



METHODOLOGY DETAIL

for A Forensic Accounting Study of Twenty Years of Charter School Finances

The Essential Questions answered in these Papers

1. ***“What have the promoters of Charter Schools done with the “freedom over their budgets, staffing, curricula and other operations.”?***
2. ***“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 finance of these “free” entities?***

These papers look at the financial and governance **results** from 20 years of charter schools operating as “Free market” deregulated entities funded by the state and federal governments’ tax payer generated revenues. Although some commentary on academic results is provided the focus of the reports is on financial and governance data at charter schools.

“A.R.S. §15-183(R) requires each charter school sponsor to adopt a performance framework. In August 2012, the Arizona State Board for Charter Schools (“Board”) adopted its Financial Performance Framework and Guidance (“financial framework”), which represents one component of the Board’s Performance Framework. The purpose of the financial framework is to communicate the Board’s expectations for ensuring that all charter holders in its portfolio are viable organizations with strong fiscal management practices. The term “charter holder” refers to the entity that has entered into a charter contract with the Board to operate one or more charter schools.”

- Source: ASSBCA documents on Interpreting the Financial Performance Dashboard.

Financial transparency in charter school operations is a recurring issue in serious research efforts trying to determine where and how the public’s money is being spent. Obtaining original financial documents for charter schools including information regarding salaries, payments to related parties, real estate transactions and other information vital to understanding charter school finances was essential to the creation of this report.

Thanks go to the Arizona Charter School Board (Andrea Leder in particular for generous giving of her time) and for making audits of individual schools available to the public through their website.

The Charter Board does not maintain any information regarding the compensation of owners, or shareholders in for profits. They do collect minutes of publicly posted meetings of the charter board, individual charter corporate board meetings, and individual charter governing board meetings. There are charters where those corporate boards and governing bodies are representative of the communities where the charters are located. In most cases these boards consist of charter holders, relatives, related parties and employees of the charter. This knowledge was gained by the author's experience in charter governance in Arizona.

Documented Contacts: A letter was sent in December of 2013 requesting data on compensation, teachers' salaries, and a complete listing of all charters (open and closed) since 1994. The request was sent to the Arizona State School Board and to the Arizona State Board for Charter Schools. Copies of those requests were archived. The charter board replied through their director stating that they do not keep records on salaries. They are not required to do so. A list of all charters that the AZ Charter Board has records on was provided.

The Charter Board does not possess audits that detail for profit and non-profit related parties or related party subsidiaries of the charters that do business with charters. They are not required to have this information. The economic model behind charter financing with taxpayer funds is based on a free market use of those funds by the charter business accepting that funding. These papers recognize that this was the intent of the charter laws and reports on the result of that intentional deregulation of public school financing and governance.

The level of transparency currently present at The Arizona State Board for Charter Schools (ASBCS) was not the case when this study was initiated in late 2012. For this transparency we owe a vote of confidence in the Charter Board's ability to get this right and manage the implementation of the recommendations respectfully given here. There *has been movement* on the transparency issues noted in earlier reports by the Auditor General.

Cooperation with inquiries was not always the case. Two years ago when this research was started with a written request to the then director of the Arizona Charter School Board, the request resulted in a terse exchange via email followed by a letter from the author asking for the information under the "Right to Know" law. The Grand Canyon Institute has retained copies of those exchanges.

The document that was finally received was an alphabetical compilation of all existing charters, their associated schools, representatives' names, addresses, opening and (if applicable) closure dates, authorized capacity of the charter, phone numbers, CTDS and Entity Numbers of each charter. The list was NOT organized by charter groups, ownership or geographical location in Arizona.

This listing was compared and contrasted to similar listings maintained by the pro-charter organization Edreform and USDOE information. This process took two months of the major researcher's time. The research on academic performances compared to district data on similar populations was coordinated

by Dr. David Wells. The primary author used the ASBCS Academic Performance Standards in side by side comparisons of that data with the same charter's Financial Performance Ratings.

The current staff at AZ State Board for Charter Schools has been helpful and forthcoming with data that is in their publicly accessible database. Andrea Leder and the staff at the AZCB have been gracious with their time and talents in the data gathering phase of this project.

The ADE provided the author with guidance and were always gracious with their time and patience during the long period of data gathering thanks to Lyle Freison and his staff. Their assistance in clarifying how the errors noted between reporting on pages 7 (used for the Annual Superintendent's Report), page 2 and page 10 of the Annual Financial Reviews led to the recalculation of those pages to reflect the actual reporting data *as it should have reported to the data set* on page 7. Data was hand transcribed into new excel sheets with self-calculating formulas built in that categorized spending on the federal reporting on page 10 and the chart of accounts reporting on page 2 of the AFRs.

The data set notes unreported figures on page 7 and discrepancies in the reporting of assets and liabilities between the AFR and the Audits. Audits were also compared and contrasted to the IRS form 990 information.

A Forensic Accounting Analysis of the Data

The reports are informed by expertise gained in the field and through graduate and doctoral level courses. The active participation of Dr. David Wells and members of the Grand Canyon Institute are gratefully acknowledged. The report was highly vetted and there were 50 plus rewrites of the report prior to its final release in September of 2017.

Author's credentials in financial analysis.

As a newly elected superintendent in New Hampshire it was my duty as an agent of the board to inform three separate boards that there was something wrong with the accounting practices being used in the front office. The discovery was made and the issues identified two months into my term as superintendent in 1999. After deciding where the issue was the district allowed the business manager to resign rather than being terminated (there were not any issues with embezzlement) and began the process of fixing the problem. Financial issues are present in the district and charter world. Financial controls are tighter and transparent in the district setting. Cases of financial malaise in districts are given in the report including how the problem was identified.

The new business manager, retired Colonel Larry Biron (Colonel Biron had managed NATO forward based Hospital logistics and finances prior to becoming a school business manager and officer in the NH ASBO group. Larry and I set about the task of dissecting the accounts and deciphering how the prior business manager had built the budgets for three school districts incorrectly. This effort required the use of forensic accounting to put things back into the proper place and then to start undoing the financial damage that had been done. We worked with the NH Auditor General and the NH Department of Education during this time. On a personal level my father-in-law Everett Taylor, a retired IRS Director

and the NH Commissioner of Revenue under John Sununu, provided valuable assistance and advice from his experiences as an IRS Corporate Investigator for 30 years.

