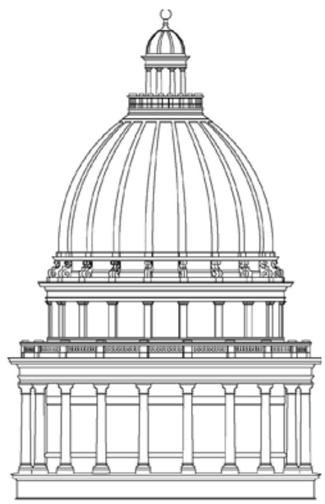
REPORT TO THE

UTAH LEGISLATURE

Number 2010-13



A Performance Audit Of Charter School Oversight

October 2010

Office of the
LEGISLATIVE AUDITOR GENERAL
State of Utah

October 21, 2010

TO: THE UTAH STATE LEGISLATURE

Transmitted herewith is our report, **A Performance Audit of Charter School Oversight** (Report #2010-13). A digest is found on the blue pages located at the front of the report. The objectives and scope of the audit are explained in the Introduction.

We will be happy to meet with appropriate legislative committees, individual legislators, and other state officials to discuss any item contained in the report in order to facilitate the implementation of the recommendations.

Sincerely,

John M. Schaff

John M. Schaff, CIA
Auditor General

JMS/lm

Digest of
A Performance Audit of
Charter School Oversight

Chapter I: Introduction

The State Charter School Board (SCSB) is responsible for the facilitation and oversight of charter schools. In the last decade, the growth of SCSB-authorized schools has increased the workload of the Utah State Office of Education's (USOE's) charter school section staff. The scope of this audit focuses on the financial practices of certain charter schools and the financial oversight by the SCSB.

Chapter II: SCSB Needs to Adopt Financial Standards and Fiscal Oversight Policies

SCSB Needs to Establish and Apply Clear Financial Standards. Recent experience demonstrates the need for better standards. The SCSB proposed terminating a school's charter because it failed to meet generally accepted standards of fiscal management. After the school appealed the termination, the SCSB voted against its own termination proposal because the standards used to evaluate the school were not specific or well-articulated.

Policies Are Needed to Address Disciplinary and Termination Concerns. SCSB actions during Beehive's disciplinary and termination processes raise concerns about hearing attendance, oversight independence, and use of staff resources. The SCSB has acknowledged a desire to infuse consistency in its processes by adopting a set of operating policies that address these concerns.

Chapter III: Charter Schools Should Adhere to Financial Best Practices

Some Schools Are Struggling with Financial Best Practices. A few schools have experienced problems with enrollment shortfalls, high facility costs, and excessive spending. The SCSB should try to guide schools to follow financial best practices. Charter school board members need to understand their financial responsibilities or access state-provided training to gain that knowledge. Some other states require training for all charter school board members. The SCSB should consider adopting a competency-based system like the one in Colorado that delivers training for individual board member needs.

Schools Are Non-Compliant with Financial Reporting Requirements. Some charter schools have not submitted quarterly financials and copies of new contracts for facilities as required. The SCSB needs to ensure it receives these important items and use them to detect potential financial problems early and recommend changes.

Chapter IV: Financial Monitoring by SCSB Needs to be Enhanced

Financial Monitoring Should Include an Analysis of Independent Audits. The SCSB has relied on Annual Financial Reports (AFRs) that focus on each school's liquidity by reporting short-term assets and liabilities. The SCSB should also review Audited Financial Statements because they provide a long-term perspective of a school's sustainability by reporting all assets and liabilities. Independent audits also include notes and audit findings that the SCSB can use to ensure that schools are addressing financial management problems.

SCSB Should Utilize USOE's New Review Process. During this audit, the SCSB implemented a prior audit recommendation to adopt a financial oversight policy. While good, the policy should be expanded to ensure schools address financial condition notes and independent audit findings.

Chapter V: Revolving Loan Program Should Be Streamlined

Statutory Loan Uses Conflict and Need to Align. Confusion exists about the purpose of the Charter School Building Subaccount. It is a component of the Capital Outlay Loan Program that provides funds for building construction and renovation. However, the subaccount allows for non-capital uses such as start-up expenses. The Legislature should consider amending statute to clarify acceptable loan uses, including placing the revolving loan program elsewhere in statute.

Subaccount Committee Policies Do Not Promote Statutory Priorities. State law provides that new schools and those with urgent facility needs may be given priority access to revolving loan funds. However, the subaccount committee has equally funded all loan applicants, thereby reducing the funds available for priority requests. The subaccount committee should develop policies to clarify how priority status will be considered. Furthermore, better tracking and a more consistent process for approving loans is needed to help ensure future compliance with the statutory loan limits.

Chapter VI: Authorizing Contracts Should Address Contractual Liabilities

Authorization Contracts Could Be Strengthened. Contracts used by the SCSB do not address who is liable for financial obligations of a school in event of default. Contracts used by authorizers in other states address contractual liabilities either by prohibiting schools from extending the "full faith and credit" of its authorizer or stating the authorizer is not liable for any contractual obligations. The SCSB should minimize the state's potential financial liability by adding similar provisions to authorizing contracts or in ***Administrative Rule***.

REPORT TO THE

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Report No. 2010-13

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Of Charter School Oversight

October 2010

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Table of Contents

Chapter I
Introduction

The State Charter School Board (SCSB) is responsible for the facilitation and oversight of charter schools. In the last decade, the total number of charter schools has increased significantly. Specifically, the increase of SCSB-authorized schools has increased the workload of the Utah State Office of Education's charter school section staff. The scope of our prior audit of the SCSB and the charter school program in 2007 was broad and included only a limited review of financial oversight. Conversely, this audit focuses primarily on the SCSB's financial oversight practices.

SCSB Provides Both Facilitation And Oversight of Charter Schools

The SCSB oversees Utah's charter school program. The following figure specifies the seven duties of the SCSB, which we generalized into the two categories of facilitating school operations and providing oversight of charter schools. The SCSB has the difficult task of balancing these very different roles.

The SCSB's seven statutory duties can be categorized into facilitating operations and oversight.

Figure 1.1 *Utah Code* 53A-1a-501.6 Power and Duties of the SCSB. The following seven duties of the SCSB generally fall into two categories, facilitation and oversight.

(1) The State Charter School Board shall:
- (a) authorize and promote the establishment of charter schools, subject to the procedures in Section 53A-1a-505;
- (b) annually review and evaluate the performance of charter schools authorized by the State Charter School Board and hold the schools accountable for their performance;
- (c) monitor charter schools authorized by the State Charter School Board for compliance with federal and state laws, rules, and regulations;
- (d) provide technical support to charter schools and persons seeking to establish charter schools;
- (e) provide technical support, as requested, to a local school board relating to charter schools;
- (f) make recommendations on legislation and rules pertaining to charter schools to the Legislature and State Board of Education, respectively; and
- (g) make recommendations to the State Board of Education on the funding of charter schools.

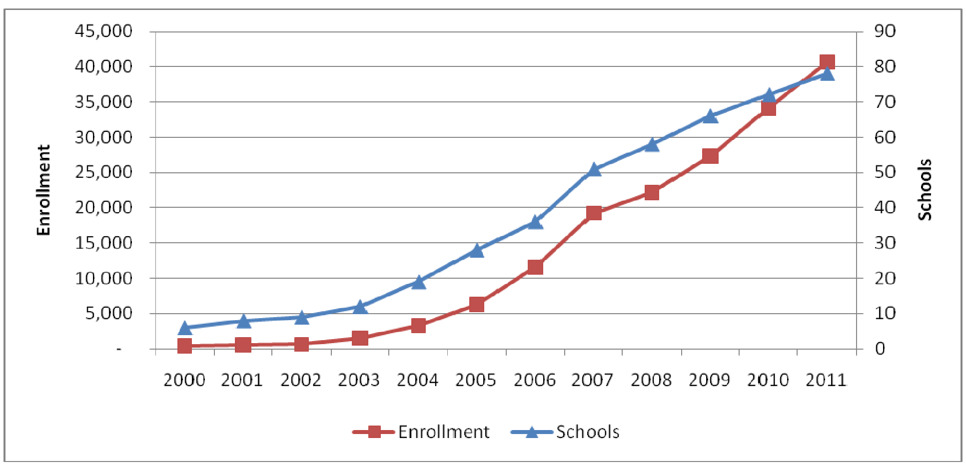
We grouped the seven SCSB duties into facilitation and oversight responsibilities. The SCSB's facilitation duties focus on creating and improving all charter schools, including those authorized by school districts. Oversight focuses on monitoring and evaluating state-chartered schools finances and operations to ensure they comply with requirements. One of the challenges facing the SCSB and charter school section staff is effectively executing these duties as the number of charter schools continues to increase.

SCSB Workload Increases as More State Charter Schools Open

Charter schools have been operating in Utah since fall 1999, with six schools opening at that time. Over the next decade, the total number of charter schools has increased to 72 for fiscal year 2010; with six more schools expected to open in fiscal year 2011. Figure 1.2 describes the growth of charter schools and student enrollment populations from fiscal year 2000 to projections for fiscal year 2011.

Since 2004, the number of charter schools has grown by 8 schools per year on average.

Figure 1.2 Charter School and Enrollment Growth over Time. Six schools began operations in fiscal year 2000 with 390 students. By fiscal year 2011, 78 schools are projected to be operating with a total enrollment of 40,647 students.



From the above chart, charter schools in Utah appear to have experienced two periods of enrollment and school growth. Fiscal years 2000 to 2003 appears to be a slow growth period with an average of three new schools and about 380 new students per year. In contrast, fiscal years 2004 to 2011 experienced faster growth of eight schools and nearly 4,900 new students annually. In fiscal year 2007 alone, 15 new schools opened and enrolled 7,694 new students.

Charter schools in Utah may be authorized by the SCSB, a local public school district, or an institution of higher education. State charter schools, which are authorized by the SCSB, make up the majority of schools in the charter system. Figure 1.3 separates the number of state-chartered schools from district-chartered schools operating since fiscal year 2000.

Figure 1.3 Count of State and District Charter Schools. Since fiscal year 2000, Utah has had significantly more state chartered schools than district-chartered schools.

