

# Background

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## SUMMARY

*Charter schools are publicly funded schools that are governed by their own boards of directors. The number of charter schools open in Minnesota has grown from 1 in fiscal year 1993 to 76 in fiscal year 2003. Another 13 charter schools are planning to open in fiscal year 2004, and 16 charter schools have closed since 1993. Charter schools in Minnesota must have a sponsoring organization. School districts sponsored about half of the charter schools operating in 2003, and colleges and universities sponsored 30 percent. State law requires sponsors and the Minnesota Department of Education to oversee charter school financial management, but it provides little guidance as to how the agencies should carry out the oversight function. In 2001, the Legislature enacted several measures aimed at improving charter school financial management and accountability, including a requirement to annually submit a financial audit report to the Department of Education.*

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In 1991, Minnesota became the first state to authorize charter schools (originally called “outcome based schools”).<sup>1</sup> Charter schools are publicly funded, nonsectarian schools that are formed by parents, teachers, or community members to foster innovative, quality education. Charter schools receive state aid, primarily based on the number of students enrolled, but they function autonomously in terms of mission and administration, and they are exempt from some statutes and rules pertaining to school districts. Each charter school is governed by a board of directors whose members are elected by the parents of children enrolled at the school and the staff employed by the school. In fiscal year 2002, charter schools received about \$105 million in funding, primarily state and federal education aid.<sup>2</sup>

As background for our evaluation of charter school financial accountability, this chapter addresses the following questions:

- **How many charter schools are operating in Minnesota, and how many have closed?**
- **How are charter schools governed, and what state laws regarding financial management apply to them?**

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<sup>1</sup> *Laws of Minnesota* (1991), ch. 265, art. 9, sec. 3.

<sup>2</sup> Charter schools and school districts follow the state fiscal year that runs from July 1 through June 30, so traditional fall to spring school years coincide with fiscal years.

To answer these questions, we reviewed state laws, legislative research reports, enrollment data provided by the Minnesota Department of Education (MDE), and other program documents. We also interviewed officials from charter schools and MDE.

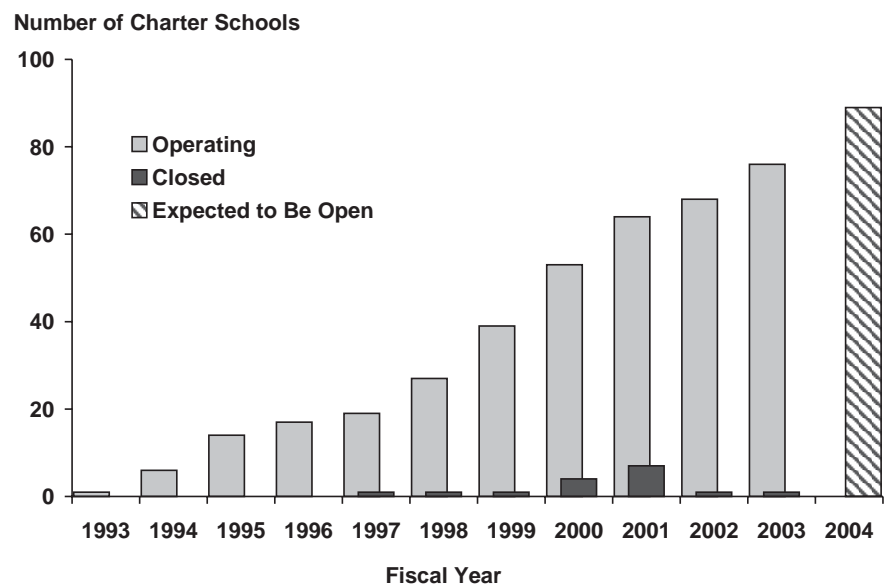
## CHARTER SCHOOLS OPERATING IN MINNESOTA

As shown in Figure 1.1, since first authorized, the number of charter schools operating has increased each year. The 1991 law authorizing charter schools limited the number of schools to eight. The Legislature gradually raised the cap in subsequent years and removed it entirely in 1997. In fiscal year 2003, 76 charter schools were open for the full school year with students enrolled.<sup>3</sup> As of June 2003, another 13 schools are planning to open in fiscal year 2004.

