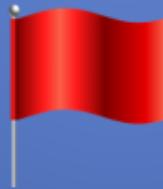


POLICY REPORT #3 IN A SERIES  
JANUARY 9, 2019

# 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***

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“Trust but Verify” – Ronald Reagan

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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<sup>1</sup> 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<sup>2</sup> 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 Discovery Creemos 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

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<sup>1</sup> 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.

<sup>2</sup> Charter ADM was evaluated over 4 years 53% of 427 charters saw either a net loss of ADM or a loss greater than 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 from the state, 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<sup>3</sup> 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).

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<sup>3</sup> 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**

<b>Sites @ FY 2014</b>	<b>Sites @ FY 2015</b>	<b>Sites @ FY 2016</b>	<b>Sites @ FY 2017</b>
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.

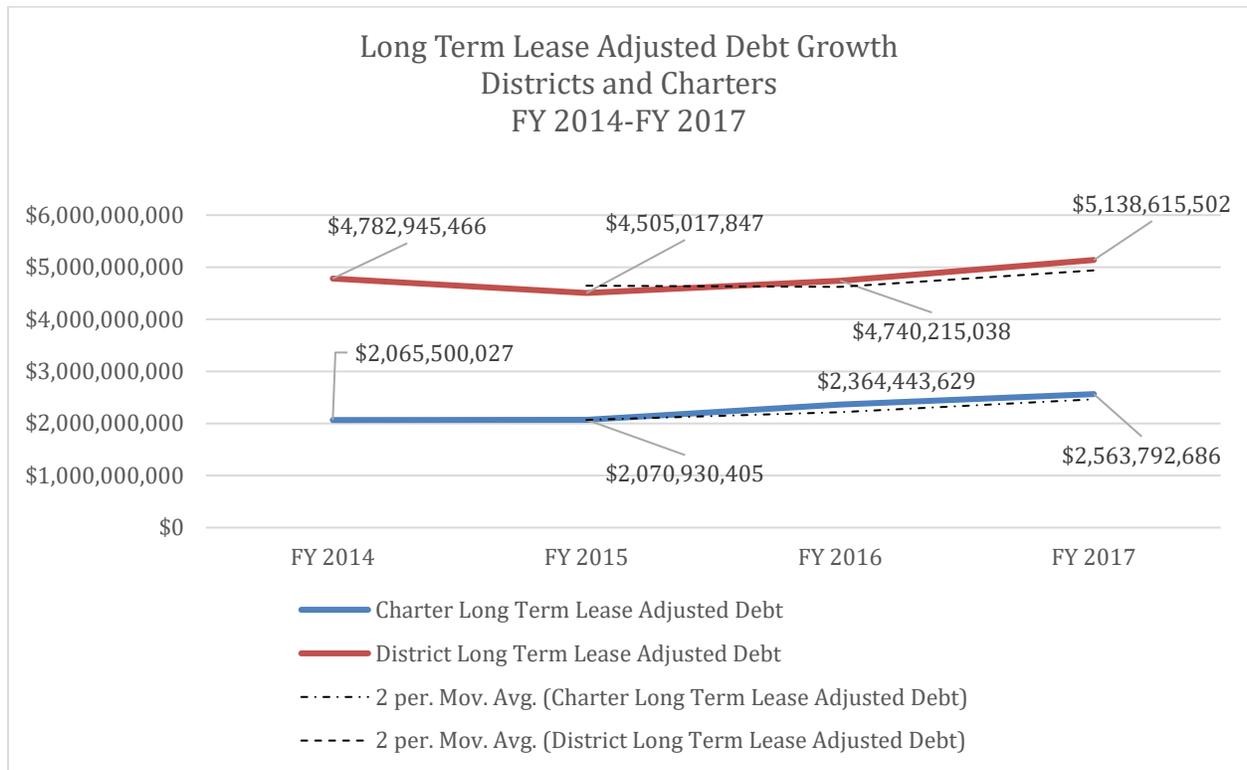
## Findings & Recommendations

### Finding 1: Arizona’s charter schools are overleveraged

In FY2017, the total lease-adjusted debt on charter property and assets was \$2.6 billion. At the end of June 2017 total depreciated property and assets at charters and their non-profit subsidiaries were valued at \$1.4 billion. The difference in depreciated property value to debt was \$1.2 billion. GCI analyzed IRS Form 990 data of non-profit education management companies along with audit data on Property and Equipment undepriciated and depreciated values to arrive at this figure. Depreciated property values were used in our analysis in keeping with the same measures used by the Arizona Department of Education (ADE) to evaluate district property values and long-term debt.

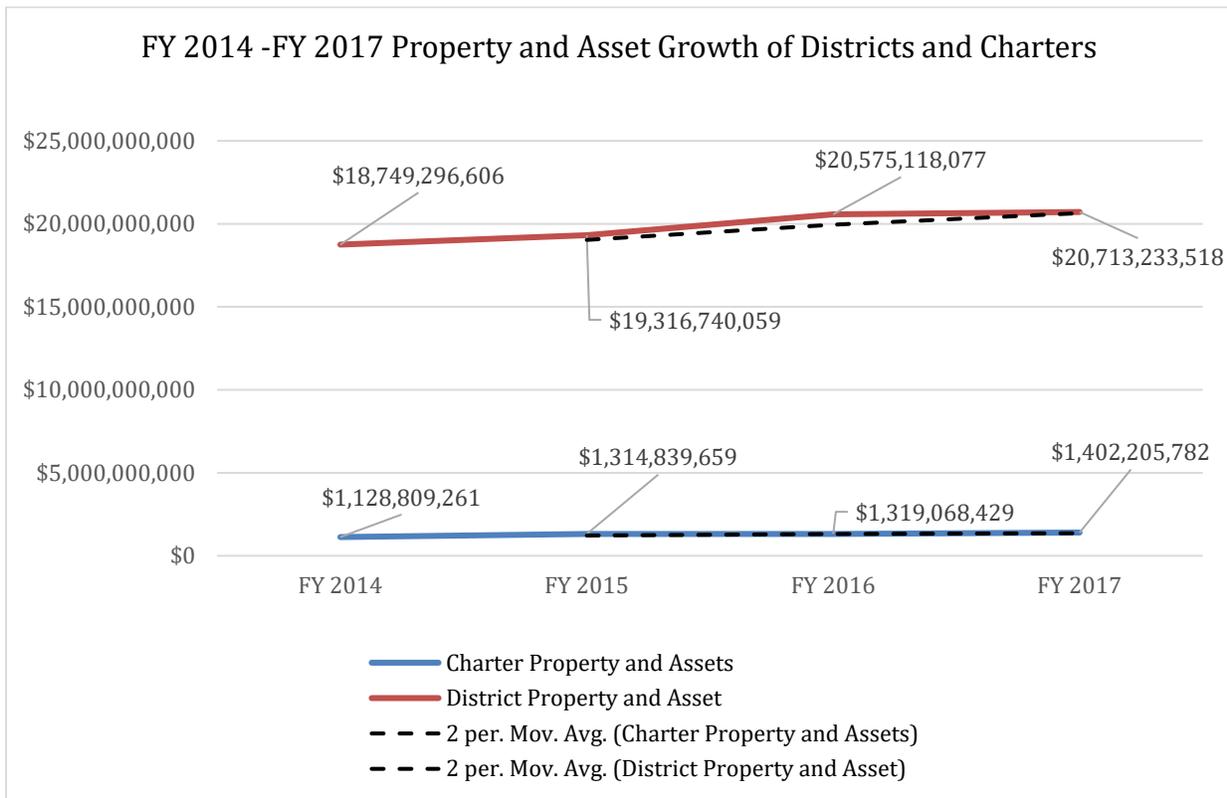
The charter market holds 33 percent of *all school debt* and educates 16 percent of Arizona’s public school students. Charters hold only 7 percent of all property and assets dedicated to K-12 education in Arizona. Whereas districts have four times the value in property as they hold in debt the charter sector holds more long-term, lease-adjusted debt than they hold property.

**Figure 2: Trends in Long Term Lease Adjusted Debt for AZ Charters and Districts**



Source: Collated Long-Term Debt Adjusted for Leases from Audits and ADE Reports FY 2014-2017

**Figure 3: Comparison of District Property Assets to Charter Property Assets**

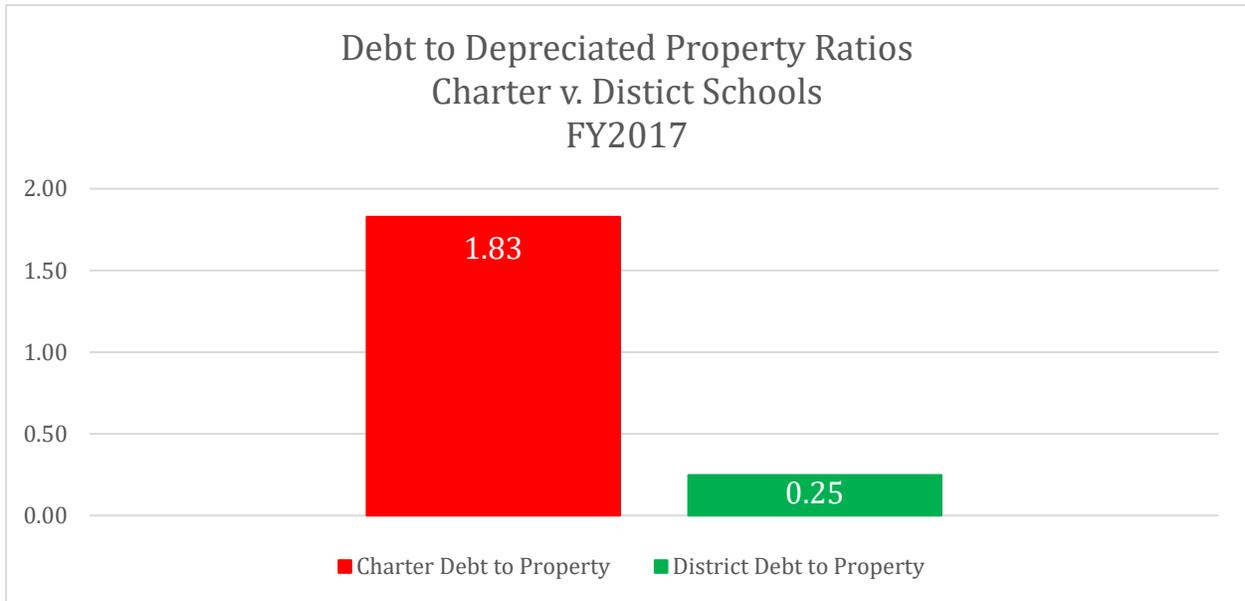


Source: Collated Property Values from Audits and Form 990s and ADE Reports FY 2014-2017

Note: Figure 3: Comparison of District Property Assets to Charter Property Assets allows a visual comparison of the relative growth in both sectors. A trend line was added to both lines. The trend for charters is virtually the same as the line representing the growth in property and asset values making it difficult to see. District Property and Asset Values are growing faster than Charters. At the same time Districts have lower debt to property rates as they pay down their properties. Continuous refinancing of debt, due to over-expansion paid for by subsidized bonds is overheating the charter property market.

Collectively, the debt to property values for districts is 0.25, while the debt to property values for charters are more than seven times greater, 1.8. This is shown in Figure 4.

**Figure 4: Debt to Depreciated Property Values: Charters v. Districts**



**Figure 5: Depreciated property value of all charters and long-term, lease-adjusted debt on those properties**

	FY 2014	FY 2015	FY 2016	FY 2017
Depreciated Property Value	\$1,128,809,261	\$1,314,839,659	\$1,319,068,429	\$1,402,205,782
Long-Term, Lease-Adjusted Debt	\$2,065,500,027	\$2,070,930,405	\$2,364,443,629	\$2,563,792,686
Property-to-Debt Difference	\$(936,690,766)	\$(756,090,746)	\$(1,045,375,200)	\$(1,161,586,904)

Source: FY 2014 through FY 2017 ASBCS Audits and IRS 990s collated by GCI

Figure 5 shows that this financial problem is escalating. Initial analysis on FY 2018 predicts that the Property-to-Debt deficit will exceed **\$(1.5 billion)** continuing this trend. The result of multiple refinancing of charter debts guaranteed by predictions of ADM gains over 25 years<sup>4</sup>. Eighty-four percent of charter sites are underwater on debt as of FY 2017. In our sample, 471 of the 564 sites evaluated are in this position.

<sup>4</sup> Charter debt analysis done by the rating agencies responsible for rating this junk bond debt ignored the constant refinancing of debt in their analysis of charter debt. A similar over-rating of bundled mortgage debt was a factor in the 2007 financial market collapse. Citations are in this report.

Charters in Arizona held depreciated property worth \$1.4 billion at June 30, 2017. A debt-to-property ratio of 2.6 to 1.4. Only Arizona charter properties and long-term, lease-adjusted debt on those properties were counted in our analysis.

The greatest concern in Arizona is that an entire chain of charter schools could go out of business during a school year due to a sudden financial collapse.

**Finding 2: One-Third of Charters Are Losing Enrollment**

Eighty percent of charter debt is *speculative* in that the debt is *guaranteed in part based on enrollment projections*. Our analysis shows that one-third of charter sites are losing enrollment with a significant portion of those sites losing more than 15 percent of their student enrollment. While the charter sector as a whole has had robust ADM growth, that growth is not evenly distributed. Nearly three-quarters of ADM growth from FY 2014—FY 2017 was captured by the top 10 charter companies with the top 5 companies capturing 60 percent of ADM growth during those four years. More than half of charter sites experienced little or no student growth between FY 2014 and FY 2017 (defined as plus or minus ½ of a percent in growth over four years).

**ADM Distribution of Charter Growth FY 2014—FY 2017**

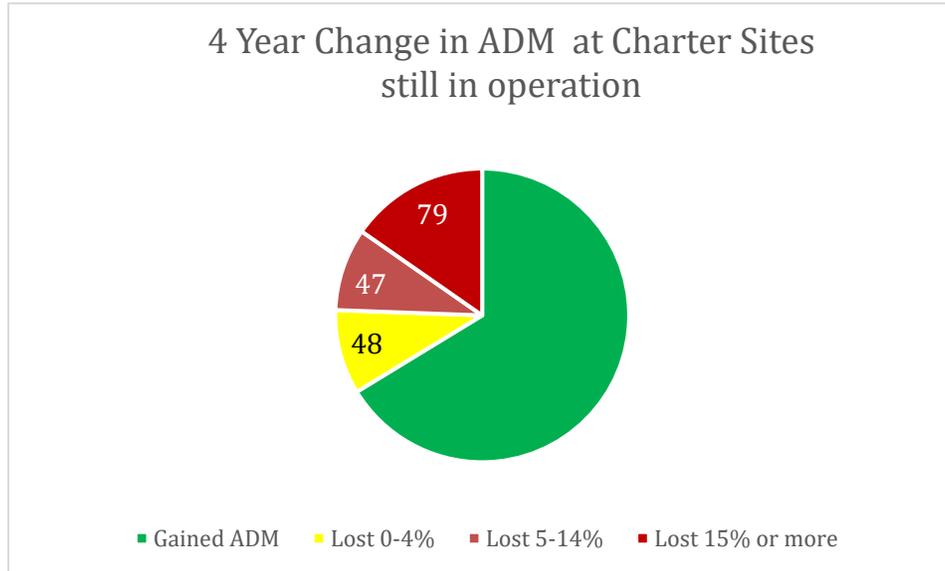
**Figure 6: Top 10 ADM gaining Charter Companies**

Charter Group	Gain	%	Arizona Sites	New Charter Sites Added
Top-10 Gaining Charters				
BASIS School, Inc.	5,683	19%	18	8
Legacy Group	5,012	17%	13	6
American Leadership Academy, Inc.	2,811	10%	6	3
Great Hearts Group	2,734	9%	23	6
Primavera Now Amer. Virtual	1,361	5%	1	
Academy of Mathematics and Science, Inc.	1,005	3%	4	1
Leman Academy	895	3%	4	1
Heritage Group	867	3%	3	2
Challenge Foundation	712	2%	5	1
Daisy Education Corporation/ Sonoran Science	623	2%	7	3
<b>Sub Total - Top 10-Gaining Charter Companies</b>	<b>21,703</b>	<b>73%</b>	<b>84</b>	<b>31</b>
<b>Sub Total - Remaining Charter Companies</b>	<b>7,846</b>	<b>27%</b>		

Source: ADE ADM Reporting FY 2014 – FY 2017 (GCI used the May 2018) updated data report

When analyzed by charter site, one-third of charter sites, excluding those that closed, had lost enrollment from FY 2014 to FY 2017, with one-sixth of charter sites losing 15 percent of their student enrollment during this time period.

**Figure 7 Enrollment Change by Charter Site**



Source: ADE ADM Reporting FY 2014 – FY 2017 (GCI used the May 2018) updated data report)

**Recommendation based on Finding 1 and Finding 2:**

The practice of using enrollment projections to guarantee debt should be eliminated or modified based on historic evidence of ADM growth. The practice of using enrollment projections to guarantee debt should be eliminated unless the borrower can show consistent four-year growth in ADM *aligned with past expansions and charter replications*. **The ASBCS must approve any charter company seeking to secure debt based on projected ADM; otherwise, the ASBCS can use a financial basis to withdraw the charter for noncompliance under HB 2663.** Current practice has led to over-leveraging and underwater properties as detailed in this report. The practice also allows bond holders to intercept funds distributed by the ADE prior to the charter receiving those funds (legislation needed).

