)
Imagine Prep Superstition, Inc.	($1,215,238)	($1,125,238)
Flagstaff Arts and Leadership Academy, Inc.	($1,267,264)	($1,042,531)
Cochise Community Development Corporation	($871,059)	($993,354)
Academy with Community Partners, Inc.	($852,925)	($955,198)

Charter Holder Corporate Name	Net Assets (Deficits) ASBCS Audit 13-14	Net Assets (Deficits) ASBCS Audit 14-15
Arizona Academy of Science & Technology	($664,026)	($915,893)
Imagine Prep Surprise, Inc.	($926,105)	($905,308)
Academy of Tucson	($969,876)	($893,835)
Cambridge Academy East, Inc.	($798,444)	($868,198)
Legacy Athlos Traditional Academy	($754,478)	($828,004)
CAFA Inc. Consolidated Reporting 3 Charters	($30,141)	($804,035)
Teleos Preparatory Academy	($518,878)	($688,237)
Arizona School for the Arts	($547,356)	($652,784)
Arizona Montessori Charter School at Anthem	($369,153)	($623,602)
Incito Schools	($326,030)	($615,817)
Premier Charter High School	($428,783)	($612,792)
Montessori Academy, Inc.	($568,859)	($558,923)
Fit Kids, Inc.	($254,315)	($545,890)
The Paideia Academies, Inc.	($161,663)	($514,231)
Skyline Schools, Inc.	($520,773)	($489,334)
Desert Heights Charter Schools	($231,262)	($480,240)
Innovative Humanities Education Corporation	Started 2014-2015	($446,792)
Imagine Coolidge Elementary, Inc.	($170,050)	($445,203)
Imagine Superstition Middle, Inc.	($429,373)	($425,373)
Legacy Traditional School- Avondale	($556,381)	($421,473)
Sage Academy, Inc.	($360,622)	($391,679)
Tucson Country Day School, Inc.	($348,278)	($352,257)
Global Renaissance Academy of Distinguished Education	($297,686)	($339,278)
Vector School District, Inc.	($111,836)	($319,826)
Imagine Camelback Middle, Inc.	($283,687)	($317,883)
EAGLE Arizona	($643,317)	($314,618)
PACE Preparatory Academy	($132,117)	($282,921)
Ha:san Educational Services	($346,896)	($264,457)
Excalibur Charter School, Inc.	($439,619)	($259,441)
Heritage Academy Queen Creek, Inc. Data In Liberty Charter	$0	($258,443)
Rosefield Charter Elementary School, Inc.	($355,694)	($255,672)
Carpe Diem Collegiate High School	($206,513)	($248,483)
RSD Charter School, Inc.	($165,210)	($247,648)
Madison Highland Prep.	Started 2014-2015	($242,212)
Khalsa Family Services	($280,439)	($230,313)
Tucson Small School Project	($271,155)	($225,986)
Imagine Avondale Elementary Inc.	($332,706)	($177,250)

Charter Holder Corporate Name	Net Assets (Deficits) ASBCS Audit 13-14	Net Assets (Deficits) ASBCS Audit 14-15
EAGLE Maryvale, LLC. (Consolidated 3 Charters)	($171,749)	($171,749)
Desert Star Academy, Inc.	$0	($166,830)
StrengthBuilding Partners	Started 2014-2015	($163,571)
Success School	($23,592)	($162,381)
Ambassador Academy	($182,572)	($158,275)
Imagine Avondale Middle, Inc.	($114,165)	($116,348)
Victory High School, Inc.	($94,826)	($109,680)
New Horizon School for the Performing Arts	($72,864)	($66,934)
Rising Schools, Inc.	Started 2014-2015	($49,651)
James Madison Preparatory	$40,922	($40,791)
West Valley Arts and Technology Academy, Inc.	$16,259	($38,002)
Graysmark Schools Corporation	$112,922	($34,845)
Imagine Middle at Surprise, Inc.	($145,109)	($32,109)
P.L.C. Charter Schools	($185,966)	($29,833)
Integrity Education Incorporated	$15,547	($27,382)
Heritage Academy Laveen, Inc. in Liberty #	$0	($23,375)
ACCLAIM Charter School	($10,800)	($21,636)
Blue Adobe Project	($26,426)	($15,189)
Center for Creative Education, Inc.	$22,289	($1,912)

In-depth example: Phoenix Advantage Charter School transferring dollars from the classroom to bondholders

The Phoenix Advantage Charter School did not meet the financial performance expectations of the charter board for 2013-2014 and 2014-2015 and still does meet the financial performance recommendations. The deteriorating position of the charter is evident in the dashboard. With GCI's recommendation of Fixed Charge Coverage Ratio's less than 1 being in red (falls far below), the situation would look much worse. This is essentially because this charter has excessive debt and lacks the ability to meet those obligations.

Financial Performance

Phoenix Advantage Charter School, Inc.

Interpreting the Financial Performance Dashboard

	Fiscal Year 2015		Fiscal Year 2016		Fiscal Year 2014
Near-Term Measures					
Going Concern	No	Meets	Yes	Falls Far Below	Fixed Charge Coverage Ratio FY 14: 1.33
Unrestricted Days Liquidity <30, but ≥15: Does Not Meet <15: Falls Far Below	31.86	Meets	5.13	Falls Far Below	
Default	No	Meets	Yes	Falls Far Below	Cash Flow is Negative in 14 and 15
					Net Income Meets in 14
					Liquidity Does Not Meet 14
Sustainability Measures*					
Net Income ≤0: Does Not Meet	($80,524)	Does Not Meet	$211,351	Meets	
Fixed Charge Coverage Ratio <1.10: Does Not Meet	0.96	Does Not Meet	0.11	Does Not Meet	
Cash Flow (3-Year Cumulative) Negative: Does Not Meet**	$140,171	Does Not Meet	($64,049)	Does Not Meet	

Cash Flow Detail by FY	FY 2015	FY 2014	FY 2013	FY 2016	FY 2015	FY 2014
	($888)	($35,477)	$176,536	($27,684)	($888)	($35,477)

Does Not Meet Board's Financial Performance Expectations

* Negative numbers indicated by parentheses.
** Target effective beginning with FY16 audits.

The charter's academic performance is also substandard.

Academic Performance

Please see the charter holder's detailed information page to view the charter holder's financial and operational performance.

Phoenix Advantage Charter School

	2012 Traditional Elementary School (K-8)		2013 Traditional Elementary School (K to 8)		2014 Traditional Elementary School (K to 8)	
Overall Rating	Overall Rating		Overall Rating		Overall Rating	
Scoring for Overall Rating 89 or higher: Exceeds Standard <89, but > or = to 63: Meets Standard <63, but > or = to 39: Does Not Meet Standard Less than 39: Falls Far Below Standard	56.88	100	54.38	100	43.75	100

Assets and Liabilities Reporting Summary 2014-2015
Phoenix Advantage Charter School

Total Assets	Total Liabilities Short and Long	Total Liabilities and Net Assets
$8,260,693	**$12,938,100**	**$8,260,693**
	2014 -2015 Total Net Assets (Deficits)	
	$(4,677,407)	

In 2013-2014, Phoenix Advantage Charter School had a Net (Deficit) of ($4,596.883)[39]. The data is organized into charts in the data set. *(Audits normally dedicate one page to the assets and liabilities of the firm).*

Current Assets:	
Cash and Cash Equivalents (Restricted Cash of $286,660)	**$314,467**
Restricted Cash Held by Trustee for Debt	**$508,432**
Due from Governmental Agencies	**$130,716**
Prepaid Expenses	**$16,209**
Due From Related Party Current Portion	
Total Current Assets	**$969,824**
Property, Building and Equipment at cost Pledged,	
Net of Accumulated Depreciation of $2,204,575	**$5,968,033**
Other Assets	
Restricted Cash Held by Trustee	**$395,183**
Replacement Reserve Fund	**$86,628**
Deferred Financing Costs, Net	**$1,125,473**
Total Assets	**$8,545,141**

Section one of the reporting appears solid as the total assets are $8,545,141. The next segment of the audit reports on the liabilities and net assets (deficits).

Current Liabilities	
Accounts Payable and Accrued Expenses	**$236,670**
Accrued Payroll and Benefits	**$60,573**
Accrued Interest	**$268,432**
Capital Lease (payable) Current Portion	**$3,176**
Current Portion of Note Payable to IDA	**$240,000**
Total Current Liabilities	**$808,851**
Non-Current (Long Term) Liabilities	
Capital Lease (payable) Net of Current Portion	**$12,515**
Management Fee to related-party Management Company (suspended)	**$1,135,348**
Note Payable to related-party Management Company	**$2,464,860**
Note Payable to IDA Net of Current Portion	**$8,720,450**
Total Long Term Liabilities	**$12,333,173**
Total Current and Non-Current Liabilities	**$13,142,024**
Unrestricted Net Assets (Deficit)	**$(4,891,911)**
Temporarily Restricted Classroom Site Fund	**$295,028**

[39] Formatting information numbers in brackets on a spreadsheet or financial document indicates negative numbers. The numbers in this report are also colored red to assist the reader.

Total Unrestricted Net Assets (Deficit)	**$(4,596,883)**
Total Liabilities and Net Assets	**$8,545,141**

Proper accounting calls for the bottom line of both charts to be equal. The number causing concern here is the **Total Unrestricted Net Assets** (Deficits)[40] of ($4,596,883). Notice that while the property is worth about $6 million, the charter owes nearly $9 million on the note payable for the property. In addition, they owed $3.5 million to a related-party management company. This is another illustration of the kind of school that should have been on financial probation. These all constitute red flags. In addition, the net deferred financing costs are not really an asset in that it cannot be converted to cash, but represent the amortization of financing costs already incurred over the life of the finance agreement. This practice while allowable under standard accounting practices is essentially a nominal bookkeeping asset.[41]

The subsequent three years tell us why this charter should have been under greater financial scrutiny and on probation. Since then the related-party management company has gone bankrupt and the "gift" to the school is that $3.5 million has been converted into a one-time asset and no longer a liability. The schools' net asset deficit has decreased accordingly (but is still negative $1.44 million) and it is now self-managed.

Phoenix Advantages' student enrollment has dropped from about 520 students to 350 students from FY2014 to FY2017, including from 420 to 350 from FY2016 to FY2017. Consequently, their ability to meet their long-term IDA bond obligation is questionable, but the school has encumbered this money directly so that state funds pay bondholders first (a subject of focus in the next *Red Flags* report).