Since the first charter school opened in September 1992, 16 charter schools have closed under a variety of circumstances. As shown in Table 1.1, insolvency was the predominant underlying cause for most closures. Only one of the sixteen charter schools closed while fiscally healthy; its board decided to end operations

**Minnesota had  
76 charter  
schools operating  
in fiscal year  
2003.**

**Figure 1.1: Charter Schools Operating and Closed, FY1993-2003, and Expected to Be Open, FY2004**



NOTE: "Operating" includes charter schools that were open for all or part of the fiscal year. One school closed in September 2002. It is counted as operating in fiscal year 2002 and closed in fiscal year 2003.

SOURCE: Office of the Legislative Auditor analysis of Department of Education data.

<sup>3</sup> One school, Mexica Multicultural, closed in September 2002 due to low enrollment. It is not included in the count of 76 charter schools operating in fiscal year 2003.

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**Most of the 16 charter schools that have closed did so because of financial problems.**

because the school's start-up grant funding had ended and projected enrollment would not be sufficient to support program costs. The remaining fifteen schools closed because of varying degrees of poor financial management and insolvency. Key issues in these closures included over reporting of enrollment and inability to repay the state for excess aid, lower than expected enrollment coupled with overspending, and errors associated with special education funding.<sup>4</sup> In some cases, the financial management problems appeared to result from mistakes made by school administrators more skilled in developing education programs than in financial management. In other cases, however, evidence suggests that school administrators or management companies made more egregious financial management errors, including repeated overstatements of enrollment, failure to maintain accurate books and records or pay taxes, and the commitment to building leases that were clearly not in the schools' best interests. The Legislature's changes to charter school law in 2001, discussed below, were intended to address some of these problems by putting tighter controls over charter school financial management.

## STARTING A CHARTER SCHOOL

To open a charter school, an applicant (such as a group of parents, teachers, or community members) must obtain a sponsor, create a cooperative or nonprofit corporation, and complete the MDE application process. One of the first things charter school developers need to do is find an organization, often a school district or university, that will sponsor the school. The sponsor must then file an affidavit with MDE stating its intent to authorize a charter school.<sup>5</sup> MDE's approval of this affidavit is required for the start-up process to continue.<sup>6</sup>

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**A charter school must have a sponsor, such as a school district or university.**

MDE requires charter school applicants to complete a lengthy, multi-part application that includes, among other things, information on the individuals proposing to develop the school; statements of the school's vision and mission; accountability measures for two academic and two nonacademic goals; a proposed school calendar; a proposed budget; a statement assuring that the school will meet special education requirements; a letter of intent from the sponsor (or copy of a school board's resolution to sponsor); and a federal grant application.<sup>7</sup> Under the assessment process used through May 2003, MDE staff reviewed each application, prepared a summary, and sent both to the Charter School Advisory

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<sup>4</sup> The link between reported enrollment and revenue is discussed in more detail later in this chapter.

<sup>5</sup> If an applicant applies to a school district to sponsor a charter school, the school district board must vote within 90 days on whether to sponsor the charter school. If the school district board votes not to sponsor a charter school, state law allows the applicant to appeal to MDE. MDE may help the applicant find another sponsor, or it may elect to sponsor the charter school itself. MDE has elected to sponsor seven charter schools. *Minn. Stat.* (2002), §124D.10, subd. 4.

<sup>6</sup> *Minn. Stat.* (2002), §124D.10, subd. 4.

<sup>7</sup> Department of Children, Families, and Learning, *State of Minnesota Consolidated Charter School Authorization and Title V Public Charter School Grant Application* (Roseville, MN: 2003).