**Finding 3: 10 to 20 Percent of Charter Sites are at Immediate Risk of Financial Collapse**

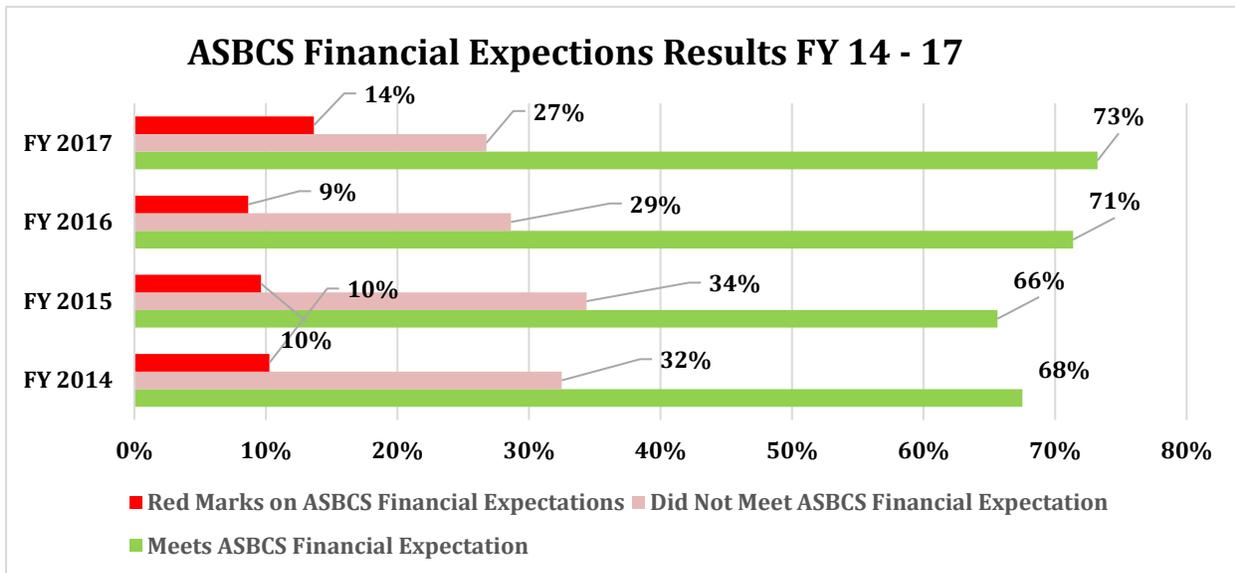
Red flags caused by excessive debt and long-term commitments emerge in charter school financial data well before they fail financially. Failure to intervene allows debt to increase, leading to greater risk to investors and resources being diverted from the charter's primary educational purpose. *Intercepts* of debt payments directly from ADE to the bond holders removes the charter holder's financial control over how those funds are utilized.

	FY 2014	FY 2015	FY 2016	FY 2017
Meets ASBCS Financial Expectation	67.51%	65.62%	71.37%	73.23%
Did Not Meet ASBCS Financial Expectation	32.49%	34.38%	28.63%	26.77%
<b>Significant Red mark</b> on ASBCS Financial Expectations. NOTE this means the charter may be close to BANKRUPTCY. Notes in the AUDITS MUST deal with this condition. A PLAN is put into those NOTES.	10.27%	9.63%	8.66%	13.65%
# Sites evaluated on ASBCS Financial Performance by GCI	477	509	531	564
# of sites that with <b>Significant Red Marks</b>	47	50	45	76

Source: Collated ASBCS Financial Performance Expectation Data for Four Years

The data in the table was sourced from the ASBCS financial performance scores over four years. Yearly ranks were assigned by monitoring the figures provided by the ASBCS applying their ranking system to single years. The ASBCS uses two-year ratings averaged. This two-year methodology means the yearly “Meets” and “Does Not Meet” ranking is subject to change as the rating is posted for two-year intervals. Example: GCI would prefer the board continue to show at least two years of financial performance, but base its assessment only on the latest year, though GCI understands the logic of a two year interval.

**Figure 8 ASBCS Financial Expectations Results for Four Years**



Source: Collated ASBCS Financial Performance Expectation Data for Four Years

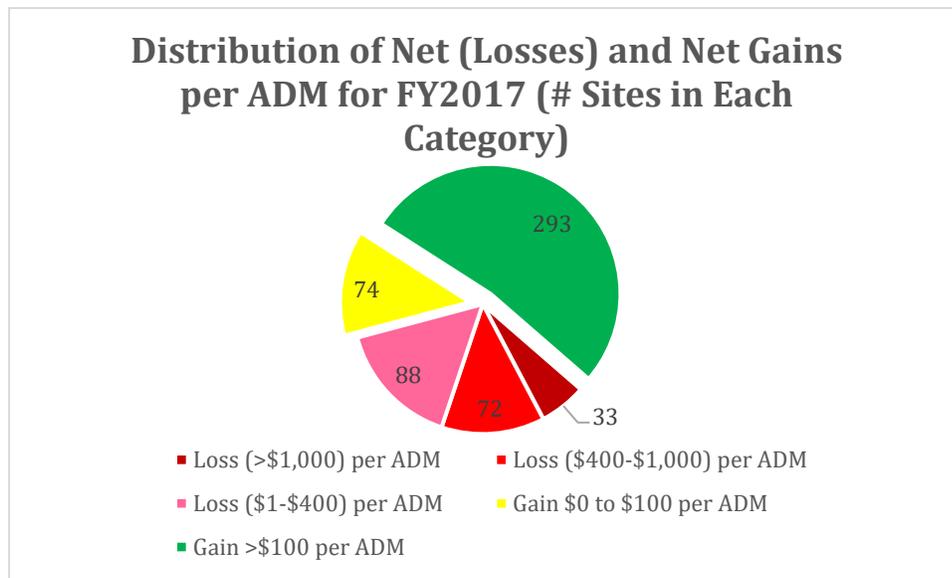
GCI's research has found that net losses (which occur when expenses are greater than income) and net (deficits), (a net worth less than zero), are a growing problem for the charter sector.

One-fifth of charter sites are currently experiencing net losses of at least (\$400) per ADM, representing more than 5 percent of revenues, which is an indicator of significant imbalances (dark and medium red in figure 9).

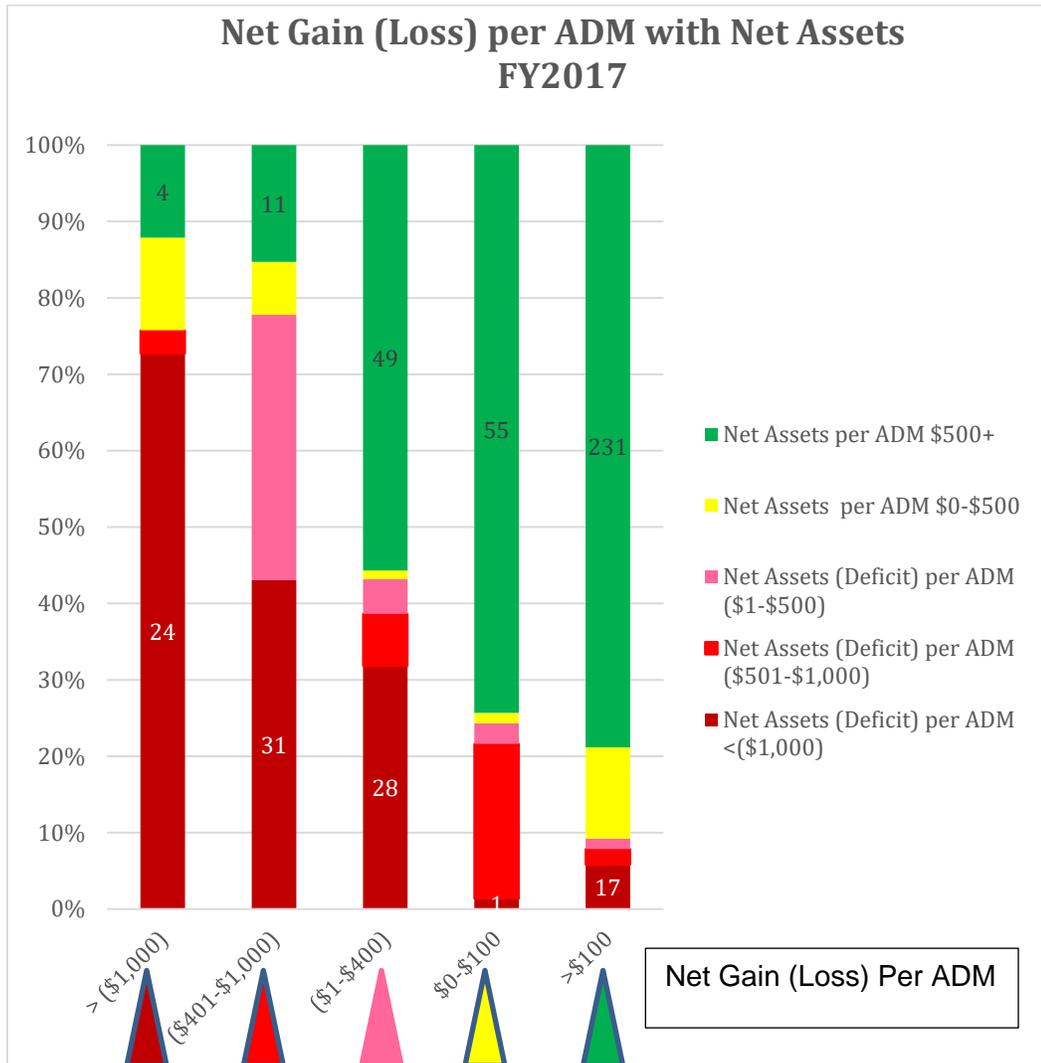
Fifty-five sites, 10 percent of all charter sites, are losing at least (\$400) per ADM and have negative net assets of (\$1,000) per ADM, making them at risk of closure.

An additional 10 percent have net annual losses combined with negative net assets. Collectively one-fifth (119) of charter sites are losing money and also owe more than they are worth. Unless their financials improve, their position is not sustainable.

**Figure 9: Distribution of Net (Losses) and Net Gains per ADM for FY 2017**



**Figure10: Net Gain (Loss) per ADM with Net Assets, FY 2017**



Source: Charter school annual audits.

As can be seen above in *Figure10: Net Gain (Loss) per ADM with Net Assets, FY 2017*, more than 100 charters sites, approximately 20 percent of the total, in FY 2017 lost at least \$400 or more per ADM. This generally represents more than 5 percent of revenue, which is the triggering amount in districts, for a state takeover. When those sites are examined more carefully, more than half of the (55) also have negative net worth of more than \$10,000 per ADM, making them at imminent risk of financial failure as seen in *Figure10*.

These two factors interrelate. Not only does a net loss draw down a company's net assets, but a company that is using borrowed money can show a false positive on net losses. Net deficits are not masked by a company using long- and short-term debt or lines of credit to shore up losses on a single fiscal year.

**Proof of Concept:** GCI applied this model to four charters that closed during the school year and one charter from our listing of charters with debt issues. Starshine was allowed to complete

the school year but was in bankruptcy proceedings. Persistent Net Losses give charter operators the choice of bailing out before their Net Assets go into deficit, as illustrated by Camino Montessori. Or they become insufficiently viable as was the case with the others.

**Figure 11 Illustrations of Charter Failures**

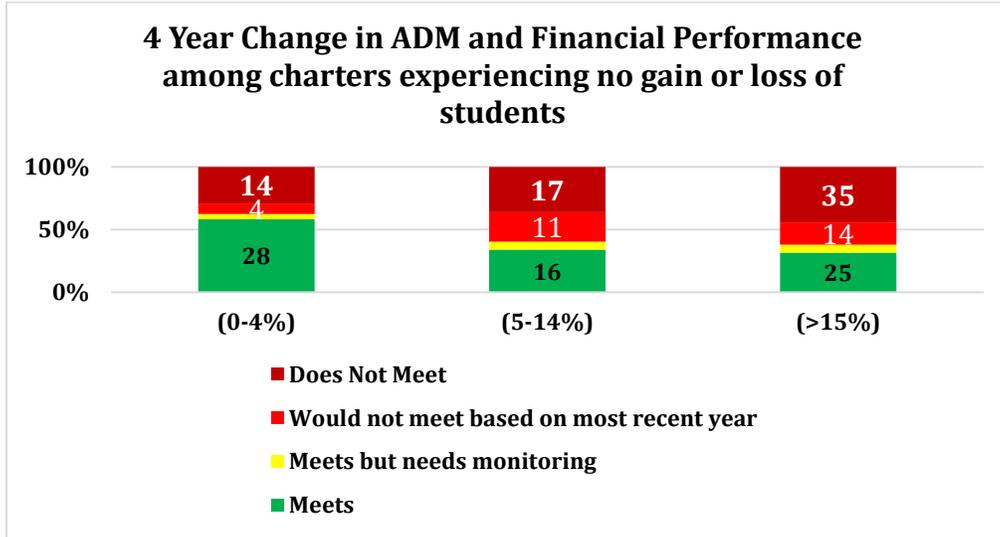
<b>Net Gains (Losses)/ADM Net (Deficit)/ADM</b>	<b>FY 2013- 2014</b>	<b>FY 2014- 2015</b>	<b>FY 2015- 2016</b>	<b>FY 2016- 2017</b>	<b>ASBCS Financial Dashboard</b>
<a href="#">Discovery Creemos Academy</a>	(-\$1,863) (-\$995)	(-\$2,664) (-\$3,672)	(-\$4,418) (-\$7,584)	Closed 1/2018	Did Not Meet Every Year
<a href="#">Camino Montessori</a>	(-\$1,553) \$4,230	\$2,455 \$5,183	(-\$1,657) \$2,551	(-\$308) \$1,547 Closed 10/2018	Did Not Meet 3 of 4 Years
<a href="#">Hillcrest Academy</a>	(-\$19,642) (-\$40,350)	(-\$40,683) (-\$71,707)	(-\$33,441) (-\$92,455)	Closed FY 2016 <sup>5</sup>	Did Not Meet Every Year
<a href="#">Starshine Academy</a>	(-\$3,200) (-\$3,139)	(-\$2,544) (-\$6,325)	(-\$4,810) (-\$14,535)	(-\$5,745) (-\$24,627) Closed FY 2018	Did Not Meet Every Year
<a href="#">Fountain Hills Charter School</a>	\$420 \$836	(-\$155) \$633	(-\$1,053) (-\$278)	(-\$1,851) (-\$2,245) Still Open	Did Not Meet Last 2 Years

Source: Collated data from ASBCS Audits and ADE ADM Statistics FY 2014 – FY 2017. Loss analysis by ADM from GCI dataset.

The combination of lost ADM and its impact on a charter’s financials is shown below in *Figure 12*. Charter sites that lost more than 15 percent of their ADM from FY 2014 to FY 2017 were very likely to not meet the ASBCS financial expectations. The current financial dashboard uses a two-year review. In a number of cases if the most recent year-alone were examined and falls far below criteria adopted as in GCI’s recommendations below, then some of these charter holders that appear to Meet Expectations would not do so.

<sup>5</sup> This charter (Hillcrest Academy) was part of a FINRA decision to pull the bond agent’s credentials. This story is reported on in the Addendum of *Red Flags: Net Losses*

Figure 12 FY 2014—FY 2017 Change in ADM and Finances



**Recommendations:**

The ASBCS Financial Performance Dashboard currently has limited ability to anticipate financial problems because it lacks no “Falls Far Below” criteria for its three sustainability measures. GCI recommends that two “Falls Far Below” criteria be developed for these sustainability measures. Most of the following recommendations are under consideration and appear likely to be adopted by the ASBCS.

1. The Charter Board’s Finance Subcommittee has already taken up this GCI’s recommendation to replace the Fixed Charge Coverage Ratio (FCCR) with the Leased-adjusted Debt Service Coverage Ratio (DSCR).<sup>6</sup> The FCCR measures how much net income a business has relative to what it needs to cover debt payments and obligations but does not make exceptions for one-time costs or (noncash) depreciation. DSCR, which excludes these, is a better overall measure of the long-term ability of a charter holder to service debt. IDA charter bonds typically have a DSCR requirement but make no mention of a FCCR.
2. If the DSCR is used, charter IDA bonding agreements typically require a minimum ratio of no lower than 1.15 (DSCR will be equal to or larger than the FCCR). That should be

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

the standard. Falling below 1.0 is considered a sign of likely default and should be the “Falls Far Below” standard.