With declining enrollment and a weak financial position, this school is both at risk of closure and more importantly moving resources from the classroom to pay its indebtedness. In fact, as shown in the comparison between ASU Preparatory Phoenix Elementary 2017 with Phoenix Advantage 2014 and Phoenix Advantage 2017, the ASU-sponsored charter puts twice the resources into the classroom. In addition, the portion of resources diverted for debt purposes represented one out of every three dollars given to Phoenix Advantage in FY2017 up from about one in five dollars in FY2014.

Is this really in the best interests of students?
Is this really how school choice is supposed to function?

When financially failing schools are allowed to continue to operate taxpayers are paying off debt-holders instead of having the money flow to the classroom.

CURRENT EXPENSES BY CATEGORY		**ASU Prep Phx .Elem. 2017**	**Phoenix Advantage 2014**	**Phoenix Advantage 2017**
Students (Oct. 1 count)		389	521	354
1. Classroom Instruction excluding Classroom Supplies	$	1,792,441	984,637	738,280
2. Classroom Supplies	$	87,733	31,381	14,702

[40] The format used in the audits is Net Asset (Deficits) if the figure is in brackets it is a Deficit. This is a standard accounting technique. In this report the color red is also used to indicate a negative number.
[41] http://simplestudies.com/accounting-for-deferred-financing-costs.html

CURRENT EXPENSES BY CATEGORY		ASU Prep Phx .Elem. 2017	Phoenix Advantage 2014	Phoenix Advantage 2017
3. Administration	$	660,951	784,588	538,433
4. Support Services - Students	$	332,722	22,250	106,050
5. All Other Support Services and Operations (includes debt service)	$	847,198	2,374,110	1,737,687
6. Total (lines 1-5)	$	3,721,045	4,196,966	3,135,152
Percent in Classroom (1+2)/6		**50.5%**	**24.2%**	**24.0%**
Debt Service				
1. Interest 6850	$	0	536,395	498,363
2. Redemption of Principal	$	0	235,000	549,025

Source: ADE Oct. 1 student's counts, ADE Annual Financial Reports, pages 7 and 10.

The **RED FLAGS** predicting financial failures are in the data. They show up in net income losses and net (deficits). The chart below includes the 12 charters that closed after or during FY 2015. Since then two more, Hillcrest Academy and Discovery Creemos Academy/Bradley Academy closed during the school year. In FY 2015, 12 charters ceased operations. A total of 38 charters ceased to exist between FY 2014 and FY 2017. The school's audits are no longer accessible, so GCI is not able to retroactively do a full analysis of each.

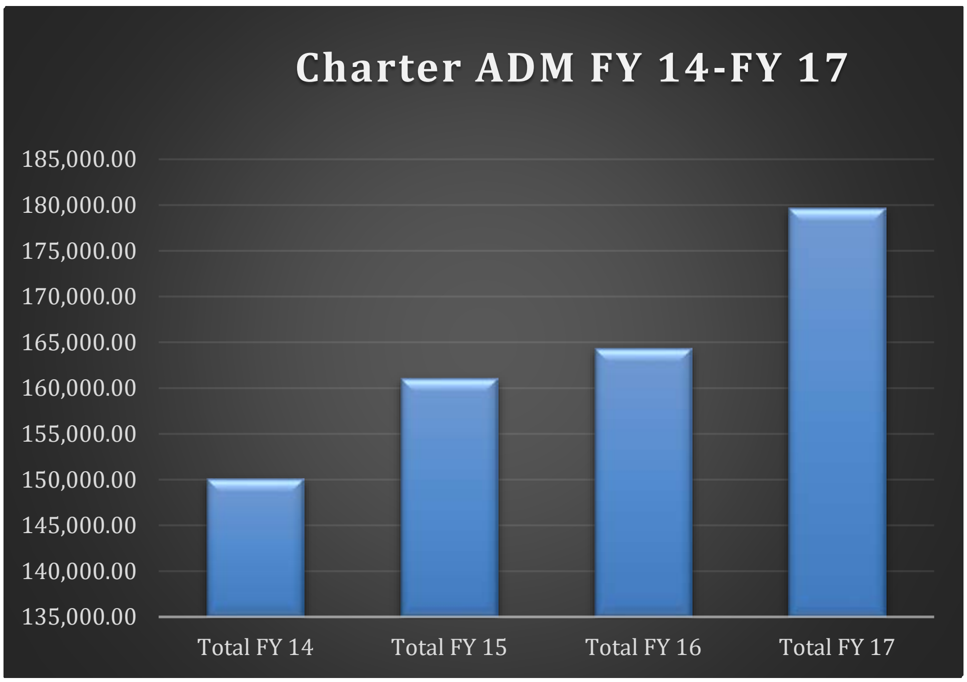
FY 2015 Charter Closures with ADM and Equalization Paid Prior to Closure

Charter Name	FY 2015 Funded ADM	FY 2015 Equalization Paid
Children's Success Academy, Inc.	72.334	$493,330.99
Developing Innovations in Navajo Education, Inc.	12.076	$86,406.11
Esperanza Community Collegial Academy	19.568	$66,670.67
International Charter School of Arizona	45.699	$181,361.61
Ira H. Hayes Memorial Applied Learning Center, Inc.	90.279	$660,515.01
Multi-Dimensional Literacy Corp.	31.625	$235,978.19
New Visions Academy, Inc.	59.991	$439,198.72
Pinnacle Education-Mesa, Inc.	38.329	$119,665.77
Precision Academy, Systems, Inc.	462.497	$3,093,416.61
Vechij Himdag Alternative School, Inc.	58.642	$429,387.77
Westwind Children's Services	134.031	$974,392.05
Westwind Middle School Academy	27.295	$178,250.14
Totals	**1052.366**	**$6,958,573.64**

Why are charter schools losing money?

Net losses and net (deficits) are financial red flags. The flags can indicate an expenditure issue or a revenue issue. ADM is the source of the funding that charters and districts receive from the state. Charter school growth has been substantial in the past four years. A rising tide should raise all boats. The growth in ADM among charter schools is illustrated below and on the graph on the following page:

Total FY 14	Total FY 15	Total FY 16	Total FY 17
150,120.17	***161,069.86***	***164,351.37***	***179,669.66***



Tracking ADM Gains

FY 14 to FY 15	*FY 15 to FY 16*	*FY 16 to FY 17*	4 Year Gain
10,949.69	**3,281.51**	**15,318.28**	**29,549.49**

Ten charter groups (with a total of 84 schools) attracted 73 percent of the growth in a marketplace that grew by 29,549.49 ADM. As noted earlier, these charter groups added 29 new schools over this time period. They added 16,732.45 ADM to their student population.

The remaining gain of 7,846 ADM went to all other charters. The analysis done involved four years of ADM data and the analysis counted a gain over 0.5 percent of the total gained ADM over four years as a gain and a gain of less than 0.5 percent as negative growth.

ADM Gain >0.5% over Four Years
187

ADM Gain <0.5% over Four Years (I.e. a net loss of ADM)
240

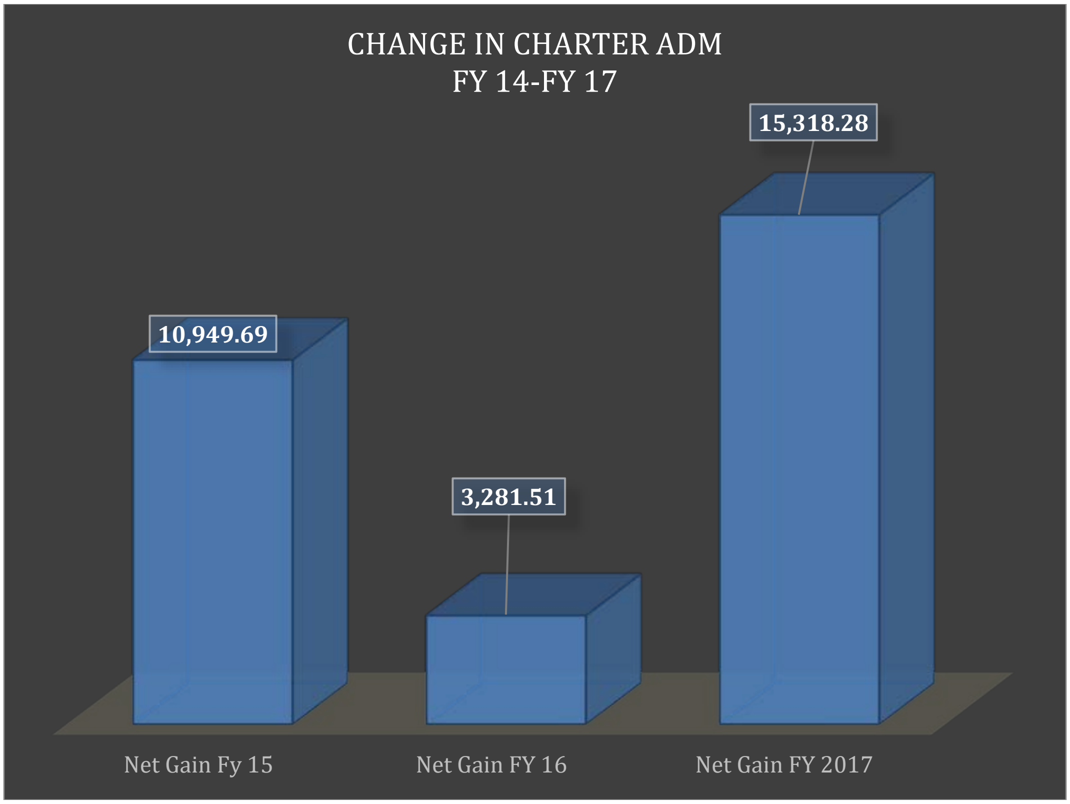
Fifty-six percent of the 427 charters, or 240 charter groups, **lost** or had marginal gains to their ADM. As a result, they also lost or had a minimal gain on the funding that followed those students during this time period. In many cases this means that smaller charter organizations, which are often known for providing specialized and unique curriculum, are struggling to hold their own in Arizona's charter school marketplace.