**Table 1.1: Charter School Closures**

Charter School and Dates of Operation	Sponsor	Reasons for Closure
Prairie Island <i>Sept. 1994 – Aug. 1996</i>	Red Wing School District	Insolvency related to low enrollment and loss of financial support from the Prairie Island Tribe.
Dakota Open School <i>Sept. 1994 – Jan. 1998</i>	Department of Education	Poor financial management involving misreported enrollment.
Frederick Douglass Academy <i>Sept. 1994 – April 1999</i>	Minneapolis Public Schools	Poor financial management involving misreported enrollment, unreasonable lease, and poor financial records.
Summit School for the Arts <i>Sept. 1997 – Apr. 2000</i>	Chisago Lakes School District	Poor financial management related to overspending and misuse of special education funds.
Success Academy <i>Sept. 1997 – May 2000</i>	St. Paul Public Schools	Poor financial management by management company involving overspending and misreported enrollment.
Toivola-Meadowlands <i>Sept. 1993 – June 2000</i>	St. Louis County School District	Low enrollment and poor financial management involving overspending that was largely related to high facility maintenance costs.
Right Step Academy <i>Sept. 1995 – Aug. 2000</i>	St. Paul Public Schools	Poor financial management by management company involving delinquent taxes and poor financial records.
Central Minnesota Deaf <i>Sept. 1997 – Dec. 2000</i>	St. Cloud Public Schools	Low enrollment and poor financial management involving overspending.
PEAKS – Faribault <i>Sept. 1999 – Mar. 2001</i>	Alexandria Technical College	Poor financial management by school founders involving unreasonable lease, misreported enrollment, and special education errors.
Strategies for Success <i>Sept. 1998 – May 2001</i>	St. Paul Public Schools	Poor financial management by management company involving misreported enrollment.
Fort Snelling Academy <i>Sept. 2000 – June 2001</i>	Normandale Community College	Poor financial management involving overspending and misreported enrollment.
Learning Adventures <i>Sept. 1998 – June 2001</i>	St. Paul Public Schools	Low enrollment and poor financial management involving overspending.
PEAKS – Pillager <i>Sept. 1998 – June 2001</i>	Central Lakes College	Poor financial management by school founders involving unreasonable lease, misreported enrollment, and special education errors.
Skills for Tomorrow Jr. High <i>Sept. 1998 – June 2001</i>	St. Paul Public Schools	Projected enrollment not sufficient to cover program costs once start-up funding ended.
Martin Hughes <i>Sept. 1998 – Nov. 2001</i>	Mt. Iron/Buhl School District	Poor financial management by management company involving misuse of special education revenue and poor financial records.
Mexica Multicultural <i>Sept. 2000 – Sept. 2002</i>	St. Paul Public Schools	Low enrollment and poor financial management involving overspending.

SOURCE: Office of the Legislative Auditor analysis of Department of Education charter school files.

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**Two funding sources unique to charter schools are lease aid and start-up grants.**

Council.<sup>8</sup> The Advisory Council reviewed the application, met with the applicant and sponsor, and made a recommendation to the Commissioner. The 2003 Legislature, however, removed reviewing charter school applications from the list of Charter School Advisory Council responsibilities.<sup>9</sup> The Commissioner, in any event, has the final say and must approve or disapprove the proposal within 60 days of receipt of the sponsor's affidavit stating its intent to sponsor the school.<sup>10</sup>