3. Net income. Net income is related to net assets, as when net income is negative (a net deficit) it reduces the firm’s net assets. The ASBCS currently has a standard stating that if net income is negative then the charter school 'Does Not Meet' the standard, but does not define a standard for 'Falls Far Below.' Since the ASBCS has no formal criteria regarding net assets, GCI recommends that if net income and net assets are negative that the charter holder be deemed as 'Falls Far Below' the standard. Alternatively, if net income is negative and 5 percent or more of expenses, it should also be noted as 'Falls Far Below', as normally negative net income greater than 3 percent of expenses is the threshold for serious cause for concern. Likewise, 5 percent parallels the 5 percent threshold for state takeovers of district schools. The Charter Board’s Finance Subcommittee has also taken this recommendation up—though it is excluding nonmonetary cost (e.g., depreciation) from its adjusted net income. GCI considers that fine but should keep in mind that the criteria used in this paper use net income inclusive of nonmonetary costs, so these thresholds might need to be tightened when nonmonetary costs are excluded. Note: this report uses a loss of \$400 per ADM as a rough approximation of this measure.
4. The 75 sites identified in FY 2017 as having significant financial red marks along with the 55 sites which as of FY 2017 were losing more than \$400 per ADM and had negative net assets of more than \$1,000 per ADM (the two have considerable overlap) should be reviewed immediately to ascertain whether closure at the end of this academic year to avoid a mid-school year financial collapse is the best path forward.
5. The ASBCS should consider annual instead of biannual financial classifications to improve proactivity in catching financial issues.

#### **Finding 4: Charter Debt is Financially Rated as Speculative Grade**

Ninety-six percent of charter school Industrial Development Authority (IDA) Educational Revenue bond debt is in the form of speculative investments, BB to CCC (NAIC category 3 to 6) ratings of bonds and the unrated nature of other charter IDA bonds<sup>7</sup> classifies these bonds as junk bonds. The long-term, lease-adjusted debt is frequently leveraged using ADM growth projections as guarantees of bonds on overleveraged real estate, which also undermines the credit rating due to the added risk.

In FY 2001 Private Activity Bonds for public educational facilities became an available source of financing for charter schools.<sup>8</sup> These bonds are issued as IDA bonds. Federal law allows these bonds to be tax-free and regulates the total amount a state can issue. They are also exempt from state taxes. The IDA bonds can be issued in one state to fund construction in another state. Because they are tax-free, their interest rates should be lower unless the degree of risk forces the rates higher.

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<sup>7</sup> An outlier in the IDA data was an A rated IDA bond that Higley School District had arranged with an outside agency. That company secured the bonding and Higley is now committed to Lease payments on the bond. Only one case of a district was in the IDA reports as of June 2017. The outlier appears to show that districts would be able to secure much lower interest rates than charters in this market.

<sup>8</sup> Maguire, Steven and Joseph S. Hughes (2018), “Private Activity Bonds: An Introduction,” Congressional Research Service, July 13, <https://fas.org/sgp/crs/misc/RL31457.pdf>.

IDA bonds are available through Industrial Development Authorities of the State of Arizona, Arizona municipalities and counties to finance debt<sup>9</sup>.

Charters currently are paying high interest rates on IDA educational revenue bonds (GCI considers 7 percent to 7.5 percent high for commercial lending on tax free bonds). Educational revenue bonds in Arizona are frequently considered noninvestment grade or “junk” bonds by the bond markets because they are either unrated or rated by the National Association of Insurance Commissioners as category 3 or lower—which for Standard and Poor is BB+ or lower<sup>10</sup>. This allows the bond market to claim higher interest rates to compensate for the added risk. Higher interest payments reduce the dollars charters can devote to their educational mission that they state has contracted with them to perform.

Charter organization debt comes from two primary sources:

- 77 percent of charter debt valued at \$1.29 billion is in the form of IDA Educational Revenue Bonds with another \$253 million of IDA debt held by one of the charter organization’s main business entities. Typical interest on this debt ranges from 4 percent to 9.5 percent.
- 19 percent of charter debt comes from charter property financing companies (typically the parent company of the charter —the charter sites then become subsidiaries<sup>11</sup> of that parent real estate holding company). 0.1 percent is in USDA loans and one charter’s required reimbursement of grant funding to USDOE. Companies operating in this part of the market in charter debt are making real estate investments that are then used as profit centers for related construction, real estate, and leasing subsidiaries of the charter group.
- 3 percent of charter debt is held commercially. Interest was a very competitive 3 percent on these commercially-sourced loans. Example: Northland Prep in Flagstaff with a 3 percent note with Chase bank.

**Figure 13 Arizona charter debt by type of debt at June 30, 2017**

Types of Debt	Total Long-Term Debt	% of Total
All Charter LT Debt from Audits	\$1,675,530,216	100%
IDA Debts	\$1,290,607,907	77%
Subsidiary Held Debt	\$313,914,398	19%
US DOE and USDA Debt	\$16,324,522	1%
Exemplary Debt (Bank Held)	\$54,683,389	3%

Source: Collated Long-Term Debt Analysis using FY 2017 Audits and IRS 990 Filings (Federal Non-Profits Only)

<sup>9</sup> See: New Market Tax Credits which were the original source of these type of tax free loans. Educational properties were added to the IDA tax free program which was originally designed to provide incentives for businesses to locate in the municipalities the bonds originated from.

See: <https://www.cdfifund.gov/programs-training/Programs/new-markets-tax-credit/Pages/default.aspx>

<sup>10</sup> An outlier discovered in school financial data and searches of IDA loans in Arizona. One AZ district has an IDA Educational Revenue bond, Higley, the company holding that bond while Higley pays a committed long-term lease, was able to obtain an AAA rated bond. GCI includes this lease in district debt figures used in this report.

<sup>11</sup> This relationship is noted in the audit titles submitted to the ASBCS.

The tax-free status of these bonds enables their net yield to the investor to be higher and keeps the interest rate charged somewhat competitive,<sup>12</sup> but not at typical commercial loan rates on a sound business' real estate debt. Because of the tax-free status this debt costs more in interest and does not increase Arizona's tax revenues because investors do not pay taxes on the interest. GCI classifies this type of tax-free transaction a de facto government subsidy on the loans because of the lost revenues represented by the bonds tax-free status. The public is not liable for these debts. These are distinct from the state guarantee of IDA bonds, which this report will address later.

Importantly, IDA bonds are typically guaranteed by property and asset values **and** student enrollment projections.<sup>13</sup> The payments based on the *actual student attendance* are the primary source of revenue used for making these debt payments. If actual enrollment is lower<sup>14</sup> than the projections used to guarantee the debt, a charter organization must divert resources from other areas of their budgets to service their debt. Frequently, the charter revenue from ADE is intercepted by the bondholder to assure that is the top use of charter revenue.

Notably Arizona has more use of junk bond financing for charters than other states. *Figure 14 Comparison of Bond Ratings and Debt on Bonds in Texas and Arizona.* shows "Below Investment Grade" and on the right side "rated par" can still be Below in Investment grade. A careful analysis of new IDA bonds in Texas compared to Arizona for 2012 to 2014 found **that 80 percent of Texas bonds were investment grade, while only about 10 percent of Arizona's were.** Texas appears to have stronger oversight of its robust charter sector. Texas also better controls the interest of taxpayers in its state guarantee of charter indebtedness for select charters. In Texas, a charter school must meet high academic standards and be able to achieve investment grade (at least BBB or NAIC category 2) on its bond issuance for the state to guarantee it. By contrast, only one of the seven issuances that have been guaranteed by taxpayers in Arizona has met that criteria (Great Hearts), all of the others have fallen short of that mark. Arizona's statute limits the state guarantee to charter companies receiving an academic performance grade of A and need only meet speculative investment grade of BB/NAIC category 3 to be eligible. The statute limits guarantees to no more than 25 percent of its portfolio schools that were rated BB- on their own. BB- is the lowest grade within the BB strata. Almost all of the state guarantees provided to date in Arizona have been rated BB on their own.<sup>15</sup> Consequently, state taxpayers are primarily backing debt that would be ineligible for state guarantees in Texas. One participant who has received two state loan guarantees totaling \$65 million is not currently meeting the overall financial expectations of the ASBCS and was not meeting it at the time their bond guarantees were approved.

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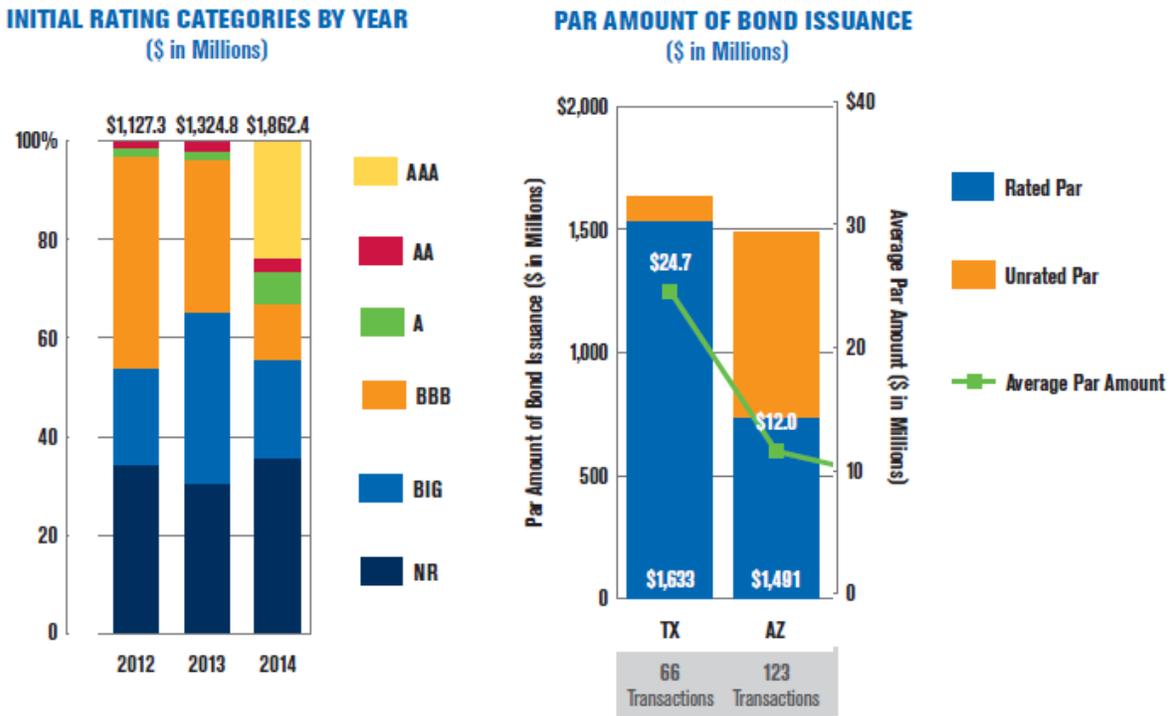
<sup>12</sup>Example: If for the same amount of risk a corporate bond was 5 percent, then an IDA issuance could yield 3.13 percent and still return the same amount for someone in the 33 percent federal marginal rate and paying Arizona's 4.54 percent marginal rate.

<sup>13</sup> This guarantee is spelled out on the audits under the sections regarding Long-Term Debt usually in notes. GCI lists these notes in its data set.

<sup>14</sup> In FY 2014 the state of Arizona overpaid ADM by \$26 million. The recovery of these funds involves withholding a part of the next year's payments. The problem is recurring in the data. Deliberately overstating ADM is fraud and the Arizona Attorney General may bring suit against the charter holder. The case at Discovery Creemos which collapsed financially in FY 2018.

<sup>15</sup> Credit Enhancement Eligibility Board, June 21, 2018 Meeting, Meeting Materials, Arizona Governor Doug Ducey, Office of Education, <https://education.azgovernor.gov/edu/credit-enhancement-eligibility-board>.

Figure 14 Comparison of Bond Ratings and Debt on Bonds in Texas and Arizona



Source: Charter School Advisors (2015): Charter School Bond Issuance a Complete History Volume 3

**Recommendations:**

1. As noted under Findings 1 and 2: The practice of using enrollment projections to guarantee debt should be eliminated or modified based on historic evidence of ADM growth. The practice of using enrollment projections to guarantee debt should be eliminated unless the borrower can show consistent four-year growth in ADM aligned with past expansions and charter replications. **The ASBCS must approve any charter company seeking to secure debt based on projected ADM; otherwise, the charter board can use a financial basis to withdraw the charter for noncompliance under HB 2663.** Current practice has led to over-leveraging and underwater properties as detailed in this report. The practice also allows bondholders to intercept funds distributed by the ADE prior to the charter receiving those funds (requires legislation).
2. Charter companies should be required to show that they have received a quote from a commercial lender OR received an investment grade rating (NAIC category 1 or 2/BBB or better) before commencing any other kind of debt and then report that rate and what lending option was chosen and its rate to the ASBCS. This will create transparency when analyzing debt that is currently missing and potentially accountability. If charter operators choose more expensive means of financing this may be because of a choice to use a related-party transaction that does not save money or create efficiencies. Charters that qualified and then used commercial lending from banks did not exhibit signs of financial distress caused by an overleveraging of property and often paid a lower interest rate (should be able to be done via rule from ASBCS).

3. Annual audits for charter holders should disclose if IDA bond debt was based on projected ADM and whether or not that projected ADM schedule is being met. A recent closure involved misuse of ADM data that created revenues the owner used to purchase goods from his own companies. This was caught after the school closed suddenly (Discovery Creemos) within six months the same type of misuse of funds was present at Starshine Academy. (rule from ASBCS needed)
4. The state should modify its state guarantee loan program to more closely follow the example of Texas while preserving opportunities for small or medium-size charter companies. This will continue to reduce borrowing costs but better protect taxpayer interests:
  - a. The charter on its own receives an NAIC category 1 rating for a bond offering (A) and meets the highest grade for academic standards (A) OR reaches the next highest grade for academic standard (B) and can show for the demographics of equivalent students served using student level data that it is doing better than most nearby schools. This expands eligibility to assist charters in lower income areas who might be disadvantaged by socio-economic or student-selection biases within a state grading system.
  - b. The Charter on its own receives an NAIC category 2 rating for a bond offering (BBB) and meets the same academic criteria. But in this case the amount of borrowing may not exceed property value.
  - c. Investment grade ratings for smaller companies are harder to achieve. For small and medium charter companies (less than 5,000 students AND less than 10 sites nationwide) on its own receives an NAIC category 3 rating for a bond offering (BB) and meets the academic criteria. But also for the past three years have met the overall financial expectations of the ASBCS, including having a lease-adjusted debt-service coverage ratio at least 5 percent greater than the minimum required, e.g., 1.21 if 1.15 was the cut off) for each of those years.

**Finding 5: Charter Additional Assistance is paying for Private Property**

All charters currently receive about \$1,600 more per student in Charter Additional Assistance than districts do regardless of academic performance or whether they have a physical school facility or are entirely on line.

The reason some charters are not doing well financially *is not due* to a lack of resources compared to district schools. Debt issues are a factor of insufficient oversight as well as a market where charter owners can still make money through related-party transactions or an affiliated charter management organization, even as they rack up losses, as was illustrated by the many related party transactions that Dan Hughes ran with Discovery Creemos. Consequently, a nonprofit charter holder may be overpaying for facilities and interest, but the benefactor is someone affiliated with the charter holder or a related-party. For charter companies, once the property is largely paid for, they have equity against which to borrow—and do not have the same need for additional state funds—as charter property is private property and upon sale of the school can reap their owners a substantial profit on real estate that was paid for with state funds.

Originally in Arizona charters were funded just like other public schools. However, many struggled with start-up costs. That need for building funding eventually led to the creation of Charter Additional Assistance.<sup>16</sup>

For FY 2019 Charter schools receive about \$1,770 per-pupil in Charter Additional Assistance (\$1,840 if the formula were fully funded). District schools receive about \$180 per-pupil, about one-tenth of what charters receive (\$460 if the formula was fully funded). The state has never fully funded District Additional Assistance, but Gov. Ducey plans to do so by FY2023.<sup>17</sup> The differential is premised on districts being able to receive added funds through bonding and overrides that are voter approved, while charters cannot do so. The Arizona Auditor General notes that district schools' nonoperational costs for land, building, equipment and interest averages \$1,500 per student.<sup>18</sup> That might suggest the current gap is appropriate. However, a critical difference is that *district school facilities are publicly owned, while charter school facilities are privately owned*. In addition, district schools tend to provide comprehensive educational opportunities including a wide range of extracurricular activities and provide educational opportunities to a wide range of students from special needs, English Language Learners and gifted. By contrast, charters vary considerably but most tend to specialize in certain kinds of education (e.g., college prep), have limited extracurricular options—meaning their base facility costs are less. Online charter schools do not need space for students, and consequently have no basis by which they should be receiving a premium in additional assistance from taxpayers.

Presently, Arizona charters receive Charter Additional Assistance *regardless of their academic performance or financial management unless the ASBCS withholds 10 percent of their funds due to problems*. They also receive it in perpetuity regardless of their actual facility-costs. GCI recommends that Arizona revise and change its Charter Additional Assistance program to blend current practice with what has been adopted in Texas for Texas for facility funding.

In Texas charter schools receive a per-student allocation similar to district schools but unlike Arizona there is no Charter Additional Assistance that Texas charter schools receive simply by virtue of being a charter school.

