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BEYOND TEST SCORES: A CENTRAL ROLE FOR FINANCIAL HEALTH IN EVALUATING ARIZONA'S CHARTER SCHOOLS

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EXECUTIVE SUMMARY

School districts across the U.S. face fiscal distress, yet financial health remains on the sidelines of state accountability systems, with few consequences for mismanaging education dollars and putting students, teachers, and taxpayers at risk. In recent years, the charter sector has led the way in promoting greater transparency, with numerous authorizers adopting financial performance frameworks that track and report on key measures of financial health. The Arizona State Board for Charter Schools (ASBCS) adopted its own framework in 2012, which provides clear performance expectations and rates charters on financial outcomes. With the recent passage of HB 2663, which allows ASBCS to close charters that fail to meet these financial standards, now is a critical time to assess how this framework is working and implement needed improvements.

Our analysis finds that:

#1 The Financial Performance Framework's roll-up mechanism fails to make important distinctions in performance.

#2 Closed charter schools are more likely to be financially distressed schools with low enrollment.

#3 Arizona's three performance frameworks—academic, financial and operational—are disconnected.

Several reforms can improve ASBCS's financial performance framework in the short term. The most important areas to address are the framework's roll-up mechanism and creating the infrastructure needed to close financially distressed charters in a manner that is fair, transparent, and accounts for local context. To do so, Arizona should revamp its summative ratings and create a more nuanced infrastructure to better assess flagged charters, which could involve creating a second-tier evaluation system that incorporates both quantitative and qualitative data (see Table ES1) and enlisting the support of an objective, third-party financial reviewer before closure decisions are made. Importantly, Arizona should also add enrollment growth as a sustainability measure of financial performance that flags charters with substantive declines over a three-year period. Not only is enrollment often related to financial distress, but it also provides valuable insight into whether a charter is using tax dollars to meet the needs of a community.

TABLE ES1: DESCRIPTIONS OF REVAMPED SUMMATIVE RATINGS

Rating	Description
Imminent Risk	Charter is vulnerable to financial distress in the short term.
High Risk	Charter could be vulnerable to financial distress.
Moderate Risk	Area(s) for improvement have been identified.
Low Risk	Charter demonstrates strong financial performance across all metrics.

In the long term, policymakers in Arizona and beyond should consider reforms to realize the full potential of financial data. Because measures of financial health capture important information about school quality that test-based accountability metrics miss, they should have a central role in evaluating performance, especially for schools of choice where parents can hold educators directly accountable for meeting their child's needs. Parents choose schools based on more than just test scores, valuing concerns such as school safety, discipline, learning environment, and special programs. Since schools are financed based on enrollment, a focus on financial health and measures of demand is a focus on parental satisfaction.

The tax-exempt bond market for charter schools provides valuable insight into how financial measures can be integrated with current accountability systems or used to reimagine how schools are evaluated altogether. The most important lesson that policymakers can learn is how ratings agencies integrate financial health and the underlying demand signals in their assessments. In the context of state accountability systems, not only would this ensure that tax dollars are being used responsibly, it would also recognize how well schools satisfy parents. By unlocking the full potential of financial data, Arizona has the opportunity to become a national model for charter school evaluation that moves beyond test scores.

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INTRODUCTION

Arizona's approach to charter school authorizing has cultivated astounding results. In recent years, the state's charter students have demonstrated substantial gains across all 4th and 8th grade NAEP subjects tested, outpacing the growth of students in the state's traditional school districts and the U.S. average.[1] In fact, Arizona's charter schools now score on par with students in high-performing states such as Massachusetts and New Hampshire, despite having more challenging demographics.[2] But what's most remarkable is that they're clearly satisfying parent demands as an increasing number of families are choosing charters over other options: in the 2014–15 school year, nearly 1 in 5 Arizona public school students attended a charter, and wait-lists as long as 20,000 students have been reported.[3]

A primary feature of Arizona's approach is its low barriers to entry, which allow promising operators to implement innovative educational models with relatively fewer bureaucratic hurdles compared to authorizing practices in other states. Inevitably, some operators fall short of meeting parent and community needs and close as a result, and while these

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1 Ladner, Matthew. "The Case for School Choice in 2018." Reason Foundation. Los Angeles. 23 Jan. 2018. Panel presentation.

2 Ibid.

3 Ladner, Matthew. "In Defense of Education's 'Wild West'" *EducationNext* 18 (2018) *EducationNext.org*. Web. <http://educationnext.org/in-defense-educations-wild-west-charter-schools-thrive-four-corners-states/> 25 June 2018.

failures can be disruptive, they're also a sign of a healthy ecosystem that empowers parents to decide whether a school flourishes or shutters its doors. According to Matthew Ladner of the Charles Koch Institute, "The conclusion is that parents are taking the lead and closing schools they don't desire. And they do this with an absolutely brutal efficiency that no state bureaucracy will ever emulate."

Of course, this doesn't mean that authorizers have no role to play in overseeing charters and the tax dollars that support them, especially in instances where parents have clearly spoken. An example of this need is the abrupt closure of the Discovery Creemos Academy in January, which left hundreds of families in search of a new school and many teachers without jobs.[4] At the time, Arizona law didn't allow the Arizona State Board for Charters Schools (ASBCS) to close charters for financial reasons, and Discovery Creemos Academy remained open despite showing substantial signs of fiscal distress years before it closed, including substantial enrollment losses.

School districts across the U.S. face fiscal distress, yet financial health remains on the sidelines of state accountability systems, with few consequences for mismanaging education dollars and putting students, teachers, and taxpayers at risk. In recent years, the charter sector has led the way in promoting greater transparency, with numerous authorizers adopting financial performance frameworks that track and report on key measures of financial health. The Arizona State Board for Charter Schools adopted its own framework in 2012, which provides clear performance expectations and rates charters on financial outcomes. With the recent passage of HB 2663, which allows ASBCS to close charters that fail to meet these financial standards, now is a critical time to assess how this framework is working and implement needed improvements.

4 Philip, Agnel and Ricardo Cano. "Dozens of Arizona charter schools are at risk of closing due to financial woes." *The Republic*. 1 March 2018. AZCentral.com. Web. <www.azcentral.com/story/news/local/arizona-education/2018/03/01/arizona-charter-schools-risk-closing-due-financial-woes/364727002/> 25 June 2018.

PART 2

UNDERSTANDING FINANCIAL TRANSPARENCY

A robust system of financial transparency comprises three primary components that work together to provide timely and user-friendly data for stakeholders such as parents, superintendents, and legislators:

1) **Allocation Transparency:** The distribution of education revenues, including the collection of formulas and provisions that determine funding allotments at both the district and school levels and the actual resources they receive.
2) **Expenditures Transparency:** How education dollars are ultimately spent by districts and schools, highlighting the various categories of outlays that consume these resources, such as administrative salaries and capital expenses.
3) **Financial Health Transparency:** The short- and long-term viability of districts and schools and the extent to which they're susceptible to financial distress, accounting for factors such as debt obligations, liquidity, and revenue trends.

These elements of financial transparency can be used to explore critical questions about the foundation of public education, including:

- Are resources allocated in a manner that accounts for student need?
- To what extent are tax dollars being used productively?
- Are funding streams fair and efficient?
- Is spending aligned with educational strategy?
- Are education dollars reaching the students they're intended for?
- Are the financial practices of districts and schools financially sustainable?

Providing stakeholders with the infrastructure to address such inquiries can help them make more-informed evaluations and decisions, but most states neglect each component of financial transparency to at least some degree. For example, it's virtually impossible to find data that overlay spending with outcomes to measure productivity,[5] and expenditures are rarely reported at the school level even though research has found widespread problems with district allocation practices.[6] But perhaps most problematic is the lack of attention given to financial health, which has consequences in classrooms and communities including chronic underperformance, bankruptcy, and even closure. Unfortunately, financial distress is common, as superintendents and board members often put short-term political gains ahead of long-term viability, as Marguerite Roza, Amber Northern, and Michael Petrilli explain:[7]

> *Districts go insolvent primarily because there are insufficient counter-pressures on their leaders to stay fiscally solvent. Existing leaders are often rewarded—through elections, appointments, or re-appointments—when they make promises that obligate monies down the road. Employees of the system often push for higher salaries, expanded benefits, retirement sweeteners, and other advantages that districts simply can't afford, but that*

5 Roza, Marguerite. "Leveraging Productivity for Progress: An Imperative for States." Edvance Research Inc., 2013. Web. <http://edunomicslab.org/wp-content/uploads/2015/03/state-imperative-SEAF.pdf> 16 June 2018. 10-15.

6 Roza, Marguerite. *Educational Economics: Where Do School Funds Go?* Washington, D.C.: Urban Institute Press, 2010. 47-60. Print.

