Policy Report #1 in the Series

September 17, 2017

Following the Money: Twenty Years of Charter School Finances in Arizona

(A Meta-Analysis of Charter School Financials and what they tell us)

By Curtis Cardine, Fellow, Grand Canyon Institute

Co-Authored with Dave Wells, Ph.D., Research Director, Grand Canyon Institute

Executive Summary

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?"

"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?"

Executive Summary

While school choice and free market economic theory have driven the Arizona charter school movement, many in the drivers' seat have found opportunities to benefit themselves through financial transactions that are specifically forbidden in public district schools. Charter schools were promoted as competition to the public school system. The “rule books” regarding financial controls and governance were replaced by laws that eliminated most oversight. Fundamentally, charter schools do not offer parents and their children true school choice when they operate without the financial accountability and transparency demanded of 'competing' public district schools.

Charter holders receive almost all their funding directly from the State’s General Fund on a per student basis. In FY2016 charter schools received $6,669 per student from the State’s General Fund, representing about 85% of their funding. Almost all of the rest comes from the Prop. 301 education six-tenths of a cent sales tax and the Federal Government (Joint Legislative Budget Committee 2017, Arizona Department of Education 2016).

This extensively researched policy report, the first in a series of three reports, highlights some of the differences in the rules that govern public district schools and charter schools. Charter schools were given greater freedom over their budgets, staffing, curricula and other operations to foster quality improvements in the education they provide and to encourage competition.

This policy report, and the others in this series, look at the actual business practices that emerged from that greater freedom from regulations, focusing on the following areas: related-party transactions, high executive compensation compared to comparable public sector salaries, questionable distributions of profits/owner’s equity, lower classroom spending, academic underperformance, and inconsistent financials. Related parties[1], while usually actual relatives of the charter holder, also includes related businesses (businesses with the same board and owners), and former charter holders that still engage in business with the charter group.

Current financial practices by most charters fall short of sound business practices and the public’s expectations as to how their educational dollars should be spent (Bennis, Parikh, and Lessem 1994, Dewey 1891, Knight and Friedman 1935, Pojman, Vaughn, and Vaughn 2014).

[1] Family members such as brothers, sisters, spouses, ancestors and lineal descendants. The charter holder names listed were researched to discern whether the listed charter holders were related. I.e. cases where the husband and wife had different last names. (Step-parents, uncles, in-laws, cousins, nephews and ex-spouses are not considered related in these reports.) A related party corporation or partnership is one where more than 50% of the stock or more than 50% of the capital interest is owned by the taxpayer who owns the corporation or partnership. In all of the charters reviewed the charter holder held 100% of the stock. Most cases noted in this study were 100% held by a related party.

Recently, KAET Horizon host Ted Simons asked Governor Doug Ducey if there was enough oversight with regards to where Empowerment Savings Account money directed to private schools. The question related to SB1431 that he had signed expanding state-funded Empowerment Savings Accounts for private schools. The Governor responded, "We want to have transparency and accountability. We can do that." (2017)

Transparency and accountability should also apply to the state's hundreds of privately owned charter schools. This policy report's findings articulate the need for greater transparency and accountability in the charter school sector. In the absence of a definitive legal standard for accountability, charter holders and their corporate boards have created financial arrangements that benefit ownership at the expense of students and teachers.

Related Parties Transactions: Three-fourths of Arizona's charter school holders engage in related-party transactions that did not fit the definition of "saving money" or "efficiency," an oft-cited reason given for allowing charters to engage in this practice. Gaming the system is often done through contractual transactions with subsidiary for profit companies owned by the charter school holder and overseen by the same corporate board as the nonprofit charter school.

In 2013-14, 48% of Arizona's charter school expenditures for contracts, leases and rents were owed (committed) to for profit companies that employed or were owned by the charter holder or a related party. These commitments amounted to $497.5 million annually. That figure would be higher if administrative and teacher salaries and benefits to related parties were included.

> ***Key Recommendation:*** *Require publicly funded charter schools to be subject to the same public competitive bid procurement process as district schools. All related party contracts need to be public information and need to meet the standard of saving money for educating students.*

Excessive Executive Salaries: Numerous cases were found where charter administrators' salaries are shockingly high for the number of students they oversee. In one case, the executive director of a youth center that also includes a 90-student, single-location charter is paid as much per year as a public school superintendent who oversees 23,000 students. Adding insult to injury, the school in question received failing academic marks from the Arizona State Board for Charters Schools.

> ***Key Recommendation:*** *Require charter school audits to justify executive and administrative salaries benchmarked to comparably sized district schools.*

Questionable Distributions[2] ***of Profits:*** One-third of for-profit charter schools were found to have made questionably large distributions to their shareholders. Six for-profit charter schools made distributions valued at 12% to 45% of their 2014-2015 state taxpayer revenue. Four for-profit charter schools took more than their net profit as distributions, turning a net profit for the year into a net loss as a consequence. While large distributions might come from accumulated retained earnings, they can also undermine the financial viability of the operation.

The data on distributions from subsidiary for profits, operated by the same owners and board as many nonprofit charters, *is unavailable to the public* as the firms are considered separate businesses from the charter. Where that information is discernable through forensic accounting, it is provided.