In Texas charter schools can now receive facility funding of about \$200 per student but must meet minimum academic performance criteria to receive it. The Texas formula is subject to a budgetary cap established by the legislature. The legislature has capped that amount at \$60

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<sup>16</sup> Ryman, Anne, Alden Woods, Craig Harris, and Justin Price (2018), "'Like the Oklahoma Land Rush,' a world with few boundaries: Arizona had second-highest number of charter schools in the nation a year after the law passed. But Critics were concerned with the lack of regulation," *Arizona Republic*, December 14, <https://www.azcentral.com/story/news/local/arizona-education/2018/12/14/charter-schools-take-root-arizona-1994-legislation/2015754002/>.

<sup>17</sup> Details on Charter Additional Assistance and District Additional Assistance can be found at the JLBC FY2019 Appropriations Report for the Dept. of Education, <https://www.azleg.gov/jlbc/19AR/ade.pdf>. Additional comparison details can be found in JLBC Staff (2018), "Overview of K-12 per Pupil Funding for School Districts and Charter Schools," June 21, <https://www.azleg.gov/jlbc/districtvscharterfunding.pdf>.

<sup>18</sup> Davenport, Debra K. (2018), "Arizona School District Spending: Fiscal Year 2017," Arizona Auditor General, March, Report 18-203, p. 4, [https://www.azauditor.gov/sites/default/files/18-203\\_Report\\_No\\_Pages.pdf](https://www.azauditor.gov/sites/default/files/18-203_Report_No_Pages.pdf).

million, but if the Texas formula were fully funded, eligible charter schools would receive \$800 per student.<sup>19</sup> Notably these dollars can only go for facility funding to:

- lease an instructional facility;
- pay property taxes imposed on an instructional facility;
- pay debt service on bonds issued to finance an instructional facility; or
- pay for any other need related to the purchase, lease, sale, acquisition, or maintenance of an instructional facility<sup>20</sup>

In Arizona Charter Additional Assistance is not restricted.

Arizona has an interest in quality charter school facilities, but needs to also balance that with private property equity that charter companies normally accumulate over time. Equity is a form of wealth created through taxpayer financing that charter companies can utilize to be less dependent on state taxpayers. GCI recommends a blending of the current model with the approach of Texas, which provides facility funding of \$800 per student if the legislature fully funded the formula, but schools must meet academic standards to be eligible and they must pay for facilities.

### **Recommendations:**

Charter Additional Assistance should be redefined as follows:

1. Charter schools would need to meet minimum acceptable academic performance standards as set by ADE and ASBCS (if they differ).<sup>21</sup> The ASBCS could provide waivers during the first seven years of operation if the school provides sufficient evidence of school improvement or circumstances that are transitory.
  - a. Failure to meet minimum academic performance standards without a waiver would mean a loss of Charter Additional Assistance. Persistent failures to meet minimum academic standards should lead the ASBCS to revoke the school's charter.
2. Charter Additional Assistance must pay for facility lease, purchase, or maintenance costs and these costs must be demonstrated to be at no more than fair market value.
3. Charter Additional Assistance at current levels would remain for "brick-and-mortar" instruction charters during their first five years for a given level of ADM, so new student growth is fully funded for five-years to assist with facility costs.
  - a. The difference between Charter Additional Assistance and District Additional Assistance would be eliminated over a ten-year phase-out period after which Charter Additional Assistance would equal District Additional Assistance.
4. Online charter operators would not qualify for Charter Additional Assistance due to no need to fund student facilities but could receive some added funding if they were providing student computers or subsidies for home internet connections for students.

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<sup>19</sup> "Charter School Facility Fund," May 1, 2018,

[https://tea.texas.gov/About\\_TEA/News\\_and\\_Multimedia/Correspondence/TAA\\_Letters/Charter\\_School\\_Facility\\_Funding/](https://tea.texas.gov/About_TEA/News_and_Multimedia/Correspondence/TAA_Letters/Charter_School_Facility_Funding/).

<sup>20</sup> "Charter School Facility Fund," May 1, 2018,

[https://tea.texas.gov/About\\_TEA/News\\_and\\_Multimedia/Correspondence/TAA\\_Letters/Charter\\_School\\_Facility\\_Funding/](https://tea.texas.gov/About_TEA/News_and_Multimedia/Correspondence/TAA_Letters/Charter_School_Facility_Funding/).

<sup>21</sup> For instance, ADE has failed to provide academic ratings for one-third of charter schools that are classified as alternative. However, we do have academic data on these schools, so the ASBCS could develop its own academic rating system if ADE fails to do so. These schools can't be in compliance by default because many are not meeting academic standards.

They may apply to receive some initial start-up grants to cover capital and technology, but these funds should be limited.<sup>22</sup>

- a. Online charter schools *not receiving a waiver for meeting minimum academic standards would have 10 percent of their state funding cut.*
5. To phase in the new formula, charters currently in operation for longer than the initial fully-funded proposed period and meeting minimum academic standards would be considered as in Year Five for 2019-2020. For brick-and-mortar operators at their current ADM they would still receive the full Charter Additional Assistance. As a phase-down, Online Charter operators would receive half of Charter Additional Assistance in 2019-2020 and none after then. GCI will do a more careful evaluation of online operators early in 2019.
  - a. The charter board could apply a one-time, one-year waiver to those not meeting minimum academic standards provided they have a sufficient plan for improvement. The waiver could be renewed for one additional year only if sufficient progress was shown.
6. Savings generated from this formula change would be added to base or performance funding for district and charter schools above the minimum requirements of Prop. 301 and Prop. 123, so this change reallocates money within district and charter schools to support K-12 education.

**Finding 6: Rising standards of financial accountability need to be enforced to be impactful.**

GCI recognizes the importance of legislation that now allows the ASBCS to rescind a charter based on the failure to meet financial performance expectation measures. GCI looks forward to continued work with ASBCS as they adjust their Financial Performance Expectations to accommodate the findings of GCI's reports. The current staffing levels at the ADE and ASBCS do not allow these agencies to oversee their ever-expanding responsibilities<sup>23</sup>

**Recommendation:**

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

GCI also recommends a standard audit form be developed that requires that all audits include details with breakdowns of specific categories. The use of general categories such as Charter School Expenses without accompanying detail hinders the monitoring agency's decision-making ability (no legislation needed)

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<sup>22</sup> As of 2015-2016, Arizona State University for its online program reported spending about \$500,000 for licensing, hosting instructional technology, transcribing, and quiz software. Boston Consulting Group for Arizona State University (2018), "Making Digital Learning Work: Successful Strategies from Six Leading Universities and Community Colleges," March, p. 29, <https://edplus.asu.edu/sites/default/files/BCG-Making-Digital-Learning-Work-Apr-2018%20.pdf>.

<sup>23</sup>At the ADE this should also include staffing to effectively monitor funds on state issued vouchers and at opportunity scholarship clearing houses. Monitoring by the Auditor General needs to continue of districts, charters, and scholarship programs.

The aim of using statistical data from the last four fiscal years is to ensure that the public is informed of the current financial state of the charter marketplace in our state.

GCI looks forward to working with the ASBCS and policymakers in their continuing effort to fulfill their oversight responsibilities for charter schools in this state. GCI gratefully acknowledges the ASBCS's assistance in making their financial data available and their willingness to engage in a dialogue on these issues.

### **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.

**APPENDICES: Detailed Exploration of Debt and Lease Obligations**

By statute Arizona's publicly-funded charter schools are privately held companies. All rights to the property and assets remain with the charter holder along with the rights to use those assets to assume debt. Charter schools receive 'Charter Additional Assistance' of about \$1,770 per year per ADM to help fund property and equipment. Charter schools do not have the opportunity to raise bond revenue through local property taxes. As a result, charters must privately finance their property and equipment.

**Figure 15 Arizona Charter debt by type of debt holder, July 1, 2017**

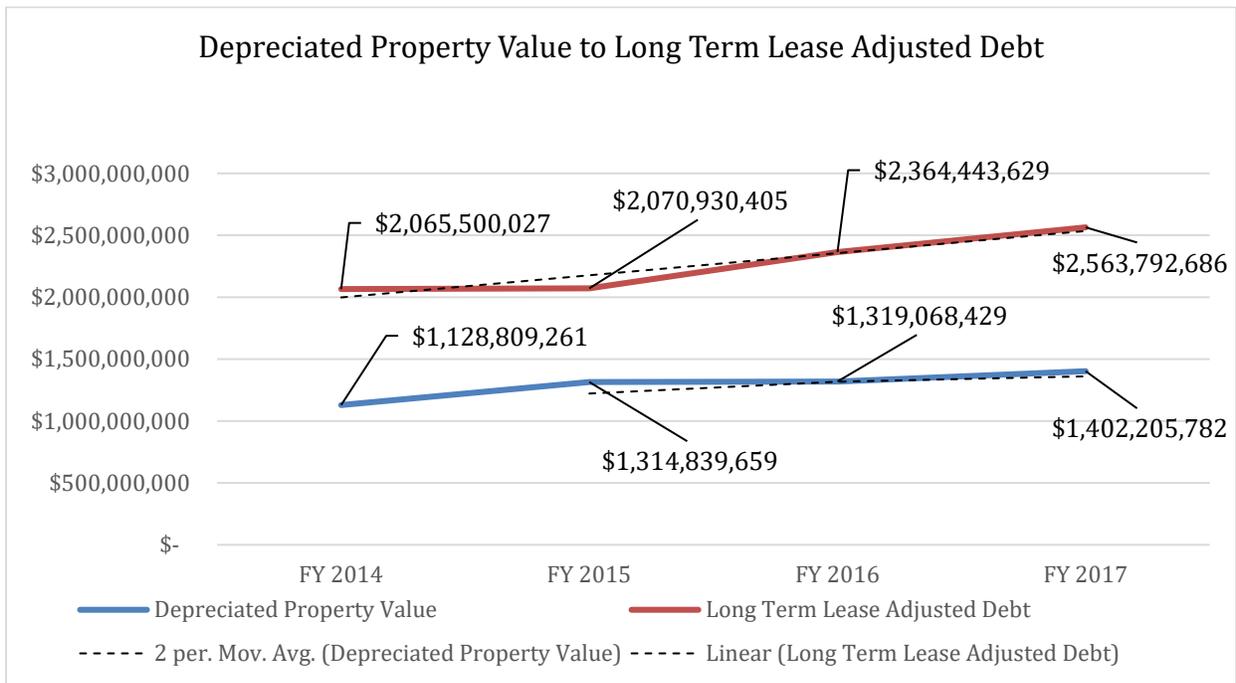
IDA Charter Bond	\$1,290,607,907	77%
Subsidiary Held Debt	\$313,914,398	19%
US DOE and USDA Debt	\$16,324,522	1%
Commercial Debt	\$54,683,389	3%

*Source: Collated long-term debt analysis using FY 2017 audits and IRS 990 filings (federal non-profits only). Figures do not include \$253 million held by charter real estate holding companies related to the charter.*

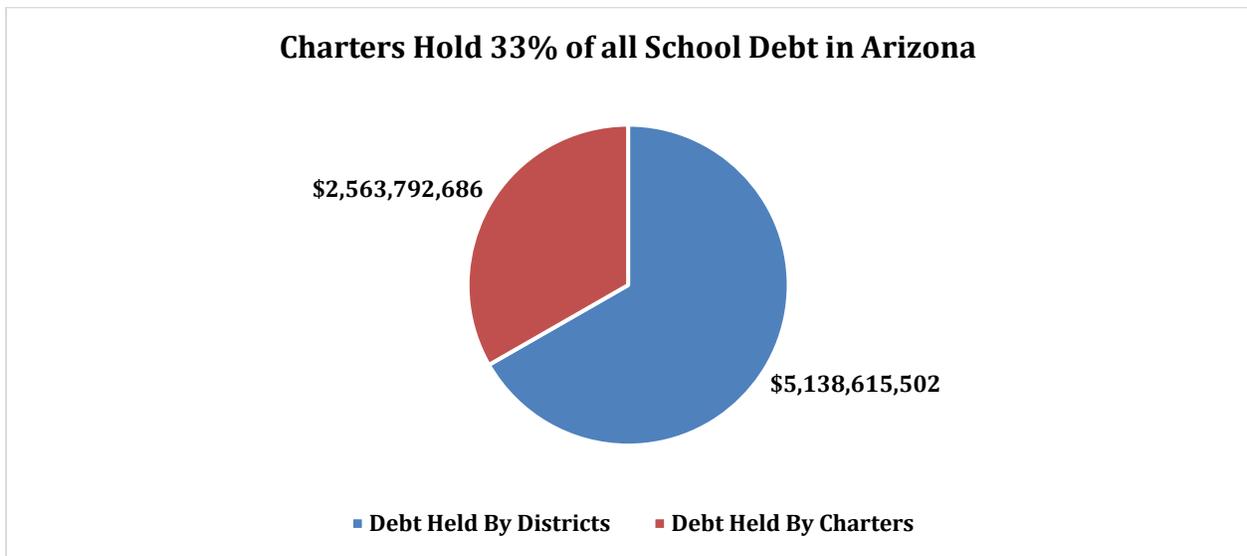
The indebtedness of charters is growing at a greater rate than the growth in the property values of all charters since 2017. Thirty-three percent of the total long-term debt on all school properties (districts and charters) in Arizona is held by charter corporations while charters enroll 16 percent of the market's students based on ADM count for FY 2017. This rate of debt is unsustainable (Green Preston and Baker 2016).

Districts hold depreciated property worth \$20.7 billion. A debt-to-property ratio of 0.25. Charters hold depreciated property worth \$1.4 billion. A debt-to-property ratio of 1.83.

**Figure 16 Charter depreciated property value to long-term adjusted debt**



**Figure 17 Charter and district debt**



Source: ASBCS Audits and IRS 990 data from FY 2017 on Charter Long-Term, Lease-Adjusted Debt and ADE reports on District Long-Term, Lease-Adjusted Debt

**Charter long-term debt and lease commitments**

At the end of FY 2017, Arizona's charter sector held \$2.6 billion in long-term debt and commitments. This includes \$1.7 billion<sup>24</sup> in bonds, notes and interest payable plus \$886 million in long-term lease commitments. Long-term debt and commitments to leases at charters are almost twice the value of the property and physical assets held by Arizona's charter holders. The difference in value is being guaranteed by expected revenues on ADM generated from student-anticipated counts. Meanwhile, the depreciated value of charter properties was \$1.4 billion.

The current state of the main issue affecting charter finances is shown in the following tables.

**Figure 18 Charter Depreciated Property Value, Bond Debt, and Long-Term Commitments at June 2017**

<i>Charter financial information</i>	<i>Amount</i>
<b>All Long-Term Bonds and Notes held by Charters</b>	<b>\$1,675,530,216</b>
Required Leases, Rents and Other Commitments From Audits	<b>\$888,262,470</b>
Total Bonds and Long-Term Commitments owed by Charters in AZ	<b>\$2,563,792,686</b>
<b>Depreciated Value of the Properties of ALL Charters in Analysis<sup>25</sup></b>	<b>\$1,402,205,782</b>
<b>Shortfall in Dollars Using Depreciated Value</b>	<b>(\$1,161,586,904)</b>
<b>Debt-to-Property ratio of Arizona's charter sector</b>	<b>1.83</b>

Source: ASBCS Audits and IRS 990 Collated Property and Long-Term, Lease-Adjusted Debt

Note: 564 Charter Sites out of 579 Sites were used in this analysis.<sup>26</sup>

**Limitations on data collection method**

If the company *holding the debt* is a for-profit or a non-profit only registered in Arizona without federal non-profit status, the public cannot see their audit(s), the subsidiary's if one exists. In other words, these figures understate the issue being discussed as some corporate debt is hidden in subsidiaries and unaccounted for here.

In comparison, school districts have debt and property values where the depreciated property value is **4 times greater than** the debt on those properties. Districts do not, as a rule, use long-

<sup>24</sup> See Avoiding Double Counts

<sup>25</sup> Depreciated Property Values are used by the AZ Department of Education in their statistical analysis of District Properties. The Depreciated and Undepreciated values (i.e. Market Value) will be utilized in this report. The latest available fiscal year of data (2016-2017) is used in these tables.

<sup>26</sup> Charters with Properties and Debt Shared with larger organizations such as CPLC and Universities were not included as they are part of the larger organization.

term leases<sup>27</sup>. The ability of districts to take on bond debt and long-term financial commitments is regulated and controlled by state laws and district policies. The public owns district schools. The school districts that overspent their budgets in FY 2017 did not overspend due to long-term debt or long-term commitments. Those losses at districts and losses at some charter sites can often be attributed to declining enrollment.

GCI found that overleveraging and the long-term debt and leases that result from that overleveraging are the larger issues in charter schools' financial pictures. The audits required by the ASBCS provide this data in several areas; primarily they are recorded as Long-Term Debt and under Commitments (money that must be paid for Long-Term Leases and Rents<sup>28</sup>). Notes in the audits provide added details regarding these items.