An intentional choice to share all of our findings and what we would do to correct the problems was shared with the Keene Sentinel, all of our governing boards and each town's selectmen. The problem was resolved in one and a quarter years with a surplus in year two which was turned back to reduce taxes (NH rules regarding surpluses).

The same type of transparent researching for this report was done with sample data sets being shared with the AZ DOE, AZ State Board for Charter Schools, the AZ Charter Association, NEA, the AZ School Boards' Association, The Arizona Republic, Grand Canyon Institute for Public Policy and The AZ Administrators Association. These meetings were documented and the materials shared are a part of the data set. An early methodology paper was also shared with these groups.

Charter Experience: The author wrote (with a team) a 1999 successful proposal for Public Charter Schools (one of only 10 granted nationally). Governance, Financials, and detailed descriptions of the proposal's goals and objectives were part of the successful grant proposal for a five year \$12.5 grant from the Department of Education. Prior to this grant the district had won multiple \$15 to \$100 K grants to plan for this grant and develop the capacity of the Monadnock Region in New Hampshire to experiment with charter schools. This work included working with Senator Judd Gregg (NH Republican NH) and Co-Senate Education chair Ted Kennedy (D MA). A "future search" was conducted in the district to gage the public's support for charter schools in the Monadnock Region. The group developed the rules to allow cross district placements (open enrollment) and governance for the NH Charters created between 1999 and 2005.

The final report generated for the Department of Education involved an analysis performed by the Josiah Bartlett Center a conservative think tank comparing the charters created by the grant and comparing their academic results to demographically similar district schools. The results were similar to the results generated by the CREDO reports and Goldwater Institute contracted reports used to compare academic scores for this report by Dr. Wells. Selection of those reports which were done earlier (15 years into the establishment of charters in Arizona) was motivated by a desire to compare similar student populations. The ASBCS system for evaluating charter academic performance was included in several parts of the data set along with the ASBCS Financial Performance ratings (Posted side by side with links to the source).

Governance Experience: The author has served as an officer (Vice President) at two charters, and has served on the governing boards of multiple charter organizations in NH and Arizona. He has been an officer at the Corporate Board level and the Governing Board level in charter organizations. He has also been the agent of multiple school districts (as Superintendent) and served as the CEO for a Supervisory Union in New Hampshire. The author has expertise in agency board relationships, organization and management, and leadership and change.

Course work and Professional Education Credentials: For several years the research practitioner was a guest lecturer at Antioch New England Graduate School teaching graduate level school finance, specifically, how to identify issues in public non-profit accounting. Each year during the author's decades long career as a principal and superintendent the author attended virtually every financial and school

law seminar offered by the Department of Education, the Association of School Business Managers, and The New Hampshire Bar Association over 2800 hours of re-certification credits were obtained during this career. Additional training and certification in multiple reading programs, developmental education, learning styles, autism and gifted education were also undertaken. The author was certified as a K-8 elementary teacher with a mathematics minor, principal and superintendent. He has taught in all elementary grades including kindergarten, junior high and high school mathematics and computer sciences and at the undergraduate and graduate levels at colleges and universities (1974 through present). He is currently a research fellow at the Grand Canyon Institute for Public Policy.

The main author is a certified in Microsoft Excel, Microsoft Access and multiple School Financial Management Packages. An expertise with school accounting was gained during the years 1985 through 2012. The author has also taught school history and organization at Franklin Pierce College as an associate professor and Educational Leadership as a mentor for Keene State College. Professional affiliations include ASCD, National School Administrators' Association, The Coalition of Essential Schools, and the Northeast Regional Superintendents' Council. He has owned three successful small businesses and served as president of a computer start-company (Somatic Digital). He is widely read in the field of Economics and has read all of the underlying economic papers and theories including Adam Smith, Dr. Milton Friedman and Frederick Hayek.

The work was reviewed and edited multiple times (over 50 edited editions) by the Grand Canyon Institute's board and advisory groups which include former AZ Legislators, ASU Professors, and others. GCI's board is listed at their websites www.grandcanyoninstitute.org. The original report consisted of 400 pages with highly detailed analysis of the meta-data. The published reports are informed by this unpublished work. A book on the topic is being published by Rowmann and Littlefield in January of 2017.

Phases of Data Acquisition, Synthesis, and Analysis

Phase One: Locate and Organize the Data

As with any research study a survey of the literature was conducted prior to the collection of data. Sources used and referenced in the report are credited in the Bibliography of this Methodology Report. The literature included books, research papers, scholarly publications, electronic sources, newspaper and magazine reporting, and all of the papers developed by the AZ Auditor General regarding charter finances. Sources of other papers included Edreform, The Goldwater Institute, and other Educational Think Tanks.

A multi-phased meta-analysis of the data was undertaken beginning in December of 2012. The first phase was collecting source data. Data gathering ended in December 2016 when a final rechecking of the primary data sources was conducted. A meta-analysis on the data generated from the research data began in December of 2015 and concluded prior to sharing samples of the data source with the agencies noted. The meta-analysis gathers data from the 6 data source files and collates the information that is used in the report. Several other spreadsheets of data were used to garner information on October 1 counts and multiple data sets of multi-year data points on the largest charter groups were created. Data that collates the Administrative and General Expenses and Operational Expenses was also created. The results of that collation are used in paper 2.

The following is an outline of the process used.

Organizing and Verifying the Data provided by the Arizona Charter School Board.

- a. Established the date the charter school was authorized and when the charter opened (this phase also captured data on charters that were authorized but did not open (or were not open as of December 2016)
- b. Verified closed school data by cross checking with the National Data base maintained by the pro-charter group Edreform (<https://www.edreform.com/home-page/>)
- c. Separated early school district charter schools from Edreform's listings (I.e. School district charters were taken OUT of the data set. Inclusion of these statistics would skew the data (i.e. reflect a higher failure rate)
- d. Verified closure dates with phone calls to the last numbers associated with the schools
- e. Verified that closures were not schools that had registered as charters but never opened.
- f. Clarified and classified school closure (individual charter school sites) versus charter (organization level) closures
- g. *Cross checked lists for schools that re-opened at another location or under a different charter holder.*
- h. *Collected data on every financial form preparer.*
 - i. *This included creating a spreadsheet containing all of the auditors used by charters in Arizona and the names and addresses of the agencies or individuals that prepared the AFR and in the case of federal non-profits, IRS 990 form for the charter (only federally registered nonprofits have an IRS 990 requirement). The submitting agents were also noted in the data set.*

Reorganization of the data from the Superintendent's Report published by the Arizona Department of Education.