> ***Key Recommendation:*** *Charter school audits need to identify the source of any profit distribution and the ASBCS would need to approve any distribution that exceeded net profits for the year.*

Reduced Classroom Spending: The losers in this mix appear to be taxpayers, teachers and students in a majority of cases. Charter school teachers on average earn 20% less than their public district school colleagues while 43% of charters do not offer a retirement or savings plan to their employees. This issue is explored in depth in the third policy report of the series.

The 2013-2014 Annual Report of the Superintendent for Public Instruction showed that charter schools spend 45% of revenues on classroom instruction compared to public district school spending at 52% of revenue. At the end of Fiscal Year 2015 the numbers were 51.5% for District Classroom Spending and 47.5% for Charter Classroom Spending. Student Support Levels at Charters was 4.9% to Districts at 7.9%. This information is not widely known because these figures are buried in the Annual Report. The data on which they are based, AFRs, are not scrutinized for accuracy for charter schools and is sometimes inaccurately entered. Another issue that is explored in this report is inconsistent financial accounting to the state, IRS and on the audits.

From related party transactions to excessive executive compensation to questionable distributions to shareholders, revenue from the state's General Fund designated for educational purposes instead disproportionately benefits the charter school holders and corporate board members of charter schools.

[2] Distributions are amounts paid to stockholders in a "for profit" charter company. The distributions reported here come from companies that are registered as for profit charters. This is not to be confused with "for profit subsidiaries of nonprofit charters". Distributions at those for profit subsidiaries are not visible to the public. Their audits are not public. It is assumed that the money for distributions in excess of the company's NET are being taken from Owner's Equity.

> ***Key Recommendation:*** Charter school financial data needs to be shared and monitored by the Auditor General just as is done with district schools.

Academic Underperformance: This financial behavior may have academic consequences (although academic performance is NOT the focus of these papers). Despite the highly esteemed academic profile of a few charters, the charter sector overall underperforms academically relative to district schools for students of similar demographic backgrounds in the same area. Two independent studies found demographically similar students did just as well or better on average in public district schools.

Reconciling Inconsistent Financials: Frequently numbers in charter school annual financial reports (AFRs), audits, and IRS filings do not reconcile even though they cover the same period. Some audits are inadequately detailed and done by out-of-state firms that may not be familiar with Arizona law. For instance, in 2014-2015, one charter holder that currently runs two schools reported a net gain in revenues less expenses of $369,000 to the Arizona Department of Education (ADE) and yet their audit noted a net loss of $134,000 to the Arizona State Board for Charter Schools (ASBCS) for the same year. The difference in total net assets reported in their audit and to the IRS were also dramatically different in fiscal 2013-2014. The IRS 990 reported $2.5 million in net assets, while the audit indicated negative net assets of $2.6 million, a $5.1 million difference!

> ***Key Recommendation:*** *Require a standard format for audits and ensure that audits, AFRs and IRS 990 filings numerically align with one another.*

Notably, one-fourth of charters are providing the opportunities promised by their founding legislation. In the absence of sufficient financial oversight, they do the right thing. A large charter that is an exemplar of this type of organization is the Arizona Agribusiness and Equine Centers. These charters should be emulated and replicated. Their business models are financially sound and ethical. They also treat their teachers fairly and as professionals.

This policy report and the policy reports that will follow are designed to give information to the public and policymakers. The information should serve as a timely financial warning. These policy reports are informed by three years of exhaustive research and a forensic accounting of the data including a meta-analysis of the most comprehensive financial data on Arizona’s charter school sector. Sources include AFRs, audits, Federal IRS 990s for nonprofits. The ASBCS and the ADE were consulted and were helpful during the information gathering phases of this effort. Their assistance was greatly appreciated. Preliminary findings were shared with these agencies.

Each section of this report offers specific recommendations designed to improve information for parents, achievement for students, and accountability to taxpayers.

The next in this series of policy reports, due to be released in the fall, will look more carefully at red flags regarding issues with financial management, growing debt with many charters, and whether current business practices are appropriate and sustainable. A failure rate of 42% since 1994 is one symptom that charter finances and governance need attention.

In the fiscal year ending June 30, 2015, a total of 138 out of 407 charters[3] DID NOT MEET the ASBCS Financial Performance Recommendations. An additional 90 DID NOT MEET the Cash Flow standard. Cash Flow, as any business owner can assert, is a canary in the coal mine. It is a red flag indicative of financial issues.

The third report to be released by the end of the year will be an in depth look at teacher compensation, benefits and issues related to travel costs for school personnel which, in many cases, exceed what much larger public districts expends for the same item.

The findings in this series of policy reports expose that, in fact, true school choice is lacking in the absence of transparent and consistent information about charter school financial data, executive compensation, contractual obligations and academic performance. In the current state of play, charter schools are not required to operate at a level of financial accountability and transparency that is as comparably stringent as is demanded of public district schools.

While information in these policy reports may be alarming, none of it, under Arizona state law, is presently illegal. It is not the intent of these reports to suggest any charter operator is currently violating state law. The identified practices are all legal under the current rules.

The law's silence on these issues is deafening.