### **Subsidiary Held Debt**

In FY2017, subsidiary held debt by related-party real estate companies was worth **\$313,914,398** in long-term debt for charter assets. These loans are guaranteed by charter revenue from ADE based on student enrollment and property values. This represents **19 percent** of all charter sector long-term debt. This debt is guaranteed by long-term lease commitments between the charter holder and the related-party real estate company. Three quarters of charter long-term lease commitments are with related parties. Data is sourced from Property and Asset Statements on Audits and IRS Form 990s.

Any analysis of bond debt to the current value of charter school properties must include long-term lease commitments to provide a complete picture of the challenges presented by long-term indebtedness of the charter sector.

To assess these commitments GCI collected and collated data on one-year and multiple-year lease commitments. This was done in order to analyze the impact of leases (Reisner et al.) on long-term debt and commitments. As noted, GCI maintains that the manifestations of the debt issues are reflected in annual Net Losses and Net (Deficits) on a charter's annual financial reporting. GCI contends that Cash Flow issues are also manifestations of the debt issues discussed in this paper (i.e. the debt is consuming the companies' cash)<sup>29</sup>.

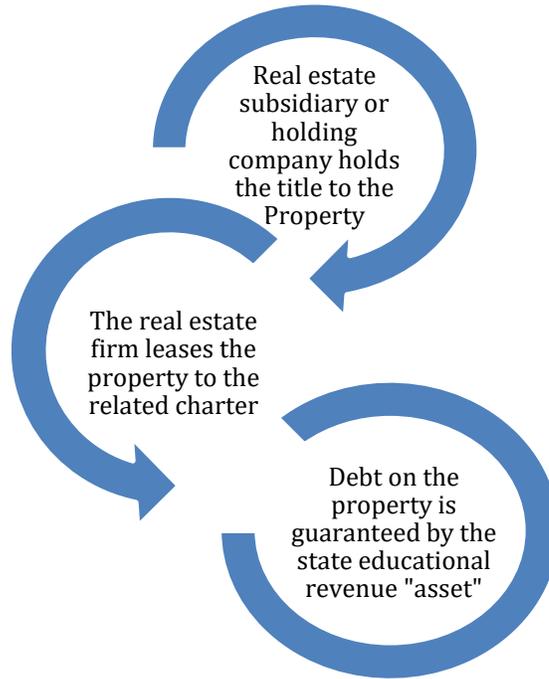
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<sup>27</sup> Exception, there is a long-term lease existing on an IDA loan taken by a Design and Build project (A+ Bond Rating) at the Higley Unified District. IDA loan was executed in FY 2012. The district leases this property from a non-profit. A search of IDA lending has confirmed this is a singular case.

<sup>28</sup> The requirement to pay is amplified by the fact that the only way the leasing agency can pay its long-term debt is by collecting the lease. In a conglomerated corporation where the only true source of funding is the revenue coming in from the state and federal government one company depends on the other for its financial viability. GCI believes that some of the charters showing net losses may have subsidiaries that are in the black. The financial data on those subsidiaries is only available as an IRS 990 report which are only required of Federal non-profits. We support requiring AZ Non-profits to also register as federal non-profits. GCI's concerns are confirmed by the current calls for greater scrutiny of non-profit status by financial professionals and in Congress.

<sup>29</sup> Cash flow issues were noted at companies that did not pay their proposition 301 money and sometimes their federal taxes in a timely manner.

### Figure 19 A Real Estate Subsidiary's Relationship to the Charter School's Lease Commitment



In this model the rules on property and asset ownership allow the business to count student ADM as an "Asset".

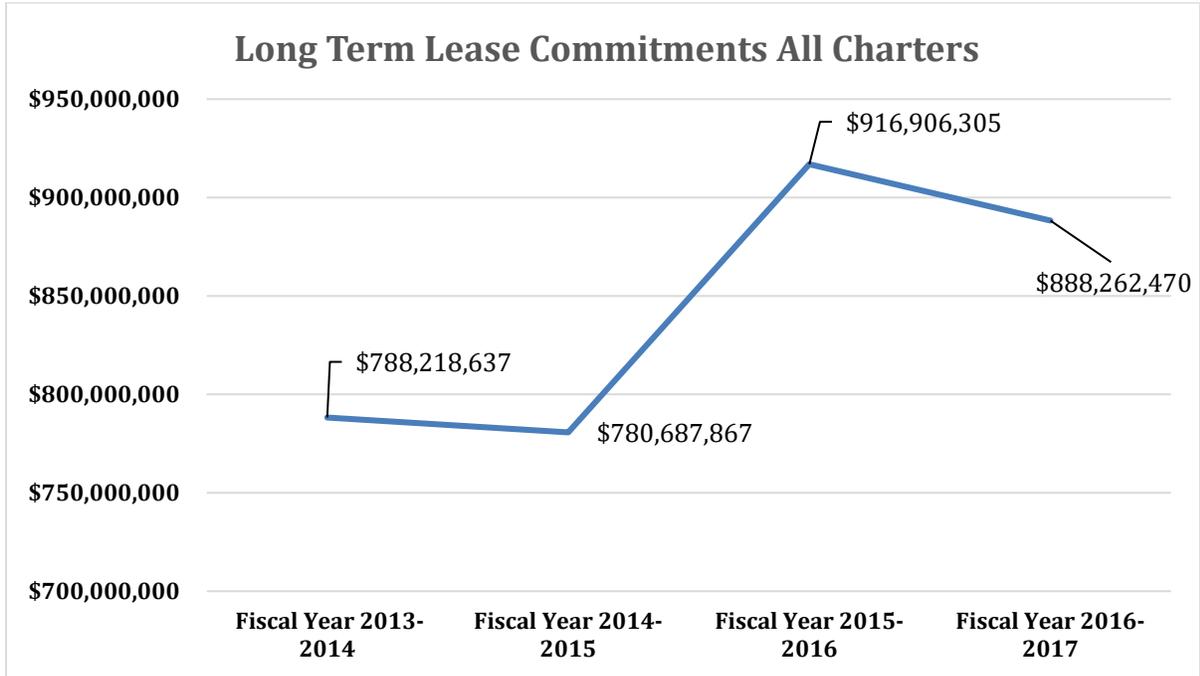
#### **Charter Lease Commitments & Related Parties**

Long-term lease commitments for properties owned by related real estate entities in FY 2017 were **\$886,262,470**.

In FY2017, consolidated yearly lease commitments for all charter sites were \$87,663,090; 77 percent of one-year leases were owed to related-party real estate firms valued at \$63,674,611 per year.

Commitments to leases and rents represent a significant financial obligation for charter schools and often have built-in increases. These automatic increases are included in GCI's data gathered from charter audits. A typical built-in increase is 5 percent to 10 percent per year at some of the larger charter groups. This means the lease is a source of profits for the real estate subsidiary of the charter, even if the charter school is losing money.

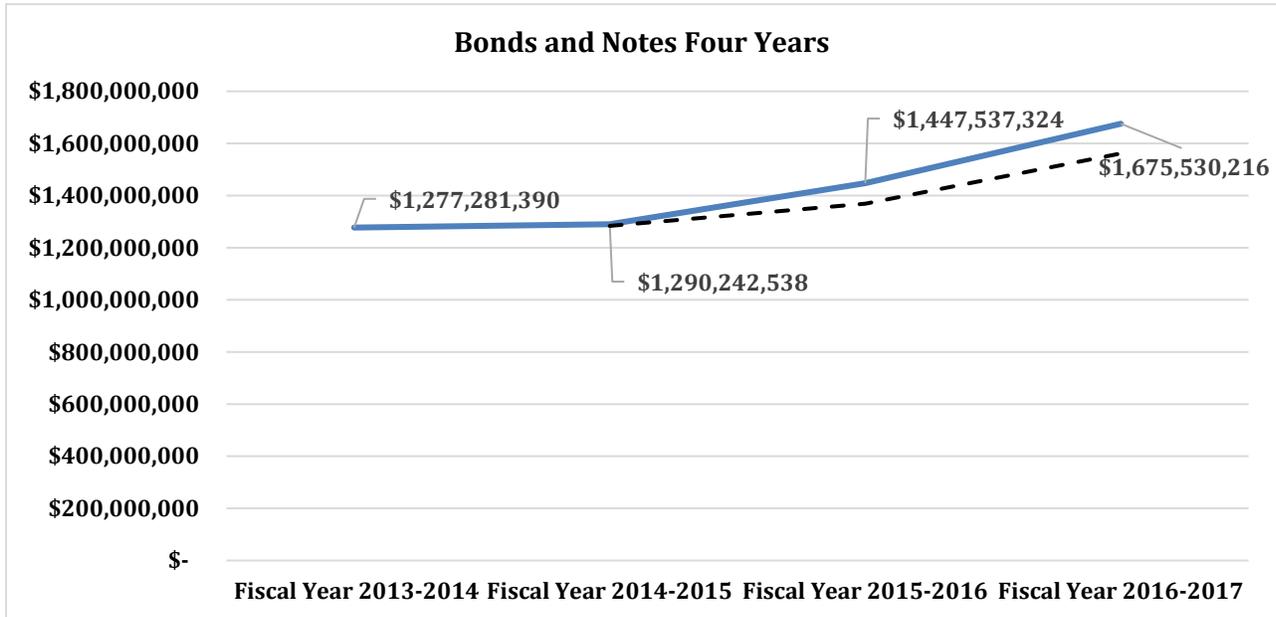
**Figure 20 Long-Term Lease Commitments FY 2014 – FY 2017**



Source: ASBCS Audits FY 2014 to FY 2017: Long-Term Leases categorized as Commitments

The drop in committed lease payments from FY 2016 to FY 2017 is due to several charters changing the ownership of the real estate from one subsidiary to another. The result shows as an increase in debt payments by the charter and a decrease in long-term leases. The increases also reflect a charter site growth pattern in the same years.

**Figure 21 Bonds and Notes FY 2014-FY 2017 with Trend line**



The sole source of income for these property management companies are the charter entities' long-term leases and rents they, the Educational Management Organization or Real Estate Subsidiary, rely on to pay their debt obligations. The only way the property holding business can profit is to charge more for the lease than the long-term bonds are costing the real estate holding subsidiary that "owns" the properties in question. Long-term lease commitments are prevalent and binding in cases where the property is held by a related-party or affiliated corporate real estate holding subsidiary of the charter. Loans (bonds) on the property are guaranteed by payments from the ADE based on projected enrollment.

A summary from the end of Fiscal 2017 follows. It compares yearly lease figures to the committed amount due to the leasing company, i.e., the amount that must be paid. The commitments are typically ten-times the yearly lease price as they guarantee the property holding subsidiary's payments on debt for charter properties. In several cases, the main company is listed as the property holding firm, i.e. the charters are listed as subsidiaries of the main firm.

**Figure 22 Charter Lease Commitments FY2017**

Long-Term Lease Commitments for Properties Owned by a Related Real Estate Entity	\$886,262,470 <sup>30</sup>
Arizona's Charter Sector Consolidated 1-Year Leases	
1-Year Lease Commitments (All)	\$87,663,090

<sup>30</sup> Ten-to-one compared to short-term leases.

<i>Leases to Related-Party Property Real Estate Companies</i>	<i>\$63,674,611</i>
<i>Percent of leases with related-party real estate companies</i>	<i>77%</i>

*Source: Audit Data from FY 2017 Collated (only leases to related firms are included)*

Long-term lease commitments can change dramatically when the charter school buys their PROPERTY through a related real estate subsidiary. The charter school entity then starts paying the Commitment to leases shown on its audits as payments to a lease with a related party. The amount charged for the lease, as with any business deal involving a similar practice, is more than the costs the property holder has on the bonds and includes the interest on that debt. We considered long-term leases that represented more than 18% of the difference between the loan payments and interest charges related to the total long-term lease commitment as excessive. I.e. the business deal with a related party did not save money for the school. A 15% mark-up was the norm.

### ***Related-Party Real Estate / Leasing Companies and Charter Properties***

It is common practice among Arizona's non-profit charter schools to sign a long-term lease agreement with a related-party real estate company for school facilities. In these cases, the charter school's ADM revenue pays the lease fee and is typically used to guarantee the debt on the property even though it is not directly owned by the charter school. Any debt held by the "for-profit" real estate company is not available for public review as those related entities do not file an audit or IRS 990. The debt figures in GCI's analysis are lower than the actual total because of this transparency issue. As a result, GCI was only able to count debt incurred by federal non-profit charter property holders. I.e. our figures are too low. The problem identified is greater than presented in our data. GCI, nor the governing agency, ASBCS, cannot access the subsidiary's for profit's source data.

Examples of major capital purchase arrangements with related parties can include:

- A. **Related Real Estate Subsidiaries of the Charter** that hold the property rights (ownership) on property that is being guaranteed by estimated ADM counts and the state revenues anticipated from those student counts. These subsidiary firms can be controlled by the same board and owners as the charter entities with whom they do business.
- B. **Long-Term Lease or Rental Commitments:**
  - a. The subsidiary<sup>31</sup> (non-profit and for profit) companies then establish long-term leases with the charter entities. A commitment to pay is written into the leasing (rental) agreement, (i.e. it is part of the expenses the charter is committed<sup>32</sup> to). These types of commitments are reported in the annual audits submitted to the ASBCS.

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<sup>31</sup> Sometimes, (Example: Great Hearts Academies), the charter schools are subsidiaries of the firm controlling the real estate and lease arrangements of the Corporation.

<sup>32</sup> A Commitment is just that, a commitment to pay over a period of time. There is NO incentive to not pay this debt as it is held by a subsidiary of the charter which relies on this source of income for its financial survival.

- b. Leases and rents can be written to provide annual increases regardless of the subsidiary’s required debt payments, i.e., the subsidiary company can profit from the lease while the charter school itself is suffering net losses. The leases can also be tied to the numbers of children attending the site (i.e. the lease goes up when the number of children attending rises, discussion of the benefits of this arrangement are provided in an analysis on Great Hearts leases in this paper).

Examples of the Process

Arizona Connections Academy: Four Years of Increasing One-Year Lease Agreement

<b>\$162,835</b>	<b>\$166,707</b>	<b>\$170,705</b>	<b>\$172,990</b>
Camelback Academy FY 2014	<b>FY 2015</b>	<b>FY 2016</b>	<b>FY 2017</b>
<b>\$432,000</b>	<b>\$444,000</b>	<b>\$528,000</b>	<b>\$672,000</b>

- C. The subsidiary company holding the charter property may borrow Arizona IDA-based funding to finance charter school properties in other states while guaranteeing that debt using the expected ADM payment from ADE. This is the case with several Arizona-based charter companies. Sixteen states and several countries operate charter corporate sites in Arizona.

***Fees, Loan Issuance Charges and Pre-Payment Penalties***

Tied to most of the \$2 billion in bonds and capital notes held on charter properties were fees that range from pre-payment penalties (often exceeding \$1 million), loan issuance fees, large payments for services to bond agents and reserve requirements (money held in reserve as a guarantee of short term liquidity). GCI noted several fees being paid to related-party brokers for securing their bonds. In addition, there were payments made to related parties for “overseeing” construction projects, these ranged from \$100,000 up. These added costs are typically related to the higher-risk associated with the financing they are incurring.

**Property Values, Depreciation and Market Values**

Charter holders report their Property Value, Depreciation and Net (Depreciated) property values on their audits submitted to the ASBCS. GCI did a thorough four-year (and sometimes 10-year) analysis of this data **and** also used IRS form 990s to compare the declared market value of the property to the depreciated and undepreciated property values on the audits. A direct correlation between the declared Market Value on the IRS 990 and the undepreciated property values on the audits was established. **In FY17, the undepreciated consolidated property value of charter schools in Arizona was \$1.8 billion, the depreciated value was \$1.4 billion.**

***Undepreciated v Depreciated Property Value***

Consideration is given in this report for undepreciated and depreciated property value as several charter holders have pointed out the effects of depreciation on their financials when responding to GCI’s previous policy paper, *Red Flags: Net Losses*. For this paper, GCI’s factor analysis included depreciation in its parameters. The latest long-term debt deficit is illustrated below, with analysis provided of both undepreciated and depreciated property values. The market being analyzed is now a mature marketplace with over 20 years of financial data. The

table below shows that regardless of which figure, depreciated or undepreciated (market value), is used the shortfall is such that the properties are significantly underwater.

**Figure 23 Charter Property Values FY 2017**

Total Bonds and Long-Term Commitments owed by Charters in AZ **\$2,563,792,686**

<b>Method of Property Valuation</b>	<b>Property Value</b>
Undepreciated Consolidated Property Value	\$1,833,077,407
<b>Undepreciated Property Values MINUS Long-Term Debt and Lease Commitments</b>	<b>\$(-730,715,279)</b>
Depreciated Consolidated Property Value	\$1,402,205,782
<b>Depreciated Property Value<sup>33</sup> MINUS Long-Term Debt and Lease Commitments</b>	<b>\$(-1,161,584,904)</b>

**Long-Term Debt and Long-Term Lease Commitments: A Growing Financial Problem**

**Avoiding Double Counts**

While GCI counted all charter and subsidiary properties in our property values we did not include any debt that had a lease commitment payment to that property holding entity to avoid double counting debt and lease payments where both occur in relation to a charter organization. This was done with all debt associated with charter lending companies and Industrial Development Authority (IDA) debt held by a hosting company that counts the charter schools as subsidiaries related to the main corporation. For example, Great Hearts Academies' long-term debt was counted as committed lease payments in our analysis, as a result, IDA loans of these companies ARE NOT included as long-term debt.