Fiscal Year	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
State-Chartered	5	7	7	10	15	23	32	45	50	57	64	70
District-Chartered	1	1	2	2	4	5	4	6	8	9	8	8
Total	**6**	**8**	**9**	**12**	**19**	**28**	**36**	**51**	**58**	**66**	**72**	**78**

The SCSB is responsible for monitoring the schools chartered under its authority. ***Administrative Rule*** 277-470-13(A) states that "The State Charter School Board shall provide direct oversight to the state's board-chartered schools . . ." Since the school districts are the authorizing and oversight body responsible for district-chartered schools, this audit is primarily focused on a review of the SCSB and its state-chartered schools.

School districts authorize and oversee some charter schools; the district-chartered schools were not included in our audit's scope.

For fiscal year 2010, the SCSB operated with a budget of $564,200, which is a 21 percent reduction in their budget from the prior year. For the same fiscal year, the SCSB was staffed with five full-time USOE employees, which is a reduction of one employee from prior years. Staff members hold the following positions:

- director
- administrative secretary
- financial analyst
- training specialist
- IT analyst

Each charter school section staff member has responsibilities that must be applied to all charter schools.

Staff members that carry out an oversight function are responsible for evaluating every state charter school. For example, during fiscal year 2010, the SCSB's financial analyst provided financial oversight for all 64 state charter schools. With the increase in the number of schools and the reduction in funding and staff, the SCSB may encounter difficulty effectively fulfilling its responsibilities in the future.

Audit Scope and Objectives

As was identified in the January 2007 audit report issued by our office, *A Performance Audit of Utah Charter Schools*, financial oversight by the SCSB has not been adequate in the past. Part of this audit again assesses the SCSB's effectiveness in evaluating charter schools' performance and compliance with regulations.

The audit request focused on concerns stemming from the financial conditions at Beehive Science and Technology Academy. The school's financial difficulties raised concern that other schools may be experiencing similar problems as well. Therefore, this audit was requested with the following objectives:

- Review the adequacy of the policies and procedures established by the State Charter School Board to oversee Utah's charter schools, specifically focusing on:
    - Developing financial standards and fiscal oversight policies (Chapter II)
    - Promoting financial best practices (Chapter III)
    - Enhancing SCSB's monitoring of schools' financial performance (Chapter IV)
- Review the administration of the Charter School Revolving Loan Fund (Chapter V)
- Assess the state's risk for charter school liabilities (Chapter VI)

Chapter II
SCSB Needs to Adopt Financial Standards and Fiscal Oversight Policies

The State Charter School Board (SCSB) needs to establish clear financial standards that apply to all schools. The need for standards was clearly demonstrated when the SCSB proposed to terminate Beehive Science and Technology Academy's (Beehive's) charter, but voted down the motion because the SCSB lacked clear standards to evaluate the school. As the SCSB attempted to address Beehive's problems and proposed terminating the school's charter, several SCSB actions illustrate the need for policies that will streamline future proceedings.

Beehive's charter was the first that the SCSB has proposed to terminate for an operating school. After multiple meetings and letters raising concerns about Beehive's operations, the SCSB placed the school on probation. Two months later, the SCSB decided that Beehive was not complying with the terms of its probation and decided unanimously to propose terminating the school's charter. After a hearing to discuss the facts of Beehive's case, the SCSB voted down its own proposal to terminate the school's charter on the grounds the SCSB was utilizing ambiguous standards.

Because of ambiguous standards, the SCSB overturned its proposal to terminate a school's charter.

The SCSB's decision demonstrates the need to enhance the statutory termination process by developing financial standards and fiscal oversight policies, which the SCSB is developing plans to do. We believe the SCSB's intentions are in line with recommendations made in our 2007 audit, *A Performance Audit of Utah Charter Schools*, to develop a better-defined financial oversight process.

SCSB intends to implement a prior audit recommendation that a better-defined financial oversight process be developed.

SCSB Needs to Establish and Apply Clear Financial Standards

After evaluating Beehive's fiscal performance, the SCSB drew the conclusion that the school failed to meet generally accepted standards of fiscal management, but the SCSB reached that conclusion using standards that were not specific or well-articulated. The SCSB's conclusion led them to propose terminating Beehive's charter, which they later dismissed because the SCSB had failed to establish specific standards that demonstrated Beehive's deficient fiscal management. ***Administrative Rules*** grant the SCSB the authority to establish specific financial standards to be applied to all charter schools. As of the release of this report, the SCSB has not established these standards, but has intentions to establish and apply a clear set of financial standards.

SCSB Fiscal Assessments Lacked Support from Clear Standards

The SCSB notified Beehive management of its poor financial performance.

During the 2010 fiscal year, the SCSB met with Beehive's management multiple times regarding financial concerns. After those meetings, the SCSB sent two letters to Beehive notifying it that "the Beehive Science & Technology Academy Board of Trustees has failed to meet generally accepted standards of fiscal management." The SCSB's rationale for this conclusion was unclear because the board did not specify what specific standards the school failed to meet. A third letter followed the two and placed the school on probation.

Without specific standards, Beehive's progress should be evaluated through compliance with corrective actions required by the SCSB. The SCSB's two letters as well as their probation letter required various corrective actions, such as:

- submitting budgets
- providing access to financials
- receiving reductions in lease payments
- obtaining debt forgiveness

SCSB notifications contained various corrective actions which Beehive was required to comply with, but omitted specific standards that Beehive violated.

During Beehive's hearing it was determined that the school had complied with each corrective action, although some compliance was on an extended deadline or untimely. Even though Beehive satisfied the SCSB's initial set of corrective actions, additional corrective actions were issued. In our opinion, the additional corrective actions give the appearance of a moving target to measure Beehive's financial performance. The use of a clear set of standards would solidify the SCSB's expectations and clarify how Beehive's progress would be assessed.

Lack of Standards Prompted the Dismissal of the Proposed Charter Termination

When the SCSB proposed the termination of Beehive's charter, it followed the process outlined in statute. However, during the required hearing, the SCSB's lack of financial standards was highlighted as a problem. As a result, the SCSB validated the need for financial standards by voting to overturn its proposal to terminate Beehive's charter and begin to develop financial standards that will be applied to all charter schools.

The process for terminating a school's charter is outlined in ***Utah Code*** 53A-1a-510(2) and consists of the following five steps:

Utah Code specifies the required steps to terminate a school's charter.

1. The SCSB shall notify the governing body of the school of the proposed termination in writing, state the grounds of the termination, and stipulate that the governing body may request an informal hearing before the chartering entity.
2. If the governing body requests a hearing, the SCSB shall conduct the hearing within 30 days.
3. The SCSB shall vote regarding the proposed termination.
4. At the request of the governing body, the State Board of Education shall hear an appeal of the termination.
5. The State Board of Education's action is final and subject to judicial review.

Since the SCSB reversed the proposed termination, only the first three steps were completed.

The SCSB completed the first step by sending a letter to Beehive proposing to terminate the school's charter for its poor financial management. Beehive initiated the second step by requesting an informal hearing before the board to plead its case. During the hearing, attorneys for Beehive and the Utah State Office of Education presented evidence that addressed the questions of whether Beehive had complied with the terms of its probation and whether the school's management adhered to "generally accepted standards of fiscal management."

The SCSB completed three of the five steps by notifying the school of the proposed termination, holding a hearing, and voting on the proposed termination.

It was determined in the hearing that a specific set of financial standards for charter schools had not been established. For example, the SCSB criticized Beehive for running a deficit on an accrual basis.

However, no clear standard was established that running a deficit was unacceptable. Instead, the SCSB only hinted at this standard by recommending the school adopt a budget "such that the school's projected financial position is out of a deficit position on an accrual basis."

The SCSB's motion to terminate Beehive's charter failed because the SCSB lacked adequate standards to evaluate Beehive's performance.

During its next board meeting in June 2010, the SCSB completed the third step of the termination process, but the motion to terminate Beehive failed and the school was to remain open under probationary status. The SCSB members made it clear that the reversal of the decision to terminate was not based on sound fiscal management at Beehive, but an acknowledgement of inadequate processes and standards on the part of the SCSB. As part of the official decision and order from the hearing, the SCSB determined it would "promulgate rules that will provide clearer standards of governance to all Utah charter schools and will imbue consistency into the disciplinary process."

Administrative Rule Allows SCSB to Specify Financial Standards

The "failure to meet generally accepted standards of fiscal management" is a common statutory ground for charter school termination that Utah shares with other states. With the statutory authority to hold schools accountable for their performance, A*dministrative Rules* allow the SCSB to establish financial standards, which it has not done. Since the SCSB's vote not to terminate Beehive's charter, the SCSB members have made it clear they intend to implement specific financial standards that will be applied to all charter schools.

Eleven other states use "failure to meet generally accepted standards of fiscal management" as grounds for terminating a school's charter.

Utah Code 53A-1a-510(1)(b) specifies five broad reasons the SCSB may terminate a school's charter, including failure to meet generally accepted standards of fiscal management. We identified eleven other states that utilize this same statutory provision, and we found cases in Pennsylvania and North Carolina where the court system has tested and upheld this provision. Rather than the statute, the problem was that clear standards that define poor fiscal management have not been established by the SCSB.

According to ***Utah Code*** 53A-1a-507(5), "a charter school shall be accountable to its chartering entity for performance as provided in the school's charter." Specifically, schools are accountable for their financial performance, because ***Administrative Rule*** R277-470-1(D) states that a deficiency exists when "a charter school is not satisfying financial obligations as required . . . in the charter school's written contractual agreement." These financial obligations should include the financial standards against which the SCSB will evaluate all schools. Each school's charter already specifies that the school must comply with all applicable laws and rules as well as comply with financial audit requirements. However, specific standards regarding school financial health have not been included.

The SCSB needs to define what specific standards represent good fiscal management.

The SCSB has acknowledged its lack of standards thus far. As discussed earlier, the SCSB has taken upon itself the responsibility to create standards as part of the official decision and order from Beehive's hearing. In addition, the SCSB has already begun discussing potential standards during a strategy session held at its July 2010 board meeting. Whatever specific standards the SCSB chooses to adopt, we recommend the SCSB formally adopt those financial standards by proposing an A***dministrative Rule*** to the State Board of Education or placing those standards in each charter school's contract.

Policies Are Needed to Address Disciplinary and Termination Concerns

During our review of the proposed termination of Beehive's charter, we identified the following actions by the SCSB, which raised questions about how the processes to discipline and propose termination of a school's charter should be carried out:

In addition to standards, SCSB needs to adopt policies that address procedural questions.