The charts below provide an overview of the distribution of ADM gains and total ADM among charter groups. Most charters have stagnant or lost ADM. The top 10 charter groups gaining represent almost three-fourths of the gain. Charters listed in **bold** are in the top 10 of total charter group enrollment. *The first five of the top 10 represent about 60 percent of the charter ADM growth are also in the top 10 for overall ADM among charters (see second table below).*

Overview of Charters that Gained or Lost ADM

ADM Counts over 4 Years FY 14 through FY 17

187	240	427
Gained	**Lost**	**Total**



4 Years ADM Growth Captured by 10 Top Gaining Charter Groups

Top Ten Gaining Charters

Charter Group	Gain	%
BASIS School, Inc.	**5,682.82**	**19.2315%**
Legacy Group	**5,012.44**	**16.9629%**
American Leadership Academy, Inc.	**2,811.23**	**9.5136%**
Great Hearts Group	**2,733.53**	**9.2507%**
Primavera Now American Virtual	**1,360.92**	**4.6056%**
Academy of Mathematics and Science, Inc.	1,005.00	3.4011%
Leman Academy	895.14	3.0293%
Heritage Group	867.31	2.9351%
Challenge Foundation	711.67	2.4084%
Daisy Education Corporation dba. Sonoran Science	623.00	2.1095%
Totals	**21,703.05**	**73.4476%**

Source of Data: Analysis of ADM counts from the 2013-2014 through 2016-2017 school years AZ Department of Education Superintendent's Report.

FY 2017 Charters Gaining With Most ADM Overall

Charter Name	FY 17 ADM	# Charters
BASIS School, Inc.	**12200.023**	**18**
Legacy Group	**11645.277**	**13**
Great Hearts Group	**11056.385**	**23**
Imagine Group	7841.722	21
Leona Group American and Kaisen	6849.804	26 and Online
Primavera Online High School/ American Virtual Academy	**6378.880**	**Online**
American Leadership Academy, Inc.	**5736.136**	**1**
EDKEY Group	5409.035	11
Portable Practical Educational Preparation, Inc.	4953.487	Online
Eduprize Schools, LLC	3350.159	1

Even though ADM gains are primarily being captured by the larger charter groups, the charters in RED are currently not meeting the ASCB's Financial Performance Expectations, suggesting the issue goes beyond small charters. In this report, we examine the situation with BASIS toward the end and in this section point out how Imagine at its West Gilbert site has lost students leading to financial challenges.

FY 2017 Charter School ADM

Charters by ADM Growth		No. of Charter Companies	% of All Charter ADM Count
Ten fastest growing charter groups	**75,420.91 ADM**	**10**	**42%**
All other charter groups	**104,248.75 ADM**	**417**	**58%**
All Charter Schools	**179.669.66 ADM**	**427**	**100%**

Other causes of net (deficits): Impact of market saturation with Imagine and lost ADM

Imagine Schools operates multiple sites in Arizona. They are well managed and use their schools to support one another economically. The statistics that follow illustrate the capacity issue. The individual Imagine sites are identified by their Entity # as it is not the intent of this report to disparage the Imagine organization. It is GCI's opinion that the ever-expanding "choice marketplace" has created a glut of charter schools in prime socio-economic areas of the state such as Gilbert. Imagine was once one of the only schools in these areas. When other mega-charters move into the same area, projections about ADM counts used to justify IDA Educational Revenue Bonds used for construction tend not to pan out.

Schools that were built with a capacity that is not being met are often in debt for an amount that represents a significant portion of the capacity number. This type of building model was observed in the author's time in the Arizona charter marketplace. The chart that follows shows some Imagine charter schools growing while others are losing students. An expansion into the southern part of the state with a building built to house an ADM of 1,150 was closed in 2014. The ADM registered at that Imagine site at the time was 265.8.

Imagine Schools Capacity and ADM for Two Years

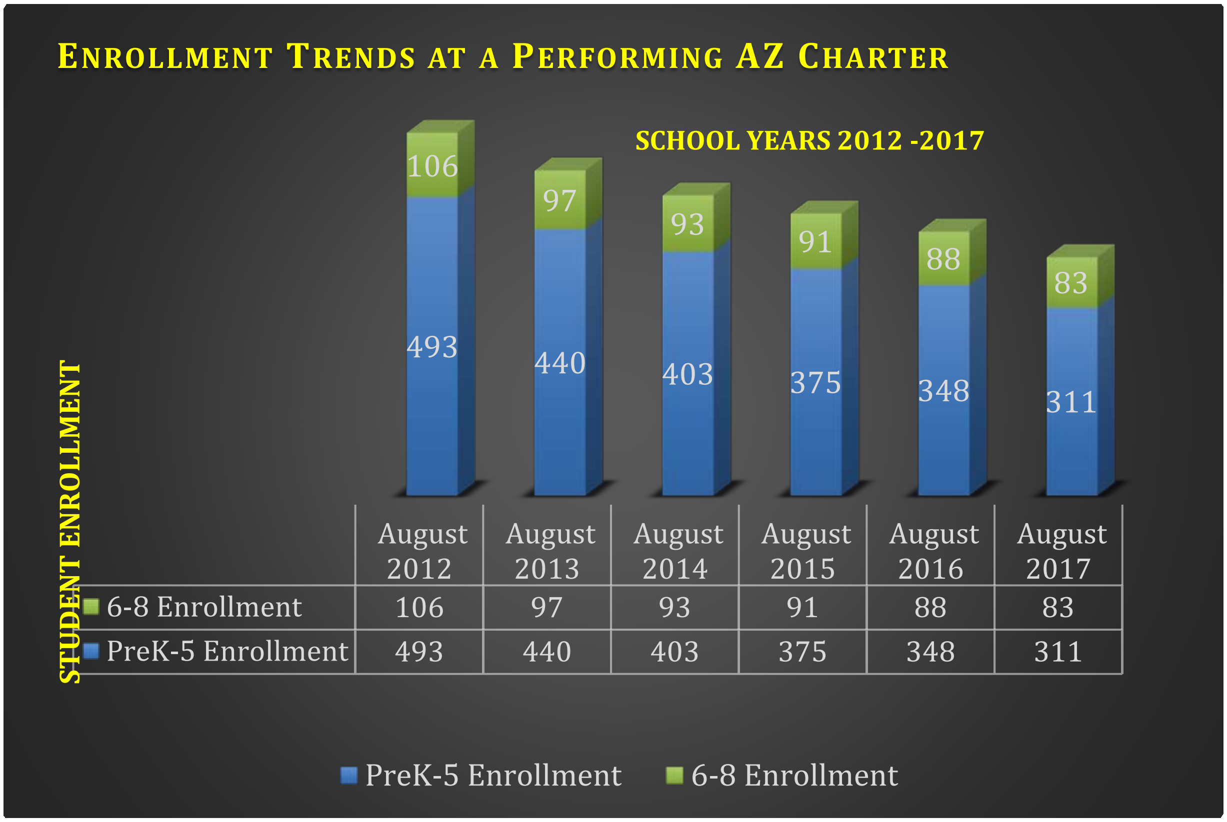
	Entity #	Cap	ADM FY14	Unused Capacity	ADM FY15	Unused Capacity
	79983	625	373.482	251.518	367.397	257.603
	79988	325	229.224	95.776	238.878	86.122
	87401	650	594.374	55.626	570.8	79.2
	89784	525	526.043	-1.043	496.846	28.154
	90162	252	161.214	90.786	193.65	58.35
	89561	280	139.932	140.068	168.432	111.568
	88365	568	454.62	113.38	450.745	117.255
	88367	825	745.803	79.197	751.571	73.429
	89563	320	281.328	38.672	316.202	3.798
	89786	850	686.845	163.155	628.381	221.619
	90034	800	603.587	196.413	502.988	297.012
	88374	568	258.594	309.406	260.729	307.271
	88369	319	106.932	212.068	127.67	191.33
	88372	319	287.707	31.293	305.001	13.999
	89788	400	119.27	280.73	178.112	221.888
	89790	400	186.238	213.762	245.017	154.983
	90160	400	97.162	302.838	94.579	305.421
	79024	675	565.855	109.145	548.056	126.944
	87399	950	691.35	258.65	703.078	246.922
Closed	79985	1150	265.8	884.2		Closed
	79497	700	333.784	366.216	296.59	403.41
	79990	325	97.992	227.008	91.439	233.561
		12226.00	7807.14	4418.86	7536.16	3539.84

Note: 3539.84 in lost ADM capacity does not include the 1,150 seats lost to the closure of one Imagine school. With growth at some sites and decline in others Imagine can manage their financials by moving money between sites (see example in Topic IV Section). The underlying problem in most charter groups is debt on property that is mortgaged based on estimated ADM counts that do not materialize. Smaller charters cannot mitigate losses in ADM to other sites.

Imagine uses a Loss Mitigation Plan at all of its sites. An in house "Insurance" plan to cover temporary losses.

A net (deficit) is mainly caused by the debt on the charter's property and equipment exceeding the actual market value of those assets and over-projections of income from the school's anticipated ADM. A net deficit is *AGRAVATED by unmet projections on student counts and excessive fees paid to subsidiary, for-profit related party firms*. The debt for **every** charter in the ASBCS audit data was analyzed prior to coming to this conclusion. Debt on overleveraged, underutilized properties *can and does* create net (deficits) on the balance sheets of the charter school. This element will be analyzed in depth in the third paper in this series.

Enrollment Trend at one Imagine School



	August 2012	August 2013	August 2014	August 2015	August 2016	August 2017
6-8 Enrollment	106	97	93	91	88	83
PreK-5 Enrollment	493	440	403	375	348	311

The current situation HURTS the charter school movement

The chart on Imagine West Gilbert summarizes enrollment data from 2012-2017. Imagine is an academically performing (B Letter Grade) charter school in an area that has been inundated with competing charters since it opened its doors. There are multiple charters on the same street and within a 3-mile radius of the school, including district schools with an "A" (highly performing) rating, Gilbert Public Schools in Gilbert and the Higley School District.

This data exemplifies the issues of over-building, particularly in affluent areas. A performing charter is affected by this type of "competition" in the same way that the performing district in the same area is adversely affected.

Imagine has debts and obligations that were based on *reasonable* projections when they assumed this debt. The two buildings at the West Gilbert site have a capacity of 1,000 students. *The current lack of geographic planning when charters are granted to new holders negatively* *impacts charter as well as district* schools. Debt on those buildings totaled $5,306,316 (Undepreciated Value); $3,816,338 is the current depreciated value.

