Evaluation Report Summary #03-06a

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Charter School Financial Accountability

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Major Findings:

- About one-fourth of the charter schools open in fiscal year 2002 had financial problems, as indicated by a negative fund balance or deficit spending combined with a low fund balance.

- Poor financial planning and insufficient monitoring of actual revenues and spending were key factors underlying financial difficulties. Many problems can be traced to schools opening before they were ready to manage their business operations.

Although the Legislature has tightened financial controls, about one-quarter of the state's charter schools had financial problems in fiscal year 2002.

- Minnesota's Department of Education (MDE) has initiated several well-received efforts to help charter schools improve financial management. However, charter schools often miss critical financial reporting deadlines, making oversight by MDE and charter school sponsors more difficult.

- Neither the law nor contracts between sponsors and their charter schools clearly define a sponsor's financial oversight responsibilities, and many sponsors do not actively oversee and assist their schools.

- Charter schools receive state aid to offset the costs of leasing a school building but are prohibited from using state aid to buy a building. In general, charter schools lease appropriate facilities and pay reasonable lease rates. However, 11 charter schools have created affiliated nonprofit corporations that buy a building and then lease it to the charter school.

Key Recommendations:

- MDE should ensure that new charter schools have financial management staff and systems in place before being allowed to open and should modify its model charter school contract to include detailed financial management requirements.

- MDE should initiate a process to more clearly define the scope and nature of sponsors' financial management responsibilities.

- The Legislature should consider amending the law to state that charter school contracts may be terminated for repeated failure to meet state financial reporting deadlines and should review and clarify its policy on charter school building ownership.

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Report Summary

Charter schools are publicly funded schools formed by parents, teachers, or community members. In fiscal year 2003, Minnesota had 76 charter schools. Each school is governed by a board of directors elected by the school's staff and students' parents. Charter schools must have a sponsor, such as a school district or university, that is charged with overseeing the school's academic and fiscal performance. The relationship between a charter school and its sponsor is defined by a contract that should describe, among other things, the academic program, expected student outcomes, and the school's administration.

Charter schools are generally subject to the same financial accountability requirements as school districts.

For the most part, charter schools are subject to the same financial accountability requirements regarding use of state and federal funds as school districts. For example, charter schools must maintain financial records, have a financial audit at the end of each fiscal year, and submit detailed financial data and audit reports to MDE.

We evaluated the extent of financial problems at charter schools, the reasons for them, and the sufficiency of oversight provided by MDE and sponsors. We also assessed the state's program for reimbursing charter schools for building lease expenses.

Charter Schools Are Vulnerable to Financial Problems, But the Proportion of Charter Schools in Statutory Operating Debt Has Declined

As a key indicator of a charter school or school district's fiscal status, MDE measures the end-of-year general fund balance as a percentage of annual general fund expenditures. If the percentage is –2.5 percent or worse, the school is considered to be in statutory operating debt (SOD). The proportion of charter schools in SOD declined from 19 percent in fiscal year 2000 to 12 percent in fiscal year 2002, when about 10 percent of traditional school districts were in SOD.

Because low fund balances place charter schools at financial risk, we used criteria broader than SOD status to identify charter schools that ended fiscal year 2002 in financial difficulty (e.g., an annual operating deficit combined with a low fund balance). In all, 16 charter schools met the criteria, accounting for 24 percent of 68 charter schools open in fiscal year 2002. Two of the 16 schools have closed.

A Variety of Factors Contributed to Financial Problems, Particularly Poor Financial Planning and Tracking

Some charter schools have been ill equipped to manage their finances.

A unique set of circumstances led to problems at each of the schools in financial difficulty, but we found that poor financial planning and insufficient monitoring of actual revenues and expenditures were general problems. For example, some charter schools used budgets that were not sufficiently detailed or were based on unrealistic assumptions. Some charter schools did not understand the extent of their financial problems and missed opportunities to make mid-year corrections. In some cases, the school director or board members did not grasp the importance of ongoing financial monitoring; in other cases, the director and board were not able to obtain reliable financial reports from their own accounting systems or from their contractors. Other factors contributing to financial problems included poorly functioning school boards, misunderstandings regarding state requirements, and insufficient resources to handle unexpected expenses. We recommend that MDE enhance training offered to charter school board members and that the Legislature reconsider the requirement that a majority of school board members be teachers.

Some Charter Schools Opened Without Sufficient Capacity to Manage School Finances

Quite often, charter schools attributed their financial problems to early mistakes and to having administrators and boards that were

The Minnesota Department of Education has increased its efforts to help charter schools, but needs to ensure that new schools have adequate financial systems in place before they open.

unprepared to manage a school's business operations. MDE approves charter school applications on the basis of a written proposal, and then charter schools generally spend at least 9 months in a planning stage to implement it. However, neither MDE nor sponsors formally assess new schools' readiness to open. We recommend that MDE require charter schools to demonstrate that they have financial expertise, systems, and controls in place before students arrive.