- two SCSB members did not attend the hearings but voted on whether to terminate the school's charter,
- the SCSB's former chair selected members to be on Beehive's board, and
- the charter school section's financial analyst invested large amounts of time to implement Beehive's corrective actions.

These actions raise various concerns that should be addressed through the adoption of SCSB policies. The SCSB has acknowledged a desire to infuse consistency in its processes and the adoption of operating policies should address that desire.

Members Voted on the Termination Even Though They Had Not Attended the Hearing

By unanimous vote, the SCSB proposed the termination of Beehive's charter. As part of the termination process, a hearing is held to discuss the facts that justify the termination. Only four of the seven SCSB members attended the hearing to hear Beehive's defense. Given the predisposition of SCSB members to terminate Beehive's charter, we think it is very important that members attend a school's hearing to be made aware of any new facts that are presented.

All SCSB members in attendance voted on Beehive's charter termination, even though two of them did not attend the hearing.

Six members of the SCSB participated in the final vote on the proposed termination of Beehive's charter, with the SCSB chair being absent for the hearing and final vote. The four members who attended the hearing updated the two absent members on the hearing's events. ***Utah Code*** 53A-1a-510(2)(c), which specifies that the board must approve the termination with a majority vote, does not address whether members must attend the hearing to be eligible for the vote. While the SCSB's approach does not appear to violate statute, questions still arise whether board members who do not attend the hearings should be allowed to vote. Whatever the SCSB decides, it should specify its policy regarding how these votes will be handled in the future.

The State Board of Education has adopted a policy that outlines who will attend hearings and how hearing results will be circulated.

One example of how the SCSB could draft such a policy is laid out in ***Administrative Rule*** 277-470-18, which outlines how the State Board of Education will handle appeals on SCSB administrative decisions. Specifically, the rule outlines that three to five State Board of Education members and a hearing officer will make up a hearing panel that will submit written findings and recommendations to the entire State Board of Education for their action. Similarly, the SCSB should clarify how it will handle these hearings when members are not in attendance.

Former SCSB Board Chair Selected Members for Beehive's Board

Two conditions of Beehive's probation were that the SCSB would reconstitute Beehive's board and the SCSB chair would hold a meeting with Beehive's parents, staff, and governing board. The SCSB determined as a group that the Beehive board would be expanded from five to nine members. After meeting with parents, staff, and governing board, the former SCSB chair personally selected all but one of the new members. It is important to note that statute gives the SCSB the authority to remove charter school board members but is silent about naming replacements. Therefore, it seems appropriate for the SCSB to adopt policies that address how replacement board members will be selected.

The SCSB's former chair selected new members on Beehive's board, which raises concerns about SCSB independence as the oversight body.

The concern with members of the SCSB selecting a school's board members is independence. The SCSB has the responsibility to oversee charter school performance. However, their independence and ability to perform this function may be diminished when the SCSB evaluates the performance of individual Beehive board members they selected. The SCSB should avoid future conflicts by establishing a policy regarding areas that might impair SCSB independence. The new chair has acknowledged this potential conflict and has given Beehive the responsibility to appoint the ninth member of the board at its discretion.

Staff Invested Extensive Amounts Of Time Implementing Beehive's Corrective Actions

As charter school section staff addresses corrective actions required by the SCSB, concerns emerge about staff independence as they develop solutions and evaluate the adequacy of resulting changes. In addition, the amount of time staff spent with Beehive cannot be sustained with future schools as staff's workload continues to grow. As discussed in our prior audit, the SCSB needs to focus on providing oversight rather than participating in making changes at schools with financial problems.

The SCSB financial analyst spent significant time recommending specific budget cuts to Beehive, which also raised concerns about independence.

Many corrective actions from the SCSB required Beehive to make budget cuts. The SCSB's financial analyst spent large amounts of time identifying and recommending specific budget cuts the school needed to make. In our opinion, recommending specific cuts raises concerns about staff independence. It seems prudent that the SCSB, as the charter school oversight body, should adopt policies that distance itself and staff from making specific decisions that directly impact school operations. This independence should allow staff to focus on evaluating a school's decisions without concerns that they are evaluating their own decisions.

As discussed in Chapter I, the workload for charter school section staff has grown with additional charter schools. Each additional charter school requires staff to review additional financial reports. As the number of charter schools continues to grow, the staff will not be able to spend the same amount of time as they did with Beehive correcting the school's problems. Staff needs to focus on identifying problems and allow the school to develop the specific plan to address the issue.

SCSB needs to adopt policies that specify procedures and ensure independence in its disciplinary and termination actions.

As was discussed in our prior audit report, the SCSB should consider focusing its activities more on oversight and less on providing schools with assistance. The role of the SCSB was also a point of discussion during the SCSB's board meeting in July. At that meeting, the SCSB made it clear its primary duty should be oversight and other parties should provide the facilitation and technical assistance charter schools need.

All three concerns discussed in this part of the chapter demonstrate the need for the SCSB to further define the process it will follow when carrying out its disciplinary and termination processes. While we discussed only three issues in this section, a comprehensive set of policies that address a variety of issues would be beneficial.

Recommendations

1. We recommend that the SCSB formally adopt financial standards by proposing an ***Administrative Rule*** to the State Board of Education or placing standards in each school's contract.

2. We recommend that the SCSB formally define the processes it will follow when carrying out its disciplinary and termination processes in ***Administrative Rule*** or in policy.

3. We recommend that the SCSB establish a policy that addresses how board members at charter schools will be selected in the event that the SCSB uses its authority to remove board members.

Chapter III
Charter Schools Should Adhere To Financial Best Practices

A small number of charter schools are having difficulty adhering to an assortment of financial best practices related to student enrollment, facility costs, and spending. Governing boards at these schools need to improve their understanding of their fiduciary responsibilities, which could be enhanced with required training. In addition, some schools have not complied with statutory requirements that facility contracts and quarterly financial data be submitted to the State Charter School Board (SCSB). These submissions provide the SCSB an opportunity to detect potential financial problems early, which will help schools comply with financial best practices.

Poor performance with financial best practices is due in part to a lack of mandatory school board training, and noncompliance with statutory requirements has limited the early detection of problems.

This chapter focuses on events that occurred at Beehive Science and Technology Academy (Beehive) and Merit College Preparatory Academy (Merit). Both schools were facing cash flow problems at the end of fiscal year 2009 and will be discussed in more detail in Chapter IV. An in-depth review of Beehive's finances was specified in the audit request. Merit was also selected for review because of its large financial deficit from school operations.

Some Schools Are Struggling With Financial Best Practices

As we reviewed the financial conditions at Beehive and Merit, we found that these schools as well as others are not adhering to financial best practices. Specifically, the following problems and fiscal impacts were identified at these schools:

- enrollment shortfalls that reduce school revenues
- high facility costs that reduce allowable instruction expenses
- excessive spending that results in deficits

We reviewed school compliance with financial best practices regarding enrollment, facility costs, and excessive spending.

The concerns referenced to above can be addressed with best practices among the charter school population, the Charter Accounting Basics Manual that charter school section staff created, and organizations that promote charter school quality. It is important to note that the best practices referred to in this section are not financial requirements. Instead, they are tools that we used to evaluate the fiscal health of schools, and struggling schools should strive to improve their financial operations by adhering to them.

Enrollment Shortfalls Reduce Actual School Revenues

While most state charter school enrollments are close to their projections, four schools have a history of consistently missing their projections by a considerable margin. Since most charter school funding comes from state sources that are tied to school enrollment, enrollment shortfalls significantly reduce actual revenues from projected, leading to budget cuts during the school year.

On average, most charter schools enrolled over 90 percent of their enrollment projections during the past four years.

Most charter schools have complied with SCSB recommendations to project enrollment as accurately as possible. During the 2007 through 2010 school years, 56 of the 64 state charter schools averaged actual enrollments that met or exceeded 90 percent of projections. Another four schools achieved nearly 80 and 90 percent because of a single year of low enrollment, bringing the percent of state charter schools averaging enrollments of nearly 80 percent or higher of projections to 94 percent.

The remaining four schools have had a history of poor enrollment as illustrated in the following figure:

Four schools have enrolled 71 percent or less of their enrollment projections during the last four years.

Figure 3.1 Four Schools with Poor Performance Achieving Projected Enrollments. This figure shows the percent of each school's projected enrollment they achieved, and the average percent for the other charter schools is given for comparison.

School	2007	2008	2009	2010	4-Year Average
Merit	-	-	40%	48%	44%
Beehive	70%	56%	81%	55%	64%
Soldier Hollow	93%	93%	55%	58%	69%
C.S. Lewis	-	54%	78%	78%	71%
Other State-Chartered Schools	**97%**	**95%**	**98%**	**100%**	**98%**

As Figure 3.1 shows, each of these charter schools had at least one year where actual enrollment was below 60 percent of their projections, and just one school achieved an enrollment above 90 percent of their projected enrollment.

The problem with enrollment shortfalls at these four schools is the impact on budgeting revenues. State funding, which is based primarily on enrollment, accounted for 84 percent of charter school revenues in fiscal year 2009. Schools create an initial budget and receive state funding based on enrollment projections. Official enrollment counts that take place on October 1 each year adjust the funding each school receives to align with actual enrollment. If a school over-projects its enrollment, then funding is cut back and the school must make budget cuts mid-year.

State funding, which is based on enrollment, accounts for 84 percent of charter school revenues.

Merit's enrollment shortfall in fiscal year 2009 illustrates the negative impact these shortfalls can have a school's finances. Merit initially budgeted $2,772,166 in state revenues. However, since actual enrollment was so low, Merit only received $1,147,089, a 59 percent reduction in their budgeted revenues. Similar reductions also had to be made on expenses as well. Since school facility costs are typically fixed, instruction spending typically bears the brunt of budget cuts, and the impact of those cuts can be severe if instruction spending is already limited by high facility cost burdens.

One school had to reduce its initial budget by 59 percent due to enrollment shortfalls.

High Facility Costs Limit Instruction Spending

Best practices suggest that schools spend no more than 25 percent of their annual revenue on facility expenses. For fiscal year 2009, four schools did not adhere to this best practice. Our in-depth review of Beehive identified additional mandatory renovation costs that were not included in this calculation. Also, Merit signed a new contract for its permanent facility that increased its facility costs, which were not offset by similar increases in enrollment, reducing the school's funds available for instruction.