IDA bond debt totaled $5,762,475. This site pays $497,635 as a lease payment to Imagine. The company also utilizes a loss mitigation strategy to control losses in its system of charters.

Despite these strategies, the schools' financial situation as captured by the Financial Performance Dashboard is deteriorating (note in this case two different charters for the elementary and middle schools).

Financial Performance

West Gilbert Charter Elementary School, Inc. — Interpreting the Financial Performance Dashboard

	Fiscal Year 2016			Fiscal Year 2017		
Near-Term Measures						
Going Concern	No	Meets		No	Meets	
Unrestricted Days Liquidity <30, but ≥15: Does Not Meet <15: Falls Far Below	21.67	Does Not Meet		30.92	Meets	
Default	No	Meets		No	Meets	
Sustainability Measures*						
Net Income ≤0: Does Not Meet	($338,212)	Does Not Meet		($325,954)	Does Not Meet	
Fixed Charge Coverage Ratio <1.10: Does Not Meet	(0.01)	Does Not Meet		0.09	Does Not Meet	
Cash Flow (3-Year Cumulative) Negative: Does Not Meet**	$163,865	Meets		($471,643)	Does Not Meet	
Cash Flow Detail by FY	FY 2016	FY 2015	FY 2014	FY 2017	FY 2016	FY 2015
	($508,343)	$508,439	$163,769	($471,739)	($508,343)	$508,439

Does Not Meet Board's Financial Performance Expectations

* Negative numbers indicated by parentheses.
** Target effective beginning with FY16 audits.

Financial Performance

West Gilbert Charter Middle School, Inc. — Interpreting the Financial Performance Dashboard

	Fiscal Year 2016			Fiscal Year 2017		
Near-Term Measures						
Going Concern	No	Meets		No	Meets	
Unrestricted Days Liquidity <30, but ≥15: Does Not Meet <15: Falls Far Below	89.64	Meets		83.05	Meets	
Default	No	Meets		No	Meets	
Sustainability Measures*						
Net Income ≤0: Does Not Meet	$7,968	Meets		($5,987)	Does Not Meet	
Fixed Charge Coverage Ratio <1.10: Does Not Meet	1.43	Meets		0.75	Does Not Meet	
Cash Flow (3-Year Cumulative) Negative: Does Not Meet**	($7,444)	Does Not Meet		($59,288)	Does Not Meet	
Cash Flow Detail by FY	FY 2016	FY 2015	FY 2014	FY 2017	FY 2016	FY 2015
	($34,451)	$9,474	$17,533	($34,311)	($34,451)	$9,474

Meets Board's Financial Performance Expectations

* Negative numbers indicated by parentheses.
** Target effective beginning with FY16 audits.

StarShine Academy: Why the ASBCS needs more power

The lack of authority to closedown charters for financial reasons appears to have played a part in how this school costs taxpayers who are paying off bondholders rather than educating students. Statements in parenthesis are added comments to Jim Hall's work.

> The StarShine Academy is a different story than the Bradley Academy. The Charter Board actually voted on May 12, 2012 to not renew the StarShine charter based upon both poor academic achievement and financial mismanagement. StarShine had failed to meet academic performance standards for five years and had serious mismanagement issues – failure to make State Retirement payments, failure to pay state and federal withholding, not following fingerprinting laws, inability to pay vendors, etc. The Charter Board voted unanimous to deny them a new charter.
>
> StarShine Academy owner Trish McCarty requested a hearing to dispute the Board Decision. After a day of testimony before the Arizona Office of Administrative Hearings, the hearing was adjourned and the Charter Board reconvened to reexamine the charter renewal for StarShine, citing "legal issues that could pose a problem for the Board". The Charter Board reversed their unanimous denial and approved the renewal with one "no" vote and two abstentions.
>
> The following year, StarShine received a $12.7 million bond from the Pima Industrial Authority to purchase their existing campus, remodel it, purchase a lot across the street to build a sports field, and build over $4 million worth of new facilities. StarShine did not mention any of the concerns on their bond application expressed by the Charter Board when they voted to deny renewal. (StarShine received a B-Alt on student achievement in 2011-2012, but a D-Alt in 2012-2013 and 2013-2014 and less than 10 percent of their students passed the 2016-2017 AZMerit testing).
>
> Unlike "Field of Dreams", they built it but students did not magically appear. StarShine's enrollment was projected on the bond application to increase to 600 students for 2014 (and 800 students in 2016 and 950 students in 2018—see p. A-9 of their IDA Bond Application) and the building was designed for 1,000). Only 428 showed up. Enrollment has continued to drop until there are just 93 students remaining as on the 100th day 2018. The $800,000 mortgage payments for the $12.7 million loan have resulted in massive deficits every year since, totaling over $3 million since 2013. StarShine's spent over $1 million a year more for their facilities after 2013…while enrollment fell.
>
> StarShine filed for bankruptcy in (February) 2016 but they are still in operation today (the bankruptcy has cut their debt payments).
>
> The high mortgage payments have taken their toll on spending for classroom instruction; per pupil expenditures are $1,247 less in 2017 as they were in

2012. But the belt tightening doesn't extend to management expenses that have doubled since 2012.[42]

On March 20, 2018 at a special meeting of the ASBCS, the board passed an intent to revoke StarShine's he U.S. Dept. of Justice that oversees bankruptcy cases. The Trustee Office had filed an emergency motion in bankruptcy court the prior week that might ultimately lead to a conversion of the chapter 11 proceedings to chapter 7 (assets sold and closincharter. The reason was based on corresponded with the United States Trustee of tg) due to noncompliance by StarShine on payments due and *"in order to stem the tide of the state's assets being squandered for Ms. McCarty's personal use, to prevent the further mismanagement of state taxpayer dollars provided to StarShine to operate its charter school, to assess and pursue potential fraudulent transfer and causes of action against Ms. McCarty and to enable a smooth transition of students for the balance of this academic year."*[43]

In this context the charter board has found StarShine out of compliance and begun proceedings to revoke its charter.

With heightened legal authority as recommended by GCI, the charter board would have been on stronger legal ground to do what was in the best interest of taxpayers, parents and students by denying the charter renewal in 2012. The only person likely benefitting from the additional six years of operation has been Ms. McCarty. It certainly has not benefitted taxpayers or children.

As of June 30, 2017 Starshine had negative net assets of $3.9 million, up from $1.2 million in negative net assets in 2013-2014. StarShine fails the ASBCS financial dashboard.

Financial Performance

StarShine Academy — Interpreting the Financial Performance Dashboard

	Fiscal Year 2016		Fiscal Year 2017	
Near-Term Measures				
Going Concern	Yes	Falls Far Below	Yes	Falls Far Below
Unrestricted Days Liquidity <30, but ≥15: Does Not Meet <15: Falls Far Below	6.03	Falls Far Below	25.06	Does Not Meet
Default	No	Meets	No	Meets
Sustainability Measures*				
Net Income ≤0: Does Not Meet	($988,072)	Does Not Meet	($908,031)	Does Not Meet
Fixed Charge Coverage Ratio <1.10: Does Not Meet	0.24	Does Not Meet	(0.33)	Does Not Meet
Cash Flow (3-Year Cumulative) Negative: Does Not Meet**	($164,869)	Does Not Meet	($73,451)	Does Not Meet

Cash Flow Detail by FY	FY 2016	FY 2015	FY 2014	FY 2017	FY 2016	FY 2015
	$37,243	($231,896)	$29,784	$121,202	$37,243	($231,896)

Does Not Meet Board's Financial Performance Expectations

* Negative numbers indicated by parentheses.
** Target effective beginning with FY16 audits.

Based on the GCI recommendations, both net income and Fixed Charge Coverage Ratio would be red (falls far below) for both FY2016 and FY2017 above. Prior years' audits showed abundant

[42] Hall, Jim (2018), "The Charter Board's Lack of Oversight Resulted in Millions Being Stolen by the Bradley Academy: The Starshine Academy is Next," Arizonans for Charter School Accountability, http://www.azcsa.org/ .

[43] Arizona State Board for Charter School Special Meeting, March 20, 2018, transcribed audio, https://asbcs.az.gov/board-staff-information/meeting-dates-materials.

red flags with negative net income beginning to exceed 10 percent of expenditures in FY2012, the same year StarShine's net assets fell into deficit.

Under a better system, this school would have closed in 2012 and never been able to take on so much new debt. GCI's recommendations are designed to limit these experiences.

BASIS: Highly acclaimed but finances do not currently meet the ASBCS financial expectations

BASIS is one of the most acclaimed charter school organizations in the country and as noted in this report captured 20 percent of Arizona's student growth in charters from FY2014 through FY2017. BASIS likely has the highest brand reputation in the state among charter schools and consequently has a strong track record of attracting students. Their difficult curriculum, higher standards and lack of extracurricular options combine for a pretty high attrition rate between 8th and 9th grade when one-third of students depart the program.[44]

The BASIS business model has evolved to heavily rely on contracting with BASIS Ed., one of the company's for-profit subsidiaries, what's termed as an Educational Management Organization (EMO), which takes about $7 out of every $10 the school receives. GCI believes that BASIS Ed. is a profitable company. BASIS Inc., the non-profit organization with the charter to operate schools, continually operates in the red and has negative net assets on their Annual Audits for their school entities (ten years were evaluated).

Related-party transactions at BASIS Inc. to the EMO as reported on audit documents[45]:

2013-2014	2014-2015
63%	68%

[44] Bezanson, Peter (2017), "What BASIS offers: A passport to 20,000 futures," *Arizona Capitol Times*, April 6, https://azcapitoltimes.com/news/2017/04/06/a-passport-to-20000-futures/.