The type of long-term lease that *did not fit* this sound leasing practice included automatic increases of the lease to a related party *regardless* of the school's ADM or overall financial situation.

**Long-Term Debt and Sustainability**

Most of the long-term debt interest rates in the charter school audits ranged from 6 percent to 10 percent. This is sustainable if the debt has a solid relationship to the company's property values and assets<sup>34</sup>. It is unsustainable when the company in question is underwater on their

<sup>33</sup> Depreciated value is used by the ADE for School District Properties. GCI provides depreciated and undepreciated values in recognition of the market value (undepreciated value) of the properties in question.

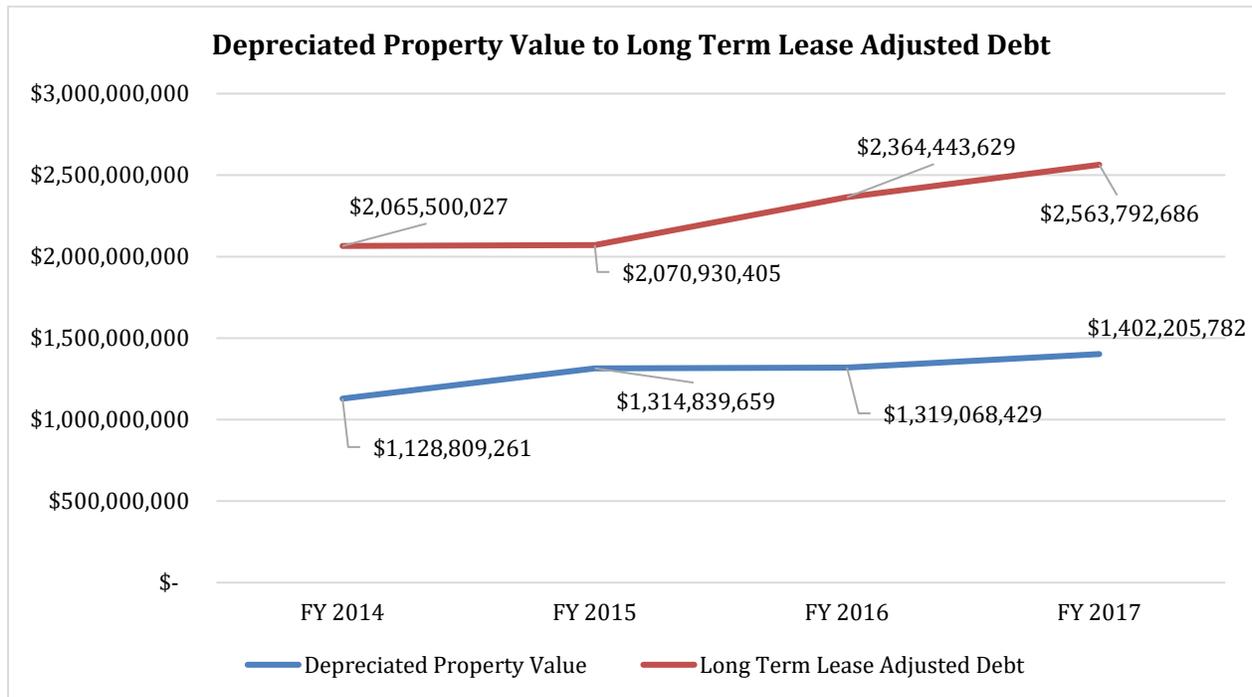
<sup>34</sup> Another measure seen in the reporting was the Debt to Income Ratio. This measure can be manipulated by enrollment predictions that do not materialize on the Income side of the equation. A problem exasperated by the counting of Anticipated Educational Revenues on Educational Revenue Bonds rather than the properties Market Value.

debt to property value, over-extended and losing students. The high interest rates are consistent with high risk junk bonds.

**Underwater Real Estate Holdings**

When debt or lease payments are not based on property-value but on an anticipated income stream (from ADM growth on the “asset” represented by students), liabilities can, and in most cases do, exceed the real property assets' market value; the property is not worth the amount owed on the debt and commitments and the charter’s ADM is not materializing as expected<sup>35</sup>.

**Figure 24 Four Years of Depreciated Property Value to Long-Term Debt adjusted for Leases**



Source: ASBCS Audits

**Overleveraged Long-Term Debt and Commitments**

Like the mortgage crisis in 2007 and 2008 this situation has been developing over a period of time. Over-leveraged bonds and loans generate excessive debt and interest payments, which in turn create negative net results and negative net assets.<sup>36</sup> Refinancing to reduce debt interest payments is a short-term solution (and often costly due to built-in pre-payment penalties), and can be detrimental when used as a long-term solution.<sup>37</sup>

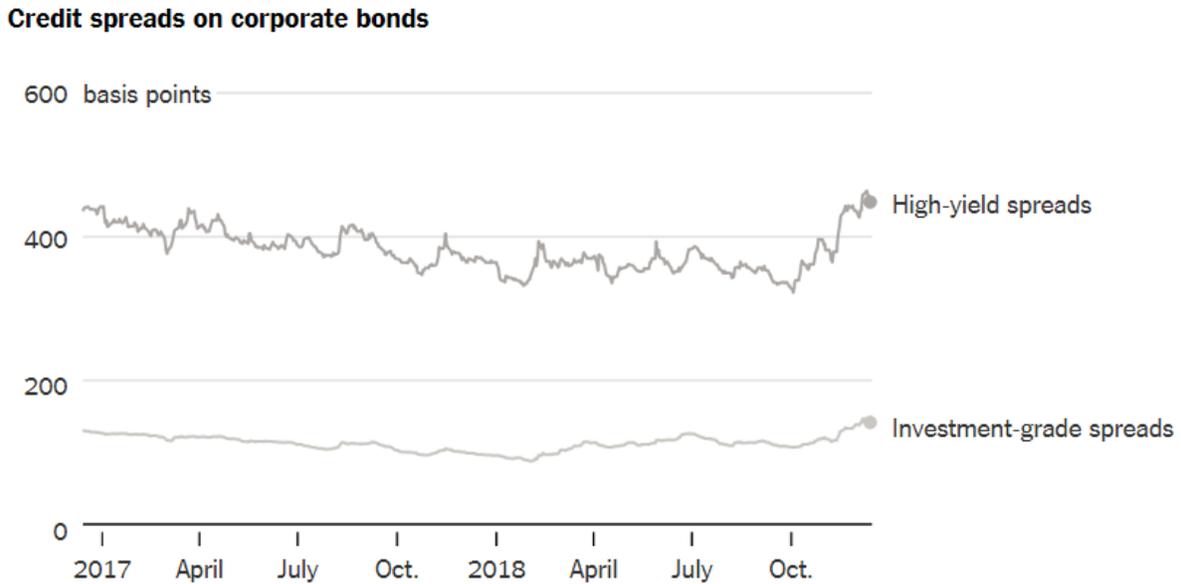
<sup>35</sup> In our analysis GCI considered ADM growth of .5% or less over four years as unsustainable (i.e. a net loss of ADM). This is a very conservative number as most of the cases predicted double digit ADM growth in their projections.

<sup>36</sup> Negative net assets are written as net (deficits) on financial statements with a bracket to indicate the negative amount. This paper uses this convention and a minus sign when there are net (deficits) indicated.

<sup>37</sup> Relying on Junk Bonds which have a negative financial history, the involvement of the Milken and their partners in charter schools and earlier in day care centers is a troubling sign of who is profiting from these type of transactions and charter schools nationally <https://www.investopedia.com/terms/m/michaelmilken.asp>. Portable Practical

A number of factors are leading toward higher interest rates which will make refinancing existing debt an ineffective means of reducing their debt burden. The Federal Reserve has been increasing short-term interest rates due to the overall strength of the economy. Likewise, high corporate debt relative to GDP is seen as increasingly risky (a greater portion is being rated as speculative), crowding out caused by heightened federal deficits, and the rising uncertainty created by the Trump Administration's trade policies all mean investors will expect a greater premium to invest in speculative-grade debt on top of a higher prime lending rate. Combined this means the favorable low interest rate environment is disappearing, so charter debt will become an increasing drag on the financial performance of charter companies.

**Figure 25 Credit Spreads Above Prime for Investment Grade vs. Speculative Bonds**



By The New York Times | Source: FactSet | Notes: Average spread for Bloomberg Barclays U.S. Aggregate corporate — and high-yield corporate — fixed-income indexes.

**Crediting the Exceptions in the Data**

GCI's analysis shows that only 3 percent of charter long-term debt has been invested by charter holders or related parties at market rates or better. These types of exemplar loans were a straight infusion of cash without an interest payment on the owner's short-term loan to their own

Education which is K-12 is one of the largest groups in Arizona. Equally disturbing is the money from real estate acquisition and imported (using work visas) teachers in the Gulen Schools identified in the data. This company's travel budget reflects travel costs that exceed \$1 M. The cost of importing teachers from the Middle East as Visa workers in the U.S. The company is the largest user of work visas in the U.S.

business. There were many cases of loans made by charter holders or related parties at rates that far exceeded market rates, otherwise known as profiteering. The data also showed examples of corporate board members providing short-term interest free loans.

This type of positive short-term lending did not always translate to sound long-term borrowing strategies. Sound long-term bonds only made up 3 percent of the market's long-term debt at the end of FY 2017. As identified in the policy report *Following the Money*, 23 percent of charters had a minimum of related-party transactions and typically had manageable debt payments. However, these businesses were not immune from what GCI considers to be *predatory lending practices*<sup>38</sup> that leave the businesses scrambling to pay their high-cost, long-term debt<sup>39</sup>.

#### Examples of High Interest Long-Term Loans in the Data

- Desert Star Academy with Charter School Capital paid 15 percent Interest on an IDA \$1.5 M Loan (\$76 K of Interest in FY 2017. This company also took Short Term Loans with money based on ANTICIPATED REVENUES).
- Odyssey Preparatory IDA Loans at 8 percent for \$21 million
- Intelli-School Note Payable at 10 percent to a related party
- Destiny School was charged 9.4 percent on a \$582,000 loan from a related LLC
- EAGLE Schools took out \$340,000 of Cash Flow Loans on anticipated revenues. I.e. the company was short on cash and borrowed on anticipated revenues.

These types of loans are market bets by junk bond companies on the charter companies' ability to capture more students. Industrial Development Authority (IDA) Loans, which are tax free (federal and state), are identified in the data as the primary source of these type of loans. These IDA bonds make up 77 percent of the long-term debt held at Arizona's charters. The tax free status of these bonds ensure the investor makes money as long as the bond holder pays on the bond for seven years. The main advantage of these bonds is the bondholder keeps more of the return on the bond because of the tax exemption. The state and federal government *de facto* subsidize the bond by exempting the bondholder from taxes. In a real free-market the government<sup>40</sup> is not offering this type of exemption.

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<sup>38</sup> Abuses of this type of lending originating with the charter holders and board members were also noted with excessive interest being charged for money lent to the charter school entity at rates higher than normal (i.e. compared to bank rates for short-term credit) borrowing costs. Multiple loans of this type were noted, many originating with corporate board members or the charter holder(s) (related parties). Grand Canyon Institutes' researchers identified these loans and the interest amounts paid.

<sup>39</sup> The debt holder typically seeks what is termed an intercept of the charter's Equalized Funding from the State Department of Education. This means that the money meant to support student's education goes directly to the debt holder first. The ADE then sends a reduced amount to the charter holder. I.e. the charter did not receive the money first. The fiscal decision making of the charter holder has been compromised by this arrangement. Intercepts are spelled out on the audit notes.

<sup>40</sup> See also: New Market Tax Credits for the origin of this type of tax free lending. The original purpose was to promote spending in depressed areas. Educational Revenue Bonds are used to pay for buildings and assets in cities, like Scottsdale, that do not fit this original criteria.

Exemplary Interest Rates were noted at 3 percent. These were commercial loans from banks. They made up 1 percent of charter debt. Junk bonds traded at 6 percent to 8.2 percent in FY 2017.

### ***Understanding the Financial Risks and Rewards of Junk Bonds***

Investment grade versus junk bonds, bond-rating systems 101. “The opposite of the safest AAA grade bond is the Junk Bond, also known as high-yield bonds. These are rated below BBB or NAIC category 3 or below. These bonds are issued by organizations that are not rated as investment grade because of a risk of default (not being able to meet their obligations). These securities are high-risk investments, yet because of the risk they have a high-yield debt security, which pays a higher interest rate. That is why they are also referred to as high-yield bonds. If you invest in speculative bonds, you might not only fail to receive the promised interest, but you might lose all or part of the principal if the company goes bankrupt or liquidates. With these bonds, although you get a great interest rate, you are taking a greater risk that the company may default on the bonds or you will get less than you paid for them.”

Source: <http://www.teensguidetomoney.com/home/bonds/bond-ratings/>

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***GCI’s inquiry asked this question, “Given the financial failure rates and the risk of default why are IDA bonds attractive to the lenders?”***

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Deregulation of junk bonds and financial deregulation in general have had historic catastrophic economic effects. The Junk Bond crash in the 1980 led to the arrest and conviction of one of the leaders in the K-12 online charter market, Michael Milken led this company for years. The Savings and Loan (Keating 6) failures, Enron, and the last mortgage and financial crash in FY 2006-2007 are all examples of deregulated financial markets failing. The belief that CEO behavior will be any different in a deregulated educational market like Arizona's charter school sector is naïve at best. A market that is funded by public revenues needs financial accountability in order to survive. The greatest concern in Arizona is that an entire chain of charter schools would go out of business due to being overleveraged.

### ***Government Subsidized Debt***

The bonds issued in this market are tax free. That is they do not generate Federal Tax<sup>41</sup> revenues or Arizona State Taxes from the “marketplace” they are operating in. As noted the rating systems (Moody’s et al) used for the IDA bond market places most of these bonds in the Junk Bond category. This in turn translates into a higher return for investors as the bonds are “guaranteed” by the revenues the charter receives from the Arizona Department of Education. These revenues are then intercepted by the bond holders by direct payments of the debt from ADE.

### ***Tax Free Status + High Interest Rates = High Yield***

A significant factor drawing investors to the IDA bond market is the benefit derived from avoiding federal and state taxes<sup>42</sup> on their investments’ return. The return on investment (ROI) is significant and basically doubles the junk bond investor’s money within five to seven years. The bonds are sub-prime (Green Preston and Baker 2016). We will show that this financing and

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<sup>41</sup>New Market tax credits are a tool used by the investment firms seeking maximum Return on their Investment. <https://www.cdfifund.gov/programs-training/Programs/new-markets-tax-credit/Pages/default.aspx>

<sup>42</sup> See related paper by the Goldwater Institute on IDA Debt: <https://goldwaterinstitute.org/article/debt-and-taxes-arizona-taxpayers-on-hook-for-66-bi/>

refinancing over multiple years is creating a charter school bond and property “bubble”. Balloon payments at the end of the loan period are also a motivating factor for the charter holder to refinance as soon as possible. These repayments often require the charter group to pay a penalty for this “early” refinancing on large bonds; these can and do run into the millions of dollars.

### ***Sound Models for Financing a Charter School Exist***

In contrast to the types of financing arrangements that cause overextension in this free market, there are charter holders that use their own cash and property to finance their start-up costs and operations. Charters that use commercial lending, as several do, must meet the criteria set by a financial institution for their loans<sup>43</sup>. Related parties are included where the spouse or parents of the charter holder are “investors” in the charter in this group. Other charter holders choose to lease from an unrelated<sup>44</sup> party that owns the property rented by the school. This type of financing reflects a fiscally conservative approach and the charters that use these types of financing and leasing in the data appear to be financially sound. These examples are the exception, not the rule (22 percent of the total)<sup>45</sup>. The public believes that this type of purchase is the norm. It isn’t, the data shows that it accounts for just 3 percent of charter long-term debt and lease arrangements.

### ***Borrowing based on property value***

Financially sound charters in the data borrow money based on the actual value of the property being mortgaged by the loan, i.e., the property and equipment is the guarantee for the loan (similar to a conventional mortgage). Other sound charter property acquisition strategies include choosing to lease until a charter holder can afford a commercial borrowing instrument.

When Governor Ducey initiated a state loan program that guaranteed several charters’ loans the selection process chose two financially sound charters (academically and financially) as beneficiaries of this guaranteed debt. One of the charter holders interviewed for this paper indicated that there is a plan to keep those properties as part of the charter, i.e. the charter holder does not consider the property her private property but that of the communities’ she serves (Linda Proctor-Downing of Arizona Equine and Agriculture Charters<sup>46</sup>).

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<sup>43</sup> Example: Northland Preparatory with a 3% loan from Chase Bank.

<sup>44</sup> Under international financial reporting standards, a related party is related to an entity if any of the following situations apply to it:

Associate. The party is an associate of the entity.

Common control. The party is, directly or indirectly, either under common control with the entity or has significant or joint control over the entity.