7 Roza, Marguerite, Amber M. Northern, and Michael J. Petrilli. "Sensible Responses to Insolvent School Districts." *Flypaper*. Thomas B. Fordham Institute. 12 Aug 2015. Web. <https://edexcellence.net/articles/sensible-responses-to-insolvent-school-districts> 11 June 2018.

union-friendly boards agree to anyway. Such long-term obligations are largely what put districts in the hole.

An example of this is Los Angeles Unified School District (LAUSD), which for years has ignored dire warnings about its unsustainable structural deficit that could overwhelm its core operations and lead to state-takeover.[8] LAUSD leaders have failed to address ballooning pension and benefit obligations while overseeing a hiring surge despite significant enrollment declines.[9] But LAUSD isn't alone. Places such as Chicago, Detroit and Philadelphia face fiscal challenges of their own as decades of mismanagement have put districts and students across the U.S. at risk, with little transparency or accountability.[10]

2.1 FINANCIAL TRANSPARENCY IN THE CHARTER SECTOR

Measures of financial health are usually assigned to the sidelines of state reporting and accountability systems, despite the dire consequences of fiscal mismanagement. But in recent years the charter sector has taken positive steps toward greater transparency as many authorizers use some form of a financial performance framework to evaluate outcomes.[11] This helps ensure that charters are good stewards of tax dollars and operate in a financially sustainable manner that avoids the same fiscal cliffs that many districts are teetering over. According to the National Association of Charter School Authorizers (NACSA), performance frameworks allow charters to know what's expected of them and can be used to inform decisions throughout the term of a charter contract.[12] NACSA recommends that authorizers establish frameworks in three separate areas to evaluate performance:[13]

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8 Snell, Lisa, Aaron Garth Smith, Tyler Koteskey, Marc Joffe, and Truong Bui. "A 2018 Evaluation of LAUSD's Fiscal Outlook: Revisiting the Findings of the 2015 Independent Review Panel." Reason Foundation, 2018. Web. <https://reason.org/wp-content/uploads/2018/06/2018-evaluation-of-lausd-fiscal-outlook.pdf> 13 June 2018.

9 Ibid.

10 Roza et. al. "Sensible Responses to Insolvent School Districts."

11 National Association of Charter School Authorizers, and Local Initiatives Support Corporation. "Charter Lenders and Charter Authorizers: Can We Talk?" 2015. Web. <http://www.qualitycharters.org/wp-content/uploads/2015/05/LendersAuthorizersReport_final.pdf> 10 June 2018. 21

12 National Association of Charter School Authorizers. "Core Performance Framework and Guidance." 2013. Web. <http://www.qualitycharters.org/wp-content/uploads/2016/01/CorePerformanceFrameworkAndGuidance.pdf> 10 June 2018.

13 Ibid.

1. **Academics:** The success of the educational program
2. **Operational:** Organizational effectiveness
3. **Financial:** The financial viability of a school

The role of the financial framework in particular is to assess the financial stability of charters and highlight those that are experiencing difficulties or might be trending in this direction.[14] This is done by measuring both near-term and long-term measures of financial health, such as financial flexibility and debt obligations. The following sections analyze and recommend short-term enhancements to Arizona's financial performance framework, and also explore how financial health transparency might evolve to play a more central role in informing performance in K-12 education in the long term.

14 Ibid. 42.

PART 3

ARIZONA'S FINANCIAL PERFORMANCE FRAMEWORK

3.1 OVERVIEW

In 2012, the Arizona State Board for Charter Schools adopted its own financial framework, which is intended to "communicate the Board's expectations for ensuring that all charter holders in its portfolio are viable organizations with strong fiscal management practices"[15] without infringing upon a charter's autonomy in determining how funds are spent.[16] ASBCS's financial framework consists of three near-term measures that indicate a charter's financial position for the upcoming year, and three sustainability measures that are meant to depict a charter's financial position over time.[17] These measures and their accompanying performance targets are provided in Table 1.

15 "Interpreting the Financial Performance Dashboard." Arizona State Board for Charter Schools. asbcs.az.gov. 2016. Web. <https://asbcs.az.gov/sites/default/files/documents/files/Interpreting%20the%20Financial%20Dashboards%208-2016.pdf> 10 June 2018.

16 "Financial Performance Framework and Guidance." Arizona State Board for Charter Schools. asbcs.az.gov. 10 October 2017. Web. <https://asbcs.az.gov/sites/default/files/documents/files/Financial%20Guidance%20Document%20Approved%2010-2017.pdf> 10 June 2018. 2.

17 Ibid.

TABLE 1: ASBCS'S FINANCIAL FRAMEWORK MEASURES

Indicator Type	Measure	Description	Performance Target
Near-Term	Going Concern	Risk that charter holder will cease operations within a year.	No going concern issue identified in the charter's annual audit.
	Unrestricted Days Liquidity	How many days a charter can pay its expenses without an influx of cash.	At least 30 days.
	Default	Whether a charter has been issued a formal notice of default by a lender.	No default on material loans.
Sustainability	Net Income	Examines whether a charter's revenues exceed its expenses.	Greater than or equal to $1.
	Fixed Charge Coverage Ratio	Whether a charter has sufficient cash flow to cover fixed obligations or charges.	Greater than or equal to 1.1.
	Cash Flow	Change in cash balance from one fiscal year to another.	Three-year cumulative cash flow is positive.

Source: "Interpreting the Financial Performance Dashboard." Arizona State Board for Charter Schools. asbcs.az.gov. 2016. Web. <https://asbcs.az.gov/sites/default/files/documents/files/Interpreting%20the%20Financial%20Dashboards%208-2016.pdf> 10 June 2018.

For each measure and its accompanying performance targets, ASBCS has developed ratings that are used to evaluate a charter's financial situation as described in Table 2. These individual ratings are then rolled up to determine two summative ratings: the Board's Financial Performance Standard and the Board's Financial Performance Expectations. To meet the Board's standard, a charter must not receive more than one *Does Not Meet Standard* rating and cannot receive any *Falls Far Below Standard* ratings in the most recent audit reporting package. A charter's financial performance standard rating for the most recent audited fiscal year and the prior audited fiscal year are then used to determine whether it meets the Board's expectations. A charter does not meet this threshold if it either fails to meet the Board's standard for two consecutive years or receives one or more *Falls Far Below Standard* ratings in the most recent year's audit.[18]

[18] Ibid. 5.

TABLE 2: FINANCIAL PERFORMANCE FRAMEWORK RATINGS

Measure	Possible Ratings	Description
Going Concern	Meets Standard	The most recent audit reporting package does not include an explanatory paragraph in Independent Auditor's Report or disclosures in the note to the financial statements.
	Falls Far Below Standard	Independent Auditor's Report for the most recent audit reporting package includes an explanatory paragraph and disclosure is included in notes to the financial statements; OR Disclosure included in notes to the financial statements for the most recent audit reporting package, but no modification to Independent Auditor's Report.
Unrestricted Days Liquidity	Meets Standard	30 or more days liquidity
	Does Not Meet standard	At least 15 days liquidity but fewer than 30 days liquidity.
	Falls Far Below Standard	Fewer than 15 days liquidity.
Default	Meets Standard	Charter holder is not in default on material loans.
	Falls Far Below Standard	Charter holder is in default on material loans.
Net Income	Meets Standard	Net income is greater than or equal to $1.
	Does Not Meet Standard	Net income is zero or negative.
Fixed Charge Coverage Ratio	Meets Standard	Fixed Charge Coverage Ratio is equal to or exceeds 1.10.
	Does Not Meet Standard	Fixed Charge Coverage Ratio is less than 1.10.
Cash Flow	Meets Standard	Three-year cumulative cash flow is positive.
	Does Not Meet Standard	Three-year cumulative cash flow is negative.

Source: "Financial Performance Framework and Guidance." Arizona State Board for Charter Schools. asbcs.az.gov. 10 October 2017. Web. <https://asbcs.az.gov/sites/default/files/documents/files/Financial%20Guidance%20Document%20Approved%2010-2017.pdf> 10 June 2018. 8-14.

Charters that fail to meet ASBCS's financial expectations are required to submit a financial performance response at specified times such as five-year interval reviews, contract renewal, and expansion requests.[19] ASBCS may also consider a charter's financial performance at other times, such as when a charter receives an "F" under the state accountability system and when a charter fails to meet the standards set forth in the academic performance framework for three consecutive years.[20] Importantly, recent legislation empowers ASBCS to close charters that fail to meet its financial performance standards,[21] although the infrastructure to exercise this authority hasn't been established.

3.2 ANALYSIS AND FINDINGS

Historical data obtained from ASBCS and publicly available reports[22] were used to analyze the financial performance outcomes of Arizona charter schools as well as the framework itself. Table 3 summarizes the financial performance outcomes for Arizona's charters from FY 14 to FY 16.