Reason for Reorganization: **Issues with the Current Reporting System:**

- The data on charters is currently organized by Arizona Counties. This data organization technique makes eloquent sense for districts, not for charters.
 - Charters typically cross county and municipality lines and are not organized like districts. Some charters also report on their out of state holdings in their audits and on the company's 990 reports. Those entities were included when their debt was funded by Arizona IDA loans.
 - This correction and categorizing by charter group should sit well with charter companies as they insist, rightfully so, they are not organized like districts (which is an accurate statement.) The resulting data set organized the data by charter holder and company. Charters are organized as businesses. The data set handles the data with this in mind.
 - This attention to detail resulted in some charters being linked together where that linkage is not clear in the Superintendent's Reports. AKAs were noted and disclosed in the final data set. Disparities between the charter's name as listed by the ASBCS and IRS were reported.
 - Company Federal IDs, Charter Identification codes, and other data points were used to organize this data.

Color coded charter groups and organized data on charter schools by charter organization

Example: All Basis Schools have their own charter identity but operate under BASIS Inc. which has its own data set in the resulting metadata. This color coding and grouping involved:

- a. Matching data on mailing addresses versus physical addresses to ascertain home state, country, etc. of the host charter company.
- b. Cross referencing owner's names to group charters under the correct owner. (Reason: There were multiple names of entities that all were part of commonly held properties.)
 - ii. Example: "Rosefield Academy" is an Imagine School without the word "Imagine" in its name).
 - iii. Other groups have NO commonality in their naming protocols but checks of the charter holders' names showed connections by ownership. This type of data, linking of ownership, is completely missing from the Annual Superintendent's Reports. Nor is it required.
 - iv. Linkages between corporate board members in different charter organizations were noted.
 - v. Linkages with current and past charter board members and legislative leaders were noted but are not reported out in this series of reports.

Collected, read, and verified the Annual Financial Report (AFR) submitted to the Arizona Department of Education.

- a. Established: The Superintendent's Report depends on the AFRs for its data sets and reporting.
 - i. The assumption is that the data provided has been correctly reported in the AFRs.
 1. This assumption is incorrect.
 - a. **Checking the Assumption:** Information on expenditures overall are reported on Page 2 where data from the charters chart of accounts (required reporting by agreed on codes) are listed, those figures are supposed to be collating to P 7 of the report that the Superintendent's Report uses. The data sent to the US DOE and Reported to the Federal Level is on P 10 of the ADE AFRs.
 - b. Data on the 2013-14 Superintendent's Report was entered as reported on the Superintendent's report and checked against P 7 of the AFR to ensure agreement. (Match with one error noted and corrected after the error was reported to the charter group).
 - c. Data on ADM (Average Daily Membership) was also entered as it was reported on the 2013-14 Superintendent's Report. A separate reporting sheet was used to accumulate 3 years of October 1 counts for all AZ Charters.
 - ii. The resulting data is reported as unused capacity in this report.
- b. **Capacity:** ADM was compared to and contrasted with the Charter's stated capacity to determine "empty chairs" in the charter system.
 - i. Adjustments were made for excessive capacity allowances, (such as online schools with 10,000 set as capacity) were made as noted in the report.
 - ii. The resulting data is reported as unused capacity in this report.
- c. **ISSUE Noted:** The last of these reports (AFRs) was received by the state many months after the due date of October 2014 and a recheck of all the data was performed during the summer of 2016 for this report. (*Special thanks to Kyle Frieson and his staff for their assistance in using the Arizona Department of Education's Budget Reporting (All Reports) system and guiding me through its nuances*). Historic data was also accessed from the AZ DOE archives of all phases each charter budget building and reporting.
- d. Checked and verified the administration numbers reported on page 7 (Data used by the Superintendent's Report) by hand calculating the fields called for on the report from P 2 of the AFR.

- i. (Reason: Many of the reports did not have self-calculation turned on and entered numbers on p. 7 manually.) The original forms provided by the ADE have these fields and the collating feature built in.
 1. This resulted in errors in the reporting. Full detail and where the errors are located in the data with a full presentation of the actual numbers and directions for completion of the AFR (example: Leaving out the 2500 account or the Special Education Administration Costs)
- ii. This data was then collated and re-calculated (the page 2 and page 10 data) into data files that compared this administrative total with one another. This data is displayed in the data set with the source locations hyperlinked. The directions for filling out this data are posted on the AFR and displayed in the data set next to the analysis.
 1. The page 10, P 7 and P 2 are presented in the report entries. The federal reported data (p 10) is detailed in the data set by categories.
- iii. The reports contain the data gleaned from this work. I.e. Data on the data, i.e. a meta-analysis.
- iv. Years 2014 – 2015 were also reviewed in an effort to check consistency between the years. Historic digs were also conducted back to 2010.

Collected, read, and distributed the data from the 2013-14 AUDITED reports sent to the Arizona Charter Board.

The ADE DOES NOT receive these reports (the Audits) and has very limited financial auditing capability on their staff. I.e. most of the auditors are checking on the distribution of state aid and the accuracy of the data on ADM and October 1 counts. State revenues to charters are based on the Equalized Funding formula even though charters are located in some municipalities that DO NOT receive this funding for their district schools (example Scottsdale).

The Auditor General of the State of Arizona receives School District Audits. (Part of this report included reading and discussing the recent (and all of the past) Auditor General's analysis of School District's spending on administration). Sunset Audits on AZ Charters were also read and cited in the reports. Reports from 2000 on were read with an eye towards the recommendations listed in those reports regarding finances.

The Arizona State Board for Charter Schools receives and posts the audits from Charter Schools. The AZ Charter Board also posts all of the rules for financial operations and reporting on their webpage. All of this data was reviewed and informed these reports.