After talking with charter school business professionals and reviewing best practice research, we identified the best practice that no more than 25 percent of a school's revenue should be dedicated to facility costs; however, other sources recommend costs ideally should be limited to 15 percent of revenues. One guide called "*Charter School Facilities: A Resource Guide on Development and Financing*" seemed to articulate these facility best practices:

Best practices suggest schools spend no more than 25 percent of revenues on facility costs.

> A comfortable range for charter schools facility expenses is 10-25 percent of the annual operating budget (rent or mortgage payments plus utilities). This can vary depending on real estate in the area, but schools who spend more than 25 percent often must sacrifice many elements of a quality educational program.

The guide makes an important point that high facility costs do not denote certain failure of a charter school, but not adhering to this practice requires budget cuts to other areas such as instruction.

The following figure shows four schools we identified with facility costs that were at least 25 percent of school revenues for fiscal year 2009.

In fiscal year 2009, four schools spent at least 25 percent of their revenues on facility leases and bond costs.

Figure 3.2 Charter Schools with Facility Lease or Bond Costs Accounting for at Least 25 Percent of 2009 Revenues. This figure shows the revenues and facility costs for the four schools spent at least 25 percent of their revenues on their facility contracts.

School	2009 Revenues	Facility Cost	Percent of Revenue
C.S. Lewis	$ 1,837,539	$ 575,376	***31%***
Beehive	1,505,266	391,409	***26%***
Noah Webster	2,842,959	743,788	***26%***
Rockwell	3,666,307	934,633	***25%***

To identify these four schools, we focused solely on each school's facility contract. Utility costs were excluded from our analysis, because they were not isolated in standard financial reports submitted to the Utah State Office of Education and represent a relatively small portion of total facility costs. For example, Beehive's utility payments for electricity, natural gas, water, and disposal costs only accounted for an additional $37,540.

Beehive incurred additional costs for a fire suppression system that the facility required for an occupancy permit.

Beyond the facility costs identified in Figure 3.2, Beehive also incurred additional facility costs of $129,674 for a fire suppression system and $184,210 for building renovations. The fire suppression system was required by the fire marshal before an occupancy permit would be issued. According to the terms of Beehive's contract, Beehive, rather than the landlord, was required to cover the cost of these upgrades. The fire suppression system in particular was a costly oversight by Beehive's board and was cited during Beehive's termination hearing as one instance of the unsound financial decisions made by the school's management.

Merit's new facility tripled prior year costs but only increased enrollment by 57 percent.

It is also important to note the financial impact of Merit's new permanent facility acquired in fiscal year 2010. Merit's temporary facility costs for fiscal year 2009 accounted for 20 percent of its revenues. However, Merit's new long-term lease for its permanent facility nearly tripled the 2009 cost. To compound the problem, the school's enrollment only increased by 57 percent. Assuming the same per student revenues as 2009, Merit's lease was projected to consume 36 percent of their revenues. Financial hardships in fiscal year 2010 required Merit to obtain $550,000 in rent forgiveness from its landlord, demonstrating the toll this and other excessive spending discussed in the next section had on the school's finances.

Financial hardships necessitated $550,000 in rent forgiveness from Merit's landlord.

Excessive Spending Leads to Deficits

Both Beehive and Merit ended fiscal year 2009 in a deficit. Management at these schools did not adequately control spending when revenues declined. The charter school section staff has developed clear budgeting best practices that specify school expenditures should not exceed their revenues and schools should not operate in a deficit. Nonetheless, both schools made decisions to the contrary.

Overstaffing and subsidized student laptops contributed to the $329,385 deficit accrued by Merit during its first year of operation.

Deficits occur when a school's outstanding liabilities exceed their assets. Beehive and Merit ended 2009 with deficits of $186,442 and $329,385, respectively. The deficits at Beehive and Merit resulted from excessive spending that was either financed with debt or in accounts that were yet to be paid. The following are two examples of excessive spending at Merit that were identified during our reviews:

- Merit's 2009 student-teacher ratio was 9:1 while the median for all charter schools was 20:1. Enrollment shortfalls justified a staffing cut of 55 percent that did not take place, which we estimate cost the school approximately $400,000 in teacher compensation it could not afford.

- Merit subsidized student laptop purchases in fiscal year 2009 through a cost-sharing program with all students. The school distributed laptops before receiving payment and some students never paid their share. The school's total subsidy for the program was $85,000, and the program continued in 2010.

In addition, books from a $30,000 library book donation recorded in Merit's accounting system could not be located. All of these instances illustrate the poor financial management at the school. Since this audit began, Merit's board replaced its director and elected a new board chair. The school's new director has indicated that management is making changes based on the issues identified during this audit.

In addition to facility upgrades, the school spent approximately $46,000 on employee visas while operating at a deficit of $186,442.

The majority of Beehive's deficit came from necessary facility upgrades and facility costs discussed earlier in this chapter. Beehive's management also engaged in a questionable practice that the school will cover the cost of immigration visas and other related documentation for foreign employees in addition to teacher compensation. The school spent approximately $46,000 over a four year period on immigration visas and related legal expenses. For fiscal year 2011, Beehive's management has relocated the school to a new facility that they anticipate will produce significant cost savings and increase enrollment capacity. Management has also stated that the school has no intentions to increase staff size at the school this year.

The USOE charter school section staff has established clear financial best practices that specify schools expenditures should not exceed their expendable revenues. The lack of spending cuts that resulted in deficits at Beehive and Merit show these schools have not adhered to these best practices. The governing boards at these charter schools have the ultimate responsibility to understand the financial best practices and implement them at their school. As we discussed Merit's problems with their former board chair and watched Beehive go through its proposed charter termination, it became clear that governing boards at schools with financial problems do not clearly understand their financial responsibilities. The next section in this chapter discusses how the lack of training contributes to this problem.

Boards Need to Understand Their Financial Responsibilities

Board members of charter schools do not always access training on their responsibilities. Other states require some form of mandatory training for all charter school board members. Given that the problems identified in the prior section are limited to a small number of charter schools, the adoption of competency-based training for all board members provides training where it is needed.

Board members at charter schools are not required to attend responsibility training.

The lack of understanding regarding board responsibilities stems from the lack of board member training. The only training provided is for applicants interested in creating a charter school. ***Administrative Rule*** 277-470-4(A) requires "all charter school applicants shall attend orientation/training sessions." This training covers a wide variety of topics including board duties and responsibilities as well as financial requirements. While some applicants who attend this training eventually become board members, some schools have no board representation at this training. For example, Merit sent a board member who later became the school's director. As a result, none of Merit's board members during the school's first year of operation had the training they need. As mentioned earlier, Merit's former board chair expressed that they did not fully understand their financial oversight responsibilities.

Colorado and New Mexico require training for all board members.

Other states make training for board members mandatory. For example, New Mexico requires at least five hours of training annually on specific topics. In addition, Colorado has developed an online training program that it requires all board members to complete. The entire training can take up to 15 hours to complete and can be completed without travel, which was a concern of the former SCSB chair. Colorado's training consists of over 30 topics, including:

- charter school finance
- financial oversight
- pitfalls to avoid
- board structure and responsibilities
- administrator selection, review, and support
- strategic planning

The topics covered in Colorado's training seem to provide an opportunity to address the issues that were identified at Beehive and Merit. In addition, Colorado's mandatory training includes a competency test that gives each board member an opportunity to test out of the curriculum.

Since financial problems were only identified at a few charter schools, training should be targeted.

Considering that weak governance is limited to only some charter schools, any training required for charter school board members should be targeted. If the State Board of Education were to implement an ***Administrative Rule*** that requires competency-based training for all board members, board members could demonstrate their understanding on individual topics, and SCSB could require additional training where needed.

Schools Are Non-Compliant with Financial Reporting Requirements

Charter schools have been noncompliant with some reporting requirements.

Charter schools are required in statute and A***dministrative Rule*** to submit supplemental financial information to the SCSB through quarterly financials and copies of new facility contracts. Charter schools have demonstrated poor compliance with these requirements. These financial reports and facility contract reviews provide the SCSB an opportunity to recommend schools address the problems discussed earlier in this chapter.

Lack of School Financials Limits Staff's Ability to Provide Adequate Monitoring

Charter schools are required to submit quarterly financials to the SCSB. However, many have failed to do so in the past, which limits the ability of the SCSB to identify schools that are overspending their budgets and require schools make necessary changes.

Administrative Rule requires that schools submit quarterly financials.

One of the responsibilities the State Board of Education has placed on the SCSB is to review charter school financials throughout the year. *Administrative Rule* 277-470-13(A) requires that:

> The State Charter School Board shall provide direct oversight to the state's board chartered schools, including . . . quarterly review of summary financial records and disbursements and student enrolment.

Charter school section staff has been unable to fulfill this duty, because many charter schools are not submitting these required materials. The staff has permitted schools' noncompliance by not enforcing this requirement.

The following figure shows the number of charter schools that failed to submit quarterly reports or submitted them in the wrong format for SCSB review in fiscal year 2009 and through the third quarter of 2010.

Compliance with quarterly financials was poor in fiscal year 2009 but is improving in 2010 with charter section staff follow-up.

Figure 3.3 Charter Schools' Compliance with Quarterly Financial Statements. Charter Schools that do not submit quarterly financial statements hinder the SCSB in providing adequate oversight as required under ***Administrative Rule.***

Year	Schools	Partial or No Reports	Complete but in Improper Format	Complete and in Proper Format
2009	55	21	29	5
2010	61	9	6	46

As Figure 3.3 shows, more schools began submitting required quarterly reports in 2010 compared to 2009. The figure also shows that proper formatting was a significant problem that is being addressed.

We believe that in order for charter school oversight to be effective, the charter school section staff needs to enforce existing standards. State statute outlines the process for dealing with noncompliance in ***Utah Code*** 53A-1a-509, beginning with notifying the school of its deficiency according to statutory requirements. At the beginning of the 2010 school year, staff began notifying schools of this requirement, which quickly increased submission rates. When we asked staff what consequences exist for schools not submitting this material, charter school section staff told us they do not possess the administrative tools necessary to compel schools to comply. Therefore, staff should solicit direction from the SCSB regarding how schools remaining in noncompliance with this requirement will be handled.

The SCSB needs to develop a process regarding how remaining noncompliance will be addressed.

Limited Records Show Noncompliance With Facility Contract Reviews

According to statute, all charter schools must submit facility contracts for review and advice from the SCSB. Lack of adequate record keeping limited our ability to review historical contracts. Most of the contracts we did review were submitted by schools after the contract was signed, which does not follow statute.