TABLE 3: ARIZONA CHARTER SCHOOLS, FINANCIAL PERFORMANCE FRAMEWORK OUTCOMES, FROM FY14 TO FY16

Indicator	Measure	Year	Meets	Does Not Meet	Falls Far Below	Total	% Far Below and/or %Does Not Meet
Near Term	Going Concern	2014	359	N/A	35	394	8.9%
		2015	380	N/A	24	404	5.9%
		2016	398	N/A	12	410	2.9%
		TOTAL	1137	N/A	71	1208	5.9%
	Unrestricted Days Liquidity	2014	268	78	48	394	32.0%
		2015	301	62	41	404	25.5%
		2016	316	54	40	410	22.9%
		TOTAL	885	194	129	1208	26.7%
	Default	2014	389	N/A	5	394	1.3%
		2015	403	N/A	1	404	0.2%
		2016	407	N/A	3	410	0.7%
		TOTAL	1199	N/A	9	1208	0.7%
Sustain-ability	Net Income	2014	236	158	N/A	394	40.1%
		2015	250	154	N/A	404	38.1%
		2016	294	116	N/A	410	28.3%
		TOTAL	780	428	N/A	1208	35.4%
		2014	220	160	N/A	380	42.1%

19 Ibid. 17-22.

20 Ibid.

21 Arizona HB 2663 <https://www.azleg.gov/legtext/53leg/2r/bills/hb2663p.pdf>

22 Calculations based on data obtained from ASBCS include financial performance framework outcomes and school closure data. Publicly available enrollment data were obtained from http://www.azed.gov/accountability-research/data/. Any errors or omissions are my own.

Indicator	Measure	Year	Meets	Does Not Meet	Falls Far Below	Total	% Far Below and/or %Does Not Meet
	Fixed Charge Coverage Ratio	2015	246	148	N/A	394	37.6%
		2016	268	130	N/A	398	32.7%
		TOTAL	734	438	N/A	1172	37.4%
	Cash Flow	2014	203	191	N/A	394	48.5%
		2015	213	191	N/A	404	47.3%
		2016	330	80	N/A	410	19.5%
		TOTAL	746	462	N/A	1208	38.3%
Overall	Meets Board's Financial Performance Standard	2014	184	210	N/A	394	53.3%
		2015	224	180	N/A	404	44.6%
		2016	272	138	N/A	410	33.7%
		TOTAL	680	528	N/A	1208	43.7%
	Meets Board's Financial Performance Expectations	2014	226	168	N/A	394	42.6%
		2015	268	136	N/A	404	33.7%
		2016	293	117	N/A	410	28.5%
		TOTAL	787	421	N/A	1208	34.9%

Data Source: Calculations based on data provided by ASBCS.

Three key takeaways emerge from this assessment.

#1 The Financial Performance Framework's roll-up mechanism fails to make important distinctions in performance.

Arizona's financial performance framework captures key measures of financial health and provides useful insights, but its roll-up mechanism is a blunt instrument that fails to meaningfully differentiate performance levels. Between FY14 and FY16, on average nearly 44% of charters evaluated did not meet the Board's financial standard.

While the labeling itself is not problematic—underperforming charters *should* be identified as such—the roll-up mechanism does not distinguish between charters in imminent danger of financial distress and those that need to improve sustainability metrics for long-term financial health. Of the 138 charters that did not meet ASBCS's financial standard in 2016, 44 received one or more *Falls Far Below* ratings on the framework's more serious near-term indicators, and the remaining 94 received two or more *Does Not Meet* ratings. Substantial variation in performance is observed in this group, ranging from a charter that missed out on two sustainability measures to a charter that failed all six measures including three *Falls Far Below* ratings. Lumping these performance levels together diminishes the framework's usefulness as an evaluative tool for ASBCS by making it difficult to identify charters that might require additional attention, as the financial challenges are overstated for some charters and understated for others. As a result, stakeholders might be misled by the summative ratings as there is greater variation in performance than what is presented.

This lack of nuance also poses challenges in evaluating mature charters that have more complex accounting requirements. For example, in recent years BASIS Schools has refinanced debt in order to take advantage of low interest rates, a financial strategy that has saved the network millions of dollars and benefited its students.[23] But because GAAP accounting rules require these expenses to be written off immediately, BASIS incurs a one-time accounting loss for each refinance, thus affecting its Net Income and Fixed Charge Coverage Ratio measures.[24] This has resulted in the charter failing to meet the Board's standard for several years, despite the fact that the charter is not financially vulnerable. In fact, BASIS earned a BB rating[25] from the credit agency Standard & Poor's in 2015 after undergoing intense review that scrutinized its financials and myriad other outcomes that are indicative of financial health, and a recent *U.S. News Report* ranking of public schools lists BASIS as having the top seven public high schools in Arizona and the five best high schools in the entire U.S.[26] The inclusion of BASIS among financially underperforming charters exemplifies the financial framework's lack of meaningful differentiation.

#2 Closed charter schools are more likely to be financially distressed schools with low enrollment.

Financial problems are often the root cause of charter failure. Table 4 shows the financial outcomes in the year preceding closure for charters that shutdown between FY14 and FY16. When compared with the overall financial data shown above in Table 3, it is clear that the financial health of these charter schools is substantially worse than for charters overall.[27] For example, 29% of closed charter schools received a *Falls Far Below* rating for Unrestricted Days Liquidity in their year preceding closure compared to an average of about 11% for all charters, and 75% of closed charters schools failed the Cash Flow measure

23 Based on conversations with BASIS leadership.

24 Ibid.

25 Because of the way charters are rated—ratings agencies generally place substantial weight on industry risk, which isn't indicative of an individual charter's financial performance—ratings for BASIS and charters are generally deflated by factors outside of their control.

26 See https://www.usnews.com/education/best-high-schools/arizona/rankings

27 Data for closed charters were examined at the school level while financial accountability ratings are assigned to charter holders, which sometimes have multiple schools. However, in most instances, charter holders have only one school.

versus an average of about 38% for all charters. In total, three-quarters of closed charter schools did not meet the Board's financial standard in the fiscal year preceding closure.

TABLE 4: FINANCIAL PERFORMANCE FRAMEWORK OUTCOMES FOR ARIZONA CHARTERS CLOSED BETWEEN FY 14 AND FY 16

Indicator	Measure	Meets	Does Not Meet	Falls Far Below	Total	% Far Below and/or %Does Not Meet
Near Term	Going Concern	38	N/A	18	56	32.1%
	Unrestricted Days Liquidity	28	12	16	56	50.0%
	Default	54	N/A	2	56	3.6%
Sustainability	Net Income	24	32	N/A	56	57.1%
	Fixed Charge Coverage Ratio	19	32	N/A	51	62.7%
	Cash Flow	14	42	N/A	56	75.0%
Overall	Meets Board's Financial Performance Standard	14	42	N/A	56	75.0%

Data Source: Calculations based on data provided by ASBCS. Financial outcomes for closed charters are for the fiscal year immediately preceding closure. In several instances these data were not available and outcomes for two years prior were used instead. Closed charters without published financial outcomes were not included in this table. Summative figure for Unrestricted Days Liquidity reflects charters that received either *Falls Far Below* or *Does Not Meet*.

A primary cause of financial distress is low enrollment, which often approximates a charter's ability to meet the needs of the community it serves effectively. Because charters are schools of choice, those that fail to satisfy parents are unlikely to attract and retain enough students to generate the revenue needed to be financially stable. In Arizona, this appears to be a force behind the financial problems of many closed schools. A plurality of the 56 charters that shut their doors between FY14 and FY16—about 43%—cited enrollment as the primary cause as shown in Table 5. In fact, the median enrollment for these schools was only 59 students, with just four serving 200 students or more as shown in Table 6. To put this in perspective, the median charter school in Arizona in FY17 enrolled

235 students and more than half enrolled 200-plus students. Importantly, approximately two-thirds of closed charters experienced flat or declining enrollment in their final year of operation with just more than half experiencing drops of 5% or more.[28] This is especially notable as it occurred during a time period when statewide charter enrollment grew substantially.

TABLE 5: CAUSES OF CLOSURE FOR ARIZONA CHARTER SCHOOLS CLOSED BETWEEN FY14 AND FY16

Reason for Closure	Count
Low Enrollment	24
Charter Contract Expired, No Application Submitted	6
Charter Not Renewed	5
Renewal Condition/Close Site	5
Merged with Another School Site or Converted to District School	5
Surrendered Under Duress or Financial Issues	4
Facility Issues	3
Failing to Meet Academic Standards	2
Other	2

Source: Calculations based on data provided by ASBCS. Categories with similar nomenclature were merged and the "Other" category was used to simplify data.