Dealing with Auditing Issues

1. The use of 38 different auditors by Arizona Charters, (many (6) not based in Arizona), leads to multiple terminology and accounting practices being used on the audits submitted to AZCB.

2. The reorganization of this data meant devising universal templates which kept the terminology of the individual auditor intact. (Example, Arizona State Funding is referred to as Arizona Equalization Funds, State Funds, State Revenues, Governmental Funds and several other references (Lumping it with Federal) etc. (The original terms used by the auditor are maintained and commented on).

Problem: ALL AUDITS are not created or reported equally.

- i. Several audits (a distinct minority) in the data set did not detail the revenue or expenditure sections of their audit. This is NOT required by the AZ State Board for Charter School.
- ii. Others did not characterize restricted monies properly or did not call them by name, (Example: Performance Pay funds were not always listed as restricted funds).
- iii. Lack of detail is noted in the report data. *Most* charters did provide detail on their audit reporting of revenue and expenditures.
- iv. A check regarding Audit Related Party Transactions from the audits with IRS 990 Related Party Transactions (Federal NON-PROFITS only) was performed to look at agreement, correlations of the data on similar year
 1. This was done with an eye on Asset Accounting, Net Returns and Net Assets (Deficits). Details of the IRS reporting (sections X through XII of the IRS 990 and the audited related party transactions are in the data set for 2013-2014. Data collations for 2014 – 2015 are also provided. A separate section of this disclosure discusses how Related Party Transactions were analyzed.
- v. Some Charters failed to disclose known Related Party Transactions in a transparent manner, *That is: the connection with a payment to a company owned by a former owner or charter member. Most auditors did an accurate job of capturing these transactions with several posting the percentage of transactions that were related party expenditures. Undisclosed Related Party Transactions were not used in the analysis. An example of this type of transaction in report one was a consulting fee to a related party that was undisclosed on the audit. The information was located on the IRS 990 of the firm.*
- vi. *The audits typically provided a pro-rated analysis of the Charter School , that is Operational Costs, Management and General, and Fundraising costs are charged to these areas. An example the management group may be using a room in the school for their operations. All costs associated with the area are charged to the management and general area.. Direct observation on how this analysis was done at one charter and detailed discussions with 5 different auditing firms confirmed that these numbers are pro-rated reports on the actual costs associated with Management, School Operations and Fundraising. The data gleaned is in the Main Data Set and also in a sub-data set discussion on these costs.*

- vii. Reporting on the Audits can be presented by Organization.
 1. (Example: Charter Schools that are part of a larger organization like the Boys Club and Chicanos Por La Causa which reported all of their property on the audits.
 2. Large groups may report one audit for the entire group according to the rules governing the audit requirements.
 - a. This required special handling of the data in the Audit for this report. I.e. the non-charter properties were not included in the charter property count.
 - b. This challenge is noted and a detailed discussion of the procedure used to accommodate the issue is presented in the second report. A clear sub-analysis is presented in the collating data set.

Collected, read and distributed data from form 990 (IRS Requirement for Non-Profits registered at the Federal Level). Minimum 2 years, Maximum 10 years.

- a. Collated all data related to Revenue, Expenditures, Net and Net Assets and Liabilities.
- b. *Compared and contrasted 2013-14 from IRS Form 990 with Audited reports sent to AZCB for the same year. Data only applies to charters with Non Profit Status at the Federal Level.*
- c. Collected IRS Form 990 Information regarding salaries, payments and transactions from and to Related Parties, Transactions with Related Parties, Occupancy Expenditures, Management Payments, Advertising and Travel Expenditures.
- d. Compared and contrasted Administrative Salary Reporting on IRS form to ADE AFR figures in the page 10 detail.

Collated data on all reports (IRS 990, AFRs and Audits) on Assets and Liabilities and presented this data to allow an analysis of the veracity of each report to be checked on.

- a. Reported out Owner's Equity and Distributions on For Profit Entities for two years (and sometimes for three years).
 - i. The data for this was organized to provide a table showing the effects of this distribution on NET for the year. An analysis of all FOR PROFIT Charters is a sub-report in the larger data report out.
- b. Provided comparisons of Form 990 Assets and Liabilities compared to Audited Statements for 2013-14.
- c. Provided data on AFR from 2014 – 15 and Audited Statements provided to AZCB.
- d. Data is provided and color coded to indicate disparities and highlight correlated financial data. NOTE: The two reports do not always use the same accounting method to report on Assets and Liabilities. Different preparers sometimes use different formats for accrued debt. There are several ways the data was presented to the ADE. (Straight, Modified Accrual, and Full Accrual). A recommendation is that the reports use the same accounting method for the AFR as they use for the same information on the Audits.

- e. Two years of data on growth / loss at each charter is collated and provided.
- f. This data was organized into a new database and sorted on NET and then on ASSETS.
- g. Incomplete or improper reporting on IRS Form 990 was noted and reported on for each school.
 - 1. Example: Not Reporting Related Party expenses that are noted in the audited statements.

Used collected data sets on each Charter to report on:

- a. ADM
- b. Total Property Held by the Charter (Charter Group) owners as characterized in the Property and Equipment data on the audits.
- c. Total Depreciation of Property Reported.
- d. Total Debt (Required Payments (Commitments)) for each charter.
- e. Debt to Income information where provided in the audit.
 - i. Not to be confused with the ASBCS reporting on Fixed Charge Coverage Ratio which is based on the amount of cushion in the charter holder cash flow to cover fixed obligation on debt and commitments.
- f. Summative Data on Cash held by each charter.
- g. Summative Data on cash held in the bank and in reserve accounts.
- h. Summative Data on Investment Holdings.
- i. Distributions of profits with distributions in excess of the company's net noted.
- j. Related Party transactions
- k. Lease Commitments
- l. Comparisons of this data with other Reports
- m. Created spreadsheets that used absolute value to show the differences between the reports. These are in the report and in the data set and are reported from highest net loss to lowest net loss. A full set of all nets is available in the data.
- n. Detailed breakouts of expenses *by category* for Administration, Other Salaries, Transportation, and Operations
- o. Presented all available data from Superintendent's Report on Various Cost Centers reported on in this document
- p. Compared and contrasted past literature's reporting
 - i. The literature surveyed is in the bibliography and was carefully selected to come from various perspectives on charter finances and governance.