[45] BASIS has until April 2, 2018 to submit its consolidated FY2017 audit, so no data is yet available. BASIS contends that in that audit that there will no longer be "related-party" contracts between the for-profit and non-profit entities due to the retirement of Michael Block from BASIS, Ed (the for profit subsidiary) that there will no longer be "related-party" contracts. Yet, like many large corporate charter entities, the charter holder and non-profit BASIS, Inc., contracts with BASIS.ed an Educational Management Organization (EMO), which essentially runs the schools, including providing management and teachers. The two share the same building in Scottsdale. The challenge EMOs pose is that they are not subject to audit. BASIS contends the EMO management fees are "reasonable" as determined by an independent firm. GCI's analysis finds the management fees are high compared to other charters. BASIS had admin costs per pupil of $2,320 in FY2017 while ASU Prep and Great Hearts Archway had admin costs of $1,491 and $1,619, respectively according to AFRs submitted to the ADE. However, when education operation and maintenance plant services are included, BASIS has much lower costs in that category and then ASU Prep and BASIS are about the same (around $2,600) with Archway/Great Hearts exceeding $3,000. Charters, including these larger operators, are still more expensive than district schools in these combined areas, even though district schools typically have more expansive facilities. Thank you to Jim Hall for compiling FY2017 AFR data for all charters in a spreadsheet.

2015-2016
71%

Source: Audits from FY 2014, 2015 and 2016. Amounts DECLARED by the Auditor as Related Party Transactions

Four years of ADM at BASIS Inc. show excellent growth and it continues to open new schools, and, as noted earlier, BASIS captured 20 percent of the growth in charter enrollment from FY2014 to FY2017.

FY2014	FY2015	FY2016	FY2017
6,517.20	8463.779	10405.614	12200.023

All of this suggests BASIS is in a solid position with growth and renowned academics. However, BASIS, Inc., the nonprofit charter holder, does not pass the ASBCS dashboard.

Financial Performance

BASIS Schools, Inc. Interpreting the Financial Performance Dashboard

	Fiscal Year 2015		Fiscal Year 2016	
Near-Term Measures				
Going Concern	No	Meets	No	Meets
Unrestricted Days Liquidity <30, but ≥15: Does Not Meet <15: Falls Far Below	33.20	Meets	39.89	Meets
Default	No	Meets	No	Meets
Sustainability Measures*				
Net Income ≤0: Does Not Meet	($7,603,309)	Does Not Meet	($9,677,198)	Does Not Meet
Fixed Charge Coverage Ratio <1.10: Does Not Meet	0.84	Does Not Meet	0.41	Does Not Meet
Cash Flow (3-Year Cumulative) Negative: Does Not Meet**	$11,026,351	Does Not Meet	$13,122,448	Meets

Cash Flow Detail by FY	FY 2015	FY 2014	FY 2013	FY 2016	FY 2015	FY 2014
	($904,867)	$804,459	$11,126,759	$13,222,856	($904,867)	$804,459

Fiscal Year 2014
Fixed Charge Coverage Ratio FY 14
1
FY 2014
Cash Flow
Net Income
Liquidity

Does Not Meet Board's Financial Performance Expectations

* Negative numbers indicated by parentheses.
** Target effective beginning with FY16 audits.

BASIS says there is little cause for concern, even though their Fixed Charge Coverage Ratio has deteriorated from a marginal 1.0 in FY2014 to a dangerously low figure of 0.41 in FY2016. The ASBCS currently has 1.10 as the standard. GCI recommends if it is below 1.0 that it be "falls far below." BASIS falls far below this standard.

BASIS lost $10 million in FY2016 (or about 10 percent of expenses) and had negative net assets of $23 million (a net (deficit)). Both of these would fall far below net income criteria by GCI recommendations (i.e., make the pink areas red in the chart).

BASIS emphasizes in correspondence to GCI that financial concerns are misplaced. BASIS has refinanced debt over FY2015 and FY2016 and consequently incurred one-time loan issuance costs and prepayment penalties on that debt which amounted to $4.5 million in FY2015 and $10 million in FY2016.[46] They also argue that their asset position is understated because they use historical valuation (what it cost to build or acquire) instead of mark-to-market valuation (current market value). The former is more conservative and not subject to market gyrations. Due to the relative newness of many BASIS facilities the difference in the two should not be large.

BASIS has also told GCI that their Debt Coverage Service Ratio, which should also be at least 1.15 to meet minimum standards required by many IDA bonding agreements[47], will be 1.25 in their FY2017 audit. The difference with the Fixed Charge Coverage Ratio is that the one-time charges and noncash depreciation are excluded from the Debt Service Coverage Ratio but included in the Fixed Charge Coverage Ratio (which means the Debt Service Coverage Ratio will always be higher). GCI recommends the ASBCS replace the Fixed Charge Coverage ratio with the Debt Service Coverage Ratio, which, if done, would improve BASIS' standing on the Financial Dashboard (see Findings and Recommendations).

Putting aside these one-time write-offs, BASIS, Inc. still lost $7 million from FY2014 through FY2016.[48] The bond rating for BASIS, Inc. has been noted as BB by Standard & Poor. Standard & Poor's definition of that rating is provided below.

Long-Term Issue Credit Ratings*	
Category	**Definition**
BB, B, CCC, CC, and C	Obligations rated 'BB', 'B', 'CCC', 'CC', and 'C' are regarded as having significant speculative characteristics. 'BB' indicates the least degree of speculation and 'C' the highest. While such obligations will likely have some quality and protective characteristics, these may be outweighed by large uncertainties or major exposure to adverse conditions.
BB	An obligation rated 'BB' is less vulnerable to nonpayment than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions that could lead to the obligor's inadequate capacity to meet its financial commitments on the obligation.

Based on what is known about BASIS, a BB rating appears to be an appropriate rating at this time. As a comparison, Arizona School Facilities Bonds were rated Aa3 in 2015.

A school with strong academic reputations and a growing ADM should not be excused from heightened oversight if it does not pass the ASBCS Financial Performance Dashboard. Its academic reputation and growth make it more likely that BASIS will eventually recover its rating with the ASBCS Financial Dashboard. If BASIS' one-time costs materialize into longer-term

[46] Essentially these loan issuance costs and prepayment penalties for refinancing are like points on a mortgage and having a prepayment penalty on your mortgage.

[47] EdKey, for instance, reports that their Debt Service Coverage Ratio for their IDA bonds must be 1.15 or higher. "The School is required to maintain a minimum debt service coverage ratio of 1.15 with respect to its Series 2013 and 2014 bond obligations. If the debt service coverage ratio is less than 1.15, the school is required to obtain a consultant to submit a written report and make recommendations with respect to revenues or other matters of the borrower which are relevant to increasing the debt service coverage ratio to at least 1.15. A failure to maintain a debt service coverage ratio of at least 1.00 shall constitute an event of default., if the fall below 1.15 then they must hire an outside consultant aimed at improving to 1.15 or higher, and falling below 1.0 is evidence of default." Henry & Horne, "EdKey, Inc. Mesa, Arizona: Financial Statements and Uniform Guidance Supplementary Reports Year Ended June 30, 2016", p. 18 http://www.govwiki.info/pdfs/Non-Profit/AZ%20Edkey%20Inc.%202016.pdf.

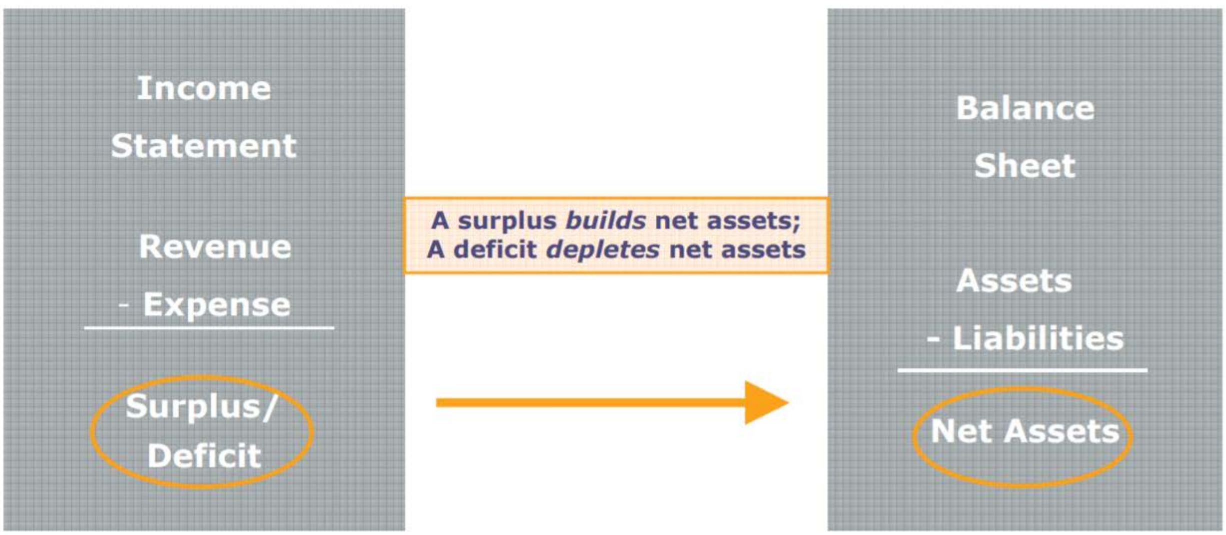
[48] The losses excluding loan issuances costs or prepayment penalties were $4.3 million in FY2014, $3.1 million in FY2015, and a gain of $250,000 in FY2016. The biggest exclusion though was in FY2016 and the FY2016 audit consolidated reporting in such a manner that a number of expenses could no longer be tracked and compared with prior years, which is why GCI is recommending that audits be required to be more detailed.

savings as suggested by their reported Debt Coverage Ratio of 1.25 is sustained, BASIS would be removed from financial probation with the ASBCS according to GCI's recommendations.

However, until BASIS meets that criteria, it should be subject to heightened oversight including providing audits for their EMO subsidiary that receives $7 of every $10 from the state and operates exempt from state procurement rules.

BASIS should also lay out its anticipated financials going forward so that it can be monitored as to whether it is on a path to improvement. These recommendations safeguard the public funds received by BASIS to educate its students and aim to ensure BASIS remains an innovative viable part of the school choice system in Arizona.

Seeing Red: The correlation of negative net income with negative net assets



When a charter holder runs persistent losses, ultimately the charter's net assets turn negative. The list of charters in potential problem is long and significant. Ranging from smaller operators like Juniper Tree Academy and AZ Compass Schools to some of the largest operators such as Imagine and Edkey.

The following tables below show net incomes from FY2014 to FY2017 as well as net assets during that span.

Four Years of Net Incomes Fiscal Year 2014 through 2017

Schools that are showing green in the chart are trending towards recovery on their nets. Schools in this set can also be seen to be trending downward. This can be a sign that they have overextended themselves and that expected ADM increases did not materialize.