New MDE Efforts to Improve Charter School Financial Management May Be Affected by Budget Cuts

MDE monitors charter schools' compliance with laws governing the distribution and use of education aid, and in recent years has implemented several well-received efforts to better assist charter schools. For example, to address historical problems with over reporting enrollment (and receiving too much funding), the legislature directed MDE to monitor enrollment reports on a quarterly basis and adjust aid payments as needed. MDE staff also initiated an early intervention effort to identify charter schools and school districts at risk of falling into SOD. MDE staff went to the at-risk schools and used budget and financial data to demonstrate the need to increase revenues, make appropriate spending cuts, and change fiscal policies. In addition, MDE staff have made concerted efforts to improve the quality and timeliness of ad-hoc assistance.

Many charter school sponsors had little interaction with the schools they sponsored.

Charter school officials generally gave MDE high marks for the training and technical assistance it provides. It is not clear, however, that MDE will be able to sustain its current level of assistance in the wake of budget cuts. For example, MDE recently eliminated the full-time position that had been allocated to charter school financial management, replacing it with quarter-time assignments to four other staff.

Charter Schools Were More Likely to Miss Financial Reporting Deadlines Than School Districts

As an accountability tool, charter schools are required to submit fiscal year financial data files to MDE by November 30 of each year and financial audit reports by December 31. Although they have improved, charter schools have a poor record of meeting these reporting deadlines compared to school districts. For example, about 29 percent of charter schools missed MDE's November 30, 2002, deadline for posting summarized audit data via the Internet compared to about 14 percent of school districts. Also, 29 percent of charter schools missed the December 31, 2002, deadline to submit financial audit reports compared to 12 percent of school districts.

Charter schools' timeliness has improved. Among 56 charter schools open in fiscal years 2001 and 2002, the percentage of late and missing audits declined from 63 percent for fiscal year 2001 to 29 percent for fiscal year 2002. We recommend that the Legislature consider amending charter school law to explicitly allow sponsors to terminate contracts for repeated failure to meet financial reporting deadlines.

Sponsors Vary in the Extent to Which They Oversee Financial Management, in Part Because Their Role Is Not Clearly Defined

State law gives sponsors general responsibilities to monitor a school's fiscal status and to evaluate its overall performance. A charter school must have a contract with its sponsor, and both parties can use the contract to spell out specific terms of financial oversight.

However, few of the contracts we reviewed set forth specific obligations or expectations regarding the charter school's fiscal performance (e.g., budget or training requirements). The contracts also did not clarify how the sponsor would oversee financial management.

Among the 11 sponsors included in our review, interactions with charter schools

The Legislature needs to review and clarify its lease aid policy for charter schools.

ranged from a hands-off approach to more active efforts to understand schools' operations and financial status. Most of the sponsors—a mix of school districts and educational institutions—limited their oversight to receipt of the annual financial audit and perhaps an annual meeting. These sponsors provided little active assistance. Other sponsors were more active, requiring more frequent financial reports or having a charter school liaison visit the school or attend board meetings. The level and nature of assistance that sponsors should provide was a point of contention between some schools and their sponsors, and several of the charter schools were considering seeking a new sponsor. We recommend that MDE initiate a process to more clearly define sponsors' responsibilities.

Lease Aid Is an Important Revenue Source, But Some Charter Schools Are Using It to Indirectly Buy School Buildings

Charter schools are not allowed to issue bonds or levy taxes to pay for building space. Instead, the state provides lease aid that reimburses charter schools for a large portion of building lease costs if the lease terms are deemed reasonable. Charter school administrators view lease aid as essential to charter schools' financial viability; without it, they would have to rely on general education aid to pay for a facility. In general, we found that charter schools lease appropriate facilities and pay reasonable lease rates.

Although state law prohibits charter schools from using state funds to acquire buildings, 11 charter schools have established affiliated nonprofit building corporations that issued bonds or obtained loans to acquire school buildings. Charter schools then leased the building from the affiliated corporation. Many of the charter schools and sponsors we interviewed advocated allowing charter schools that have demonstrated sound fiscal and academic performance over several years to buy buildings directly. They argued that ownership can be more cost-effective in the long run. On the other hand, other officials were concerned that charter school boards and administrators may lack the sophisticated financial management skills required to arrange bond deals. Because use of nonprofit building corporations has introduced a gray area in the states' policy on building ownership, we recommend that the Legislature review and clarify the policy on use of state funds to buy charter school buildings.

The full evaluation report, *Charter School Financial Accountability (#pe03-06), includes the agency's response and is available at 651/296-4708 or:*

www.auditor.leg.state.mn.us/ped/2003/pe0306.htm

Summary of Agency Response:

In a letter dated June 16, 2003, Cheri Pierson Yecke, Commissioner of the Minnesota Department of Education (MDE), generally agrees with the report's conclusions and recommendations. Specifically, the Commissioner said she supports the report's recommendations to modify the model charter school contract, enhance charter school training, expand enrollment monitoring, and better define the sponsor's role. In addition, she said that MDE plans to submit legislative proposals in 2004 that will support the recommendations to the Legislature regarding school board membership, financial reporting timeliness, and building ownership.

Regarding the recommendation that MDE use a two-stage charter school approval process, she said that it is essential to "increase the amount of cooperative interaction between the Department, the sponsor, and the school during its 'planning year,'" but said that MDE is not prepared to support a two-stage approval process until it has established the benchmarks that a charter school should meet before opening its doors to students.