TABLE 6: ENROLLMENT DATA FOR CLOSED CHARTERS AND ALL ARIZONA SCHOOLS

	Closed Charters FY 14-FY 16	AZ Charters FY 17
Total Schools	56	541
Median Enrollment	59	235
200+ Students	4 (7%)	307 (56.7%)

Source: Calculations based on data provided by ASBCS and from http://www.azed.gov/accountability-research/data/.

28 Several closed charters did not have the enrollment data required for this analysis and are not included in enrollment figures.

#3 Arizona's performance frameworks are disconnected.

ASBCS's three performance frameworks—financial, academic and operational—largely function in silos, as is the case for virtually all frameworks employed by authorizers throughout the country. Although it makes sense to group the respective measures by performance area, the manner in which data are reported and evaluated fails to illustrate a comprehensive and streamlined picture of performance. This trifurcated approach makes it difficult to unearth important trends that might lend valuable insight into a charter's performance, and leaves stakeholders to connect the dots themselves as needed.

For example, financial measures might capture important signals about parental priorities, such as specialized curricula and school safety, that might not be evident in test scores (e.g. a performing arts school might have only average test scores yet be highly popular with parents, resulting in strong enrollment demand and solid financial health). And persistently poor operational governance might be indicative of larger issues that spill over into classrooms. For most stakeholders, the natural inclination is to focus primarily on test scores while using financial and operational data in a supporting role. But as the following sections will illustrate, this approach to evaluation misses a significant opportunity to more accurately convey whether a charter is serving its community effectively and using tax dollars with fidelity.

PART 4

RECOMMENDATIONS

The power of financial data is yet to be fully tapped by U.S. education systems, not only to flag districts and charters that are on the verge of fiscal distress but also to highlight those that are meeting parental demands effectively and using tax dollars in a financially responsible manner. Arizona has an opportunity to pioneer the tapping of this potential. Policymakers should pursue four short-term basic reforms to increase transparency, provide ASBCS with a more practical evaluation tool, and work toward more cutting-edge and long-term changes. Such improvements would make Arizona a national model for transparency in public education.

4.1 SHORT-TERM REFORMS

Reform #1: Revamp the Summative Ratings

Perhaps the most important short-term change is to revamp the financial framework's summative ratings, which currently muddle transparency by failing to meaningfully differentiate among performance levels. The current summative ratings could be replaced by four performance levels as shown in Table 7: Low Risk, Moderate Risk, High Risk, and Imminent Risk. The label "Risk" conveys a central purpose of the framework, which is to approximate the degree to which a charter's financial position and institutional practices make it vulnerable to failure. Regardless of nomenclature, increasing the number of ratings labels will enhance transparency for parents, taxpayers and ASBCS by providing a more nuanced assessment of performance. Table 8 shows the ratings and their respective performance levels, which are based on historic data and the need to more effectively differentiate between charters that are at significant risk for closure and those that simply need to strengthen performance to ensure long-term sustainability.

TABLE 7: DESCRIPTIONS OF REVAMPED SUMMATIVE RATINGS

Rating	Description
Imminent Risk	Charter is vulnerable to financial distress in the short term.
High Risk	Charter could be vulnerable to financial distress.
Moderate Risk	Area(s) for improvement have been identified.
Low Risk	Charter demonstrates strong financial performance across all metrics.

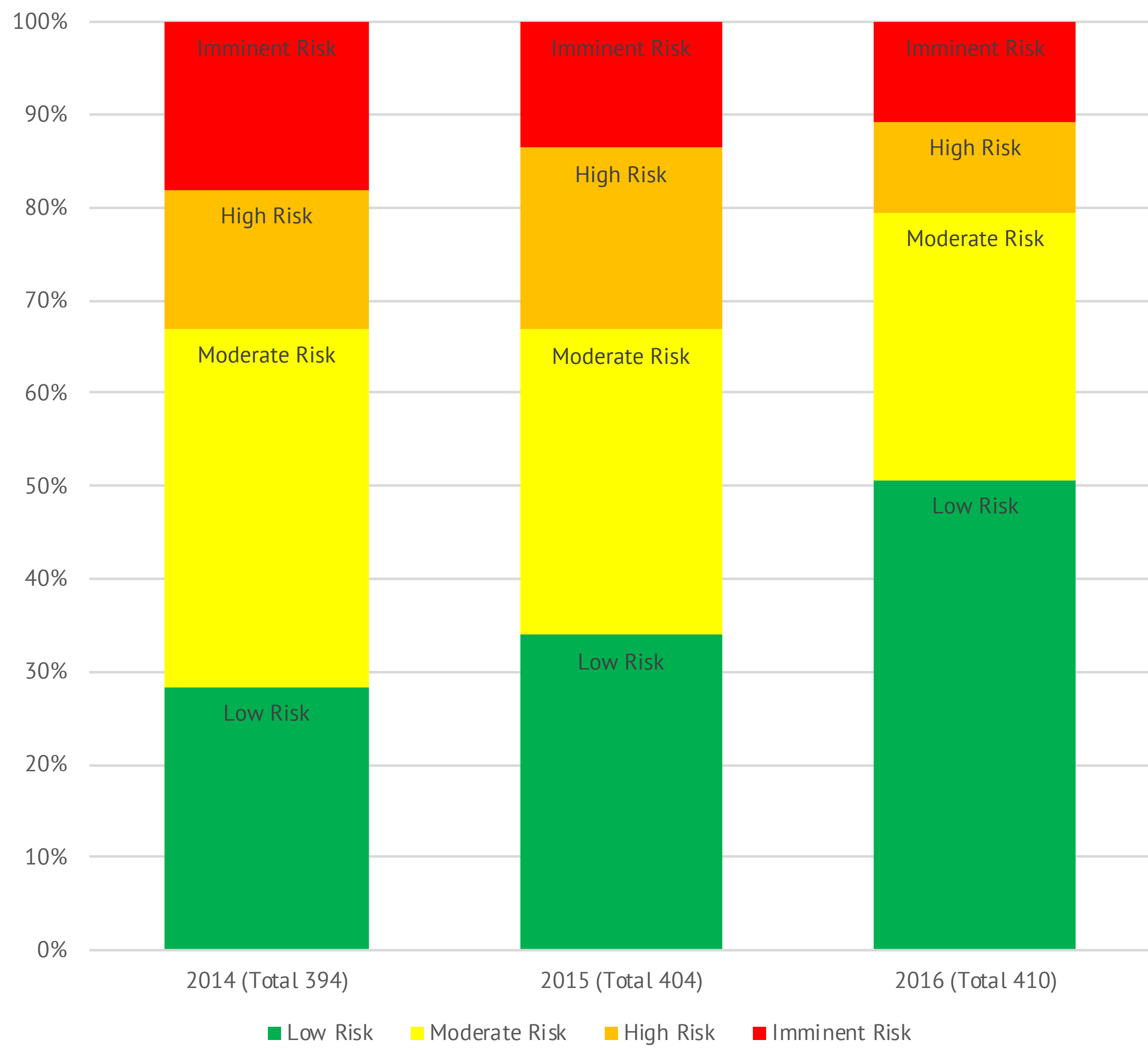
TABLE 8: REVAMPED SUMMATIVE RATINGS PERFORMANCE LEVELS

Rating	Financial Performance Area
Imminent Risk	One or more *Falls Far Below*
High Risk	No *Falls Far Below* Three or Four *Does Not Meet*
Moderate Risk	No *Falls Far Below* One or two *Does Not Meet*
Low Risk	No *Falls Far Below* No *Does Not Meet*

Note: ASBCS could also consider integrating a longitudinal flag that highlights districts that are rated High Risk for consecutive years. For example, a district rated High Risk for two or three consecutive years without improving could be flagged for possible interventions.