Used and Presented AZCB Data on each charter's Financial Performance (Meets or Does Not Meet Expectations) in color coded graphic and linked the AZCB report to the presented data so user can see the data leading to the rating by following the link.

Used and Presented AZCB Data on each charter's Academic Performance (Presented Graphically) and linked the report to the original reports at AZCB. The board's interpretation guidelines informed this analysis. SEE:

<https://asbcs.az.gov/sites/default/files/documents/files/Interpreting%20the%20Financial%20Dashboards%208-2016.pdf>

- a. All data is linked to its source data for the purposes of allowing quick access to the data gathered for the report. The veracity of the data is easily checked.
 - vi. This linking also includes links to the charter's webpage.
 1. All webpages and the details provided by individual charters regarding meeting of the governing board, governance and financials were reviewed. Calls to individual charter business managers were made when questions regarding their reporting were generally answered by the appropriate manager.
 - vii. ADE reports are linked to the ADE webpage with directions given in the data set regarding using those links.
 - viii. ASBCS reports and Audits are linked to the ASBCS website directly.
 - ix. IRS 990 Links to Guidestar's PDFs of the 990 are provided (two years).
 - x. Links are provided to all historic data accessed for this report.
 - xi. Special Note: This feature was added after discussions with some of the original charter proponents, (currently owners), in Arizona yielded comments such as, "I don't care what the charter owner makes just about the performance they achieve". This seems to be a recurring answer when discussing charter finances and is recorded as part of this record.
 - xii. The data is used in the Case Studies Section

Performed a Detailed analysis of P. 10 AFR information regarding all spending.

1. Dissected information into the categories used by the federal government from page 10. Individual spreadsheets were collated on each charter's P 10 data.
2. Compared and contrasted all entries in the administrative areas to discern patterns in spending.
3. Collated information into a master report on spending on administration, instruction, transportation, maintenance etc. by category.

Performed a Detailed analysis of all Audited Spending (AZCB Audits)

4. Compared and contrasted all participation of charters in the Arizona Retirement System (AZRS), In House Retirement Plans were also counted and tabulated (401s, savings plans, etc.) and provided a tabulation of all charters without retirement plans. This was done using data from the audits.
 - a. All spending associated with Retirement for 2013-14 is accounted for in this report. This data is reported on in the audits including the company's contribution to their own retirement offerings. Data on all of this information was collated and is reported in report 3.

5. Compared IRS 990 Management Costs and Administration Salary Statements to the AFR and Audited Reports on the same areas.
6. Consulted with ASBCS, ADE, AZ School Boards Assn., AZ NEA, AZ Administrators, Various Legislature Members, ASU Faculty, the Grand Canyon Institute and the public.
- a. Provided information on Administration (Owner) Revenue Sources that Charter Owners can legally use as income from their “business”.
 - i. Example: Subleasing leased property to their school,
 1. “Leased Teachers”,
 2. Renting the property paid for by IDA loans to the school the “Leasing Company”
 3. Listed all Leases to Related Parties (listed as Commitments on the Audits), (Also listed all Occupancy Fees noted on IRS 990s),
 4. Management Fees to Related Companies were noted,
 5. For Profit Distributions are detailed as well as who owns stock in the company
 6. Related Party Purchases company owned software, curriculum, supplies, and space (storage) are noted and collated.
 7. Purchases with maintenance or food companies owned by the charter holder or related parties.
 - a. Noted: Rarely are any of these “profit centers” count toward administrative costs.

Collected and Collated

- a. Travel costs, as they related to non-student travel. A detailed analysis of page 10 of the AFRs was done breaking out transportation costs, maintenance costs, and details on administrative spending and classroom spending by area.
 - i. Errors in reporting were corrected by calling the auditors and the charter involved in the error. I.e. one auditor had listed travel expenses that included the student transportation costs.
- b. Advertising (over \$5K) were identified.
- c. All Federal Spending to the Charter. Noted charters that took NO Federal funds.
- d. Money owed to the ADE for over-stated ADM was derived from the audits and reported on in report two.
- e. Compared and contrasted Administrative Costs for Salaries and Benefits to Administrative Costs for Purchased Administrative Services.
- f. Transportation Costs (Student) were 1.9% of all spending at charters.
- g. Maintenance Costs.
 - i. Identified Related Party Maintenance Deals and compared them to market prices for similar services.

Analyzed the average pay of teachers and staff and provisions for non-retirement benefits provided to teachers and staff.

- a. **Reason:** Test the premise that a free market approach and de-unionizing teachers forces the market to compete for talented teachers, compensate and provide benefits to that staff and reward performance.
- b. **The legislation enabling charters permits charters to participate in the AZ Retirement System.**
 - i. The intention: To allow charters to compete for teacher
 - ii. The realities of charter participation in retirement programs and incentives for teachers and administrators are detailed in the report.
 - iii. An analysis of the actual participation of charter employees in voluntary retirement matching plans was done (typical plan matches up to 4% of the employee's contribution).
 - iv. Analysis of benefit costs was performed as a percentage of salaries.
- c. **Model Assumption:** Teachers and administrators at the building level will follow the same free-market thinking that the owners of the charter's bring to the process. I.e. they will act in their own self-interest (the invisible hand theorized by Adam Smith). This will force charters to compete for the best teachers.

Analysis Used to Determine Related Party Expenditures as Efficient and Cost Saving.

- Charters were counted as a charter entity if they had an independent charter. This method negated the consolidation effect of consolidated audits¹. The statistics revealed a total of 101 charters with either no related-party transactions OR related-party transactions that fit the criteria, "related-party expenditures can be a way to save money through efficiency". I.e. the figures for these services matched that standard.
- While 101 Charters met that criteria, charters that had not passed the ASBCS Financial Performance Standards or their Academics were D or less were taken out of the count. Thus the number 91 in the final data set. These charters are reported in Report 1: Following the Money.
- 43 of the 101 of the charters with related party transactions in this group met the criteria, "Related-party expenditures can be a way to save money through efficiency". The method used to determine this was looking at similar costs for contracted services on the same service.
- 58 avoided any conflict of interest by heeding standard district protocols regarding related-party transactions. I.e. they had no related party transactions recorded in their audit or IRS documents.
- 74 of the 101 had diverse Corporate Boards with community representation on those boards.