All charter schools are required to submit new facility contracts to SCSB for review prior to signing.

One of the requirements charter schools have is to submit their unexecuted contracts to the SCSB for review and comment. According to ***Utah Code*** *53*A-1a-507:

> Beginning on July 1, 2007, a charter school shall submit any lease, lease-purchase agreement, or other contract or agreement relating to the charter school's facilities or financing the charter school facilities to its chartering entity for review and advice prior to the charter school entering into the lease, agreement, or contract.

As we attempted to review compliance with the statute, we found that records of correspondence had not been retained for future reviews.

Records kept by former employees could not be reviewed because submissions were kept in old e-mail accounts.

When we asked the SCSB's director for records, she told us that correspondence with former employees was not retained and left in their old email accounts. We recommended charter school section staff establish a formal process for keeping these records, and the director has indicated that submissions will be archived.

Some facility contracts were submitted after they were already signed.

As of February 2010, charter school section staff responsible for these reviews had received seven contracts for comment. Five of these contracts were submitted after the contract was signed, leaving two schools complying with statutory requirements. The five schools that did not fully comply with the statute had their own independent attorney review the contract. However, the attorney was not authorized by the SCSB to provide the review. The charter school section staff has since clarified the process with the attorney and future compliance is expected.

Additional observations from school submissions raise concerns about school awareness of this requirement. One school that submitted its lease appropriately made the following comment:

> It's my understanding that an existing, functioning, charter school . . . might not be required to submit the lease/purchase option for their new facility for [SCSB] review.

This comment raises concerns that existing schools might not realize that this requirement applies to them as well. Therefore, the SCSB needs to develop a process that ensures school business officials and board members are aware of the requirement they submit their facility contracts for review. For the two facility contracts charter school section staff commented on, the advice they offered appears to address potential shortfalls in enrollment as well as high facility costs, which were problems that were identified earlier in the chapter.

Existing schools need to understand that all new facility contracts must be submitted to the SCSB for review.

Recommendations

1. We recommend that the SCSB establish guidelines for charter schools related to best practices regarding areas such as enrollment, facility costs, and budgeting.

2. We recommend that the SCSB require competency-based training for all charter school board members. If necessary, the SCSB should approach the State Board of Education to amend ***Administrative Rules***.

3. We recommend that the charter school section staff solicit direction from the SCSB regarding how remaining noncompliance with quarterly financial submissions should be handled.

4. We recommend that the charter school section staff establish a formal process for maintaining correspondence records between staff and charter schools dealing with facility contracts.

5. We recommend that the SCSB ensure school business officials and board members are aware of the requirement to submit facility contracts for review.

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Chapter IV
Financial Monitoring by SCSB Needs to Be Enhanced

The State Charter School Board (SCSB) should take a more comprehensive approach to monitoring charter school financials. The SCSB has reviewed charter school financial health from a short-term liquidity perspective by focusing on Annual Financial Reports (AFRs), which do not include all school assets and liabilities. However, the SCSB has limited their use of audited financial statements that include all assets and liabilities and provide a long-term perspective on school sustainability. Audited statements also contain highly valuable independent auditor analysis of school financials in the form of notes and findings, which should be utilized by the SCSB to detect problems early.

The SCSB financial reviews should supplement existing AFR reviews with additional information found in audited financial statements.

The SCSB has been slow to implement recommendations from our 2007 audit that focused on establishing policies regarding financial oversight. During this audit, the SCSB adopted a policy, but specific analysis regarding audited financial statements was omitted. The internal auditor and school finance section at the Utah State Office of Education have begun developing a process to review independent auditor notes and findings found in audited statements. We recommend the SCSB utilize the results of this process when evaluating schools' financial health.

Comprehensive Financial Monitoring Should Include Analysis of Audited Financial Statements

Historically, the SCSB has assessed charter school financial health primarily by reviewing the liquidity of each school. In their analysis, the SCSB utilizes AFRs that report only liquid assets and most short-term liabilities. The SCSB's awareness of schools' financial problems has been limited by this short-term focus. Audited statements, which report all assets and liabilities, could provide the SCSB with a long-term perspective of financial problems and identify schools with financial positions that are not sustainable. Since the two types of reports provide different insights into each school's financial condition, the SCSB should expand its monitoring of charter school

Audited statements would provide a long-term perspective on sustainability that complements the AFR's liquidity analysis.

finances to include audited statements so it can evaluate both the liquidity and sustainability of charter schools.

The AFRs Used by SCSB Are Valuable for Identifying Short-Term Liquidity Problems

In the past, the SCSB has relied on the AFR to identify schools with financial problems. These reports identified liquidity problems at three schools whose short-term liabilities exceed their liquid assets. One limitation of the AFRs is that only liquidity problems from short-term assets and liabilities are reported, which may limit the early detection of financial problems because problems with long-term assets and liabilities are omitted.

SCSB staff have relied on AFR reports to assess charter school financial health.

SCSB meeting minutes from October 8, 2009 reflect the SCSB's reliance on AFRs. During that meeting, "the SCSB [was made] aware of charter schools that are in a financial deficit for FY09. Those schools are Beehive Science and Technology Academy, Merit College Preparatory Academy, and Utah Virtual Academy." We confirmed that only these three schools had accumulated a deficit according to their AFRs. Our review of school audited financial statements, however, found that nine schools had accumulated deficits when long-term assets and liabilities are included.

One of the limitations of relying solely on AFRs to identify problems is that not all assets and liabilities are included. As we reviewed reconciliations between the AFR and audited financial statements, we noted that the following additional assets and liabilities were included in the audited statements but excluded from the AFR:

Some assets and liabilities are omitted from the AFR.

- building improvements
- office equipment and furniture
- lines of credit
- outstanding loans
- lease obligations

The following figure shows the impact these additional assets and liabilities had on Beehive's financial position in fiscal years 2008 and 2009.

Figure 4.1 Reconciliation of Beehive's AFR and Audited Statements. Some assets and liabilities are omitted from Beehive's AFR that had to be added to generate the school's equity position in its audited statements. The addition of these assets and liabilities magnifies the extent of the school's financial problems.

	FY 2009	FY 2008
AFR Fund Balance	**$ (22,996)**	**$ 89,008**
Assets Excluded from AFR	292,633	54,539
Liabilities Excluded from AFR	(456,079)	(214,079)
Audited Financial Statement Net Assets	**$ (186,442)**	**$ (70,532)**

Beehive's audited statements showed a deficit one year before its AFR, which helps detect problems early.

The addition of assets and liabilities in the above figure make two things about Beehive's finances. First, Beehive's problems are not isolated to short-term problems but include long-term sustainability concerns. As shown above, Beehive's short-term deficit on the AFR in 2009 was $22,996, but the inclusion of long-term liabilities grew its deficit to $186,442 on its audited statements. These additional liabilities include the debt from Beehive's revolving loan from the state, which was not reported on the AFR.

Beehive's responsibility to repay its state revolving loan is not reported on its AFR.

Second, the addition of assets and liabilities serves as an early detection mechanism of future liquidity problems. Looking specifically at 2008, Beehive had a positive equity position on its AFR of $89,008 but reported a deficit position of $70,532 in its audited statements. If the SCSB had been actively monitoring audited statements in addition to the AFR, then it could have begun addressing Beehive's financial problems one year sooner. Instead, no formal action was taken with Beehive until its long-term sustainability problems evolved into short-term liquidity problems on the AFR.

Audited Financial Statements Raise Concerns About Some Schools' Long-Term Sustainability

According to audited financial statements, nine schools ended the 2009 school year with a deficit.

Charter school audited financial statements reported nine of 56 state-chartered schools that ended fiscal year 2009 in a deficit. The additional schools with deficits on their audited statements and not their AFRs were a result of more liabilities than assets being excluded from their AFRs. The primary differences between AFR and audited statement balances are seen in the handling of bond-related assets and liabilities. Since audited statements can provide a very different perspective of a school's financial health, the SCSB should utilize audited financial statements more and analyze both financial reports.

Audited financial statements take into account all assets and liabilities in determining a school's financial position.

Charter school audited financial statements detail schools' financial positions on a full accrual basis, meaning that all assets and liabilities are included. The deficits at the nine schools arise from each school's liabilities exceeding its assets. The size of the deficits ranges from less than one percent to 17 percent of 2009 expenses.

Beehive and Merit were the only two schools that reported deficits on both their AFR and audited financial statements. The difference between fund balances reported on the AFR and audited financial statements can be quite large, causing some schools to report positive net assets on the AFR and negative net assets on the audited financial statements. For example, we found three schools with AFR and audited financial statement differences greater than $1.5 million. It is important to take into consideration the accounting rules used by the various reports, which report items like bonds for school facilities differently.

AFRs report cash reserves from bonding activities but not the corresponding liability that shows reserves must be repaid.

The underlying problem with AFR reporting of bonding activities is they do not report proceeds for cash reserves as having to be paid back. For example, one school with a deficit in its audited financial statement issued $10,750,000 in bonds to purchase its facility. Some of the bond proceeds were set aside as cash reserves. The school has invested that cash and ended fiscal year 2009 with $1,100,854 in cash investments that were reported on the AFR, but the corresponding liability from these bonds was not reported on the AFR. Similarly, proceeds from state revolving loans are included in AFRs, but the corresponding long-term liability is not.

The SCSB should supplement existing monitoring of AFRs with additional reviews of audited statements.

It is important to note that the omission of facility liabilities on the AFR was not a reporting mistake by the school, but the nature of AFRs which focus only on short-term liabilities. The case regarding cash bond proceeds illustrates how the omission of long-term debt on AFRs can make a school look good in the short-term with adequate liquidity but raise questions about the school's long-term sustainability. These different conclusions about the financial health of the school emphasize the need to utilize both the audited financial statement and the AFR.

Auditor Notes and Findings Identify Additional Financial Concerns

By not reviewing audited financial statements more extensively, the SCSB has not addressed financial condition notes that independent auditors issue in these reports. These notes further identify significant financial challenges some schools are facing. In addition, independent auditors are identifying significant audit findings in each school's audited statements that need to be addressed. However, some schools continue to have audit findings that persist from the prior year even though our prior audit in 2007 recommended repeat findings be addressed.

Another advantage of audited statements is the auditor's notes which discuss the financial health of the school.