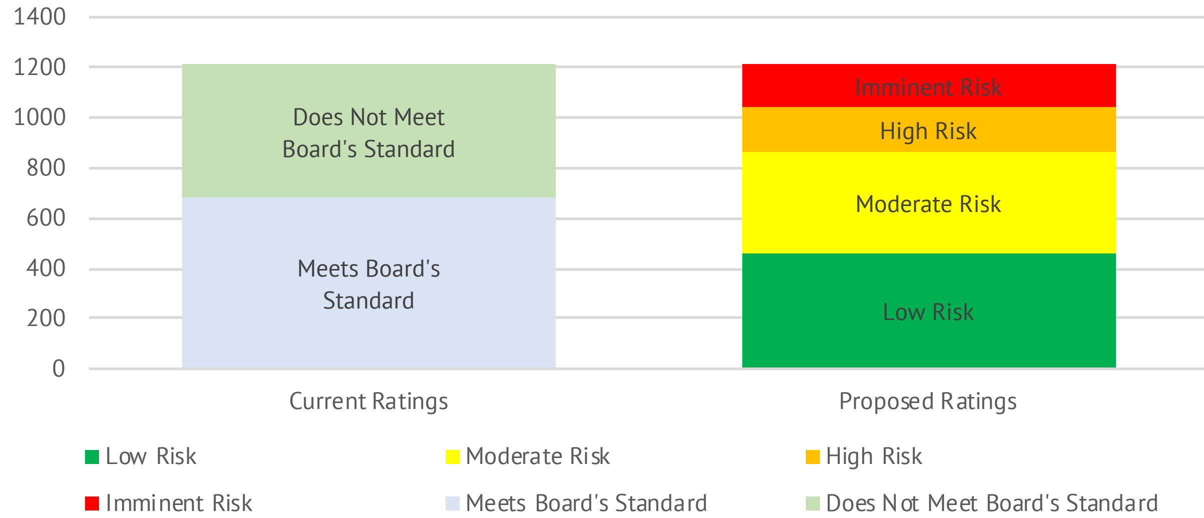
Applying these ratings to actual FY14–FY16 data yields the modeled results displayed in Figure 1, and Figure 2 compares the aggregate of these ratings with those generated by ASBCS's current methodology during the same time period. Notably, the proposed methodology flags an average of about 14% of charters as *Imminent Risk* and 15% as *High Risk*, indicating the severity of level of each group's shortcomings while also providing ASBCS with a more practical starting point to further evaluate outcomes with 44 charters in the most serious category in FY16. In comparison, the current financial performance standards identified an average of 44% of charters for financial underperformance, including 138 flagged in FY 16, a group with substantial variation in performance as previously noted. To assess the revamped ratings, when charters that closed between FY14 and FY16 are isolated and the proposed standards are applied to their financial outcomes in the year preceding closure, about 64% are flagged as either *Imminent Risk* or *High Risk* as shown in Figure 3. This indicates that even though the new standards flag substantially fewer charters overall, those that are the most financially unstable are still likely to be captured, which would help ASBCS to direct resources more efficiently and provide a fairer evaluation of performance.

FIGURE 1: FY14-FY16 MODELED FINANCIAL RATINGS USING PROPOSED METHODOLOGY



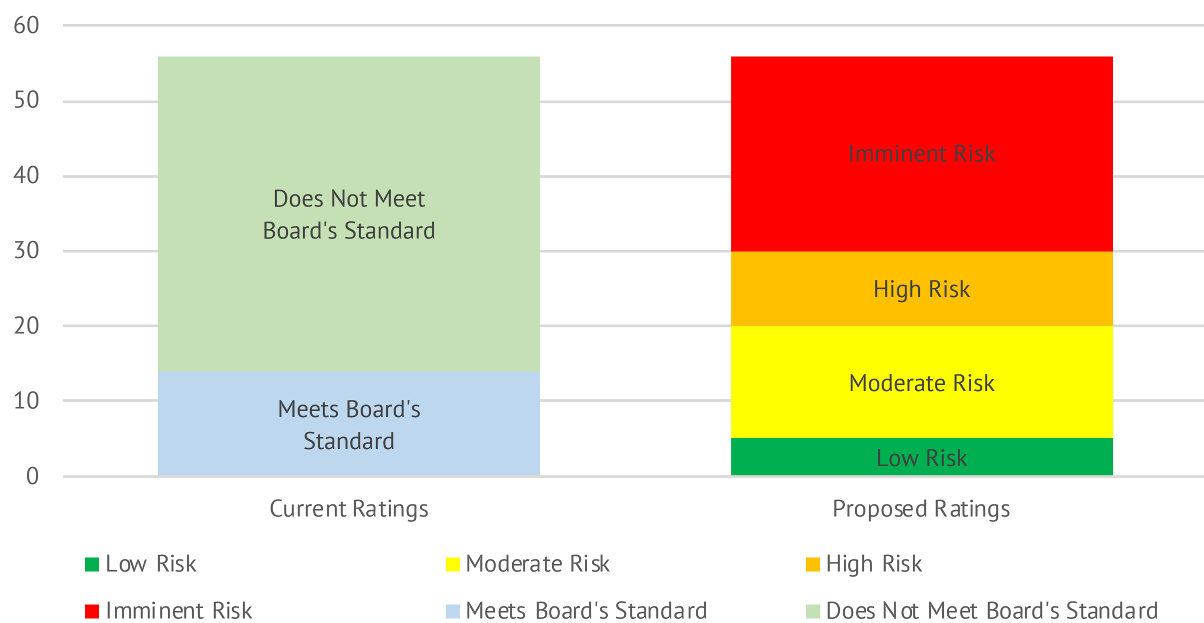
Source: Calculations based on data provided by ASBCS using the revamped performance levels described in Table 8.

FIGURE 2: FY14-FY16 FINANCIAL OUTCOMES FOR ALL ARIZONA CHARTERS: CURRENT RATINGS VS. PROPOSED RATINGS:



Source: Calculations based on data provided by ASBCS. Proposed Ratings were calculated using the revamped performance levels described in Table 8.

FIGURE 3: FINANCIAL OUTCOMES FOR CHARTERS CLOSED BETWEEN FY14-FY16: CURRENT RATINGS VS. PROPOSED RATINGS



Source: Calculations based on data provided by ASBCS. Proposed Ratings were calculated using the revamped performance levels described in Table 8.

Reform #2: Add Enrollment Growth as a Sustainability Measure of Financial Performance

Enrollment is an especially critical metric for schools of choice because they can't rely on residential assignment to fill seats. Not only is enrollment often related to financial distress, it also provides valuable insight into whether a charter is using tax dollars to meet the needs of a community. This is why enrollment is a factor that ratings agencies consider when assessing a charter's risk as detailed in section 4.2 below. As such, ASBCS should incorporate enrollment growth as a measure in its financial performance framework. This would serve as a useful flag for financial risk and also provide rich context when evaluating the financial data of charters flagged for possible intervention.

For example, a *High Risk* charter with declining enrollment might have more difficulty becoming financially healthy than one that has stable or growing enrollment. One option is to include enrollment growth as a sustainability measure of performance by assigning *Does Not Meet* to charters based on an average of enrollment growth in each of the three most recent years as shown by the example in Table 9. Evaluating enrollment trends over a three-year horizon allows for normal variation in student populations, including atypical events that might not be indicative of problems, while also giving newer charters time to stabilize before they're evaluated on this measure. Setting the performance threshold at somewhere between a decline of 3%–5% seems to strike a good balance for a cut-point. A more aggressive threshold might flag enrollment losses that charter leaders can readily adjust to, while a less aggressive threshold might fail to highlight charters with potentially deep structural issues that could make right-sizing difficult or unlikely. Of the 348 charters that were rated in FY16 and had the enrollment data required for this calculation, 24.7% had a decline of 3% or more and 17.5% had a decline of 5% or more.

Additionally, ASBCS should also explore ways to collect and report on waitlist and student retention data for informational purposes, which would provide even greater context for performance as they similarly indicate a charter's ability to meet parent needs and achieve financial stability. These figures aren't currently collected in any official capacity by the state, even though charter leaders should have them readily available. To be sure, collecting these data might present logistical challenges that need to be worked out, including considerations such as methodology and verification, but ASBCS should begin taking steps to assess how this could be done. This would further increase transparency and ensure that these data are front-and-center when ASBCS evaluates outcomes.

TABLE 9: EXAMPLE ENROLLMENT GROWTH CALCULATION
The annual enrollment growth in the example data below are -10%, 2.2%, and -8.7% for an average annual growth rate of -5.5%. For example, the growth between the 2014–15 and 2015–16 school years would be calculated as (225–250)/250. This charter would be assigned a *Does Not Meet* rating for the Enrollment Growth metric.
2017–18 Enrollment (Current): 210
2016–17 Enrollment: 230
2015–16 Enrollment: 225
2014–15 Enrollment: 250

Reform #3: Enhance Financial Reporting

ASBCS's reporting dashboards allow stakeholders to access data by individual charter school for all three performance frameworks. While this is a good start, some relatively minor adjustments can make this information even more accessible and functional. Most importantly, it's currently not possible to compare outcomes across schools, which means that policymakers and campus leaders can't easily do things such as benchmark performance levels or summarize statewide data by measure and summative rating (e.g. the percentage of charters that received *Meets Standard* for Unrestricted Days Liquidity). ASBCS should create an interactive report that shows the outcomes and ratings by measure for every charter in Arizona, which should also include pertinent summary data.[29] To make it easier to access, this information could also be integrated with Arizona's Accountability & Research website, and each performance framework rating could be added to the state's School Report Cards in order to increase transparency even further.