¹ Consolidated audits can be used by charter groups with multiple charters. An example is the EDKEY group which consolidates multiple charters with various schools under each charter on a Consolidated Audit. Consolidation of audits is discussed in Report 2.

Greater Detail on the Methodology: Each type of transaction with a related party subsidiary or an individual related party was analyzed.

The hiring and payments to relatives on the payroll were NOT include in the analysis as the hiring or relatives is allowed and fully disclosed in the 990s.

What counted?

1. **Loans from Related Parties:**

A. Counted as money saving and efficient when the loan was at a low interest rate.

Example: Heritage Academy Related Party loan at 3.25% was considered a cost savings.

Individual charter holders putting their own assets on the line with zero percent loans are noted and praise in the data set.

B. The loans did not count as money saving when the interest rate on the related party loan was greater than the company's rate on a line of credit or exceeded market rates for short term loans.

Example: Loans from a related party at double digit interest rates. An outlier example was 30% interest for a related party loan.

The interest payments and the amount being finances are part of the data set.

2. **Leasing Teachers:**

a. The company saves an immediate 11.1% on the Arizona Retirement System for Teachers by leasing their staff. This "saves" money for the company at a cost to the employees. (Arguments were noted in conversation with charter advocacy groups that stated this was a business saving money. Implied in those conversations were comments regarding the differences between the **classroom expenditures** at charters versus district that participate as part of their benefit packages with their teachers. I.e. the teacher retirement payments are part of the 1100 accounts tracking teacher salaries, payroll taxes and benefits.

i. The original rules on charter schools participation allow charters to participate in the AZ Retirement System. Leased teachers are not eligible to participate. The intent of the rules was to allow charters to compete with the benefits offered at districts.

ii. Transactional costs between the charter school and the subsidiary company leasing the teachers to the school were assessed using forensic accounting.

1. The 11.1% and greater was being absorbed by the transactional costs to the subsidiary company. I.e. the company leasing the teachers was

making a profit on the transactions. Several charters engaged in this process declared a 10% levy on the transaction.

2. The fact is that the Classroom Expenditure argument made by the industry does hold water. If the money saved by providing a matching plan or was reflected in increased compensation the effect of not providing the benefit but providing equal benefits or increased salaries would show up in the classroom expenditure accounts. *There appears to be no business reason for leasing teachers other than capturing the fees associated with the transaction at the unregulated un-audited related party company (typically a for profit LLC)*

3. Rents with Related Party partners that own the school property:

- a. The transactions that did not meet the “saving money” for the charter school were evaluated and compared to the expenses for the loans on the properties being rented. Payments on the loans are listed in the audits and in the data set.
 - i. Ever increasing rental prices on a five year lease commitment do not reflect the fixed cost on the loans for those buildings. A profit is being taken on the loans via Leases. This is good for the subsidiary for profit, it is NOT a savings for the charter non-profit. For instance, an analysis of one lease/rental revealed that the charge for the lease was over \$100,000 more than the related party holding the property was paying on the bonds. The percentage increase noted was 0.5% every five years on a loan that started with a 9% interest rate.
 - ii. Subsidiary Real Estate companies are profiting at the expense of the charter. The fact that the parties are related means that the new costs to the non-profit charter school are known to the boards and the charter holder.
 - iii. Rentals on storage facilities and equipment were also evaluate. In one case rental fees of \$5,000 per year (\$600/month) on a small shed owned by a related party were considered extravagant.

4. Property Loans held by a related party for a profit real estate company and Guaranteed by Intercepted AZ State Equalized Valuation Payments.

- a. Loans on property (IDA and other sources) are often GUARANTEED by the payments coming from the ADE. INTERCEPTS of the payment to the charter are contractual agreements that the funds paying the loan are sent to the BOND HOLDERS not the charter. I.e. a direct payment. This type of transaction flies in the face of the backpacks full of cash following the student to the charter. Parts of the backpacks, full of taxpayer funds are now moving directly to the bond market via intercepts. This is tolerated because the credit rating of the charter makes normal bond transactions risky for the bond holder. The interest rates on these loans which are backed by junk bonds are typically 7 to 9% with outliers at 11%.

5. Related Party Transactions for Curriculum and Software Programs were analyzed.

- a. Comparisons for software contracts for online schools were contrasted with district costs for similar software packages. Mesa and Tucson’s “Beyond Textbooks” are examples with the Mesa costs being presented in the report as an example.
 - i. The costs being charged by several major providers of online programming are greater than similar costs for purchasing the programs from other vendors. I.e. the charter is allowing itself to be monopolized by the related party software company. Again the cost of this transaction negatively impacts the charter school’s bottom line while increasing the profitability in the unregulated related party business.

6. Related Party Transaction to Related Management Companies

- a. Management fees were collated in several sections of the data. IRS form 990 provides a section for Management Fees and Occupancy Costs. The 990 Management Fees listed on nonprofit charters were compared to the audited Management Fees noted in the Related Party segment of the Audits. The payments are reported as gross sums going to the Management Company. An example of the raw data for one of the charter groups in the corporation is presented below.

Note High Interest Rate and Multiple Inter Company Expenses with Owners	
Paid to Related Party	\$2,014
Salary and Related Expenses to CFE	
Management Fees to CFE Owned by Hales and Gregorys	\$2,858,000
LTSS for Special Education (Related Party)	\$522,000
Advances from CFE	\$123,000
Balances Due to Related Parties at 12%	\$83,000
Interest on Above	\$104,000

This example, (every charter was analyzed in the same manner) shows a high interest rate of 12% on the amount due to related parties and a management cost of \$2.86 Million. This is on ONE of multiple charters that filed separate Audits on some of their holdings and consolidated audits on others. Similar management costs to the same related parties are noted on the other audits. *Over \$8 M of Management fees were collected by CFE Management in 2013. This was the cost to schools that had 6800 pupils. Over \$1700 per student in management fees or about \$1 for every \$4 coming from the state.*

The audits also show related party transactions moving between the different locations. This type of transaction would count as a cost saving transactions as they are using the assets of the corporations to shore up companies within the corporation with commonly held funds rather than loans.

