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Authorizing Matters

Measuring Charter School Financial Health

The Bottom Line: Measuring Charter School Financial Health

As schools are in the business of educating students, academic performance should be the primary outcome by which a charter school is evaluated. But a charter school cannot provide students with a good education if it cannot meet payroll, afford to keep the lights on in the building, or worse yet, improperly uses public funds that should be spent in the classroom.

Clearly, fiscal health is a key indicator of charter school success, and monitoring financial performance and position is inherent to quality charter school authorizing. The portfolio nature of charter school authorizing, relatively standardized accounting practices, and wealth of publicly available financial data create an ideal information ecosystem for authorizers to evaluate fiscal health of schools they charter. And although most charter school authorizers – like the leaders of the schools they oversee – are not drawn to the education world nor inspired by its implicit financial responsibilities, there are several relatively simple duties that authorizers must execute to effectively evaluate a charter school's financial health:

- Reading and interpreting charter school financial statements.
- Knowing if a school's resources have kept pace with expenses.
- Tracking financial trends.
- Spotting characteristics of financial health, as well as warning signs and red flags.
- Identifying if a charter school is gaining or losing financial ground.

The purpose of this Issue Brief is to provide simple guidance, in layman's language, to support authorizers in understanding and conducting the financial due diligence and oversight responsibilities inherent to the authorizing function.

Financial Basic #1:

Financial health is essential for the effective delivery of schools' educational services

When to Measure: A Stage-Based Approach to Financial Oversight

As the evolution of a school's charter follows a relative predictive life cycle, a stage-based approach is one helpful way to frame authorizers' role in monitoring financial health. Below is a simple framework explaining the points of entry where authorizers could – and should – insert themselves in this lifecycle from a financial monitoring standpoint.

- **Stage One – Charter Application:** New charter schools face the same financial challenges as any other start-up enterprise. Though the specific financial requirements of charter applications may vary state to state, there are several common components, including: annual operating budget, multi-year financial projections, cash flow projections, and in the case of a school renovating or building a facility, a capital project budget. At this stage, the authorizer is ultimately evaluating the school's financial plan like any other new business



plan – questioning its assumptions and evaluating its merits based on a combination of facts and evidence to answer such questions as:

- Are the financial statements complete, reasonable, based on documented assumptions, and presented according to generally accepted accounting principles?
- Are the financials provided in sufficient detail and for a reasonable period of time?
- Are there any assumptions in the financial statements that should be challenged?
- Is the business and operations strategy clear and acceptable?
- Are the risks and any mitigating strategies clearly identified?

■ **Stage Two – Ongoing Monitoring:** Quality authorizers conduct a steady stream of periodic and cyclical monitoring and compliance activities to understand and keep pulse of the performance of the schools they have authorized. From a financial standpoint, this may include the collection of:

- Monthly, quarterly, and/or annual financial reports
- Monthly, quarterly, and/or annual enrollment reports
- Annual audited financial statements
- Board meeting minutes
- Other finance-related compliance reports (e.g., those related to student, staff, financial, or operational reporting as dictated by state statute)

The cyclical nature of these activities means that monitoring trends over a period of time plays an important role in evaluating a school's financial health over the course of its charter term. Look for patterns – whether good or bad – that offer opportunities to recognize strong performance or intervene in the case of potentially negative trajectories. Included as appendices to this Issue Brief are ten characteristics of financially healthy charter schools, as well as ten red flags to watch out for in your ongoing monitoring.

■ **Stage Three – Renewal:** As you accumulate evidence to build your case toward renewal or non-renewal of a school's charter contract, be sure that you have a clear understanding of the school's financial past, present, and future.

- **Past:** Whether or not the school has met your expectations of financial performance.
- **Present:** Whether the school is currently financially stable.
- **Future:** Whether the school's past performance and current financial position offer sufficient evidence to support its organizational plans over the course of a renewed charter contract term.

Do not wait until the eleventh hour to compile and analyze the required information – building a simple but effective way to track your school's financial and operational data will pay dividends down the line when you need to substantiate your renewal decision, whether favorable or unfavorable.