Reform #4: Develop the Infrastructure for Effective Intervention Decisions

The recent passage of HB 2663 allows ASBCS to close charters that aren't meeting the standards set forth in its financial performance framework, substantively increasing the financial metric's importance.[30] Policymakers should give careful consideration as to how this policy shift is implemented, especially given the aforementioned problems with the current methodology. Importantly, *High Risk* or *Imminent Risk* designations alone (or whatever ratings ASBCS adopts) should never result in automatic closure. Rather, the

[29] Texas provides an example of what this could look like. https://pryor.tea.state.tx.us/Tea.CharterFirst.Web/Public/OverallStats.aspx

[30] Arizona HB 2663 <https://www.azleg.gov/legtext/53leg/2r/bills/hb2663p.pdf>

financial performance framework is an initial screen that flags charters for further evaluation by ASBCS. However, after further evaluation it might be evident that a flagged charter should be closed based primarily or even solely on its financial condition in instances where a charter school is clearly financially unviable. ASBCS should develop the infrastructure needed to systematically evaluate flagged charters in a comprehensive and thorough manner that looks at financial outcomes through four lenses:

- ***Local Context:*** *Qualitative factors that aren't readily apparent in the financial measures.* Is there a sound explanation for why a charter underperformed on a given measure?

- ***Severity:*** *The extent to which a charter underperformed on a financial measure.* For example, did it barely miss the required threshold or did it perform at a level well below it, signaling a serious danger of insolvency?

- ***Trends:*** *The extent to which a charter's fiscal condition has improved or deteriorated over time.* In what direction is the charter's financial health heading?

- ***Financial Leadership:*** *The quality of a charter's plan to address its shortcomings and, if applicable, the extent to which it has executed on proposed strategies in the past.* Do the proposed strategies actually address the problem(s) and are they realistic to implement?

At this point, decisions about further interventions should be based on a mix of quantitative and qualitative factors. One option is to implement some variation of the process described below, which is designed to identify and prioritize distressed charters.

Step 1: Flagged Charters Submit a Performance Response

In general, charter authorizers should seek to minimize bureaucratic requirements that divert scarce resources away from a school's core mission, which is especially important for small charters and those struggling to improve. However, requiring flagged charters to submit a Financial Performance Response similar to the one currently used by ASBCS gives them a platform to provide local context and updated financial data, and potentially avoid other resource-consuming interventions. To promote fairness and transparency, these responses could be publicly reported online and could provide ASBCS with a valuable reference point in the event a charter continues to struggle financially in the future.

ASBCS should consider revising its current Financial Performance Response to also include staffing and expenditure data that indicate the degree to which a charter is "right-sized" (i.e. the costs of a school's operations are aligned with its enrollment). Although an authorizer should never impose requirements on how a charter spends its dollars, any conversation around financial health is incomplete without this information, which is especially important for smaller schools and those with declining enrollments. For example, the staffing patterns of a charter with 500 students should look substantially different from one with 100 students, and charters with declining enrollments need to adjust expenditures to reflect this reality. The key is to look at staffing patterns and convert dollars spent on everything from extra-curricular activities to custodial services to per-pupil figures, which will help charter leaders identify outlier expenses and evaluate trade-offs in potential cuts.[31] The bottom line is that a charter's operations should reflect the dollars it has available to spend. Bringing awareness to these patterns is a valuable first step toward financial health for operators who can then seek creative opportunities to become more efficient. For ASBCS, recognizing an inability to right-size over the course of several years is a red flag for financially distressed charters that continue to fall short of financial sustainability.

Step #2: ASBCS Assesses and Prioritizes Flagged Charters

Once underperforming charters have been identified by the financial performance framework, ASBCS will need to determine which are in need of additional interventions. Although the financial performance framework alone provides valuable information, additional structures could be developed to help assess flagged charters in a systematic manner. One option is to create a second-tier evaluation system that integrates outcomes and rates charters using both quantitative and qualitative data.

At first glance this might seem redundant, but there are several advantages to this approach. First, not all flagged charters will require additional interventions, and ASBCS will need to prioritize those that are most at risk. Providing structure to this process will help ensure fairness and also give ASBCS an opportunity to develop greater familiarity with flagged charters. Second, because flagged charters represent a relatively small subset of

[31] Roza, Margeurite. "Now Is a Great Time to Consider the Per-Unit Cost of Everything in Education." *Stretching the School Dollar: How Schools and Districts Can Save Money While Serving Students Best.* Eds. Frederick M. Hess and Eric Osberg. Cambridge: Harvard Education Press, 2010. 71-96. Print. Note: Putting expenses in per-pupil terms is an easy exercise, although this might be limited by the school-level financial data available.

the overall charter population, a more nuanced rubric can be developed that incorporates qualitative information, accounts for the Performance Response described in Step #1, and analyzes performance based on the aforementioned four lenses. Lastly, a second-tier evaluation system would also be a good opportunity to streamline performance outcomes such that financial, academic, and operational data are assessed together before decisions are made about further interventions. ASBCS could develop a second-tier evaluation process similar to how rating agencies rate bond issuances, as described in detail in section 4.2. If ASBCS goes in this direction, the Financial Performance Response described in Step #1 could be adjusted to allow charters to respond to any failed measures in the academic and operational frameworks, also giving them the opportunity to provide evidence of positive outcomes not captured by these data, such as college acceptance rates, norm-referenced test data, and indicators of parent satisfaction.

Step #3: Additional Interventions

Charters identified in Step #2 would be subject to additional interventions, which could include:

- **Review Hearings** (In-person meetings to review outcomes and plans to address shortcomings.)
- **Community Feedback** (Efforts to collect feedback from parents, school staff, and members of the community.) This could take the form of public testimony, town hall meetings, and a comprehensive survey administered by a third-party organization.
- **Third-Party Financial Reviews** (Contracting with financial experts to provide a third-party evaluation of a charter's financial health.) A benefit of this approach is that it would provide technical expertise and help insulate the process from political influence. See section 4.2 for additional information on what this might look like.

Having the infrastructure in place to effectively assess flagged charters ensures that ASBCS has the information needed to make decisions that put kids first.

4.2 LONG-TERM REFORMS

Recent steps by ASBCS and other authorizers to improve transparency are positive moves, but financial health should have a much larger role in informing the performance of both charters and traditional public schools. Current approaches to accountability focus mainly on high-stakes testing data, as is the case with Arizona's A–F Letter Grades system, on which ASBCS's academic performance framework is largely based. While it's true that test results convey valuable information, a primary criticism of test-centric accountability is that it narrowly defines school quality, incentivizing educators to make curricular adjustments that favor tested content at the expense of untested content.[32] This is exemplified by a Center on Education Policy study of 349 school districts after No Child Left Behind was enacted. It found that 62% of elementary schools had increased instructional time for English language arts and/or math, while 44% had cut time on one or more subjects or activities including science, social studies, art and music.[33]

In other words, schools are incentivized to target their programs and finances to providing things that parents don't necessarily prioritize in choosing schools, creating an existential problem for schools of choice by fundamentally altering their educational models.

The problem with this shift in priorities is two-fold: research shows little relationship between changes in test scores and improvements in later-life outcomes,[34] and parents tend to place little importance on test scores when choosing schools, instead prioritizing factors such as student safety, discipline, and a school's learning environment.[35] In other words, schools are incentivized to target their programs and finances to providing things that parents don't necessarily prioritize in choosing schools, creating an existential problem

32 Green, Jay P. "Futile Accountability Systems Should Be Abandoned." *Education Next* 17 (2017) *educationnext.org*. Web. < http://educationnext.org/futile-accountability-systems-should-be-abandoned-forum-greene/> 10 June 2018.

33 Center on Education Policy. "Choices, Changes, and Challenges: Curriculum and Instruction in the NCLB Era." Web. 2007. <https://www.cep-dc.org/displayDocument.cfm?DocumentID=312>10 June 2018>.

34 Hitt, Colin, Michael Q. McShane and Patrick J. Wolf. "Do Impacts on Test Scores Even Matter? Lessons from Long-Run Outcomes in School Choice Research." Web. American Enterprise Institute, 2018. <http://www.aei.org/wp-content/uploads/2018/04/Do-Impacts-on-Test-Scores-Even-Matter.pdf> 10 June 2018.

35 Kelley, James P., and Benjamin Scafidi. "More than Scores: An Analysis of Why and How Parents Choose Private Schools." Web. EdChoice, 2013. < https://www.edchoice.org/wp-content/uploads/2015/07/More-Than-Scores.pdf> 10 June 2018.

for schools of choice by fundamentally altering their educational models. Of course, state policymakers are bound by federal mandates that dictate things such as testing requirements and the structure of accountability systems. Nevertheless, policymakers and authorizers can begin taking steps toward putting financial health at the center of performance evaluation, which would not only promote greater transparency with tax dollars but also allow a more comprehensive picture of performance to emerge that goes beyond mere test scores and provides educators with the flexibility needed to meet parental demands. The tax-exempt bond market provides insight into what this could look like.