	FY 2014	FY 2015	FY 2016	FY 2017
Hillcrest Academy, Inc. (FAILED IN 2016 Bankrupt) See CASE STUDY	$(1,515,901)	$(4,084,353)	Closed in 2016	Closed in 2016
BASIS System wide Information	$(4,290,205)	$(3,074,317)	$244,681	Report Due March 31
Edkey Schools	$(885,495)	$(1,265,948)	$(2,273,049)	$(2,634,176)
Imagine Prep Coolidge, Inc.	$(486,708)	$(1,129,412)	$332,303	$(1,172,078)
Legacy Traditional School- Gilbert	$(551,780)	$(543,745)	$45,680	$309,496
Discovery Creemos AKA Bradley Academy	$(716,832)	$(1,011,727)	$(1,946,771)	Closed in 2018 (with up to $3.3 million in losses)
The Odyssey Preparatory Academy, Inc.	$256,318	$(963,135)	$(1,123,283)	$(3,576,381)
Juniper Tree Academy	$(206,513)	$(265,251)	$(818,591)	$(1,594,800)
StarShine Academy	$(1,217,278)	$(803,397)	$(988,072)	$(908,031)
AZ Compass Schools, Inc.	$(713,016)	$(779,454)	$(622,447)	$(745,281)
CAFA Inc. Consolidated Reporting	$(364,612)	$(773,894)	$(592,751)	Report Due March 31
Challenge School, Inc.	$(55,423)	$(668,379)	$16,628	$58,455
Telesis Center for Learning, Inc.	$(444,330)	$(550,248)	$(378,607)	$314,708
Legacy Traditional School- Laveen	$(429,960)	$(516,257)	$110,282	$248,350
Arizona Connections Academy Charter School	$489,436	$(495,693)	$88	$12
EAGLE College Prep Maryvale, LLC.	New In 2015	$(457,501)	$99,341	$280,328

Four Years of Net Asset (Deficits) Fiscal Year 2014 through 2017

Net (Deficits) that continue for multiple years can be a sign that a business is over-extended. Hillcrest and Discovery Creemos are prime examples of this overextension catching up with a business. While BASIS is on this listing this business has a much greater income stream and footprint than smaller charters. The addition of multiple new sites can be a factor in their Net (Deficit).
Schools on this list are also on the prior listing showing their Nets for the same time period.

Charter Name	Net Assets (Deficits) FY 2014	Net Assets (Deficits) FY 2015	Net Assets (Deficits) FY 2016	Net Assets (Deficits) FY 2017
Hillcrest Academy, Inc. (FAILED IN 2016 Bankrupt) See CASE STUDY	$(3,115,086)	$(7,199,439)	$(11,283,792)	Closed Oct 2016
BASIS System wide Information	$(5,807,354)	$(13,312,226)	$(22,989,424)	Report Due March 31
Edkey Schools	$1,512,120	$(1,474,613)	$(3,747,662)	$(6,381,838)
Imagine Prep Coolidge, Inc.	$(1,043,993)	$(2,173,405)	$(1,841,102)	$(1,798,180)
Legacy Traditional School- Gilbert	$(90,517)	$(1,622,552)	$(1,162,389)	$(852,893)
Discovery Creemos AKA Bradley Academy	$(382,915)	$(1,394,642)	$(3,341,413)	Closed Jan 18
The Odyssey Preparatory Academy, Inc.	$(1,349,077)	$(2,152,064)	$(2,187,508)	$(5,557,638)
Juniper Tree Academy	$16,769	$(248,482)	$(1,067,073)	$(2,661,873)
StarShine Academy	$(1,194,016)	$(1,997,413)	$(2,985,485)	$(3,893,516)
AZ Compass Schools, Inc.	$(558,254)	$(1,337,708)	$(1,960,155)	$(2,705,436)
CAFA Inc. Consolidated Reporting	$(30,141)	$(804,035)	$(1,396,786)	Report Due March 31
Challenge School, Inc.	$1,216,563	$548,184.00	$548,114	$777,667
Telesis Center for Learning, Inc.	$(46,719)	$(596,967)	$(952,079)	$(660,866)
Legacy Traditional School- Laveen	$(1,063,315)	$(1,579,572)	$(1,469,290)	$(1,220,940)
Arizona Connections Academy Charter School	$596,388	$100,695	$100,783	$100,795
EAGLE College Prep Maryvale, LLC.	New in 2015	$(171,749)	$(93,057)	$187,271

Commentary on charters with net losses and net (deficits)

Charter Name				
Hillcrest Academy, Inc. (FAILED IN 2016 Bankrupt) See CASE STUDY	Collapsed Financially	Also closed a prior Location in Mesa		Prior Closures
BASIS System wide Information	High Degree of Payments to Subsidiary Companies	Massive Expansion Last 4 Years. Largest Growth in ADM of All Charter Groups in AZ	Reorganized debt with substantial fees paid for Refinancing. Nets Appear to be Stabilizing.	None Noted in AZ
Edkey Schools	Trending Downward			Allowed to Expand while identified issues were present
Imagine Prep Coolidge, Inc.	Trending Downward	Includes $1.2 M Forgiven Debt	Real NET Assets are -$3 M	See CASE STUDY ON Imagine Overall
Legacy Traditional School- Gilbert	Trending Downward			
Bradley Academy of Excellence, Inc.	Collapsed Financially			
The Odyssey Preparatory Academy, Inc.	Trending Downward			
Juniper Tree Academy	Trending Downward			
StarShine Academy	Trending Downward, In Bankruptcy	Starshine St. John's	StarShine Fay Landrum Academy	Prior Closures
AZ Compass Schools, Inc.	Partner in Multiple Financially Troubled Charters	6 Entities on top of this one		
CAFA Inc. Consolidated Reporting	Trending Downward			
Challenge School, Inc.	Trending Upward			
Telesis Center for Learning, Inc.	Stabilizing			
Legacy Traditional School- Laveen	Stabilizing			
Arizona Connections Academy Charter School	Appears to be compensating for Finances	STABLE		
EAGLE College Prep Maryvale, LLC.	Expected Variance NEW School Addition			

Comments on Cases Presented: Yellow coloring indicates substantive concerns regarding economic viability the latest ASBCS ratings are provided on the next page.

Arizona State Board for Charter Schools Financial Performance Rating for include charters with net losses and net (deficits)

Ratings showing 2014 and 2017 Financial Performance Expectation Rating.

Charter Name	ASBCS FINANCIAL PERFORMANCE RATING FY 2014	AZBCS FINANCIAL PERFORMANCE RATING FY 2017
Hillcrest Academy, Inc. (FAILED IN 2016 Bankrupt) See CASE STUDY	Going Concern Far Below	CLOSED SUDDENLY OCTOBER 2016
BASIS System wide Information	Does NOT Meet ASBCS Financial Recommendations	Does NOT Meet ASBCS Financial Recommendations (2016)
Edkey Schools	Does NOT Meet ASBCS Financial Recommendations	Does NOT Meet ASBCS Financial Recommendations
Imagine Prep Coolidge, Inc.	Does NOT Meet ASBCS Financial Recommendations	Does NOT Meet ASBCS Financial Recommendations
Legacy Traditional School- Gilbert	Going Concern Far Below	Meets ASBCS Financial Performance Imagine Uses Loans and Sharing Across its System to Prop up Troubled Sites
Bradley Academy of Excellence, Inc.	Going Concern Far Below	CLOSED SUDDENLY JANUARY 2018
The Odyssey Preparatory Academy, Inc.	Meets ASBCS Financial Performance Recommendations	Does NOT Meet ASBCS Financial Recommendations
Juniper Tree Academy CARPE DIEM SCHOOLS	Does NOT Meet ASBCS Financial Recommendations	Going Concern Far Below
StarShine Academy	Does NOT Meet ASBCS Financial Recommendations	Does NOT Meet ASBCS Financial Performance Expectations
AZ Compass Schools, Inc.	Does NOT Meet ASBCS Financial Recommendations	Going Concern Far Below
CAFA Inc. Consolidated Reporting	Does NOT Meet ASBCS Financial Recommendations	Going Concern Far Below
Challenge School, Inc.	Does NOT Meet ASBCS Financial Recommendations	Meets ASBCS Financial Performance Recommendations
Telesis Center for Learning, Inc.	Does NOT Meet ASBCS Financial Recommendations	Meets ASBCS Financial Performance Recommendations
Legacy Traditional School- Laveen	Going Concern Far Below	Meets ASBCS Financial Performance Recommendations
Arizona Connections Academy Charter School	Meets ASBCS Financial Performance Recommend	Meets ASBCS Financial Performance Recommend
EAGLE College Prep Maryvale, LLC.	Going Concern Far Below	Meets ASBCS Financial Performance Recommendations

A review of Arizona Connections Academy's Scoring on the prior pages is recommended to the reader. GCI does NOT agree with the ASBCS Financial Performance Recommendations scores for this entity. Remarkable recoveries need to be further analyzed and will be included in a future report that will look at the impact of increased debt (refinancing) on the ASBCS Rating System.

Conclusion

This GCI paper is reporting on 24 years of charter financing and governance in this series of reports.

We have asked two essential questions of the data:

"What have the promoters of charter schools done with the freedom over their budgets, staffing, curricula and other operations?"

"What is the result of eliminating the substantial conformity of governance and finance rules for operating schools (financed from taxpayers' dollars) on the governance and finances of these entities?"

It is GCI's contention that during that time period (the 22 years charters have existed in Arizona) financial collapses of charters, during the school year and outside of the school year were predictable and preventable. The evidence is in the data.

We are in agreement with the Charter Board's assertion that the ASBCS does not have the authority at the present time to close a charter for financial reasons. We also commend the staff and board for their work creating a Financial Performance Framework for the charter sector.

GCI recommends greater authority be given to the ASBCS in this area. A free market, hands-off approach is NOT controlling the marketplace and preventing catastrophic losses of taxpayer financed properties and educational expenditures due to failing charters.

The recent "sudden" closures of Bradley (Discovery Creemos) and Hillcrest are preceded by 67 other closures during the school year since 1994 (Bulkley 2002, Davenport 2003, Hassel 2004, Consoletti 2011, Fabricant and Fine 2012, West 2014, Staff 2016, Green 2017, Hall 2017, Editors 21015)

"If you see fraud and do not say fraud then you are a fraud."