Also, look for opportunities to benchmark the financial performance of your portfolio of schools – against one another, against other high-performing schools, and against industry standards. By benchmarking financial performance in an objective manner – just as you would with academic data – you're able to transparently and objectively introduce financial health into the renewal dialogue with quantitatively and qualitatively sound information and rationale.

If there is reason to suspect that the school's financial management isn't where it needs to be, make sure you take the time to engage with school leaders to ensure that you understand – and that they are able to articulate – the story behind the numbers. Though not all school leaders may be able to explain the specific nuances of their financial statements, they should be able to use and speak about their school's financial information and reports in a way that demonstrates accountability, provides for effective evaluation of the school's goals, and shows that the school is able to respond effectively to financial challenges.

Authorizing Matters Issue Briefs are a publication of the National Association of Charter School Authorizers (NACSA), the trusted resource and innovative leader working with public officials and education leaders to increase the number of high-quality charter schools in cities and states across the nation. NACSA provides training, consulting, and policy guidance to authorizers and education leaders interested in increasing the number of high quality schools and improving student outcomes.

Visit us at www.qualitycharters.org

Navigating Changes

Realizing that the progression through the term of a charter contract is predictive – not prescriptive – it's important to recognize that there are several financial “detours” that a charter school may encounter along the way. These specific events might necessitate a deviation from “standard practice” in evaluating and monitoring a school's financial health:

- A significant unplanned change in student enrollment.
- A significant unexpected change in the policy environment.
- The sunseting or sudden loss of a particular revenue stream (e.g., federal start-up funds).
- A contemplated (or unplanned) facility change.
- Significant turnover in leadership at the executive or board level.

Financial Basic #2:

Anticipation is the key to financial stability

Anticipation is one of the keys to financial stability. Whether in advance of (or if need be, in response to) these triggering events, a school ought to develop contingency plans – several versions or scenarios of their operating budget.

Contingency plans can be powerful fortification mechanisms to navigate potential financial crisis. Authorizers should recognize the trigger points – both qualitative and quantitative that should cause a school to activate its contingency plans and monitor the school’s action in doing so.

Know What You Are Looking At

Each state determines whether charter schools follow non-profit or governmental accounting standards, submit uniform financial data, or complete independent audits. As with any other type of organization, charter schools produce and use various types of financial reports, which provide different kinds of information to readers, and are used for varying purposes. Regardless of a state’s standards and requirements, there are a finite number of sources for financial information that can be used in performing core authorizing activities. Below is a brief outline of the usefulness and limitations of these various financial statements, with a particular focus on the anatomy of an audit – the common denominator of financial reporting for all charter schools.

- **Internal Financial Statements:** Internal financial statements are just that – financial statements used by school staff or management to monitor ongoing financial performance. Internal financial statements have not been reviewed by a professional external to or independent of the school, typically include more detail than an audit, and should demonstrate fund- or program-based accounting, or in other words, revenues and expenses by fund or program.
- **Financial Statement Compilation:** A compilation is the first of several financial statements that involve an external certified public accountant (CPA) to varying degrees. This type of statement is prepared in accordance with guidelines issued by the American Institute of Certified Public Accountants (AICPA). The preparer accepts information given to it by the school without auditing or reviewing that information, and puts the information into the AICPA format for financial statements.
- **Financial Statement Review:** A review includes a limited examination of the financial statements by a CPA. During a review, the CPA asks questions of school management and conducts some analysis, but does not undertake the more extensive testing required for an audit. It provides a limited assurance that the financial statements present a fair picture of the school’s financial condition. It costs less than an audit and is used by some nonprofit organizations in place of a full audit.

Financial Basic #3:

Financial information is based on periods of time. The past is captured in financial statements, the future laid out in budgets or financial plans, and present reality – schools’ financial lifeblood – in cash flow.

Past.....Financial Statements
 Future.....Budget
 Present Reality.....Cash Flow

CASH- VS. ACCRUAL-BASED ACCOUNTING

A state’s accounting standards will dictate whether charter schools use cash or accrual accounting. Cash basis accounting records only those events that involve the exchange of cash, and ignores transactions that do not involve cash. Accrual basis accounting records amounts payable and amounts receivable in addition to recording transactions resulting from the exchange of cash, and represents the true financial condition of the school by recording all income and expenses, whether paid or not.