Family member. The party is a close family member of a person who is part of key management personnel or who controls the entity. A close family member is an individual's domestic partner and children, children of the domestic partner, and dependents of the individual or the individual's domestic partner.

Individual control. The party is controlled or significantly influenced by a member of key management personnel or by a person who controls the entity.

Joint venture. The party is a joint venture in which the entity is a venture partner.

Key management. The party is a member of an entity's or its parent's key management personnel.

Post-employment plan. The party is a post-employment benefit plan for the entity's employees.

<sup>45</sup> While this type of leasing arrangement is a normal business practice, (example, McDonald’s franchise model where McDonald’s leases the properties to the franchisee) we are questioning the related party nature of these transactions as they are conducted using money from public sources guaranteeing the debt with payments from taxpayer sources.

<sup>46</sup> In previous papers GCI incorrectly listed Dr. Proctor-Downing as Dr. Proctor-Dowling. We apologize for this error.

### **Exemplar Examples: Sound Borrowing**

- Prime plus 3 percent Loan from Chase for \$6.724 million to Northland Preparatory School
  - Yavapai Capital Loan at 5 percent to PACE Preparatory Academy for \$1.8 million.
  - Paradise Honors refinance with a financial company at 4.46 percent for \$2.9 million.
- 

### **Red Flag: Private Ownership of Arizona's Publicly-Funded Charter Assets**

Arizona charter law clearly states that the property of the charter school is the property of the charter holder, even if it is paid for with proceeds from taxpayer dollars or extra revenues to charters for this purpose. This private ownership of public school assets is not the case in several other states with charter schools. The charter holder does not have to reside in Arizona to obtain an Arizona charter.

The law (AZ 15-183) allows the charter holder to use that private property and the charter's expected state equalization and other anticipated state and federal revenues<sup>47</sup> as collateral (guarantees) for borrowing (debt).

- 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.*

The charter holders and their corporate boards can organize their companies as LLCs and C corps (for profit and non-profit) to limit their liabilities. This is a common business strategy for limiting personal liability and financial responsibility.

Charters holders have many options regarding the acquisition of property and equipment (assets). This paper focuses on how charters finance their properties<sup>48</sup> through long-term debt and lease commitments. GCI notes that sales of charter school properties are conducted without oversight or high-level review by the governing agencies charged with oversight of the charter schools. GCI recommends changes based on the emergent practices discovered while analyzing the property sales and financing noted in the audits. Reasons for this include:

- The prices these properties and their potential income from state revenues on the charter's student counts command premium prices when charter holders sell their

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<sup>47</sup> Student Revenues are de facto used as an asset in IDA Educational Revenue Bonds Sales. Those counts guarantee the debt.

<sup>48</sup> The data used is based on charter entities consolidated (grouped by common owner). 14 entities are excluded in the data set as the charter is held by companies with multiple real estate holdings included in their audits that are not part of the charter operation. Chicanos Por La Causa is an example.

business. That debt is then guaranteed by IDA and charter finance company loans that count ADM projections as collateral (guarantees) on the loans.

- GCI notes several IDA loans were used to finance the charters activities in other states<sup>49</sup>. The charter market is not the only market IDA loans from Arizona have been used for in other states and US Territories.
- Inflated real estate sales to related buyers increase the long-term debt of the new charter holders. The use of “Good Will”, a questionable representation of a business’ assets, is seen being used in audits, prior to the sale, to justify these higher prices along with inflated projections on ADM growth.
- Related-party sales amplify the inflation built into the agreed upon sales prices as new owners (typically related parties) and old owners determine the “market value” of the properties being transferred.<sup>50</sup>
  - Additionally GCI’s data indicates that “consulting fees” for undelivered future services are present in many of these sales agreements. These add to the long-term commitments of the firm. Examples of \$240,000<sup>51</sup> yearly payments for “Consulting” were present. These fees are then confirmed using MOUs (Memorandums of Understanding), which are not publicly available or monitored by the governing agency.

### Red Flag: How Much Should the State Pay for Private Property?

Charter schools presently receive Charter Additional Assistance because they cannot bond for property improvements like district schools. Charter Additional Assistance currently exceeds District Additional Assistance by about \$1,600 per student, yet according to the Arizona Auditor General districts are only spending about \$1,500 for nonoperational capital-related costs (land, buildings, equipment) and interest.<sup>52</sup> Why are charters receiving more when districts typically have far more comprehensive educational programs than charters do—so have greater facility requirements.

Presently, Arizona charters receive Charter Additional Assistance regardless of their academic performance or financial management unless the ASBCS withholds 10 percent of their funds due to problems. They also receive it in perpetuity regardless of their actual facility-costs.

In Texas charter schools receive a per-student allocation similar to district schools similar to Arizona, but there is no Charter Additional Assistance that Texas charter schools receive simply by virtue of being a charter school.

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<sup>49</sup> During discovery and our search of the literature we also found IDA loans going to other states (Nevada in particular) and a U.S. Territory, Guam. We thank the Goldwater Institute for their assistance in this research and their work on IDA loan practices which is cited elsewhere in this document.

<sup>50</sup> In Red Flags: Net Losses and Net (Deficits) we reported on the financial manipulations used by a charter financing broker. That led FINRA to remove that agent’s license. See report at [www.grandcanyoninstitute.org](http://www.grandcanyoninstitute.org)

<sup>51</sup> The example is from Edkey Inc. The related party was the former charter holder. Source: IRS 990 FY 2015 at Guidestar.

<sup>52</sup> Arizona Auditor General (2018), “Arizona School District Spending: Fiscal Year 2017,” Special Study March, Report 18-203, [https://www.azauditor.gov/sites/default/files/18-203\\_Report\\_No\\_Pages.pdf](https://www.azauditor.gov/sites/default/files/18-203_Report_No_Pages.pdf).

In Texas charter schools can now receive facility funding of about \$200 per student but must meet minimum academic performance criteria to receive it. The Texas formula is subject to a budgetary cap established by the legislature. The legislature has capped that amount at \$60 million, but if the Texas formula were fully funded, eligible charter schools would receive \$800 per student.

One of the challenges is determining what actual facility costs are as in Arizona many accounting systems are inconsistent across charters or due to contracts with related-parties, including charter management organizations, taxpayers can't necessarily be confident that what's being expended is necessarily at market rates.

Two sources of data suggest charter school facility costs are lower than district schools.

An analysis of charter schools in Texas and their expenditures in 2009 compared to district schools is below (note Arizona is only approaching these figures now).

**Figure 26 Texas Operating Expenditures per pupil for Charter and District Schools, FY2009<sup>53</sup>**

Expenditures by function	Open Enrollment charter school districts	Traditional public school districts
Instruction	\$4519	\$4948
Instructional resources and media services	\$33	\$133
Curriculum development staff	\$130	\$168
Instructional leadership	\$127	\$120
School leadership	\$697	\$477
Guidance counseling and evaluation	\$180	\$292
Social work services	\$19	\$24
Health services	\$34	\$85
Student transportation (pupil)	\$158	\$235
Food services	\$387	\$450
Extracurricular activities	\$74	\$229
General administration	\$936	\$249

<sup>53</sup> Gronberg, Timothy J., Dennis W. Jansen, and Lori L. Taylor (2012), "The relative efficiency of charter schools: A cost frontier approach," *Economics of Education Review*, Vol 31, No. 2 (April), pp. 302-317. <https://doi.org/10.1016/j.econedurev.2011.07.001>.

<b>Facility maintenance and operations</b>	<b>\$1149</b>	<b>\$895</b>
Security and monitoring services	\$60	\$67
Data processing services	\$141	\$117
Fund raising	\$57	\$0
Total current operating expenditures	\$8700	\$8490
<b>Expenditures by object</b>		
Personnel	\$6517	\$7261
Instructional payroll	\$3556	\$4561
Non-instructional payroll	\$1858	\$2306
Contracted instructional services	\$317	\$77
Contracted non-instructional services	\$787	\$318
<b>Rent</b>	<b>\$535</b>	<b>\$43</b>
Utilities	\$237	\$294
Supplies	\$813	\$744
Other operating	\$597	\$149
Total current operating expenditures	\$8700	\$8490
Number of districts	201	1030
Number of students	101,754	4,625,713

*Notes.* This table presents pupil-weighted averages for all districts with actual financial data in PEIMS. Instructional payroll is payroll expenditures in function 11 and contracted instructional services are contracted services in function 11.

*Source:* *Evaluation of Charter Schools 2009-10, Report prepared for Texas Education Agency*<sup>54</sup>

This data suggests facility cost differences were between \$500 and \$850 per pupil depending on whether or not facility maintenance and operations are included. Based on the state facility funding formula in Texas, which charters are currently only receiving a portion of there, the

<sup>54</sup> Table reproduced from Timothy J. Gronberg, Dennis W. Jansen, and Lori L. Taylor (2012), "The relative efficiency of charter schools: A cost frontier approach," *Economics of Education Review* 31, pp. 302-317.

additional facility amount funding in Texas should be \$800 per student for open-enrollment charter schools (they currently are receiving about \$200).<sup>55</sup>

Another case that was in the news related to ASU Prep renting space near downtown Phoenix from Phoenix Elementary district. The current space has about 1,100 students and the rent was \$300,000 annually (less than \$300 per student). Phoenix Elementary citing the increasingly lucrative location had sought initially \$2.7 million as the market rent (almost \$2,500 per student). Ultimately, the district offered \$800,000 and they settled at \$550,000 (about \$500 per student).<sup>56</sup> Most charter schools don't have such an expensive location combined with a very large footprint. BASIS Phoenix Central, for instance, also has a prime real estate location for about 900 students, but has an attractive facility on a significantly smaller lot.<sup>57</sup> A full evaluation of charter facilities is outside the scope of this study.

Principal Author's Opinion: The historic data should inform the need for a transition to any change to the current formula for extra assistance to online schools. In business terms this would be a change in the contract that these schools have with the state. The state needs to honor that contract even while those online schools continue to take high distributions, which are drawn from their owner's equity and the healthy net profit that they make each year. Recent reports regarding the largest online provider in Arizona the perception was that Primavera focused on the profits of the owner over his duty to provide educational services. Perception is everything if the charter market is going to survive. Another article centered on the profits being made during a real estate deal tied to a for-profit to non-profit change at a highly performing brick and mortar site. Charters are businesses. These were legitimate, i.e. legal transactions.

Why do these transactions "feel" wrong? The tension between a capitalist economy system and a democratic republic rears its head when the public reads about legal transactions that feel like "this isn't business it's personal." The inverse of "it's not personal its business." The problem is an economic model applied to a public good. That model for charter schools allows the economic issues GCI has reported on to take place.

Barry Goldwater noted that, "You can't legislate morality." Martin Luther King responded with, "No, but you can regulate behavior." The deregulated nature of charter legislation needs to be evaluated if the market cannot come up with a solution to the difference between freedom to make a profit and liberty and justice for all. The rules of the game need to change.

### Red Flag: Greater Oversight is needed

The market theory behind charter school financial models relies on and trusts a free market economic theory organized around educational services contracted by the state with private charter holders. Once the state pays the contractor there are limited restrictions on how taxpayer funds can be used. The state is contracting for educational services, not the property or assets of the charter holder<sup>58</sup>. The contractor owns the property and assets and may use

<sup>55</sup> "Charter School Facility Fund," May 1, 2018, [https://tea.texas.gov/About\\_TEA/News\\_and\\_Multimedia/Correspondence/TAA\\_Letters/Charter\\_School\\_Facility\\_Funding/](https://tea.texas.gov/About_TEA/News_and_Multimedia/Correspondence/TAA_Letters/Charter_School_Facility_Funding/).

<sup>56</sup> Altavena, Lily (2018), "ASU Prep will stay in its downtown home for at least 2 more years," *Arizona Republic*, Dec. 22, <https://www.azcentral.com/story/news/politics/arizona-education/2018/12/22/asu-prep-strikes-deal-stay-downtown/2153348002/>

<sup>57</sup> BASIS Phoenix Central, "Our School," <http://www.basised.com/phoenix-central/our-school/>.

<sup>58</sup> GCI verified the model's premises regarding what the state contract is for with charter holders and the ASBCS.

them as collateral on debt. Section 15, Chapter 1, Article 8 of Arizona's Revised Statutes provides the legal framework for charter schools. Arizona's statutes free charter schools from many of the financial requirements normally associated with school finances. This effectively deregulates this market sector without providing a mechanism to verify the contractor's use of equalized valuation funding or the contractor's fiscal ability to deliver on the product. The contracting of road contracts is an oft-used analogy to the state's charter model. Arizona municipalities have formal bidding and financial checks built into their contracting process to verify that contractors have the fiscal ability to deliver on their contracts.

The free market economic theory justifying the "hands-off" stance once the state sends equalized valuation and additional funding payments to the charter contractor is predicted to financially self-regulate. (Friedman, 1962; Friedman, 1970; Friedman, 1981; Friedman, 1984; Friedman, 1993) Simply stated, the theory predicts that market financial results based on the contractor's delivery of academic outcomes will cause underperforming charters to fail financially as parents leave the school. This exit theory is based on the concept that parents will exit academically underperforming schools. GCI's thesis is that the research on Exit, Voice, and Loyalty does not support this academic exiting theory. (Dooley, 1995; Hirschman, 1970; Kroll, 2005; Olson, 2001; Weick, 2001) GCI tests these theories by looking at *the results, not the intentions* of the state's charter legislation. This educational free market is funded by tax revenues and tax-free bond capitalization. While the model considers this funding to be the property of the contractor once it is delivered as a payment from the ADE or the federal government, the source remains taxpayer funding. The public has a vested interest in verifying the financial results of 25 years of the state government's contracting out of "public" education to private companies.

### ***Charters' Backpacks full of Debt are guaranteed by Students' Backpacks full of Cash***

GCI recommends changes to the financial oversight of charter schools that it believes will safeguard the public's investment in education while providing transparency regarding how tax dollars are being spent. The expression "backpacks full of cash" has been used to describe taxpayer funding following children to their school of choice. Debt and commitment levels that would not be tolerated in districts by the governing boards overseeing them and the rules of the game for districts protect taxpayers' money.

GCI contends that backpacks full of debt on properties the public does not own are a "clear and present danger" to our educational funding sources. Taxpayers are funding charter long-term debt with intercepted educational revenue dollars flowing directly to the debt holders through "guaranteed" payments. The money is not going to the "educational service contractor" first. If steps are not taken to stem the burgeoning debt in the charter sector these payments will consume more and more of the dollars being spent to educate our future citizens.

The debt on charter properties is being incentivized (amounting to a government subsidy) using tax free (federal and state) IDA bonding and New Market Tax Credits. The financial flexibility that the charter laws give the charter holder are crippled when debt payments are sent directly to the bondholders first, i.e. the money is not available to "improve educational outcomes." The contractor's ability to make decisions on how they spend Equalized Educational Funding is compromised. Insisting that charters are contracted service providers entitled to do as they wish with Equalized Educational Funding from the state ignores the scope and danger to public education funding from overleveraged debt presenting itself in the data.

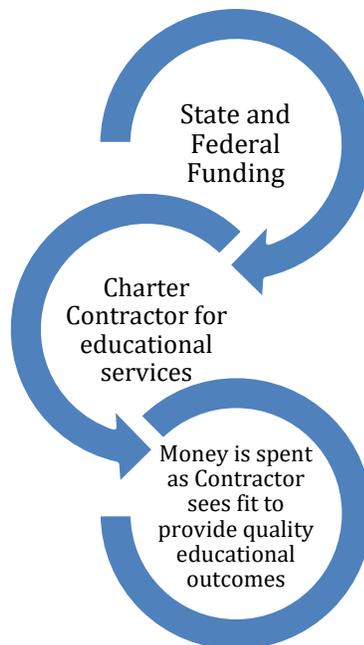


The tools to analyze this overleveraging issue are currently in place. The audits used to generate the data in this report are the same audits used to analyze the ASBCS Financial Performance Expectations.

### **Charter financial oversight under current charter law**

Arizona's charter laws are intentionally designed to give the charter holder maximum control over how they allocate and spend their educational funding from the state and federal government. This freedom from regulations is frequently referred to as allowing charters to “run schools like a business”. Economic theories of action provide an economic “logic” for the distribution of public funds, which were collected to support a public good<sup>59</sup>.

**Figure 27 Theoretical Distribution of Tax Funding to Charter Contractors**



<sup>59</sup> Friedman referred to this justification as the “neighborhood effect”. Friedman’s first choice was a system of vouchers to be used for public and private education. His theories first emerged after Brown vs Board of Education. Friedman also advocated for private ownership of National and State Parks. See: (Friedman, 1975;Friedman, 1977;Friedman, 1978;Friedman, 1981;Friedman, 1984;Friedman, 1993;Friedman, 1982 ;Friedman, 1990)

Espoused theory of Action: Charter holders are contractors free to use the taxpayer-funded revenues they receive from the state and federal government as they see fit. This is the meaning of the statement. “However, they have more freedom over their budgets, staffing, curricula and other operations.”

Arizona Charter Law currently allows charter holders to encumber the payments they receive to service debt obligations before providing education services.