Nassim Nicholas Taleb in Anti-fragile: Things that Gain from Disorder (Taleb 2014)

The fact is that 153 charters suffered net losses in 2014-2015. Those charters were not subject to the same rigorous financial corrections that districts like Murphy or Roosevelt are obliged to take when they have a deficit in a fiscal year. Action has only been taken with charter schools after multiple years of poor financials are accepted.

In Arizona, deficits in districts are often created by the movement of students from public district schools to a new charter. *This is also happening to charter schools when a new charter school opens in the same geographic area.*

The ASBCS, as a regulatory body, has the responsibility of providing oversight for the state's charter schools. This responsibility has been evolving in an era where anti-regulation and free-marketplace beliefs have prevailed.

The ASBCS, in its *Financial Performance Framework and Guidance* dated October 2017, states the following:

> *The Board, in its oversight of charter holders and the schools that they operate, strives not to be over-reaching, but also recognizes the need to protect the public's interests. Because charter schools are public schools they must maintain the public's trust that they are implementing their education program as set out in the charter, spending public funds responsibly, and adhering to laws and charter requirements regarding their operations. However, the Board is aware of the delicate balance between appropriate oversight and infringement on autonomy.*

Based on the findings of this report, the ASBCS' efforts—either due to limited legal authority, ideological mindsets or lack of resources—have favored charter holders and bondholders over taxpayers and the state's children. It is time that the ASBCS' mandate and its ability to proactively oversee charter schools be revisited and strengthened.

Our recommendations are repeated from earlier in the report.

Findings & Recommendations

1. **Finding:** Average Daily Membership Predictions are not being met at the majority of charters.

Change in ADM from FY2014 to FY2017

Gained at least >0.5% ADM	Zero or Lost ADM (<0.5% ADM Change in ADM)
187 Charter Entities	240 Charter Entities
44%	56%

   a. ASBCS currently can only not renew a charter OR renew it for 20 years, nothing in between.

b. Charter schools commonly use *Educational Revenue Bonds* through Industrial Development Authorities to finance debt that is premised upon obtaining new students (ADM). These bonds are marketed and rated (normal bond or junk bonds) with greater weight placed on the charter's *projected* ADM counts and less weight placed on the **existing** property value of the charter school. This topic is further explored in the next *Red Flags* report.

c. New ADM Distribution over Four Years (FY 14 through FY 17)

Gain Represented by Top 10 Charter Companies	**At 84 Sites**
% Gain to Top 10 Charter Companies	**73%**
ADM Gain Posted by Top Ten	**21,703**
ADM Gain Shared by Remainder (417 Charter Corporations)	**7,846**
Total Gain of ADM FY 14 to FY 17 ALL CHARTERS	**29,549**

University sanctioned charters gained 2,414 ADM during this time frame. Which means the remaining charters (Outside of the top 10) actually shared a gain of 5,432 ADM.

Recommendation: The Arizona Legislature must grant the ASBCS the authority to place charter holders on financial probation as well as to close them if charter holders do not effectively implement a financial improvement plan within a specified period of time.

2. **Finding:** About 4 in 10 charter holders are showing signs of financial distress—either suffering net losses or otherwise not meeting the financial performance standards of the ASBCS. However, often it takes two to three years of substandard financial performances to have a "does not meet" rating from the ASBCS. The ASBCS does not currently closely examine financial transactions of these charters, including transactions with related-party or affiliated subsidiaries that operate outside public procurement requirements.

Recommendation: The ASBCS will perform annual financial performance expectation reports rather than the current practice of grading charter organizations based on two years of financial data.

a. That a charter entity which does not meet the ASBCS Financial Performance Dashboard Expectations receive a thorough review of the underlying financial decisions behind those weaknesses identified in the Financial Performance Expectations. This would require an in depth review of the audit and supporting financial records as well as possible inconsistencies in related financial documents associated with the charter, i.e. IRS 990s and AFRs from the ADE. ASBCS should bring any concerns and recommendations to the attention of the charter holder.

b. **That any charter entity *that has negative net income and / or net asset (Deficits)* be required to submit the audits of any related-party or otherwise affiliated subsidiaries dealing with that charter that operates outside a public procurement process. The current system allows these companies, whose sole source of income comes from taxpayer funding via the charter school they conduct business with, to operate without financial oversight from the ASBCS and the public.**

c. **That charter school audits be required to include details on revenue and expenditures rather than gross accounting for the Charter Program and Management and Other.**

d. **That charter organizations that show negative net income and / or net asset (Deficits) for consecutive years be placed on financial probation and be required to submit an action plan for correcting the deficits. Continuation of the charter organization's charter should be determined at an ASBCS board meeting after operating for two years on financial probation and a thorough review of the plan's efficacy.**

3. **Finding:** Red flags emerge in the financials for Charters well before they fail financially. Failure to intervene allows debt to increase, leading to greater risk to investors and resources being diverted from the classroom to bondholders.

   Recommendation: The ASBCS Financial Performance Dashboard currently has no "falls far below" criteria for its three sustainability measures. GCI recommends that two "falls far below" criteria be developed for these sustainability measures.

   a. **The ASBCS should replace the Fixed Charge Coverage Ratio (FCCR) with the Debt Service Coverage Ratio (DSCR). The FCCR measures how much net income a business has relative to what it needs to cover debt payments and obligations, but does not make exceptions for one-time costs or (noncash) depreciation. Because net income is also tracked and includes these costs, DSCR which excludes these is a better overall measure of the long-term ability of charter holder to service debt. Industrial Development Authority (IDA) charter bonds typically have a DSCR requirement, but make no mention of a FCCR.**

   b. **If the FCCR is used, the current 1.10 ASBCS standard is appropriate. However, if the FCCR falls below 1.0, then the business must rely on cash reserves or maneuvers that delay debt payments in order to meet this obligation or simply take on more debt. Hence, falling below 1.0 should be classified as "Falls Far Below."**

   c. **If the DSCR is used, charter IDA bonding agreements typically require a minimum ratio of 1.15 (DSCR will be larger than the FCCR). That should be the standard. Falling below 1.0 is considered a sign of likely default and should be the "Falls Far Below" standard.**

   d. **Net income. Net income is related to net assets, as when net income is negative (a net (deficit)) it reduces the firm's net assets. The ASBCS**

currently has a standard that if net income is negative then the charter school 'Does Not Meet' the standard, but does not define a standard for 'Falls Far Below.' Since the ASBCS has no formal criteria regarding net assets, GCI recommends that if net income and net assets are negative that the charter holder be deemed as 'Falls Far Below' the standard. Alternatively, if net income is negative and 5 percent or more of expenses it should also be noted as 'Falls Far Below', as normally negative net income greater than 3 percent of expenses is the threshold for serious cause for concern. Likewise, 5 percent parallels the 5 percent threshold for state takeovers of district schools.

4. **Finding:** Raising standards of financial accountability need to be enforced in order to be impactful.

   Recommendation: The Arizona Legislature should allocate adequate resources to the ASBCS so that it can fulfill its obligations as the regulatory body overseeing the majority of the state's charter schools and ensure that it is sufficiently staffed to meet the technical tracking needed to effectively meet the recommendations in this report.

Primary data sources

Access to source data

The following is full disclosure regarding the source data referenced in preparing this policy paper. Data used for this report include financial reports submitted by charter organizations to different oversight entities. Every effort has been made to make the original documents easily accessible from the data set to allow the reader to see where the information came from. The data set contains links to the original materials cited in the data. The link locations are noted below.

Audits submitted to the Arizona State Board for Charter Schools

Audits submitted for 2013-14 were used in an analysis of all reporting submitted that particular year. An audit analysis of 2014-2015 data was performed on all charter schools. In all, approximately 1100 audits were studied for the information in this analysis. Audits from 2015-2016 were also included in this report's analysis. When available, audits from 2016-2017 were included. These are not due to ASBCS until March 1, 2018. Reports defined as 'missing' were not late as of February 20, the final edit date of this report.

We thank the ASBCS for their efforts in making the data available.

A complete listing of the Charter School Laws in Arizona is provided at the Arizona State Board for Charter School's website here:
https://asbcs.az.gov/board-staff-information/statutes-rules-policies

Access Link for Audits on the ASBCS website: **Pick Documentation** **Go to Document Management then Click Charter Holder** **Select Audit Documents and Pick Year then Download the FILE**
http://online.asbcs.az.gov/charterholders/view/592/legacy-traditional-school-avondale

Form 990 submitted to the IRS

For this study the author looked at ALL Form 990s for each non-profit school. The link to each 990 is in the data set. Example: **Legacy Avondale Form 990 FY 2013-14 .** Special thanks to GuideStar and Charity Finder for providing access to this data.

Links to the data are in column BA of the data set. For-profits DO NOT file a Form 990 and nonprofits that are only registered as such in Arizona are exempt from the filing rules for federal nonprofits.

Annual Financial Reports (AFRs) submitted to the AZ Department of Education

The **AZ School Finance Start Page** is the entry point to access charter school AFRs submitted to the ADE. As of this writing this page will take you to the starting point for 2016-2017 Annual Financial Reports. Moving through the dataset at ADE will allow the user to locate the more than 1800 AFRs from three fiscal years used in the creation of this data set referenced for this report. In particular, fiscal year 2014-2015 is detailed in the data and reported on in this document.

Thanks to the staff at the Arizona Department of Education for their patient assistance as I learned to navigate this information.

AZ Superintendent of Public Instruction Reports are easily located at the ADE website. The information in this data set was gleaned from Volume One of the Annual Superintendent's Reports. The link is provided here.
http://www.azed.gov/superintendent/superintendents-annual-report/

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About the Principal Author

Curtis Cardine is a fellow for the Grand Canyon Institute and can be reached at CCardine@azgci.org

Mr. Cardine was Superintendent of Schools for a large school multi-district supervisory union in Southwestern New Hampshire. The supervisory union was comprised of three districts with over 5,000 students. Mr. Cardine established charter schools in New Hampshire in 1999 with local funding and then expanded the program using federal public charter school grant money. Those schools are still in operation.