CORE COMPONENTS

- Independent Auditor's Report
- Statement of Financial Position (Balance Sheet)
- Statement of Activities (Income Statement)

SUPPLEMENTARY OR OPTIONAL

- Statement of Cash Flows
- Schedule of Functional Expenses
- Notes to the Financial Statements
- Management's Discussion and Analysis (Governmental Entities Only)

- **Audited Financial Statements:** This type of statement has been examined and tested by independent certified public accountants using protocols established by the Financial or Governmental Accounting Standards Board (FASB or GASB depending on how charter schools are treated in your state). It is accompanied by an "Independent Auditor's Report" which expresses an opinion as to whether the financial statements have been presented fairly by the school's management. The audit footnotes are an integral part of the audited financial statements and should be included as a component of an authorizer's annual reporting requirements.

This type of statement is often also accompanied by a "Management Letter," which is the auditor's less formal communication to the school's leadership about the financial statements. Authorizers should require that schools also file these management letters, which can include insightful observations and recommendations about how the school can improve its financial practices. Additionally, in states where charter schools are treated as governmental entities, leadership is responsible for completing an accompanying "Management's Discussion and Analysis" – commonly referred to as an MD&A – evaluating and explaining in narrative form the organization's financial performance for the given period. Again, the MD&A can be a powerful tool to gain a sense for a school's own perspective on its financial performance.

As mentioned earlier, depending on state-by-state requirements, schools' audited financial statements can include a number of components, some of which comprise the "core" of an audit, with others either supplementary or optional.

- **Form 990:** Return of Organization Exempt from Income Tax: This report is required by the IRS for most nonprofit organizations with gross receipts over \$25,000

In 2008, the IRS Form 990 had its first revision since 1979, which included new questions regarding governance, compensation disclosure requirements, and definitions intended to increase transparency and accountability to the public. For more information on these revisions, see Resources on page 6.

per year. These Form 990 filings are available for public inspection (www.guidestar.org), and while they may not play a key role in an authorizer's financial analysis, they are an important piece of the financial compliance puzzle. They are increasingly providing the public with transparent information – good and bad – about nonprofit organizations of all shapes and sizes.

Financial Statement Basics: Putting Financial Statements to Work

Statement of Financial Position: The statement of financial position (called a statement of net assets under governmental accounting standards), or balance sheet, is a simple way to measure whether a school is gaining or losing ground from year to year. In one concise statement, the balance sheet reports what an organization is worth at a particular point in time. The balance sheet is comprised of three main sections, and the relationship or equation between these three sections – assets, liabilities and net assets – is where the "balance sheet" gets its name.

- **Assets:** Economic resources that the school owns, which may include cash, accounts and grants receivable, pre-paid expenses, and equipment. Assets are classified as current or non-current, separating those that can reasonably be expected to be turned into cash within a year (current) from others (non-current).

Financial Basic #4:
Assets can be as, if not more,
important than income

- **Liabilities:** Financial obligations, or what the school owes, which could include accounts payable, accrued expenses, or loans payable. Liabilities are also classified as current (those obligations due within the year) and non-current (debts due beyond one year).

- **Net Assets:** This figure is simply the difference between what the school owns and what it owes. Net assets represent the accumulated surpluses or deficits

incurred since the school's inception. If, over the years, surpluses have exceeded deficits, net assets will be positive; if the opposite, net assets will be negative.

Statement of Financial Activities: The statement of activities, or income statement (also commonly called a profit and loss statement), provides another indicator of a school's financial health. As the balance sheet summarizes a school's net worth at a given point in time, the income statement reports where a school's income came from, where it went, and how much was left once expenses were subtracted from income.

