POLICY REPORT #3 IN A SERIES
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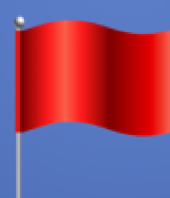
RED FLAGS:
OVERLEVERAGED DEBT



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

Policy Report #3 in a Financial Analysis of Twenty+ Years of Charter School Governance and Finances in Arizona

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

"Trust but Verify" – Ronald Reagan

GCI's series of reports asks two questions of the data in its meta-analysis; both questions relate to the results not the intentions of the explicit and implicit economic freedom given in charter laws.

"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

Red Flags: Overleveraged Debt is the Grand Canyon Institute's (GCI) third policy paper in a series analyzing the financial and governance practices of Arizona's charter schools. In this paper, GCI finds that Arizona charter school debt has increased to a level that means that many charter schools are failing financially, and many others are at great risk of failing financially.

From FY 2014 to FY 2018, the long-term, lease-adjusted debt[1] held by Arizona's charter sector consistently exceeded the current depreciated value of its property and assets. On the whole, the sector owes more than it is worth. A business property or homeowner in this position is deemed to be underwater on their debt. Like any business, an overleveraged charter is financially vulnerable and could fail if it then suffers an income loss.

Ten percent of charter sites are in significant financial distress with closure a near certainty due to excessive debt and poor underlying financials. Another 10 percent are at risk of closure. Charter school sudden closures during the school year from FY 2016 through the Fall of 2018 have resulted from financial issues related to charter long-term, lease-adjusted debt on those properties. Unfortunately, many charter operators were allowed to borrow based on projected student enrollment growth, i.e., using future educational revenues from students as a guarantee for their bond debts.

Increasingly, charter schools appear to be competing amongst themselves for students as the charter industry is consolidating. From FY 2014 - FY 2017, 60 percent of growth in student enrollment, known as Average Daily Membership (ADM), was captured by 10 charter companies, while 35 percent of charter companies experienced losses in their ADM[2] during the same time period.

Government tax-free bonds and federal charter credit enhancements, which were designed to allow charter holders to acquire educational assets have enabled this overleveraging. A similar over-leveraging of debt was partially caused by the excessive lending policies of Fannie Mae and Freddie Mac in the last mortgage industry failure (2007). GCI identifies the overleveraging of charter properties and assets as the underlying reason for financial failures.

Proactive action is critical to avoid future charter closures during the school year. Last January the sudden closure of Creemos Discovery charter school stunned many, but not if you had traced their finances for the prior years. GCI demonstrates that financial data can be used to prevent school year closings, which can be most harmful to a child's education. Of 426 charter closures since 1994, an unacceptable 67 charters closed their doors between October 1 and April 30.

Charters can be educational and financial innovators. It is not in the charter market's best interest to continue to allow financial practices that are destructive to other charters and to

[1] Long-term, lease-adjusted debt is defined as all of the committed long-term debt payments and all of the amounts of contractually-committed lease agreements. This information is sourced from charter school audits.

[2] Charter ADM was evaluated over 4 years 53% of 427 charters saw either a net loss of ADM or a loss greater that 0.5% of ADM during this time period. The figure of 0.5% is a bare minimum.

districts. The children in schools that close during the school year place new demands on other charters in the area and to school districts trying to absorb those students mid-year.

Increasing charter school financial transparency and accountability will further competition among schools. GCI's research shows that a charter school financial failure can be predicted two years in advance. This gives ample time to either assist the charter in solving its financial problems or plan for the closure in a way that does not disrupt a child's education.

In 2018, the Arizona legislature passed HB 2663 granting the ASBCS the authority to close or deny renewal of a charter school for financial reasons (previously, the ASBCS could only close a school for poor academic performance). Subsequently, the ASBCS appointed a subcommittee charged with updating its current financial framework and adopting rules and policies to be used for accountability purposes in fulfilling its new obligations. GCI was invited to participate in this process and has worked with the ASBCS' subcommittee to identify benchmarks for assessing the financial performance of charter schools.

GCI hopes that charter holders see this as an opportunity to use financial data to deleverage their businesses. Borrowing based on projected ADM is a cause for concern as GCI believes that academically performing charters are being financially disrupted, leading to closures at sites that should be thriving both academically and financially. Relying on a mindset that only focuses on academic performance is misguided.

In addition, the legislature needs to reconsider the extent to which public tax money should be used to pay for privately-held charter school property. Charter schools currently receive about $1,600 more per student than district schools, primarily to pay for private property. That amount is the same regardless of academic performance, whether it is a physical or virtual school, and how long the charter has received the extra payments.