Prior to becoming a superintendent in New Hampshire, Mr. Cardine served as an elementary school principal in Troy, New Hampshire (3 years) and as a principal (13 years) and teacher (11 years) in Winchester, New Hampshire two of the least affluent schools in that state. During that time he created public school options for highly involved multiple handicapped children and a highly recognized program for autistic children. He has taught in every grade from Kindergarten to the Graduate Level.

His expertise is in mathematics, school finance, school law and leadership and change.

Arizona Charter Experiences:
Mr. Cardine opened other charters as lead principal and then as a superintendent in Arizona charter organizations. The New Hampshire schools have won recognition from ASCD and were featured in Sam Chaltain's, American Schools. They, and the Arizona charter schools are still operating as stand-alone charters.

He moved to Arizona in 2006. From 2008 until 2015 he worked in a leadership role in two of Arizona's larger charter companies. He has also run small and medium sized businesses. His experience in the business, charter and public school models informs this work and the philosophy that is evident in the writing.

Mr. Cardine is the author of several reports and a book on charter school finance and governance published by Rowman and Littlefield in January of 2018.

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The Grand Canyon Institute, a 501(c) 3 nonprofit organization, is a centrist think tank led by a bipartisan group of former state lawmakers, economists, community leaders and academicians. The Grand Canyon Institute serves as an independent voice reflecting a pragmatic approach to addressing economic, fiscal, budgetary and taxation issues confronting Arizona.

Appendix A (Hillcrest Academy)

Hillcrest Academy

Case Study: Fraudulent Lending Practices to Facilitate Charter School Bond Sales

The Financial Industry Regulatory Authority (FINRA) announced on May 30, 2016 that it had filed a complaint against Phoenix-based firm, Lawson Financial Corporation, Inc. (LFC), and Robert Lawson, the firm's President and Chief Executive Officer, with securities fraud in connection with the sale of millions of dollars of municipal revenue bonds to customers[49]. The firm has supported many charter schools as they negotiate financing deals for building bonds and refinancing debt. Lawson Financial was a fixture at charter school conferences nationally and in Arizona. A conviction followed this FINRA investigation: http://www.finra.org/newsroom/2017/finra-expels-lawson-financial-and-bars-ceo-robert-lawson-fraudulent-municipal-bond

The junk bond market in charter debt and the charters themselves rely on the fact that charters will refinance their debt on a regular basis. This is highly reminiscent of the mortgage market prior to the 2007-2008 financial crisis. At that time, homeowners would attempt to remortgage prior to the balloon payment on their risky loan coming due.

In addition to the primary charge, the complaint against the Lawson financial firm charged the owners of the company with self-dealing. The complaint alleged that the firm abused its position as a co-trustee of a charitable remainder trust and improperly used the trust funds to indirectly prop up the struggling offerings in the charter finance arm of the firm.

The charges stemmed from the transfer of millions of dollars from a charitable remainder trust account. The complaint also charged Robert Lawson with misuse of customer funds.

> "The municipal revenue bonds at issue in the complaint include: (1) a $10.5 million bond offering in October 2014 for bonds relating to an Arizona charter school (author's note: Hillcrest Academy) was underwritten by LFC and sold to LFC customers, as well as subsequent sales of these bonds to LFC customers in the secondary market; (Society for Economic Anthropology (U.S.). Meeting (2006 : Ventura Calif.), Browne et al.) secondary market bond sales to LFC customers in 2015 of earlier-issued municipal revenue bonds relating to the corporate predecessor of the same Arizona charter school; and (3) secondary market sales to LFC customers between January 2013 and July 2015 of earlier-issued municipal revenue bonds concerning two different assisted living facilities in Alabama.
>
> The complaint alleges that Robert Lawson and LFC carried out their fraudulent scheme by transferring millions of dollars from a deceased customer's charitable trust account to parties associated with the conduit borrowers to hide the financial condition of the bond borrowers and the

[49] Hillcrest Academy is a case study presented in the Grand Canyon Institute's Report: *Following the Money*.

risks posed to the municipal revenue bonds. In particular, the complaint alleges that LFC and Robert Lawson hid from LFC customers who purchased the bonds the material fact that Robert Lawson – in his role as co-trustee of the charitable trust account, and with the knowledge of his wife Pamela Lawson – was improperly transferring millions of dollars of funds from the charitable remainder trust account to various parties associated with the bond borrowers when the borrowers were not able to pay their operating expenses and, for certain of the bonds, were not able to make the required interest payments on the bonds." Source FINRA Financial Industry Regulatory Authority

The Issue of Related-Party Boards

If FINRA looked at the corporate board listings for charter schools available on the ASBCS web pages as a part of their investigation in Arizona they would find Pamela Lawson, various contractors (who build the schools and profit from those charter school loans) and multiple cases of owners of one group of charter schools on the corporate boards of other charters. *This type of relate-party activity and inter-related composition of boards at the corporate board level lends itself to what would normally be referred to as collusion. These practices are tolerated in Arizona's charter school laws by their silence on the practice. Several large and small charters have dealings with "development companies" who own and lease the land and buildings to the school. The rates charged for "Development Fees" appear excessive (upwards of $200,000 on a $3 million project) when compared to similar fees charged in public school construction*[50]*.*

There are no rules in place within Arizona law to disallow this type of board composition. Under the charter laws there is nothing illegal about arrangements like these that allow board structures that create the conditions for collusion.

There are also cases where the land owner selling property to a charter holder was a related party. Overpriced land deals were witnessed by the author on several occasions including paying per acre "deals" of 10 times the market price for undeveloped (no water, electric or sewer) desert property. The charter group had been "locked" into this deal by signing a lease that included a clause regarding purchasing the land within a certain time frame - this was a "deal" negotiated by a related party to the former charter holder. This transaction contributed to multiple years of net (deficits) at that entity (Edkey).

This Case Study is presented because it details some of the misrepresentation of bond risk involved in the FINRA case. The case involved the defunct Hillcrest Academy in Mesa (and then again on Power Road in Gilbert). Hillcrest was a struggling charter school that went out of business at the start of the 2016 school year. It's net (losses) and net (deficits) were alarms that went unheeded. Its first school closed its doors in 2013. In 2014 it had 77 students. In 2015-2016 it only had 122 in a multi-million dollar facility. Related parties were leasing teachers to the school and managing it as well. The company did not MEET

[50] In New Hampshire and districts in Arizona this oversight is normally handled by a board appointed Clerk of the Works. Typical Clerk of the Works payments were $25,000 for multi-million dollar construction projects.

the ASBCS' Financial Recommendations at the time. The charter board website indicates that the school's closure was due to its charter being revoked due to issues with contract compliance. This reason is misleading when the financial reasons for the closure are clear. The firm went bankrupt.

In 2015-16, the year prior to Hillcrest Academy's closure, it reported a positive net of $105,136 to the ADE on their AFR. This figure was "misleading" at best as it did not include an accounting of the school's debt load. The less charitable proposition is that the report to the ADE was the result of financial deception. (See Charts on nets AND charts regarding net (deficits).

Financial information reported to the ADE and ASBCS by *the same company is not cross checked*. *That type of simple collaboration between the two agencies does not require new laws or bureaucratic meddling. It requires cooperation and comparisons of data. Excuses that the two financial measurements are measuring different things are not acceptable. Using the same accounting method, Accrual or Modified Accrual would ensure that the audits and AFRs would align regarding the assets and of deficits listed. This simple fix also requires providing those agencies with additional auditors in their finance departments. There is no excuse for this lack of oversight of public funds.*

The reality of Hillcrest's financial position was a net loss of (-$4,084,353). Hillcrest was in debt to a Florida-based financial company (junk bond holder) among others when they went bankrupt in October of 2016. The IDA was the source of lending for the bonds in the FINRA report. The debt was bundled by junk bond dealers just like bad mortgage debt was bundled in the financial crash in 2007. In this case the bond buyers were "misinformed" by the company that was selling the bonds regarding the risks involved.

The deception used by the bond company involved the misappropriation of funds from another one of their accounts to "prop up" the failing charter group's portfolio on paper. The financials posted to ASBCS for several years showed the type of net assets (Deficits) that the forensic accounting used to research this report uncovers - in this case, the (-$4,084,353) amount of net (deficit) at Hillcrest at the end of fiscal year 2014-2015.

Conclusion: This school should have been shut down by the ASBCS years earlier. They should not have been allowed to construct a new site that now sits empty in Gilbert. The company also had several related-party, for-profit businesses taking funds and fees from the charter school including Varsity Staffing, a teacher leasing subsidiary. The school had under 200 students when it went bankrupt.

By way of comparison, school districts are required to end the year in the black. There are consequences when they don't. Charter advocates often cite the fact that the Phoenix, Arizona-based Roosevelt School District had a net loss in 2015. When a public school district has a deficit it must cut staff and other expenses to balance their books.

Unbalanced Budgets: Surviving on Credit

Within the data the use of new “debt” to pay day-to-day operational expenses was seen in many of the charters that were struggling. Borrowing costs (interest) on short-term debt ranged between 0 to 35 percent (an outlier).

The industry and ASBCS representatives cite charter holders that put their own money into their businesses. This is the exception rather than the rule. These types of transactions were typical in the 23 percent of charters previously identified by GCI for ethical and sound business practices. GCI did note credit extensions at 0 percent, which was seen in multiple occasions as a loan from the principal officer (charter holder) or a concerned board member. This is the type of short-term capital input *one would expect of a business owner* in normal free market enterprises. The loan is a straight infusion of cash without an interest payment on the owner’s short-term loan to their own business.

Abuses of this type of borrowing were also noted with excessive interest being charged for money lent to the charter at rates higher than normal (i.e. compared to bank rates for short-term credit) borrowing costs. Many loans of this type were noted, most originating with corporate board members or the charter holder(s). The data set identifies these loans and the interest amounts paid. An interest rate of 9% or more was considered to be excessive, especially if the company had a line of credit available at a lower rate. Real estate debt and debt in general are topics that will be covered in *Red Flags: Over-leveraged Debt,* a policy paper due out in spring 2018. GCI will report out on interest rates being paid out in that paper.

Bottom Line

The core issue is that a critical mass of charter schools *are over-estimating their revenue sources (Equalized Value Payment Projections of ADM) during the loan application process*. The loans are based on the property values *AND expected revenues from payments for student counts for ADM. Net losses and net (deficits) are manifestations of these financial issues. In our next paper GCI will look at charter debt, leases, and property acquisitions and transfers (sales of charters).*