Charter schools, like school districts, get most of their revenue through state aid based on a general education funding formula that is linked to student enrollment. In fiscal year 2003, charter schools received basic education aid of \$4,601 per pupil unit.<sup>11</sup> In addition, charter schools receive operating capital revenue, sparsity revenue, training and experience revenue, and equity revenue based on the state average amount per pupil unit and may earn basic skills revenue based on the school's student population of low income students or those with limited English proficiency. Charter schools may also receive special education aid and transportation aid if they provide transportation services. Two types of aid are unique to charter schools. Building lease aid pays for 90 percent of the cost of leasing facilities up to a maximum amount per pupil unit. The 2003 Legislature reduced the maximum building lease aid from \$1,500 to the greater of \$1,200 per pupil unit or the amount per pupil unit that the school received in fiscal year 2003.<sup>12</sup> In addition, new charter schools may receive federal and state start-up funding. Currently, charter schools are eligible for three years of federal funding: \$140,000 for planning the year before the school opens, \$150,000 in the first year of operation, and \$125,000 for the second year of operation. In the past, the state offered start-up funding for the first two years of operation equal to the greater of \$50,000 or \$500 per pupil unit.<sup>13</sup> Due to action by the 2003 Legislature, charter schools opening in fiscal years 2004 and 2005 will not receive state start-up funding.<sup>14</sup> Charter schools may receive grants or gifts, but they may not issue bonds or levy taxes.<sup>15</sup>

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<sup>8</sup> The Charter School Advisory Council was created by the 2001 Legislature. It was charged with encouraging the creation of charter schools, providing leadership and support to sponsors, providing management training to charter school boards, facilitating compliance with auditing and other reporting requirements, and recommending approval or disapproval of charter school applications. Under the original legislation, the Council was scheduled to sunset on June 30, 2003. Among other changes, the 2003 Legislature extended the sunset date to June 30, 2007. *Minn. Stat.* (2002), §124D.10, subd. 2a and *Laws of Minnesota* (1Sp2003), ch. 9, art. 2, sec. 21.

<sup>9</sup> *Laws of Minnesota* (1Sp2003), ch. 9, art. 2, sec. 21.

<sup>10</sup> *Minn. Stat.* (2002), §124D.10, subd. 4(b).

<sup>11</sup> *Minn. Stat.* (2002), §126C.10, subd. 2. Pupil units are based on average daily membership (ADM), which is the sum for all pupils of the number of days of the school year each pupil is enrolled divided by the number of days that school is in session. ADM is converted into pupil units by weighting pupils according to grade level as follows: kindergarten = 0.557; grades 1 through 3 = 1.115; grades 4 through 6 = 1.06; and grades 7 through 12 = 1.3. Pre-kindergarten students with disabilities are weighted based on the number of hours of services they receive. *Minn. Stat.* (2002), §126C.05, subd. 1 and subd. 8. For an in-depth description of K-12 school funding, see Minnesota House of Representatives Research Department, *Minnesota School Finance: A Guide for Legislators* (St. Paul: 2002).

<sup>12</sup> *Minn. Stat.* (2002), §124D.11, subd. 4 and *Laws of Minnesota* (1Sp2003), ch. 9, art. 2, sec. 28.

<sup>13</sup> *Minn. Stat.* (2002), §124D.11, subd. 8.

<sup>14</sup> *Laws of Minnesota* (1Sp2003), ch. 9, art. 2, sec. 51.

<sup>15</sup> *Minn. Stat.* (2002), §§124D.10, subd. 25(b) and 124D.11, subd. 6.

## FINANCIAL ACCOUNTABILITY REQUIREMENTS

For the most part, charter schools are subject to the same financial accountability requirements regarding use of state and federal funds as are school districts.<sup>16</sup> This was not always the case. In 2000 and 2001, several charter schools closed amid allegations of financial mismanagement and conflicts of interest. As a result, the 2001 Legislature amended charter school law to increase charter school accountability.<sup>17</sup> The following requirements now apply to charter schools:

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### Legislative action in 2001 put tighter financial controls on charter schools.