One way that audited statements differ from AFRs is that independent auditors have an opportunity to comment on school financial operations. Each set of audited statements contains a section of notes that provides background information and analysis pertaining to each financial statement. One note of particular interest is the financial condition note which allows auditors to discuss the financial health of the school and summarize management's correction plan. Audited statements also include letters to management with findings related to internal controls, compliance with financial requirements, and other concerns.

Financial Condition Notes Require SCSB Attention

In 2009, six of 56 schools received financial condition notes that express auditor concerns and management's plan to address these problems. Given that the success of management's plan will determine the school's ability to survive, the SCSB needs to incorporate the review of financial condition notes in its oversight process.

Six schools received financial condition notes that identify possible financial difficulties that need to be addressed by school management.

While nine state-chartered schools ended fiscal year 2009 in a deficit, the following six charter schools received financial condition notes:

- Beehive Science and Technology Academy
- C.S. Lewis Academy
- Freedom Academy
- Gateway Preparatory Academy

- Merit College Preparatory Academy
- Rockwell Charter High School

For these six schools, independent auditors identified conditions and events that indicate possible financial difficulties as well as management's plan to address the schools issues. For example, the following statements were made in the financial condition notes regarding the two schools:

- The School's operations have been dependent on debt financing.

- The school has financed the net deficiency in assets through issuing a note payable as well as delaying payment of certain accounts payable.

The financial condition notes briefly mention that management's plans to address these problems included increasing enrollment and decreasing expenditures. However, the notes report that "the financial statements do not include any adjustments that might be necessary if management's plans are not successful."

Audited financial statement reviews should identify which schools received financial condition notes.

Beehive, which received a financial condition note in fiscal year 2009, also received a financial condition note in each of its audited financial statements for the prior three years. Multiple years with financial condition notes may indicate that the school is not addressing its financial problems. Considering the importance of management's plan regarding the school's ability to survive financially, the SCSB should be more aware of these notes and the progress management is making in implementing their plan. As mentioned earlier, these notes are unique to a school's audited statements and are not included in its AFRs. As a result, this information needs to be reviewed as part of the SCSB's financial monitoring process.

Audit Findings Need to Be Addressed in a Timely Manner

Independent auditors identified several instances at schools where internal controls were deficient and/or noncompliance with financial requirements has occurred. These findings can impact the quality of financial statements. While most schools address their findings, seven schools have not. The SCSB needs to ensure that schools are addressing audit findings as part of each school's compliance with financial audit requirements.

For fiscal year 2009, 40 of the 56 state charter schools had internal control or noncompliance findings identified in their financial statements. The following figure summarizes the findings found in charter school financial statements for fiscal year 2009.

Many schools have noncompliance and internal control problems that have been identified by independent auditors.

Figure 4.2 Internal Control and Noncompliance Audit Findings. These findings were pulled from individual reports regarding internal controls and noncompliance in each school's financial statements.

Material Findings	School Count	Total Findings
Internal Control:	33	40
Noncompliance	26	40

While most schools in Figure 4.2 had a single internal control and/or compliance finding, we did find that some schools had multiple findings, including one school had five noncompliance findings and another had three internal control findings.

It is important that these findings be addressed by schools as they have the potential to adversely affect a school's financial position. In a couple schools' financial statements, auditors gave the following statement of effect regarding an internal control weakness:

> The School's accounting does not provide a complete, accurate accounting of the school's financial transactions.

SCSB staff should ensure that schools are addressing all audit findings.

This effect statement was provided because the auditor had to make significant adjustments to the school's accounts. The accounts mentioned include prepaid expenses, accounts payable, payroll liabilities, and bond accounts. Given the financial misstatements that might occur, the SCSB should take a greater interest in audit findings for the schools it oversees.

Most schools have addressed prior year audit findings. As we compared 2008 findings with 2009 findings, seven schools had a repeat finding. Repeat audit findings were a significant problem identified in our prior audit conducted in 2007. In that audit, we

Seven schools had repeat findings in fiscal year 2009, so SCSB needs to ensure audit findings are being addressed.

stated "follow-up by the state to ensure that charter schools are complying with state law and adhering to accepted accounting standards should be a priority."

Given the importance of findings, repeat findings are unacceptable. The role of the SCSB is to ensure that findings are addressed in a timely manner as schools are required to comply with audit requirements. These deficiencies and problems have already been identified and reported by independent auditors. All the SCSB needs to do is follow up with the school and ensure changes are being made.

SCSB Should Utilize USOE's New Audited Financial Statement Review Process

During this audit, the SCSB implemented a prior audit recommendation to adopt a formal policy regarding financial oversight, but the policy does not include specifics for reviewing audited financial statements. The internal auditor and school finance section at USOE are developing a process that reviews charter school audited statements for problems identified in this chapter and requires schools to submit corrective actions. The SCSB should utilize the work being conducted by the USOE so it can easily include analysis of audited statements in its comprehensive review of charter school finances.

New SCSB Process Lacks Specific Audited Financial Statement Monitoring

The SCSB finally implemented a prior audit recommendation that a financial monitoring process be adopted.

Our 2007 audit of charter schools recommended the SCSB adopt a formal policy outlining how staff would conduct financial monitoring. During this audit, charter school section staff realized the recommendation had still not been implemented and proposed a policy to the SCSB. During its board meeting in January 2010, the SCSB formally adopted a financial oversight process that can be found in Appendix A of this report.

The process outlines specific problems that staff should look for while reviewing schools' AFRs. However, the process for reviewing audited statements is vague. Part B of the process specifies the following actions to be taken regarding audited statements:

> Where concerns are identified, USOE charter school section financial staff will review situation with school in light of nature of identified concerns, and will recommend or request corrective action where warranted.

The new policy does not include specific analysis of audited financial statements.

While the process allows a lot of latitude in staff review of audited statements, we want to ensure that specific concerns indentified in this chapter are addressed on an annual basis. Fortunately, USOE's internal auditor and school finance section began developing a process to review charter school and school district audited statements.

USOE Is Developing An Audited Financial Statement Review Process

USOE is developing a process that reviews audited statements for deficits, financial condition notes, and audit findings.

Since January 2010, the USOE internal auditor and school finance section have been reviewing all school district and charter school financial statements. These reviews focus on the issues raised in this chapter by covering the following areas:

- prior audit findings
- current audit findings
- school deficits
- related party concerns

All of these issues are considered together and the auditor assigns a risk level to each school. In addition, the auditor also determines what action, if any, will be required from the school district or charter school.

All school districts and charter schools receive a letter from USOE regarding their audited financial statements. The content of these letters either 1) identifies no serious findings and thanks them for their hard work or 2) details the significant problems and requests a plan of corrective action. Overall, the financial statement review being conducted by USOE's internal auditor appears to address the scope of concerns raised in this chapter.

One uncertainty surrounding this process is who will conduct this analysis in the future. USOE's internal auditor said that her assignments change often and routine reviews are not typical.

Therefore, USOE needs to determine who the permanent "owner" of the process will be going forward.

The SCSB should provide follow-up on problems identified through USOE's audited financial statement review process.

Since USOE's internal auditor and school finance section are already developing a process to review charter school audited financial statements, the SCSB should utilize the results from the new process to identify financial deficiencies at schools. The SCSB has the responsibility and tools to ensure that charter schools meet financial requirements placed on them. Therefore, the SCSB should follow-up with schools and ensure problems identified in audited statements are being addressed and schools are complying with the review process, including the development of corrective action plans.

Recommendations

1. We recommend that the SCSB supplement their financial monitoring of AFRs with additional focus on audited financial statements.

2. We recommend that the USOE formalize the new audited financial statement review process by documenting the new process and specifying who will perform this analysis annually.

3. We recommend that the SCSB amend its financial oversight policy to utilize the audited financial statement analysis conducted by USOE, which identifies charter schools with financial condition notes and audit findings.

Chapter V
Revolving Loan Program Should Be Streamlined

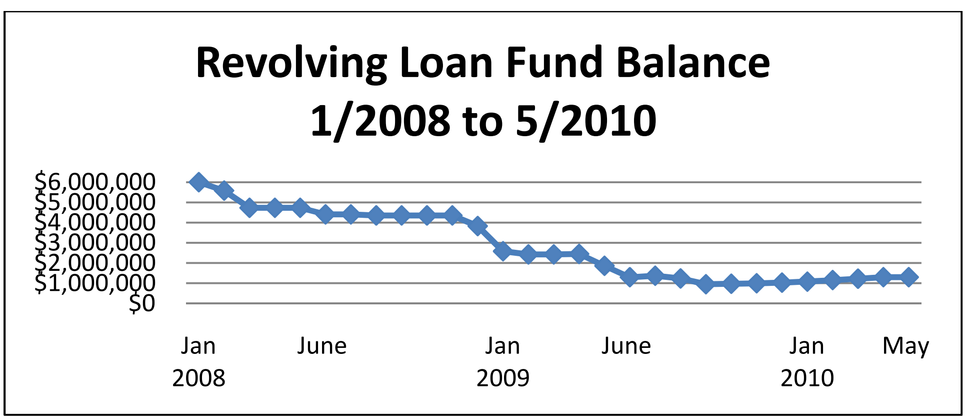
According to statute, the Charter School Revolving Subaccount is a part of the Capital Outlay Loan Program; however, the subaccount's current uses extend beyond those allowed by the larger Capital Outlay Loan Program. Statute also allows prioritization of loans for some purposes, but the subaccount's committee and the State Board of Education have not given priority to qualifying loans. In addition, the State Board of Education needs to adhere to statutory limits placed on loans approved in any year.

All members of the subaccount committee are appointed by the State Board of Education. The subaccount committee has the responsibility to review and recommend loans to the State Charter School Board and State Board of Education. The State Board of Education gives final approval of loans based on recommendations from the subaccount committee, State Charter School Board, and state superintendent. Three groups of loans have been awarded so far, and the State Board of Education recently approved its fourth group of loans, which had not been funded as of May 2010.

The subaccount committee reviews and recommends loans, which the State Board of Education approves.

School loans carry a five year term and low interest rate of approximately 1.5 percent. The following figure shows the ongoing balance of the subaccount, which includes interest and principal payments by schools.

Figure 5.1 The Revolving Loan Fund Balance Since 2008. The fund started with $6 million and is now approximately $1.3 million.



As of May 2010, the State Board of Education approved three groups of loans, leaving $1.3 million of the original $6 million to be awarded.