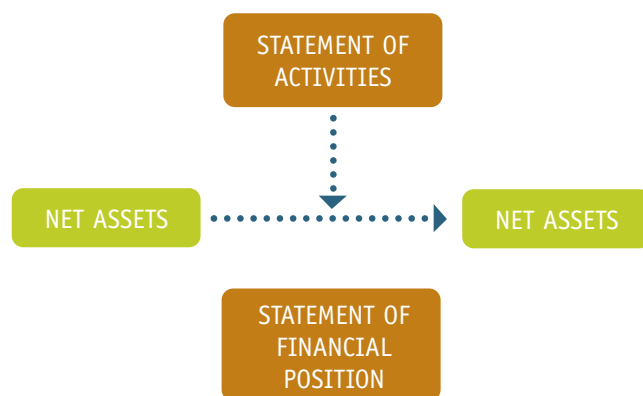
How the Two Tie Together: Income and expenses are simply other names for increases and decreases in net assets. At the end of the year, after the statement of financial activities is completed (showing the year-end change in net assets), the effect of income and expenses is shown in the net asset account on the statement of financial position.

Managing capital is as, if not more, important than attracting it. That isn't to say that income isn't important. But for most charter schools, income is the one thing over which they have least control, particularly once they reach full enrollment. An asset-based approach to financial health – one that values managing what is within schools' control – can be far more valuable in an environment of scarce resources and finite revenue growth.

Cash Flow Projection: Cash flow is the financial lifeblood of business – for-profit and nonprofit alike. It is a time-dependent term that means having sufficient income when needed to meet expenses. Technically, it's the difference between cash receipts and cash disbursements over a given period of time. But for all practical purposes, cash flow means that a school is able to stay solvent – that it is able to pay debts and claims as they come due. Schools need to anticipate, plan, and balance the flow of cash in and out of the organization. This allows schools to have enough cash when they need it and to make the most of excess cash.

Many schools have trouble distinguishing cash flow problems from operating deficits, though they are very different circumstances. Negative cash flow occurs when a school's demand for cash is higher than the amount of cash on hand – a situation that, although disruptive to smooth operations, shouldn't be confused with running a deficit. Negative cash flow assumes that, within the course of the year, there will be enough money to handle all budgeted financial obligations. The problem is that the receipt of funds will be slower than the time period in which bills must be paid. It is a timing issue.

A deficit, on the other hand, occurs when schools overspend their operating income. Naturally, when schools spend more annually than they receive, there will be cash flow problems. But in such cases, negative cash flow is a symptom of the deeper deficit problem.



The Basics of Assessing Financial Health

Effective financial analysis enhances the story told by financial statements. It produces insights that allow authorizers to form judgments – and questions. Below is a review of specific tools and considerations authorizers can use to effectively evaluate the financial health of their schools.

- **Standards for Comparison – Other High Performing Schools, Past Experience, and Goals for the Future:** Numbers are meant to be compared, and the most effective measures of financial health represent relationships between two numbers. These measures' utility lies in their ability to impart greater knowledge than is readily discernible from standalone financial data. To be useful, many measurements need to be related to something else: the same type of metric viewed over time, for example, provides substantially greater information than one metric for one time period. Similarly, by comparing a metric for one school with the same metric for other similar schools, authorizers gain another useful perspective.

Benchmarking and financial trend analysis can also be a way for authorizers to encourage sharing and collaboration among your schools, stimulate conversation and reflection within boards, advocate on your schools' behalf, and take pulse of environmental trends. Using these analytical techniques within the portfolio environment of charter school authorizing helps you as an authorizer to:

- Determine whether financial resources are sufficient to support the schools' missions.
- Gauge how resources are used, and whether they are being used efficiently and effectively.
- Assess how your schools are performing on a relative basis.

- Identify problem areas that you can help solve.
- Discover areas of superior performance or accountability.

Financial Basic #5:

Numbers are meant to be compared

- **Key Financial Metrics:** The table on the insert summarizes several financial indicators that are key to effectively monitoring schools' financial health, organized into the following four categories: student data, staff data, financial performance and position, and financial ratios and metrics. The indicators presented, while not intended to be fully exhaustive, offer a practical starting point for financial data collection and analysis.
- **Quantitative vs. Qualitative Evidence:** Financial health manifests itself in many forms other than data, thus it is important to look beyond the numbers. The following are several areas to look for qualitative evidence of financial health and financial management capacity:
 - Short- and long-term organizational plans
 - Contingency plans addressing potential funding shortfalls or other disruptive events
 - Sustainability of current funding streams
 - Evidence of regular financial reporting that allows course correction
 - Management (bench) strength
 - Evidence of self-efficacy and awareness of shortcomings
 - Adequately staffed financial systems supported by proper internal controls
 - An engaged board of directors with a finance committee and at least one financial expert