- Charter schools must submit an audit report to MDE by December 31 each year. If the audit report indicates that a material weakness exists in the financial reporting systems of a charter school, the school must submit a written report to MDE explaining how the material weakness will be resolved.<sup>18</sup>
- Charter school boards must keep minutes of meetings and make them available to the public upon request.<sup>19</sup>
- Charter schools must make annual financial reports available to the public upon request.<sup>20</sup>
- Charter schools must adhere to the same requirements that apply to school districts regarding contracts for services and materials.<sup>21</sup>
- Charter schools in statutory operating debt must submit a corrective action plan and limit expenditures accordingly.<sup>22</sup>
- MDE must provide financial management training for charter school board members.<sup>23</sup>
- Charter school board members may not be employed by or serve on a board of a for-profit contractor doing business with the school.<sup>24</sup>

As shown in the list above, charter schools must meet various reporting requirements. Like school districts, charter schools must annually report financial data to MDE using a system of accounts called the Uniform Financial Accounting

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<sup>16</sup> In general, state law and MDE procedures treat charter schools as if each one were a school district consisting of one school. For example, MDE assigns a school district number to each charter school. Whereas regular school districts submit consolidated financial reports for all the schools in the district, charter schools only have to report on a single entity.

<sup>17</sup> *Laws of Minnesota* (1Sp2001), chap. 6, art. 2, sec. 20-28, 66.

<sup>18</sup> *Minn. Stat.* (2002), §124D.10, subd. 6a.

<sup>19</sup> *Ibid.*

<sup>20</sup> *Ibid.*

<sup>21</sup> *Minn. Stat.* (2002), §124D.10, subd. 8(i) and §123B.52, subd. 1.

<sup>22</sup> *Minn. Stat.* (2002), §124D.10, subd. 8(i). We discuss statutory operating debt in Chapter 2.

<sup>23</sup> *Minn. Stat.* (2002), §124D, subd. 4(e).

<sup>24</sup> *Minn. Stat.* (2002), §124D.10, subd. 4a.

and Reporting Standards (UFARS).<sup>25</sup> MDE uses UFARS data to monitor the fiscal health of school districts and charter schools and to track revenues and expenditures. Since school funding is based on the number of students served, charter schools, like school districts, must report regularly on the number of students attending school. Aid payments for the school year are initially based on enrollment projections made in June at the end of the prior school year. In general, MDE reconciles differences between projected and actual enrollment and adjusts aid payments at the end of the school year. The requirements for charter schools in their first three years of operation are different. These charter schools must submit quarterly enrollment reports to MDE, listing each student by grade and showing the student's start and end dates. MDE uses these data to make interim adjustments to aid payments, as needed.<sup>26</sup> Charter schools must also submit an annual report to the school's sponsor and MDE.<sup>27</sup>

## GOVERNANCE AND OVERSIGHT

Charter school oversight begins with charter school boards, but sponsors and MDE also have oversight responsibilities. In this section, we provide background information on their roles. A more detailed discussion of how they implement their responsibilities is in Chapter 2.

Charter schools must be governed by a board of directors elected by the staff employed by the school and the parents of enrolled children. By the end of the third year of operation, a majority of the school's board must be teachers unless MDE waives this requirement.<sup>28</sup> Boards generally set school policies, adopt budgets, and make major decisions. They usually hire directors who are responsible for the day-to-day operation and financial management of their schools.

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### The relationship between each charter school and its sponsor is defined in a contract.

As shown in Table 1.2, six types of organizations may sponsor a charter school.<sup>29</sup> Currently, 39 entities sponsor the 76 charter schools operating in fiscal year 2003. School districts sponsor the majority of charter schools (51 percent). The Minneapolis and St. Paul school districts each sponsor nine charter schools. None of the 16 other school districts that sponsor charter schools sponsor more than two. Colleges and universities sponsor 30 percent of the charter schools, with the University of St. Thomas and Central Lakes Community College each sponsoring three. MDE sponsors seven charter schools, and charitable organizations sponsor five.

The sponsor's authorization for a charter school must be in the form of a contract that, among other things, describes the school's program, including specific

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<sup>25</sup> *Minn. Stat.* (2002), §123B.77.

<sup>26</sup> *Minn. Stat.* (2002), §124D.11, subd. 9(d).

<sup>27</sup> *Minn. Stat.* (2002), §124D.10, subd. 14.