As Figure 5.1 shows, the value of the subaccount has decreased significantly over three years. As of May 31, 2010, the subaccount balance was approximately $1,300,000.

Statutory Loan Uses Conflict and Need to Align

The Capital Outlay Loan Program limits the use of loan funds to activities related to building construction and renovation. According to statute, the Charter School Building Subaccount is a component of the larger Capital Outlay Loan Program. However, the Charter School Building Subaccount statute allows for additional uses of the funds, such as start-up expenses, that are not related to building construction as specified in the Capital Outlay Loan Program. The purposes of the Capital Outlay Loan Program and Charter School Building Subaccount need to be aligned to reflect legislative intent.

The Charter School Building Subaccount is a part of the larger Capital Outlay Loan Program.

The Capital Outlay Loan Program is intended to provide assistance to charter schools and school districts. Specifically, ***Utah Code*** 53A-21-401(1)(a) states "the Capital Outlay Loan Programs [is] to provide assistance to charter schools to meet school building construction and renovation needs." Within the Capital Outlay Program, the Legislature created the Charter School Building Subaccount that tracks funds set aside for charter school needs.

A concern with the Charter School Building Subaccount is that its allowable uses are more inclusive than those allowed for the Capital Outlay Loan Program. ***Utah Code*** 53A-21-401(5)(c) specifies that the revolving loan fund may be used to cover costs of:

- planning expenses
- constructing or renovating charter school buildings
- equipment and supplies
- other start-up or expansion activities.

The Charter School Building Subaccount's uses conflict with those in the Capital Outlay Loan Program.

Lawyers from the Office of Legislative Research and General Counsel (LRGC) have opined that start-up expenses allowed by the Charter School Building Subaccount statute must be related to building construction or renovation, which is required by the Capital Outlay Loan Program statute. Without that interpretation, the Charter

School Building Subaccount statute, as currently written, conflicts with the Capital Outlay Loan Program.

If the intent of the Legislature is to provide funds to charter schools to cover start-up costs unrelated to building construction, then the Charter School Building Subaccount statute needs to be moved to a different section of the ***Utah Code*** or Capital Outlay Loan Program uses need to be expanded to reflect legislative intent. However, if the intent of the Legislature is for these funds to be used only for building construction and renovation, then the State Board of Education needs to change their policies and require that costs be related to building construction and renovation.

The statutory purposes of the subaccount and loan program need to align.

Subaccount Committee Policies Do Not Promote Statutory Priorities

According to statute, new schools and those with urgent facility needs may be given priority access to loan funds. However, the subaccount committee has disregarded this statutory provision and generally distributes funds equally to all loan applicants when fully funding requests is not an option. Distributing funds equally has reduced the amount of the loan requests that schools qualifying for priority status receive. To facilitate awarding priority status, the subaccount committee needs to clearly identify when loan requests qualify for priority status.

Most Requests Qualify for Prioritization

Statute currently provides two criteria that may be used to prioritize loans. The majority of loan requests come from new schools that qualify for priority status. Since the inception of the revolving loan program, only one school has been identified as having an urgent facility need. All other requests came from existing schools that did not demonstrate urgent facility need.

According to ***Utah Code*** 53A-21-401(5)(d), priority status in awarding loan funds may be given to "new charter schools or charter schools with urgent facility needs." ***Administrative Rule*** R277-470-1 further defines these terms as follows:

According to statute, loan priority status may be given to new schools and those with urgent facility needs.

- “New charter school” means any charter school through the first day of its second year with students, or a satellite school that requires a new location/campus.

- “Urgent facility need” means an unexpected exigency that affects the health and safety of students such as:
    1. to satisfy an unforeseen condition that precludes a school's qualification for an occupancy permit; or
    2. to address an unforeseen circumstance that keeps the school from satisfying provisions of public safety, public health or public school code.

17 of the 29 approved loans were from new schools or those with urgent facility needs qualifying for priority status.

Of the 29 loans approved through fiscal year 2009 by the State Board of Education, 17 qualified for priority status as a new school or a school with an urgent facility need and 12 were for non-priority purposes. As a result of funding non-priority requests, less funding was available for priority requests.

Equal Distribution Reduces Awards for Priority Requests

Despite the statutory language allowing priority treatment of certain loan requests, the revolving loan committee has adopted the practice of giving loan funds to all applicants. The subaccount committee’s decision has resulted in partial funding of loan requests from schools eligible for priority status when funds are available to fully fund these requests.

The revolving loan committee has equally distributed funds rather than giving priority treatment to those that qualify.

In the second of four rounds of loan requests reviewed by the subaccount committee, the total value of requests exceeded the statutory loan cap of $2,000,000, which required the subaccount committee to either partially fund or exclude some requests from being funded during this round. The following figure illustrates how the committee accommodated the excess requests.

Figure 5.2 Partially-Funded Loans Have Been Awarded to All Requestors. Schools that were not eligible for priority status received the same treatment as those schools that were eligible for priority status for the first group of loans approved in fiscal year 2009.

Charter School	Eligible for Priority	Requested Amount	Loan Amount
Beehive Science and Technology Academy	No	$ 243,725	$ 184,210
DaVinci Academy	No	300,000*	184,210
Dual Immersion Academy	No	47,900	47,900
Lincoln Academy	No	300,000*	184,210
Pinnacle Canyon Academy	No	300,000*	184,210
Thomas Edison Academy	No	300,000	184,210
Non-Priority Requests		*$ 1,491,625*	*$ 968,950*
Excelsior Academy	Yes	$ 200,000	$ 184,210
Gateway Preparatory Academy	Yes	243,000	184,210
Merit College Prep	Yes	300,000*	184,210
Open High School	Yes	110,000	110,000
Quest Academy	Yes	300,000*	184,210
Vista at Entrada	Yes	200,000	184,210
Priority Requests		*$ 1,353,000*	*$ 1,031,050*
Total All Requests		**$2,844,625**	**$2,000,000**

** Requests were in excess of $300,000, which is the maximum loan amount for schools.*

Schools were given equal loan amounts rather than fully-funding priority requests.

According to statute, no more than $2,000,000 can be awarded in any year. Figure 5.2 shows how the committee reduced over $4 million in requests to comply with this requirement.

Loan requests from schools qualifying for priority status totaled $1,353,000, which was within the $2 million limit. Therefore, the committee could have fully funded these priority loans and distributed the balance among non-priority requests. Instead, the committee funded all large loan requests equally. While the committee's practice is allowed by statute, it does not align with the statutory intent that some schools may receive priority access to loan funds.

Although statute does not require priority be given to some requests, Legislative intent should be followed.

Considering the subaccount committee's current practices, we recommend they begin implementing the prioritization provision, awarding funds to new schools or those with urgent facility need as defined in ***Administrative Rule***. The Legislature has demonstrated this intent in statute and the subaccount committee should follow this guidance.

Recommendations Need to Clearly Identify Priority Requests

Requests from schools with urgent facility needs have not been clearly identified.

Rather than clearly identifying that a school's request qualifies for prioritization among other pertinent information such as request amount, school name, and contact information, the committee identifies the prioritization in its narrative analysis. For example, the committee issued the following statement about the Guadalupe Charter School, which was identified as an urgent facility need:

> The Committee concurred with Committee staff that Guadalupe qualifies as a case of 'urgent need,' offering them funding priority. Guadalupe's is currently unable to qualify for an occupancy permit for a total of 175 children (i.e. their chartered enrollment) demonstrates the urgency of their need.

Since these statements are not easily identified in the committee's recommendation, inconsistencies have arisen as to which schools qualify with urgent facility needs.

Staff reports have inconsistently classified school requests as urgent facility needs.

As we reviewed additional information from staff assigned to the committee, inconsistencies arose regarding urgent facility need. For example, one loan made to Guadalupe Charter School was identified as having urgent facility need in the formal recommendation to the State Board of Education, but reports that staff maintain showed the school did not have an urgent facility need. The opposite scenario was also seen. Beehive Science and Technology Academy's first loan was classified with urgent facility need in staff reports, but the committee's formal recommendation made no such claim.

The committee needs to clearly identify whether a school qualifies for priority status in its recommendation to the State Board of Education. Currently loans are being misclassified, and as discussed earlier in this section, priority status for schools that qualify is not being awarded. In order to begin implementing a process that awards priority, the committee should start by consistently identifying whether a school qualifies for priority consideration.

Compliance with Statutory Loan Limits Is Needed

Statute has limited the total amount of loans the State Board of Education can approve in any year. The State Board of Education exceeded the statutory cap in fiscal year 2009 by awarding two groups of loans. Better tracking and a more consistent process for approving loans is needed to help ensure future compliance.

According to *Utah Code*, the State Board of Education is allowed to approve no more than a total of $2,000,000 in loans per year.

Utah Code 53A-21-401(9) specifies that "the State Board of Education may not approve loans to charter schools under this section that exceed a total of $2,000,000 in any year." As we reviewed compliance with this statute, uncertainty about what constitutes a year became apparent.

As mentioned earlier, the State Board of Education has approved three groups of loans. The first group was approved during fiscal year 2008, and in fiscal year 2009, as shown in the following figure, the State Board of Education approved two groups of loans valued at nearly $2,000,000 each.

The State Board of Education approved two groups of loans during fiscal year 2009, thereby exceeding the statutory limit.

Figure 5.3 Groups of Loans Approved During Fiscal Year 2009. In FY 2009, the State Board approved loans for over $2 million, which is over the limit set in statute.

Board Meeting	Number of Loans	Loan Total
Fiscal Year 2009 Group 1:		
November 7, 2008	11	$ 1,815,790
December 16, 2008	1	184,210
Group 1 Total	12	2,000,000
Fiscal Year 2009 Group 2:		
May 1, 2009	5	1,024,679
June 5, 2009	4	752,279
Group 2 Total	9	1,776,958
Fiscal Year 2009 Total	**21**	**$ 3,776,958**

As Figure 5.3 shows, two groups of loans were approved approximately six months apart during fiscal year 2009. While each group of loans complies with the $2,000,000 limit, the total of these loans exceeds the limit on a fiscal year basis. In addition to approval dates, we verified that yearly limits were also exceeded using disbursement dates in the USOE's accounting system.

Multiple groups were approved in fiscal year 2009 because the committee tried to get funds to new schools as soon as possible.