Conclusion: How to Get Started

This Issue Brief was designed to help authorizers build their financial oversight capacity by demystifying traditional accounting concepts and translating them into fundamentally sound financial measurement techniques. Whether you are new to authorizing looking to build systems from the ground up, or an existing authorizer interested in taking your financial oversight practices to the next level, the following are several steps to help you get started:

- **Step 1:** Review the information you're already collecting.
- **Step 2:** Ask your staff and schools if they're satisfied with current practice.
- **Step 3:** Check for alignment between your authorizing expectations and your monitoring practices.
- **Step 4:** Determine the most efficient way to fill any information gaps.
- **Step 5:** Evaluate the trade-off from a cost vs. benefit and capacity standpoint: how important is it, how intensive is it to collect, and how practical is it to sustain?
- **Step 6:** Develop an implementation process and timeline.
- **Step 7:** Implement, take pulse, and adjust practice accordingly.

RESOURCES

Background Paper

www.irs.gov/pub/irs-tege/background_paper_form__990__redesign.pdf

IRS Instructions and Tools

www.irs.gov/charities/article/0,,id=185561,00.html

Frequently Asked Questions

www.irs.gov/charities/article/0,,id=176667,00.html

Act Now to Prepare for the New 990

www.larsonallen.com/Health_Care/Home_Care/Act_Now_to_Prepare_for_the_New_990.aspx

10 CHARACTERISTICS OF FINANCIALLY HEALTHY CHARTER SCHOOLS...

1. Are committed to income-based spending.
2. Have sufficient financial resources to ensure stable educational programming.
3. Retain positive fund balances or net assets at the end of each year, or if incurring an intentional deficit, have accumulated surpluses which are greater than the current year's deficit.
4. Have established, or have specific plans to establish, a working capital reserve to finance cash shortfalls and program growth.
5. Deploy financial systems that are adequately staffed, ensure proper internal controls, and support the school's educational mission.
6. Maintain healthy relationships with outside financial entities such as their bank and audit firm.
7. Have boards that hold themselves responsible for the financial stability of the school.
8. Provide financial reports in a timely manner that contain accurate information, are presented in the context of the school's mission, and appropriately match the knowledge level and role of the audience.
9. Use financial information in a way that demonstrates accountability to stakeholders, provides for effective evaluation of the schools' goals, supports broad planning processes, and allows the school to respond effectively to change.
10. Clearly communicate short and long term goals with their authorizer, work with their authorizer to establish reasonable information commitments (in terms of quality, quantity, and timeline), and proactively deal with authorizer issues and concerns.

...AND 10 RED FLAGS

1. Consistently and materially falls short of its enrollment projections.
2. Continually spends more money than it receives in revenue.
3. Leadership is unable to communicate about the school's financial health in clear, understandable language.
4. Payables (the money a school owes others) mounting up and going unpaid.
5. Regularly dips into restricted or deferred funds for today's expenditures, coming up short later when the project those funds were dedicated toward is ready to go.
6. Accounts receivable (the money others owe a school) are going uncollected.
7. Lack of money has become the focal point of conversation at staff and board meetings.
8. Lack of regular board meetings or board minutes without a financial review.
9. Demonstrates a lack of effective policies and procedures, management tools, metrics, and reporting.
10. Exhibits excessive optimism – an unwillingness to acknowledge potential pitfalls or changes in the external environment.

ENDNOTES

Select content adapted from: Stevens, Susan Kenny. 2002. All the Way to the Bank: Smart Nonprofit Money Management. Minneapolis: LarsonAllen, LLP. All rights reserved.

ABOUT THE AUTHOR

Ben Aase is a managing consultant with LarsonAllen, LLP specializing in strategic, financial, and operational consulting for nonprofit and government organizations. Ben's work in K-12 education includes strategic and business planning, debt restructuring and financial renewal, and board development. Ben also designed and manages LEAD for Charters – a Cargill Education Partnership – formed to help a group of Minneapolis area charter schools ensure their long-term stability.

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