4.21 The Tax-Exempt Bond Market for Charter School Facilities

Charters are increasingly turning toward the tax-exempt bond market as a lower-cost source of facilities financing. The tax-exempt bond market for charters has had more than 1,100 transactions since the first issuance in 1998, and Arizona charters have been especially active with 49 issuances between 2015 and 2017 alone, tied with California for most among the states during this time period.[36] Overall, 53% of bonds are rated at issuance, a practice that has accelerated in recent years.[37] While the overall default rate for charter bonds is 5%, more than three-quarters of these were unrated at the time of issuance and the annual trend has been declining as rating agencies have developed more advanced methodologies that better integrate financial and academic outcomes.[38]

"Charters are increasingly turning toward the tax-exempt bond market as a lower-cost source of facilities financing."

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[36] "Understanding P3 Financing for Public Charter School Construction." The Bond Buyer. Webinar. 16 May 2018. Presentation.

[37] Berry, Wendy. "Charter School Bond Issuance: A Complete History, Volume 3." Charter School Advisors and Local Initiatives Support Corporation, 2015. Web. <http://www.lisc.org/media/filer_public/70/28/7028ad74-0040-49cc-9b5b-d988d738781e/2015_charter_school_bond_issuance_v3.pdf> 10 June 2018. 2.

[38] Ibid. 1-2

Notably, the default rate for bonds with an Investment Grade rating is only 1.2%, and Local Initiatives Support Corporation (LISC) has found that defaulting charters tend to have lower enrollments and underperform academically.[39] According to LISC, "Academic performance is a fundamental factor in charter school underwriting. It drives enrollment, financial strength and charter renewal."[40] This link between educational quality and financial health reveals an important relationship: investors and communities care about the same questions regarding school quality, including:

- How effectively is a charter meeting parent needs?
- Is a charter outperforming other local schools?
- Are charter leaders making sound financial decisions that minimize long-term risk and maximize the productivity of tax dollars?

There's more to bond ratings than esoteric alphanumeric scores, because what's good for investors—quality instruction, competent leadership, sustainable debt obligations, etc.—is also good for parents and taxpayers. Rating agencies have improved their methodologies over the years, thanks in large part to engaging stakeholders such as educators, authorizers and state officials, and now policymakers can learn from their practices. Standard & Poor's methodology provides an example of what the rating process looks like.

Example: Standard & Poor's Methodology for Rating Tax-Exempt Charter Bonds

The core of S&P's analysis is composed of the enterprise and financial analytical frameworks as summarized in Table 10.[41] Each risk profile contains factors that are scored based on measures that are assigned one of six ratings from "extremely strong" to "highly vulnerable", which correspond to numeric values of 1 to 6. Since S&P finds that some factors have a greater effect on credit quality than others, weights are assigned to reflect these differences. Additionally, S&P incorporates positive and negative considerations into each measure's rating as applicable, which provides them with the flexibility necessary to account for conditions that aren't formally included in the rubric, but may result in a stronger or weaker score for a given measure. Some examples of these considerations are given in the explanations below.

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39 Ibid. 3.

40 Ibid.

41 "U.S. Public Finance Charter Schools: Methodology and Assumptions." S&P Global Ratings, 2017. Web. <https://www.spratings.com/documents/20184/908554/USPF+Charter+School+Criteria12017/5ebab49e-5dd0-410d-8bae-66a7cec923e6> 10 June 2018.

TABLE 10: STANDARD &POOR'S ANALYTICAL FRAMEWORKS

Enterprise Profile			**Financial Profile**		
Factor	Weight	Measures	Factor	Weight	Measures
Economic Fundamentals	10%	-School age population	Financial Performance	45%	-Lease-adjusted MADS coverage -Excess margin -Total revenue
Industry Risk	40%	-Economic cyclicality -Competitive risk and growth	Liquidity and Financial Flexibility	25%	-Unrestricted days' cash on hand -Unrestricted reserves/debt
Market Position	30%	-Demand & competition -Statutory framework -Charter standing -Academic quality	Debt Burden	30%	-Lease-adjusted MADS burden -Debt to capitalization
Management and Governance	20%	-Strategic positioning -Risk management -Organizational effectiveness -Governance			

Source: "U.S. Public Finance Charter Schools: Methodology and Assumptions." S&P Global Ratings, 2017. Web. <https://www.spratings.com/documents/20184/908554/USPF+Charter+School+Criteria12017/5ebab49e-5dd0-410d-8bae-66a7cec923e6> 10 June 2018.

The Enterprise Framework

The enterprise profile assesses the non-financial aspects of a charter school and includes four factors as described below.

Economic Fundamentals: Measures the size and growth of a charter's service-area demographics to help determine sustainability. The primary gauge of this is school-aged population growth, with an increase of more than 5% scored as "extremely strong" and decline of 5% or more as "highly vulnerable."

Industry Risk: Provides a general baseline of risk that is common to all charter schools and is based on barriers to entry, the development of competing substitutes, and revenue diversity.

Market Position: Assesses a charter's performance in relation to other schools in its service area as a gauge of long-term success. S&P considers "demand & competition" to be the most critical component of market position and uses four primary metrics to measure this: enrollment, enrollment growth, wait-list size as a percentage of enrollment, and retention rate. Academic quality is also closely examined using state test results and outcomes such as SAT scores and graduation rates. Other considerations that might result in a stronger or weaker score include receiving a prestigious award from a state or national organization, enrollment volatility, and failure to meet state minimum standards for a grade level.

Management and Governance: Measures the strength of a charter's management team and the level of oversight provided by its governance structure. This includes evidence of articulating and achieving goals, instituting policies that effectively recognize and mitigate risks, and maintaining sufficient internal controls.

The Financial Framework

The financial profile assesses the financial strength of a charter school and includes three factors as described below.

Financial Performance: Assesses how a charter's debt servicing capability could be affected by recent and projected earnings and cash flow.[42] The most important measure of this is "Lease-adjusted maximum annual debt service (MADS) coverage," which is the number of times an organization could cover its lease-adjusted MADS from operating and non-operating cash flows. Excess margin and total revenue are also evaluated as components of financial performance. Additionally, an example of a positive consideration that could result in a stronger score is a demonstrated ability to reduce expenses without affecting quality.

Liquidity and Financial Flexibility: Assesses how cash flow and unrestricted reserves may affect debt servicing capability using two measures: Unrestricted days' cash on hand and unrestricted reserves to debt, with the former receiving greater weight.

Debt Burden: Assesses the extent to which liabilities may affect a charter's ability to service its debt. Lease-adjusted MADS as a percent of total revenue is the primary measure, with debt to capitalization considered as a secondary factor. An example of a negative consideration that might result in a weaker score is underfunded post-employment benefits obligations.

[42] Ibid.

Putting It All Together

Once the resulting framework scores have been tabulated, they are combined to determine the initial indicative rating as shown in Table 11. But the final score assigned to a charter—the indicative rating—is only established after a few additional steps.

TABLE 11: COMBINING THE ENTERPRISE PROFILE AND FINANCIAL PROFILE SCORES

		Financial Profile					
		Extremely Strong (1)	Very Strong (2)	Strong (3)	Adequate (4)	Vulnerable (5)	Highly Vulnerable (6)
Enterprise Profile	Extremely Strong (1)	a+	a+	a+	a	bbb+/bbb	bb+/bb
	Very Strong (2)	a+	a+	a+	a-	bbb/bbb-	bb/bb-
	Strong (3)	a+	a+	a	bbb+/bbb	bbb-/bb+	bb-
	Adequate (4)	a	a/a-	a-/bbb+	bbb/bbb-	bb	b+
	Vulnerable (5)	bbb+	bbb/bbb-	bbb-/bb+	bb	bb-	b
	Highly Vulnerable (6)	bbb-	bb	bb-	b+	b	b-

Source: "U.S. Public Finance Charter Schools: Methodology and Assumptions." S&P Global Ratings, 2017. Web. <https://www.spratings.com/documents/20184/908554/USPF+Charter+School+Criteria12017/5ebab49e-5dd0-410d-8bae-66a7cec923e6> 10 June 2018. Note: S&P scores are represented as lower-case letters only when conveying initial indicative ratings. Final ratings are represented as upper-case letters.

First, S&P makes any applicable adjustments to the initial profile assessments as outlined in Table 12. For example, a charter's financial assessment framework would be negatively adjusted by up to two assessment levels if its contingent liabilities are greater than unrestricted reserves. Similarly, if a charter's market position is assessed as "highly vulnerable", its enterprise framework would automatically receive the same rating to reflect the substantial risk of this score.