Overview of Recommendations: Rule and legislative changes

1. ASBCS should follow through on forthcoming recommendations from their financial subcommittee to add a "Falls Far Below" criteria to a modified net income measure and lease-adjusted debt service coverage ratio (rule).
2. Charter companies should not be permitted to incur new debt beyond property value[3] unless they have well-documented ADM growth history and approval by the ASBCS is granted (legislation).
3. Charter companies should be required to get a loan quote from a commercial lender or show their bonds would be investment grade when seeking new financing, and that this information be reported along with their chosen means of debt-finance to the ASBCS to improve transparency (legislation).
4. Charter companies that have taken out debt based on projected ADM growth be required to report whether or not they are meeting that growth in their audits (rule).
5. The current state loan guarantee system be modified to require that charter companies meet investment grade (at least BBB or NAIC category 2) on their own or for smaller operators that they meet the highest speculative grade (BB or NAIC category 3) and meet ASBCS financial dashboard criteria sufficiently for the last three years, especially their lease-adjusted debt service coverage ratio (legislation).

[3] Including construction in progress' property values, which allows for expansion and growth in the market.

6. Charter Additional Assistance be modified to be contingent on satisfactory academic performance and be limited to facility funding at no more than fair market value to provide early support for schools and then gradually phase down so after 15 years it equals District Additional Assistance for a given level of ADM (legislation).
7. Charter Additional Assistance be replaced by limited start-up support for online charter schools and any additional funding beyond base student amounts be limited to covering costs associated with providing students computers in their homes or subsidizing their home internet service (legislation).

GCI's Methodology & Dataset

Grand Canyon Institute's (GCI) papers regarding the financial and governance practices of Arizona's charter schools use a forensic accounting approach to evaluate the financial and regulatory outcomes from a quarter century of charter school operations in Arizona. GCI's previously published policy papers on the topic — ***Following the Money***, published in September 2017 and ***Red Flags: Net Losses*** published in March 2018 — were the first to provide a meta-analysis of all publicly available financial data on Arizona's charter schools.

In FY2017, 16 percent of Arizona's public school students attended charter schools, which operate as private businesses contracted by the state to provide educational services. The effort to evaluate the relationship between charter school academic and financial performance was designed to test the economic theory's predications that links academic performance to financial results in this market, i.e. parents would leave academically underperforming schools causing those schools to financially fail.

The dataset for this research includes all of the publicly available financial data from 564 of 579 charter sites as of FY 2016-2017. Data from FY 2014 through FY 2017 is included in the data analyzed for this report. Charter school annual financial data was sourced from the following reports prepared by charter organizations:

- Annual Audits submitted to the Arizona State Board for Charter Schools (ASBCS).
- Annual Financial Reports (AFRs) submitted to the Arizona Department of Education (ADE).
- Form 990 filings for federal non-profit entities submitted to the Internal Revenue Service (IRS).
- ADE Superintendent's Reports.
- Industrial Development Authority educational revenue bond information.

GCI's FY2017 charter school dataset includes information based on charter site, charter holder and charter company.

- **Charter sites**. A charter site is an individual location operating as a charter. Each site reports data to the Arizona State Board for Charter Schools. In FY 2017 GCI used **564 charter sites of 579** for its reporting. University, Native and sites with other physical holdings, I.e. Chicanos Por la Causa were not included in this report.
- **Charter holders.** Charter holders operate one or more charter sites. The ADE tracks ADM statistics by charter holder. In FY 2017 there were **427 charter holders.**
- **Charter companies.** Charter companies can hold multiple charters operating either the same number or multiple charter sites. Example: BASIS is a charter company that holds multiple charters at multiple sites. In FY 2017 there were **239 charter companies** in Arizona.

GCI focused on charter sites in this report as this method was considered the best approach for making equivalent comparisons and charter sites is the method used by the ASBCS's financial and academic reports. Exception: For some parts of the analysis charter holders will also be analyzed to give a sense of the number companies operating in Arizona. The use of sites provides a better picture of the scale of the problem—as a charter company with ten sites would appear ten times and another with two sites appears twice.

Figure 1: Number of charter sites per fiscal year included in GCI's dataset

Sites @ FY 2014	Sites @ FY 2015	Sites @ FY 2016	Sites @ FY 2017
Data Set: 477 Sites	Data Set: 509 Sites	Data Set: 531 Sites	Data Set: 564 Sites

Fifteen charter school sites are not included in GCI's dataset in FY 2017 because they are not overseen by the ASBCS. They include charters affiliated with a university, a native charter, or are part of a larger organization with multiple properties.

About the Primary 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 public charter schools in New Hampshire in 1999 with local funding and then expanded the program using federal public charter school grant money.

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 through the Graduate Level. His expertise is in mathematics, school finance, school law and leadership and change.

The New Hampshire charter schools noted 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.

Arizona Charter Experiences:

Mr. Cardine opened other public charters as lead principal and then as a superintendent in Arizona charter organizations.

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 left both charter companies for the same reason. Ownership's use of situational business ethics applied to the financial and governance practices of those charter groups that *were not in the best interest of children. This mismatch created a moral quandary that could not be resolved by working with the charter holders.*

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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.