Each group of loans was approved to ensure that schools in their planning year had as much time as possible to make necessary start-up purchases. The group of loans in fiscal year 2008 provided funds to start-up schools three months before they began operations. For groups of loans in fiscal year 2009, the committee tried to give start-up schools more time to make necessary purchases, increasing that lead time to six months and 13 months. This effort to give schools as much time as possible resulted in two groups of loans being awarded during the same year.

Now that the committee is awarding loans up to one year early to allow new schools to make purchases, future problems like this appear unlikely. Nonetheless, to ensure future compliance with this statute, we recommend the State Board of Education track the amount of loans it approved. Specifically, the State Board of Education needs to determine when approval takes place.

It was never clear during the audit what date is being used. Multiple dates such as board meetings, promissory note signings, disbursements, and accounting system withdrawals were submitted as dates the State Board of Education approved these loans. Depending on the date used some loans are counted in different fiscal years. To ensure consistency going forward, the State Board of Education needs to determine which date it will use to track approved loans.

Recommendations

1. We recommend the Legislature clarify the purposes for which loan funds may be awarded. The Legislature may want to consider moving the loan program to another section of code and clarify whether the loan is intended for start-up schools.

2. We recommend the subaccount committee clearly identify in its recommendations whether a school qualifies for priority status.

3. We recommend the subaccount committee develop more detailed policies regarding its criteria for awarding loans, including how priority status will be considered.

4. We recommend the State Board of Education track the amount of loans it approved as required in statute.

Chapter VI
Authorizing Contracts Should Address Contractual Liabilities

Authorization contracts used by the State Charter School Board (SCSB) do not address who is liable for financial obligations of the school in event of default. Contracts used by authorizers in other states address contractual liabilities either by prohibiting schools from extending the "full faith and credit" of its authorizer or stating the authorizer is not liable for any contractual obligations. The SCSB should minimize the state's potential financial liability by adding similar provisions to authorizing contracts or in ***Administrative Rule***.

Without court decisions regarding the state's liability, it is difficult to assess whether the state would be liable for future charter school liabilities. Therefore, our approach in this chapter was to determine the implementation status of several legal tools that might protect the state from charter school liabilities. These tools were recommended by Legislative Research and General Counsel (LRGC) in a document titled, "*Response to Questions About Charter Schools Regarding: Funding, Facilities, Assets and Liabilities, and Technical Assistance and Oversight.*"

We found that most recommendations from LRGC that limit the state's exposure to charter school liabilities have been implemented.

In that document (released in November 2006) LRGC identified nine tools that could be implemented. ***Utah Code*** and ***Administrative Rule*** address many of the tools identified by LRGC, and others were intended to be used on a case-by-case basis. As we reviewed the authorization contracts for charter schools, we are unsure whether potential contractual liabilities are adequately addressed, and thus we discuss those liabilities in more detail in this chapter.

Contractual liabilities remain as one risk area that should be addressed in authorization contracts.

Authorization Contracts Do Not Address Contractual Liabilities

In accordance with state statute, the SCSB must sign an authorization contract that outlines expectations with which each charter school must comply. By signing the agreement, the charter school indemnifies the authorizer (the state) from liabilities resulting from school actions, also known as tort liabilities, but may not adequately address liabilities arising from a contractual agreement.

Existing authorization contracts focus on protecting the state from tort liabilities.

One of the provisions contained in the contract is the following section regarding indemnity, which protects the authorizer against damages and losses from actions of the charter school and those affiliated with it.

Figure 6.1 Indemnity Provision in SCSB's Authorization Contract. Each school the SCSB authorizes agrees to this provision which may protect the state from liabilities resulting from actions of the schools.

Indemnity The Governing Board agrees to indemnify and hold harmless the USOE, State Board of Education, State Charter School Board and local boards of education, their officers, agents, employees, successors and assigns from all claims, damages, losses and expenses, including attorney's fees, arising out of or resulting from any action of the School caused by an intentional or negligent act or omission of the School, its officers, agents, employees, and contractors.

Existing authorization contracts do not appear to address liabilities from breach of contract.

This provision in Figure 6.1 is designed to protect the state from tort liability rather than liabilities arising from contracts entered into by the charter schools, such as promissory notes and leases. Lawyers in LRGC reviewed this contract at our request and explained that the SCSB should be concerned with two types of liabilities, tort and contractual. Tort liabilities arise from injuries to persons due to wrongful action by an entity that results in legal damages. In contrast, contractual liabilities result from the requirements of the contract itself and from a breach of contract – for example, if a charter school fails to perform its duties under the contract. The language adopted by the SCSB in Figure 6.1 focuses primarily on tort liabilities. Therefore, we are concerned that the authorization contract used by SCSB does not adequately address contractual liabilities.

Other States Address Contractual Liabilities

Although Utah has not been held liable for charter school liabilities so far, the state should consider further protecting itself like other states that have more experience with closing charter schools. Arizona and Colorado have clarified how contractual liabilities are handled, and the SCSB should consider adding a similar provision to its authorization contract or in ***Administrative Rule***.

Arizona authorizes its schools through the Arizona State Board for Charter Schools. In its authorization contract, the board adds the following acknowledgement that prevents the board and state from being held liable for contractual liabilities.

Arizona clearly states in its authorization contracts that the state is not liable for the "debts or financial obligations of a charter school."

Figure 6.2 Arizona's Acknowledgement Regarding Contractual Liabilities. The authorization contract specifically addresses school debts and financial obligations.

14. Indemnification and Acknowledgement

A. The parties acknowledge that neither the Arizona State Board for Charter Schools, nor the State of Arizona, nor its agencies, boards, commissions or divisions are liable for the debts or financial obligations of a charter school or persons or entities who operate schools.

B. The parties acknowledge that, pursuant to law, the Arizona State Board for Charter Schools, its members, officers and employees are immune from personal liability for all acts done and actions taken in good faith within the scope of its authority.

This figure is a subsection of the Board's indemnity provision, which deals with tort and contractual liabilities separately. It clearly specifies the board and state are not liable for debts or financial obligations.

When we spoke with the Arizona State Board for Charter Schools' director, she told us that the state has not been held liable for the financial obligations of closed schools. She credited the provision in Figure 6.2 as contractual protection that shields the state from those liabilities. Through 2009, Arizona had closed 96 schools and 59 percent of which were closed for financial reasons. Therefore, the provisions of Arizona's authorization contract have been tested extensively.

Colorado school districts, which authorize charter schools in that state, take a different approach than Arizona. Their approach is to prohibit the charter school from extending the faith and credit of the school district to third-party vendors. The following figure shows the language used by a Colorado school district.

Colorado school districts address contractual liabilities by prohibiting charter schools from using the district's credit.

Figure 6.3 A Colorado School District's Prohibitions on Extending Faith and Credit to Vendors. This provision is contained in the contract's legal liabilities section and is accompanied by a separate indemnity provision.

Faith and Credit
[The charter school] agrees that it will not extend the faith and credit of the School District to any third person or entity. [The charter school] acknowledges and agrees that it has no authority to enter into a contract that would bind the School District and that [the charter school]'s authority to contract is limited by the same provisions in law or Board policy that apply to the School District itself. [The charter school] also is limited in its authority to contract by the amount of funds obtained from the School District, as provided hereunder, or from other independent sources. [The charter school]'s Governing Board shall hereby be delegated the authority to approve contracts to which [the charter school] is a party, subject to the requirements and limitations of the Colorado constitution, state law, Board approved policies and provisions of this Contract.

While Arizona's contract focused on shielding the state from charter school obligations, this contract focuses on prohibiting the school from obtaining credit in the district's behalf.

In summary, both the Arizona State Board for Charter Schools and a Colorado school district have taken different approaches to protecting the authorizer from contractual obligations of charter schools. Since the SCSB's authorization contract does not currently address contractual obligations, the SCSB should clarify that the state is not liable for charter school liabilities either in authorization contracts or in ***Administrative Rules.***

Recommendations

1. We recommend that the SCSB amend its authorization contract or ***Administrative Rule*** to either:

   - clarify the state is not liable for school financial obligations, or
   - prohibit schools from extending the faith and credit of their authorizer.

Appendix

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Appendix A
SCSB Policy Regarding Financial Oversight
(Adopted January 14, 2010)

A. The following responses to occur upon USOE receipt of AFRs:
   1. Budget not submitted: Contact and request.
   2. Fall in Net Assets: Review AFR in detail to determine cause and nature of fall in net assets.
   3. End of Year Deficit: In depth review, determination of causes. Technical assistance or intermediation, possible recommended action. Conduct of cash flow analysis of upcoming year to determine if imposition of corrective action is required.
   4. Large variation between previous and current year's Oct. 01 enrollment counts; large mid-year loss of enrolment; large difference between charter projection and Oct. 01 count: In depth review, determination of causes. Technical assistance or intermediation, or possible recommended action may also be required. Conduct of cash flow analysis of upcoming year to determine if imposition of requirement of corrective action is necessary.
   5. Combination of any of the above: In depth review, determination of causes. Technical assistance or intermediation, possible recommended action. Conduct of cash flow analysis of upcoming year to determine if imposition of requirement of corrective action is required. Possible request for more frequent or additional financial reporting.
   6. The State Charter School Board, as reasonably soon after the receipt of AFR/APR data as possible, will be offered a written report of the financial position of schools including asset reserves and asset growth or decline. The Board may direct financial staff to take additional intervening or assistive action.

B. The following responses occur upon USOE receipt of Audited Financial Statements:
   1. Where concerns are identified, USOE charter section financial staff will review situation with school in light of nature of identified concerns, and will recommend or request corrective action where warranted.

C. Annual reporting to the State Charter School Board by USOE financial staff should include following additional features upon receipt of both AFR and Audited Financial Statements:
   1. Compilation and report of Current and Debt Load Ratios, Enrollment Variances (Difference between Oct. 01 Enrollment, Projected Enrollment values on which July 01 funding is based, and chartered enrollment) and Fund Balances/Changes in Fund Balances.

2. USOE Financial staff should adhere to the annual procedure of reviewing each AFR/CAFR in depth for a determination of causation behind financial concerns which arise out of this reporting, and following up with schools which give create concern.

D. Increased Board training should be instituted
   1. USOE should require training of LEA Board members in financial oversight responsibilities of Local Boards.
   2. USOE Charter Section should complete assistive manual specifying appropriate financial procedure and oversight on the part of Charter LEA Boards and Business Administrators

Agency Response

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