TABLE 12: EXAMPLES OF ADJUSTMENTS MADE TO THE INITIAL PROFILE ASSESSMENT

Framework	Reason	Adjustment
Enterprise	Regulatory review or oversight that identified deficiencies	Enterprise profile assessment generally negatively adjusted by up to two assessment levels
	Country risk assessment for U.S. is “4”, “5”, or “6”	Enterprise profile assessment generally capped at “adequate”, “vulnerable” or “highly vulnerable”
	Economic fundamentals or market position is assessed as “highly vulnerable”	Enterprise profile generally assessed “highly vulnerable” if economic fundamentals or market position presents sufficient risk
Financial	Contingent liabilities greater than unrestricted reserves, or lack of appropriate insurance coverage could cause this	Financial profile assessment generally negatively adjusted by up to two assessment levels
	Negative financial policies assessment if two or more of the following five factors are identified as negative and deemed a credit risk: transparency and disclosure, investment allocations and liquidity, debt profile, contingent liability principles, and legal structure	Financial profile assessment generally would be negatively adjusted by one assessment

Source: “U.S. Public Finance Charter Schools: Methodology and Assumptions.” S&P Global Ratings, 2017. Web. <https://www.spratings.com/documents/20184/908554/USPF+Charter+School+Criteria12017/5ebab49e-5dd0-410d-8bae-66a7cec923e6> 10 June 2018.

Next, S&P applies any applicable overriding factors. For example, high unrestricted reserves could result in an indicative rating that is one notch higher, while violation of regulatory requirements set by the charter authorizer or state legislature could result in an indicative rating that is up to three notches lower. Similarly, if certain conditions are observed, S&P might place a cap on the indicative rating. This means that an indicative rating could not exceed a given level even with positive overriding factors. For example, factors that could cap the indicative rating include significant academic weakness, rapid enrollment decline, and negative unrestricted assets. Finally, a holistic analysis is performed to illustrate a comprehensive picture of creditworthiness, which can result in a positive or negative adjustment of the indicative rating by one notch or no change whatsoever.

4.22 Three Key Insights from Ratings Agencies

As S&P's methodology shows, some aspects of credit ratings might not apply in the context of evaluating charter performance. For example, industry risk accounts for a significant share of its Enterprise Profile's risk assessment, but doesn't reflect the actual performance of any charter in particular, so states would thus have no need to incorporate this information. Nevertheless, policymakers have much to learn from ratings agencies when reimagining performance evaluation. These lessons might be applied narrowly (i.e. to charters only) or broadly (i.e. to all public schools) and could range from simply integrating financial health measures more effectively into current evaluation systems to completely overhauling test-centric accountability altogether within the confines of federal restraints. Regardless, financial health data contain important clues about performance that are waiting to be uncovered.

Key Insight #1: A Central Role for Financial Health and Measures of Demand

Ratings agencies provide insight into what a robust and fully integrated performance framework might look like. Naturally, financial health is an integral component of credit ratings, since investors want to limit their exposure to risk, and scores reflect financial vulnerabilities such as expanding too rapidly via debt or maintaining insufficient levels of cash reserves. According to HR Ratings, "Limited expertise from the management team will be reflected in the financial statements, severely hindering the issuer's financial flexibility."[43] Over the years ratings agencies have learned how to incorporate academic outcomes to project financial performance, which has helped improve the quality of their methodologies. But just as academic outcomes help investors assess financial health, the inverse is also true: financial health can help assess educational quality.

Parent satisfaction is an especially critical variable that ratings agencies consider, since it is a key driver of enrollment and thus operating revenue. This is done by analyzing demand signals such as application volume, wait lists, student retention rates, and enrollment trends. Demand signals provide valuable information about educational quality that are otherwise difficult to capture. After all, parents place different values on school attributes, and when empowered with choice they make nuanced evaluations and tradeoffs that testing data alone simply can't capture—one family might prioritize academic

43 HR Ratings. "Charter Schools Credit Risk Evaluation." HR Ratings. Web. <https://www.sec.gov/Archives/edgar/data/1628352/000162835215000013/Exhibit2Charter.pdf> 12 June 2018.

specialization, another might seek out robust extracurricular opportunities to bolster college applications, while still another wants a safe learning environment free from bullying. These complex decisions are reflected in a charter's demand signals, which ultimately feed into financial health.

For policymakers, allowing financial health to play a more prominent role in evaluation isn't about cobbling together disparate pieces of separate puzzles, but using complementary sources of information to illustrate a picture of performance with greater depth and clarity. States should consider financial health as more than just dollars and cents and work toward integrating these outcomes with other measures of performance, not only to ensure that schools are good stewards of public resources but also to capture the underlying demand signals that indicate parent satisfaction and quality.

Key Insight #2: Accounting for Local Context

Ratings agencies give careful consideration to a charter's local environment, which directly affects financial health. According to Moody's, it is "critical to evaluate a school relative to its most direct competitors, whether these are public, private or other charter schools,"[44] since this provides insight about a school's current and future market position. However, this involves more than simply comparing the test scores of charters against those of their local districts, as some authorizers already do. Ratings agencies analyze the competitive environment of a charter's immediate geographic area including enrollment trends, academic outcomes, and demographic factors such as migration patterns, housing, transportation and age distribution. From an investor's perspective, a high-performing charter in an underserved community is well-positioned to generate and sustain enrollment, as is a different charter that effectively delivers specialized offerings. Conversely, operators that enter saturated markets, underperform relative to local schools, and fail to differentiate their offerings are more vulnerable to financial distress. For parents, accounting for a school's local environment addresses an important concern: the performance of their child's schools relative to other local schools, especially those at which their child could potentially enroll. Not only is this the most meaningful comparison, but it promotes the productive use of education dollars by rewarding charters that successfully launch in underserved communities and those that implement innovative models to meet student needs.

[44] Ibid.

Key Insight #3: Independent and Competing Methodologies

The credit ratings industry is a highly regulated market with barriers to entry that artificially restrict competition, factors that have helped earn it some well-deserved criticism in recent years, especially after the Great Recession.[45] But despite these and other flaws, it still provides a glimpse of how a system of independent and competing evaluators could flourish in K-12 education, especially in comparison to current models of top-down accountability that are characterized by rigidity, politicization, and unintended consequences.

A model of independent and competing agencies such as non-profits, academics, analytics firms or other for-profit institutions would provide a few key benefits. First, unlike current state accountability systems, independent agencies would be insulated from political forces and free to home in on what's most important: whether schools are meeting the needs of students and using tax dollars responsibly. Such a system could be structured in a manner that eliminates potential conflicts of interest, and comprehensive performance analyses could be published to show exactly how scores are derived. This approach would also allow measures of quality that aren't readily standardized across school systems—and thus difficult or impossible to integrate with current approaches to accountability—to be used as indicators of performance. For example, college acceptance data, AP passing rates and long-term outcomes could all be introduced, as well as factors that differentiate a school's programmatic offerings, including a renowned arts program, foreign language immersion, and character development. Lastly, specialized agencies would have the expertise to effectively incorporate complex financial metrics and develop more-advanced models of evaluation over time. Since their reputations would be tied to the quality of their analyses, there would be a strong incentive to continuously refine the methodologies employed and deliver quality information that is both thorough in detail and accessible for parents.

45 For a thorough account of the credit ratings industry's shortcomings as well recommended solutions see: Joffe, Marc. "Unfinished Business: Despite Dodd-Frank, Credit Rating Agencies Remain the Financial System's Weakest Link." Reason Foundation, 2018. Web. <https://reason.org/wp-content/uploads/2018/02/dodd-frank-credit-rating-agencies-system-weak-link.pdf> 10 June 2018.

PART 5

CONCLUSION

With the recent passage of HB 2663, now is a critical time for Arizona to assess how it evaluates charter schools. ASBCS's financial performance framework, created in 2012, is a good step toward improving financial health transparency, but there are important reforms that policymakers should consider. In the short-term, the most important areas to address are the framework's roll-up mechanism and creating the infrastructure needed to close financially distressed charters in a manner that is fair, transparent, and accounts for local context. To do so, Arizona should revamp its summative ratings and create the infrastructure needed to assess flagged charters, which could involve creating a second-tier evaluation system that incorporates both quantitative and qualitative data and working with third-party agencies to evaluate outcomes before closure decisions are made.

An analysis of historical outcomes reveals that several reforms can improve ASBCS's financial performance framework in the short term, but Arizona policymakers shouldn't stop there as the full potential of financial data is yet to be tapped. Because these measures of financial health capture important information about school quality that test-based accountability metrics miss, they should have a central role in evaluating performance, especially for schools of choice.

The tax-exempt bond market for charter schools provides valuable insight into how financial measures can be integrated with current accountability systems or used to reimagine how schools are evaluated altogether. In the long term, the most important lesson that policymakers can learn from the tax-exempt bond market is how ratings agencies integrate financial health and the underlying demand signals in their assessments. In the context of state accountability systems, not only would this ensure that tax dollars are being used responsibly, it would also account for measures of quality that parents want. By unlocking the full potential of financial data, Arizona has the opportunity to become a national model for charter school evaluation that moves beyond test scores.

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