The management fees overall are another issue. We can see the amount going to the Management Company but from there how the money is spent depends on the corporate structure beyond the Charter School. At this point the funds going to the subsidiaries are being treated as assets of the charter group. I.e. the economic theory is that the taxpayer funds that went to the charter on ADM are no longer the taxpayer's funds, they are the costs associated with the operation of the charter schools.



This report reports on the following:

- 1. *What have the promoters of Charter Schools done with the “freedom over their budgets, staffing, curricula and other operations.”?***
- 2. *“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 finance of these “free” entities?***

The question asked of the data regarding related party transactions was, “Do the transactions save money and make the charter school more efficient?”

If the counter argument is that the other entities ARE the charter school group then those entities should be audited. If they are not, the premise of this analysis, then money is not being saved by the charter schools by the exchange. The purpose of the transaction is to make money for the subsidiary entities.

The data shows that this type of transaction often drives the charter entity into the DOES NOT MEET FINANCIAL EXPECTATIONS category. Charters that the public assumes are doing well financially based on their Academic Scores and New Construction are often victims (The charter entity itself) of related party transactions that are benefiting the subsidiaries by over-charging.

7. Handling the Raw Data:

- a. The data on related party transactions was collated in the main section of the data set.
 - i. Data from the audits (identified in the Related Party Transaction Section of the Audit and data from the IRS 990 filing from sections X and XI were compared. Transactions that were on the 990 but not on the audit were included in the data.
 - ii. The data was copied to a new section of the data base where it was collated based on the criteria stated in this section.

The Ethos Driving the Inquiry and Methodology.

In 2006 I moved to Arizona and started working as a Vice President for sites at Pinnacle Charter Schools. As noted I left Pinnacle after 16 months, my prior experiences lasted 30 years. At the time a new partner was brought in to prepare the company for an expansion into other online marketplaces. This departure continued a very high rate of turnover in administration. At the time I was leaving some of the assets and business were being sold to a new partner based out of New York. Shortly after my departure Pinnacle stopped offering Arizona Retirement System participation to its rank and file. They are one of several charter groups to drop AZRS after earlier participation in the system. The upper management at the company was vested at that point which meant that the company's departure from the AZ Retirement System wasn't going to impact their retirement plans. The company listed the following related parties in 2013-2014.

MGRM Pinnacle, Inc. (MGRM) Pinnacle Education-Tempe, Inc. (PNTTP) Pinnacle Education-Mesa, Inc. (PNMS) Pinnacle Education-WMCB, Inc. (PNCB) Pinnacle Education-Kino, Inc. (PNKA)

Matwick Family Holdings, L.L.C. MRM Global Education, LLC MGRM Holding, Inc. MGRM Inc. MGRM Technologies, LLC MGRM Net Limited MGRM Medicare Limited

In 2009 I was asked to come into the Edkey Administrative Office to meet Mr. Ron Neil, the new CEO and superintendent for Edkey Inc. Ron, was an exemplar of what charter school management can look like.

Ron hired me to start a charter school in Maricopa, AZ (this school has grown into a highly successful 1200 student K – 12 program). The directors of this charter network, Sequoia Schools (Edkey Inc.), asked me to serve as Superintendent and Corporate Vice President when Ron left the company. Mr. Neil passed away in December of that year. Prior to and during his tenure as CEO / Superintendent, Mr. Neil attempted to correct many of the fiscal and academic issues that manifested themselves in the charter's operations. Again, let me state that according to Arizona law, none of the issues that are being discussed regarding Pinnacle or Edkey violates the rules governing finance and governance in the charter school laws in Arizona.

An example of some of Mr. Neil's efforts to curtail unethical uses of taxpayer funds.

The school that was being developed in Maricopa had a "promoter" who had been told by previous management that if he started a school he could collect 4% a year from its gross revenues. This is a school that soon grossed more than \$5 M a year. That would have meant \$200 K at 4%.

Ron negotiated the departure of this "partner". Counsel negotiated a settlement of this verbal agreement at a substantial cost to the company. Ron was not the one that made the original "deal". These type of "deals" appear to be present in some of the related party expenditures studied in this data set. Many of the audits reflect buyouts of partners and negotiated payments through MOUs (Memorandums of Understanding). During the process of analyzing the data this experience informed the forensic accounting methods used to analyze the transactions.

Edkey was on their way to cleaning up their business practices under Ron Neil. It was his personal ethics that made him operate the company in as ethical a manner as he could.

Therein lies the problem.

An ethical personality or business model can never be guaranteed. However, as stated in the reports charter schools are like a religion without some version of the Ten Commandments guiding their practice. We have laws, policies and rules for legitimate reasons. It isn't all about fighting bureaucracy as we have been led to believe. While Barry Goldwater noted, "You cannot legislate morality" Martin Luther King responded that, "You can regulate behavior". These papers should point out the need for regulation.

Ron Neil retired and passed away in December of 2013. On January 10th 2015 I decided I could no longer, in good faith, participate in the disturbing way this and other charter schools were operating financially. To their credit the corporate board at EDKEY did attempt to correct the sea change that was being rushed through. My concerns were transmitted to the CEO and the corporate board verbally and in writing through internal memos and my letter of resignation.

Most discouraging was the fact that under AZ Charter Law, the things that were most disturbing financially were and are legal under the state's rules for governing and financing charter schools. At the risk of being redundant, let me state that according to Arizona law, none of the issues that are being discussed here or in the reports violate the Charter School laws in Arizona.

The research that led to this essay will also point out that a portion of the charter schools in the state **(22.75% or 91 of the 400 with academic and financial rating) are operating in an ethical and legitimate manner to ensure their finances, admission policies, and governance are consistent with schools that proclaim themselves "public" should be.** This was the direction Mr. Neil was heading in when he passed away. In his words, "we want to have "real schools", not people playing at school." He also cited the charter's moral imperative to build schools for the homeless in a depressed area of Phoenix and provide DEAF programs at the main campus.

He was up against the status quo for charter finances and governance in his efforts. There are other Ron Neils in the charter holder world, we owe it to them to work on the issues identified in this research.

A Short History

The Wild West

Arizona's charter school law was passed in 1994, making the state the 11th in the union to enact such a law. The Legislature legislated the law with a very public push by a group of highly interested lobbyists for the Charter School Movement and with opposition from the existing public schools and the Arizona Unlike many of the other issues surrounding education in Arizona there were no efforts to place the question of whether to allow charter schools on a special ballot for a direct vote by the electorate.