<sup>28</sup> *Minn. Stat.* (2002), §124D.10, subd. 4(c).

<sup>29</sup> The 2003 Legislature added certain chambers of commerce, business associations, or similar nonprofit corporations to the list of eligible sponsors, but these associations may only sponsor a school that has operated for at least three years with another sponsor. *Laws of Minnesota* (1Sp2003), ch. 9, art. 2, sec. 22.

**Table 1.2: Sponsorship of Charter Schools Open in FY2003**

<u>Type of Sponsor</u>	<u>Number of Sponsors</u>	<u>Number of Charter Schools Sponsored</u>	<u>Percentage of Charter Schools</u>
School District	18	39	51%
College or University	15	23	30
Department of Education	1	7	9
Charitable Organization <sup>a</sup>	4	5	7
Intermediate School District <sup>b</sup>	1	2	3
Education District <sup>c</sup>	<u>0</u>	<u>0</u>	<u>0</u>
Total	39	76	100%

<sup>a</sup>Charitable organizations must belong to the Minnesota Council of Nonprofits or the Minnesota Council on Foundations, must be registered with the Attorney General's Office, and must have a year-end fund balance of at least \$2 million.

<sup>b</sup>The state has three intermediate school districts that provide services, particularly in the areas of vocational and special education, to member school districts in the Twin Cities metropolitan area.

<sup>c</sup>Education Districts are agreements among five or more school districts to coordinate programs and services. None of Minnesota's 18 education districts sponsored charter schools in 2003.

SOURCES: *Minn. Stat.* (2002), §124D.10, subd. 3 and 4; §§123A.15–123A.19; §§136D.01–136D.76; and Department of Education data.

**Sponsors and the Department of Education share responsibility for overseeing charter schools' fiscal performance.**

outcomes students are expected to achieve; the school's management and administration; and the requirements and procedures for program and financial audits. Contracts may last up to three years.

The sponsor's oversight responsibilities, as broadly stated in statute, are to monitor and evaluate the fiscal and student performance of the school.<sup>30</sup> Each charter school must report annually to its sponsor with the information the sponsor requires.<sup>31</sup> At the end of the contract term, the sponsor must evaluate the school's performance and decide whether to renew the contract. The sponsor must give the school 60 days notice if the contract is not renewed. The sponsor may also terminate a contract mid-term with 60 days notice. The grounds for either terminating or not renewing a contract are the same:

- failure to meet the requirements for pupil performance contained in the contract;
- failure to meet generally accepted standards of fiscal management;
- violations of law; or
- other good cause shown.<sup>32</sup>

<sup>30</sup> *Minn. Stat.* (2002), §124D.10, subd. 15. A sponsor may annually assess a school up to \$30 per student (\$10,000 maximum) for the first three years of sponsorship and up to \$10 per student (\$3,500 maximum) for subsequent years to pay for monitoring and evaluation.

<sup>31</sup> *Minn. Stat.* (2002), §124D.10, subd. 14.

<sup>32</sup> *Minn. Stat.* (2002), §124D.10, subd. 23(b).

A school may appeal a sponsor's decision to terminate or not renew a contract to MDE. Unless MDE approves a different eligible sponsor for the school, the school must be dissolved.<sup>33</sup>

MDE's other oversight responsibilities for charter schools are similar to those for school districts. For example, MDE must ensure that state academic and testing requirements are met, that teachers are licensed, and that buildings meet health and safety requirements. As the agency responsible for distributing state education aid, MDE must verify the accuracy of enrollment counts. With regard to financial matters, MDE monitors compliance with financial reporting requirements, receives and evaluates financial audits, and provides training and day-to-day technical assistance in financial management.

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<sup>33</sup> MDE may also terminate an existing contract between a charter school and its sponsor if the school has a history of financial mismanagement or repeated violations of the law. *Minn. Stat.* (2002), §124D.10, subd. 23(c).