### **Contracted Service**

The National Conference of State Legislatures’ latest definition of charter schools puts this contractual arrangement into perspective.

“They are privately managed by an organization that has a charter, or contract, with an authorizer”<sup>60</sup>.

Following the money in the diagram shows the revenues meant to pay for the services contracted for by the authorizer are going to the debt holders first, not the contract holders. The chain of possession of money that the taxpayers paid to educate our children goes to the “intercepting” bondholders before the “contractor” takes possession and delivers any educational “service”. Importantly, debt payments take precedence over classroom spending—once paid off, the charter holder will privately own the facilities for which the debt was taken. The facilities paid for with taxpayer funds will not belong to the state. This creates a conflict of interest for charter holders as to their financial priorities—servicing their debt for future property ownership or classroom spending.

### **Market Reality**

When students’ “backpacks full of cash” are guaranteeing debt on long-term bonds the money is not transferred to the charter holder first. Instead, bondholders intercept their payments directly from the state, extracting their payments before the charter holder receives their state allocated funding. *Funding goes to debt first, the remainder then goes to the charter school. These guarantees and intercepts are articulated in charter audits.*

The backpacks full of cash, which represent the state’s equalized education funding revenues, are allowed to be intercepted because they guarantee the charter holder’s **privately held property** and assets. Assets in this case include the charter’s expected revenue from Average Daily Membership<sup>61</sup>, which represents student enrollment numbers. Stated another way, student revenue is part of the guarantee on the property and assets (i.e. the students are an asset). The rules allow mortgages to be underwritten based on projected enrollment numbers, even if the property is underwater.

Federal grant money received by state education departments and individual charter holders use “Credit Enhancement for Charter School Facilities”<sup>62</sup> grants to help charter holders gain access to the tax-free bond markets which are overwhelmingly plied by the junk bond industry. The USDA has also provided direct loans to two charter groups.

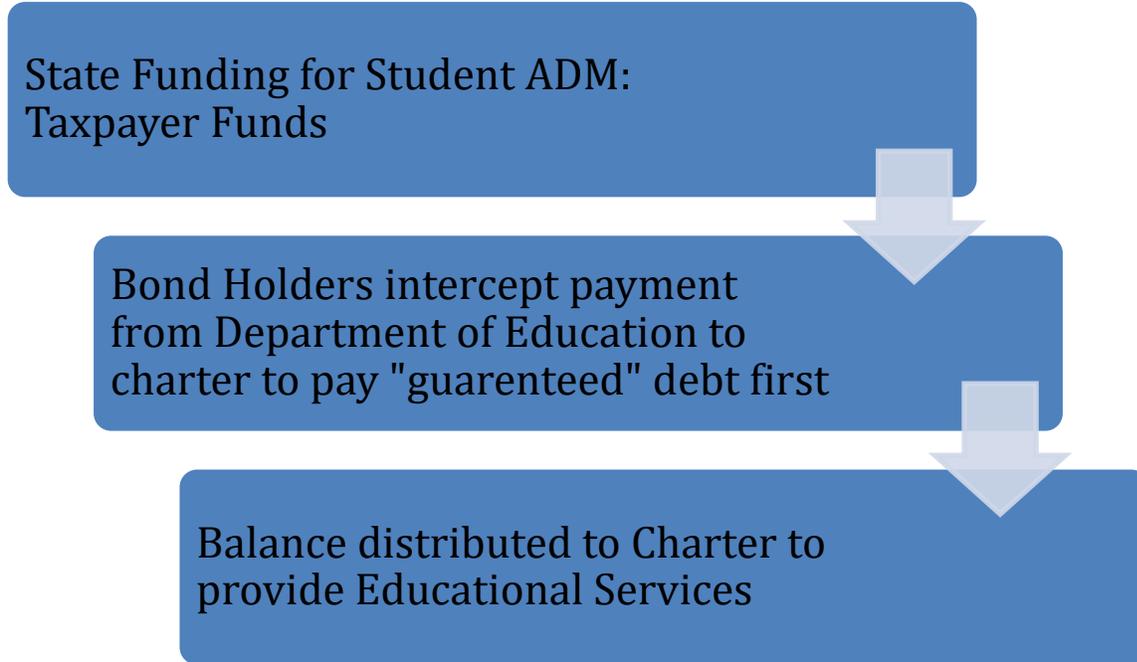
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<sup>60</sup> <http://www.ncsl.org/research/education/charter-schools-overview.aspx>

<sup>61</sup> Go to [www.grandcanyoninstitute.org](http://www.grandcanyoninstitute.org) for an Addendum Report on Financing AZ Public Education.

<sup>62</sup> See: <https://www2.ed.gov/programs/charterfacilities/index.html> for details on these Credit Enhancement programs.

**Figure 28 Flow of Educational Revenue Intercepted to Pay Charter Long-Term Debt**



***Continuing transparency issues***

In contrast to the positive legislative move in May of 2018 to allow the Arizona State Board for Charter Schools the authority to deny renewal to charters that do not meet their financial performance expectations an amendment to HB 2663 quietly removed the requirement that procurement rules and the procurement gifting prohibitions include charter schools. This move exempted charters from the expanded procurement rules on districts within the bill. These changes were rushed through the Legislature in the final minutes of the 2018 session, enabling charter owners to operate with even less transparency and creating more opportunities for related-party transactions and gifts. The change took effect in August of 2018.<sup>63</sup>

***Charter debt is impacted by these lax "rules"***

This newest exemption from procurement laws means *charter owners can still buy from anyone*, including themselves. As an example, non-profit charters often purchase all their curriculum materials, supplies and lease their buildings and even their employees from a for-profit (or non-profit subsidiary) company owned by the charter holder. This process is done without obtaining bids, making the transaction invisible on the audits collected by ASBCS<sup>64</sup>. No one is auditing the

<sup>63</sup> Fischer, Howie (2018), "Hundreds of new Arizona laws take effect Friday," Arizona Daily Star, July 30, [https://tucson.com/news/local/hundreds-of-new-arizona-laws-take-effect-friday/article\\_91335724-b86a-56f1-bfb9-c3809748b01a.html](https://tucson.com/news/local/hundreds-of-new-arizona-laws-take-effect-friday/article_91335724-b86a-56f1-bfb9-c3809748b01a.html).

<sup>64</sup> By doing an analysis of the amounts going out to these companies from the charter and the amounts of payroll, benefits, and employment taxes a determination can be made regarding the fees being charged for this service. GCI

for-profit or non-profit subsidiary<sup>65</sup> firms set up to capture revenue from the charter entities they do business with. This is the kind of transparency issue cited by a US Department of Education Auditor's Report from 2016.<sup>66</sup>

### ***Case in Point: Discovery Creemos and StarShine academies***

In GCI's second paper, *Red Flags: Net Losses and Net (Deficits)*, textbook examples were cited of the related-party transaction issues that were reflected in net losses at Discovery Creemos Academy and StarShine Academies in the spring of 2018. Both of these charters had issues that were surfacing in their audit reports. Discovery Creemos Academy, which had purchased over \$500,000 in supplies from four companies owned by the CEO, closed suddenly and its CEO left the state suddenly with millions in Arizona tax dollars. Similar misappropriation of funds were discovered at StarShine Academy. The ability to generalize reporting on their audits, a subject broached in that paper, also diminishes the public's ability to ensure that their publicly raised funding for education are transparent.

In sharp contrast to the laissez-faire charter school fiscal oversight are the fiscally conservative financial checks and balances the state imposes upon districts that are operating in the red. The Murphy school district was taken over by the state in the spring of 2018 for a budget shortfall (net loss) that was millions of dollars less than many of the charters in our data on net losses.

The latest changes in Arizona School Finance Rules expanded district bidding rules and procurement requirements (a reaction to several publicized reports involving district personnel).

*It is a march of folly to insist that procurement rules should not apply to the public funds used to finance charter schools.*<sup>67</sup> The industry's claim that the market will take care of financial issues ignores the fact that there is not a conclusive connection between financial performance data and academic performance data.

### ***Theoretical Safeguard: Market Forces***

Charter school proponents claim that the free market will correct itself, ensuring the public that market driven academic and financial accountability and the decision making of parents to remove their children from academically under-performing charter schools will self-correct the market (Fuller 1997). GCI's research findings challenge the assertion, "that the market will self-correct"<sup>68</sup>. An analysis of all of the financial data from FY 2014 through FY 2017 shows that "self-correction" is not present in the data. GCI now has more than 24 years of data. The

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noted fees of between 10 and 20% of payroll. Typical fees were 10%. This analysis was complicated for companies that used gross figures in their audits for charter school program (one number) and management (one number). If 990 information was available GCI used a breakdown of this data to establish a figure. Limited use of AFRs also were used to glean data unavailable on the generalized audits. GCI's recommendations would eliminate the use of gross summative categories on the Audits.

<sup>65</sup> To accommodate this lack of transparency GCI used form 990 filings of "non-profit" subsidiaries to glean the information needed.

<sup>66</sup> U.S. Dept. of Education Office of the Inspector General (2016), "Nationwide Assessment of Charter and Educational Management Organizations: Final Audit Report," September, ED-OIG/A02M0012, <https://www2.ed.gov/about/offices/list/oig/auditreports/fy2016/a02m0012.pdf>.

<sup>67</sup> See bibliography for Bulkley, 2002; Chingos, 2014; Consoletti, 2011; Fabricant, 2012; Green Preston and Baker, 2016; Hall, 2017; Hassel, 2004; West, 2014.

<sup>68</sup> The idea that the only purpose of a business is to make a profit has been challenged in the financial literature as economists have the hindsight of the last mortgage meltdown, the junk bond failures in the last century and the demise of the Savings and Loans industry in their collective memory. See: <https://www.forbes.com/sites/stevedenning/2013/06/26/the-origin-of-the-worlds-dumbest-idea-milton-friedman/#543b9e2d870e>

marketplace data results contradict the theoretical economic predictions of market corrections.<sup>69</sup>

Essentially what has occurred in Arizona has been an open market for charter schools to enter. They have predominantly entered into areas where they frequently compete with each other now but have premised their debt holding based on growth that for many charter operators is either not occurring or very unlikely to occur.

*The emergent market is financially unstable and unhealthy for charter companies' and district public schools. The sources of revenue (public taxpayer funds) are compromised in this business arrangement.*

GCI concludes that without proactive financial oversight, deeply in debt, over-leveraged charter schools and their subsidiaries will continue to be forced to prioritize guaranteed payments to bondholders<sup>70</sup> and shareholders over classroom resources. Funds designated to improve educational outcomes need to be going to the classroom, not to long-term unsustainable debt.

### **Government Exemptions from Regulations and Business Suicide**

Milton Friedman warned about what he called “business suicide” (Friedman 1999). Friedman stated business suicide occurs when business owners seek out favors and exceptions from the rules that would normally govern the use of the tax dollars that fund their businesses. The use of tax free IDA bonds is an example of a government sponsored program that is encouraging investors to speculate in the educational marketplace. It is designed to make bond money available in order to influence lending decisions by investors. This is done by providing tax free status to those bonds.

The business connections between those making the rules (charter legislation), charter advocacy groups, and those gaming empowerment scholarships are a matter of public record. FANNY MAE and FREDDIE MAC were major players in the last financial meltdown along with private sector lenders. IDA loans appear to be following the same high risk, low equity requirements of that market disaster. GCI's data shows that a predictable financial meltdown of the charter market is illustrated in the data.

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

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This paper continued our look at the *results, not the intent of the free market theories and legislation underlying the charter sector*. GCI postulates that the bonds backing charter debt have created an over-leveraged market that is under-water on its debt. Red flags in the data on year to year Nets and Net (deficits) are a clear and present danger to the charter industry, public school districts and the taxpayer dollars that fund public education. This report, Red Flags: Overleveraged Debt, ties those net losses and net deficits to the overleveraged debt in the charter marketplace. The final graph that follows graphically shows the depth of the issue.

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<sup>69</sup> See bibliography for Bulkley, 2002; Chingos, 2014; Consoletti, 2011; Davenport, 20138; Editors, 2015

<sup>70</sup> Guaranteed Debt payment DO NOT give the charter holder flexibility in using their taxpayer Educational Revenue Funds when there is an INTERCEPT set up in the bond contract. The money goes from ADE directly to the bondholders.

## Conclusion

We have asked two essential questions of the data:

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

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

GCI supports a financially healthy and ethically managed charter school sector. It is a tragic loss to our public education offerings when an academically performing, innovative charter school fails financially. However, emphatically stating that charters are being “run as businesses” does not excuse their management nor the agency charged with charter oversight from fiscal responsibility for public funds<sup>71</sup>. Public funds are paying for privately held real estate that appears to be the primary business for several of the players in this market sector. Real estate acquisition is not what public education was designed for.

It is GCI’s contention that during the 22 years that charters have existed in Arizona, financial collapses during the school year and outside of the school year were predictable and preventable. The evidence is in the data on Net Results year to year and Net Assets (Deficits) long term. When we looked at actual charter failures we then evaluated prior fiscal year’s financials. While this may appear to the industry as “after the fact” “hindsight analysis” it was not intended to be.

**Proof of Concept:** GCI applied this model to four charters that closed during the school year and one charter from our listing of charters with debt issues.

Net Gains (Losses)/ADM <i>Net (Deficit)/ADM</i>	FY 2013-2014	FY 2014-2015	FY 2015-2016	FY 2016-2017	ASBCS Financial Dashboard
<a href="#">Discovery Creemos Academy</a>	(-\$1,863) (-\$995)	(-\$2,664) (-\$3,672)	(-\$4,418) (-\$7,584)	Closed 1/2018	Did Not Meet Every Year
<a href="#">Camino Montessori</a>	(-\$1,553) \$4,230	\$2,455 \$5,183	(-\$1,657) \$2,551	(-\$308) \$1,547 Closed 10/2018	Did Not Meet 3 of 4 Years
<a href="#">Hillcrest Academy</a>	(-\$19,642) (-\$40,350)	(-\$40,683) (-\$71,707)	(-\$33,441) (-\$92,455)	Closed FY 2016 <sup>72</sup>	Did Not Meet Every Year

<sup>71</sup> The law’s ambiguity results in charter holders litigating board decisions regarding financial closings. GCI noted several transcripts where this threat of litigation disrupted their ability to take corrective action promptly.

<sup>72</sup> This charter (Hillcrest Academy) was part of a FINRA decision to pull the bond agent’s credentials. This story is reported on in the Addendum of *Red Flags: Net Losses*

Red Flags: Overleveraged Debt

<a href="#">Starshine Academy</a>	(-\$3,200) (-\$3,139)	(-\$2,544) (-\$6,325)	(-\$4,810) (-\$14,535)	(-\$5,745) (-\$24,627) Closed FY 2018	Did Not Meet Every Year
<a href="#">Fountain Hills Charter School</a>	\$420 \$836	(-\$155) \$633	(-\$1,053) (-\$278)	(-\$1,851) (-\$2,245) Still Open	Did Not Meet Last 2 Years

Source: Collated data from ASBCS Audits and ADE ADM Statistics FY 2014 – FY 2017. Loss analysis by ADM from GCI dataset.

Our four-year analysis shows the predictive value in the data. Ignoring the predictable failures in the market is irresponsible oversight of our public education monetary resources. Market corrections, the mechanism that is theorized to correct financial issues in charter schools, are not occurring in a timely manner because the market is neither free nor open. It is subsidized by government extra revenues and tax free junk bonds.

GCI recommends greater authority and resources be given to the ASBCS in this area to monitor charter school debt-to-income ratios and actively participating in the transfer of existing and future charter holdings. The quasi- free market, hands-off approach is NOT controlling the marketplace’s financial abuses and miscalculations. As a result, catastrophic losses of taxpayer-financed properties is occurring. The current relationship between charter debt and long-term commitments on their anticipated income is resulting in more money going to debt than into improving educational outcomes.

The ASBCS, as a regulatory body, has the responsibility of providing oversight for the state's charter schools. This responsibility has been evolving in an era where anti-regulation and free-marketplace beliefs have prevailed. The ASBCS and the State of Arizona need to re-assess the type of lending that allows charter holders to over-extend their debt and obligations to that debt. GCI is not the first to question risky IDA lending by municipalities.<sup>73</sup>

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

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

Based on the findings of this report, the ASBCS' efforts—either due to limited legal authority, ideological mindsets or lack of resources—have favored charter holders and bondholders over

<sup>73</sup> Bottari, Mary. 2013. "From Junk Bonds to Junk Schools: Cyber Schools Fleece Taxpayers for Phantom Students and Failing Grades." Last Modified October, 2, 2013, accessed March 17, 2017. <http://www.prwatch.org/news/2013/10/12257/junk-bonds-junk-schools-cyber-schools-fleece-taxpayers-phantom-students-and-faili>. Flatten, Mark. 2012. Debt and Taxes: Arizona Taxpayers on Hook for \$66 Billion Tab run up by State, Local Governments. Goldwater Institutes.

taxpayer interests and the state's children. It is time that the ASBCS' mandate and its ability to proactively oversee charter school finances and debt structure be revisited and strengthened.

Autonomy should be continued however as Ronald Reagan reminded us we need to “trust but verify”.

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