A “perfect storm” of political opportunity led to the passage of the Arizona Charter School laws. Fife Simington was the Republican Governor with a Republican dominated Arizona legislature.

Representatives of many out-of-state operators of charter school groups influenced and orchestrated the debate.

A portion of the people voting on the issue in the state legislature would become Charter School operators, charter corporate board leaders, and charter board members in the newly authorized charter school system.

Authorizers of the rapidly approved charter school network received over 400 charter school applications, with 67 approved to open in the fall of 1995.

This was In spite of an annual cap of 25-charters on each of the two state authorizing agencies. The charter school system in Arizona grew quickly - between 1994 and 2002. The Arizona State Board for Charter Schools approved 76 percent of the applications it received, and by 2003 nearly 500 charter schools were operating in the state. [\[7\]18](#)

The law isn't up to the challenges of human avarice and greed

Charter School Law in Arizona is not comprehensive, nor is it designed to protect the financial interests of the citizens who pay the taxes that fund the schools in Arizona.

The purpose set out in 15-181 is reproduced below.

15-181. Charter schools; purpose; scope

A. Charter schools may be established pursuant to this article to provide a learning environment that will improve pupil achievement. Charter schools provide additional academic choices for parents and pupils. Charter schools may consist of new schools or all or any portion of an existing school. Charter schools are public schools that serve as alternatives to traditional public schools and charter schools are not subject to the requirements of article XI, section 1, Constitution of Arizona, or chapter 16 of this title.

B. Charter schools shall comply with all provisions of this article in order to receive state funding as prescribed in section 15-185.

A noble and easily supported premise.

The devil is in the details, details of which there are precious few in Arizona’s Legislated Charter School laws.

Taxation and Distribution of State Revenues without Representation on the Governing Boards

The focus of this study centers on the financial and governance issues with “public schools” that are not publicly owned or governed by public boards.

The financial issues addressed focus on a provisions in AZ 15-183, parts S and T and to some extent provisions O and P.

15-183. Charter schools; application; requirements; immunity; exemptions; renewal of application; reprisal; fee; funds; annual reports. These provisions are taken directly from the Charter School Legislation.

- 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.

In layman’s terms, this means all buildings and land are owned by the charter. If the charter sells capital assets—including land and buildings—the proceeds belong to the owner of the charter school.

In many cases this means an individual or a private company, not a group of trained educators and parents seeking a choice. At the time of a sale of the assets of the charter (usually to a related party) there is a transferring the assets to the new boards and COO. There is a price paid to the former “owners” as they sell their assets in unregulated real estate transfers (usually at a premium that has nothing to do with things like market value).

It also means that the funds used to acquire these assets, state tax dollars, are financing the debt and property acquisitions of the charter owner. Recent (2016) legislation provides State Guaranteed Loans for charter school owners. The risk taking of the owners is minimized by the way the law reads.

Calling this a risky business is an insult to real businesses who put their own capital and assets on the line.

Protection Clauses for owners and the state

Prior to items S and T, items O and P of the same Charter Law limit the liability of the taxpayers, (State) and the sponsoring agencies.

- 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.

Most of the voting public remains unaware of these provisions of the “public” charter schools legislation put into place in 1996.

The term legislation versus law is an intentional use of language in this look at the flaws, philosophically and financially of Arizona's charter school legislation. Arizona legislated their charter schools.

The title of the book that will follow this paper refers to the carpet-bagging of the Arizona public school system. This is a term that will surely rankle many of the promoters of "freedom schools" and "educational choice". Just as the original use of the word during the Reconstruction Period did not mean every person who went to the South to "help" was corrupted by the experience, it is not the intent of this report to diminish the work of those trying to improve public education with well-run charter schools.

Unfortunately, carpet-bagging and opportunism are the best analogies for describing what is happening in many of Arizona's public charter schools. The carpet-baggers have moved in from overseas, out-of-state, and in state to use public funds for private gain.

A systematic, intentional, unregulated, takeover of public education is taking place in Arizona and this country.

This takeover is similar and dangerously akin to the takeovers of the financial system that led to the demise of ordinary citizen's pensions and savings. Charlatans posing as educators have come from within the state and from beyond our borders to profiteer on public money. They dishonor the charter movement. The second report compares some of the related subsidiaries to the ENRON scandal and its use of subsidiaries.

What's broken needs fixing. Charters can, and should be a vital part of educational reform and innovation. The bad actors can't be allowed to destroy the great charters that are out there. Our goal should be an inverse of this statistic.

A portion of the charter schools in the state **(22.75% or 91 of the 400 with academic and financial rating) are operating in an ethical and legitimate manner to ensure their finances, admission policies, and governance are consistent with schools that proclaim themselves "public" should be.**

Sound rules could positively affect the 77.25% (309) with financial and governance issues that can be corrected without harming the charter entities bottom line. The matter demands attention if we are serious about educating our children.

Rawl's Theory of Justice Applied to this Work

Reference was made to Rawl's Theory of Justice early on in the original paper. A very brief summary is included here. The book influences this author's way of being and the thinking in this paper.

The comparison of Districts to Charters in chart form in the first paper, *Following the Money*, plays on this theory's logic.

Rawl's Theory in compact form:

The cry for educational freedom of choice is a hallmark of charter advocacy groups. Rawl's points out that freedom and equality are not mutually exclusive. His conclusion is that in order for justice to be "just" each person must be afforded the same rights under the law.

The comparisons included in this paper shows that the laws regarding charters have been set up to provide two sets of "rights" regarding finances and governance. One for districts and the other for charter holders.

The "Veil of Ignorance"

What is a "Veil of Ignorance?" I

If we were all stripped of our privileges and social status what kind of justice system would we want to be subjected to? The veil of ignorance means I don't know ahead of time what my social status or privileges are before making a choice about whether the laws are just.

Rawls points out that the only logical choice is a system of justice that treats people equally, regardless of social class, race, gender, etc. makes sense when this unprotected version of ourselves is judged.

The approach is called, a social contract approach. This theory contrasts with utilitarianism, intuitionism, and other theories looking to define what justice means.

Our spending on public education whether district or charter needs to be done in a manner that promotes the common good.

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