LET'S DO THE NUMBERS: SEVEN PRACTICES FOR SOUND FISCAL MANAGEMENT OF CHARTER SCHOOLS

by

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Overview

A colleague and friend who is a charter school authorizer, Jim Goenner, executive director of the Charter Schools Office at Central Michigan University, says, "There are two main considerations for authorizers at the end of the day: 'Are students learning, and has the money been taken care of?'" (NACSA, 2003, p. 63). Both considerations are critical to the success of your school and to the success of charter schools as desirable public policy.

Yet the business aspect of education is one that some school leaders and board members shy away from. This must be remedied since charter school boards owe it to the public on whose behalf they govern, to exercise good internal controls coupled with proper financial reporting and other oversight practices. This paper is intended to help boards understand how to establish the basics for ensuring "the money is being taken care of."

A high-profile example of the money *not* being taken care of occurred in the 2004 failure of California Charter Academy. As "a for-profit education management company then undergoing several investigations into its finances and operations, [it] closed more than 60 California campuses serving almost 10,000 students" (Lake & Hill, 2005, p. 43).

Fortunately, as Robin J. Lake and Paul T. Hill note in their excellent report, *Hopes, Fears, & Reality: A Balanced Look at American Charter Schools in 2005*, "In part, because of the efforts of the California Charter Schools Association, every student displaced by the CCA's failure found a new school without instructional disruption" (p. 43).

Nevertheless, coverage in the *New York Times* (2005) and other news media, did not help the charter school cause. Lake and Hill stated "The event crystallized concerns about charter school oversight and accountability … " (p. 43). And while "The story is about an unscrupulous business enriching itself at public expense … " (p. 43), one may be forgiven for wondering what the boards of CCA's schools were doing. Did they require and receive regular financial reporting? Did the boards have good internal controls? Did they have their own auditor? How many red flags were missed?

If such questions sound overly vigilant, I can attest from firsthand experience what happens when a board doesn't ask them. As a board member of a not-for-profit agency several years ago, it was distressing to discover that the executive director had imperiled the existence of the organization by embezzling money. As a current charter school board member, I use what I learned from that experience about sound fiscal management to govern effectively. I've written this brief to help others as well.

Thankfully, the majority of charter school leaders and education service providers are honest. But good internal controls and accountability are necessary to validate their honesty. This paper discusses several ways to implement and monitor such controls, as well as other sound fiscal management procedures. The references at the conclusion of the paper contain additional recommended reading.

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Introduction

The benefits of sound fiscal management of charter schools are numerous. Among them:

- The board is able to assure its constituencies that it is properly fulfilling its role.
- The school has little difficulty in passing audits which is invaluable when it comes to grant-seeking and borrowing.
- The public's money is being used only for that which it was intended.

Best of all, student achievement is unhindered by school exigencies and the charter movement as a credible reform effort isn't tarnished by negligence or bad actors.

The first and foremost element of sound fiscal management that every board should understand is that *it* is ultimately responsible for the school's finances. Even in schools where the board has contracted the management of the school, *the board is still ultimately responsible for the school's finances* (see more on this on p. 7).

This is a serious responsibility, indeed the very viability of the school hangs in the balance. Yet most board members are not accountants, financial managers or investment bankers. If financial reports are presented, many boards have trouble understanding them.

So how is a board supposed to hold the school's leadership accountable for proper fiscal management? The answer is in the following seven practices which will be discussed in this paper:

1. Establishing internal controls (through policy)
2. Monitoring compliance with fiscal policies
3. Developing financial reporting interpretation skills
4. Developing accurate budgets
5. Recognizing red flags
6. Minimizing risk
7. Hiring *its own* independent auditor

By adhering to these seven practices, a charter school can make large strides toward sound fiscal management. In contrast, ignoring even one or two practices puts the school at unnecessary risk.

The good news: These practices don't necessitate every board member becoming an auditor or accounting wiz-bang. They are simply proven business practices that help the board do its job of ensuring financial accountability.

One final note here. It is possible that in its zeal to ensure proper fiscal accountability, a board can overlook its other primary responsibility which is to ensure that its students are learning. If a board is spending 50 percent of every meeting reviewing financial statements, it isn't devoting sufficient time to its mission. Besides ensuring proper fiscal accountability, the seven practices discussed in this paper should actually minimize the amount of time the board spends discussing finances.

The board's responsibility to require reasonable assurances that the school's finances are being properly handled should not diminish its focus on why the school is in business.

At the end of the day, sound fiscal management is only a means of getting to an end. It should never be confused with the end purpose of charter schools—to produce student achievement.

Practice #1 Establishing Internal Controls (Through Policy)

An effective board governs through policy (Carver, 1997). It does this by establishing sensible policies and then by monitoring compliance with those policies on a regular basis.

A key governing responsibility is to prevent fraud by establishing internal fiscal controls. In the policy context, controls are nothing more than limitations. Thus, through policy, the board limits what the management of the school is free to do with the school's money and assets.

To be sure, there is no foolproof method of protecting an organization from fraud. But that doesn't mean that the board can't stipulate internal controls to reduce those risks. Let's discuss a few examples.

An easy step to take in any charter school is what auditors call "segregation of duties." This means establishing policies that prevent only one or two people, such as the bookkeeper or business manager, from having total or near total control of the finances.

A business office with properly segregated duties for example, will not permit the same person who makes the journal entries to reconcile the bank statement. Why? Because the bank statement will reveal the actual activity of the school's account. If a different person reconciles the account, this places another set of eyes on the school's finances and it inhibits any one individual from falsifying the books to match the bank statement.

Further, the person who maintains the school's books should not have the authority to enter new vendors or employees into the software. (Good accounting software allows a system administrator to determine who may perform certain functions like creating a new vendor.) By separating the functions of keeping the books from creating new payees, a person is prevented from manufacturing faulty invoices or entering bogus employees in order to cut checks that they themselves will later cash. Another easy way to avoid false invoices is to have every person who orders a service or product, sign and date the invoice as having received it before processing for payment.

Sometimes in small schools, it can be difficult to segregate some of these duties because the business office consists of just one person. Still, it is a good practice to spread some of these duties around. At a minimum, if it is necessary to have the bookkeeper reconcile the monthly bank statement, a copy of the bank statement can also be sent to a board member's home or work address directly from the bank itself.

This is by no means an exhaustive list of segregating duties. The board can and should talk to its accountant or auditor for further recommendations. The key point here is for boards to recognize that they need policies establishing such controls. Without them, an ill-intentioned individual has a completely free hand to defraud the organization with little risk of being caught until it's too late.

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Practice #2 Monitoring Compliance with Fiscal Policies

Some board members assume that establishing good policy is all that is necessary to ensure sound fiscal management. This is a mistake of potentially huge proportions. The board must rigorously monitor the organization to ensure that its policies are being followed. This oversight function is one of the primary purposes of the board.

As the world's leading authorities on Policy Governance,© John and Miriam Carver note in one of their several outstanding books, *Reinventing Your Board*:

> The board will acquire monitoring data by one or more of three methods: (a) by internal report, in which the CEO discloses compliance information to the board, (b) by external report, in which an external disinterested third party selected by the board assesses compliance with board policies, and (c) by direct inspection, in which a designated member or members of the board assess compliance with the appropriate policy criteria" (1997, p. 124).

Each of these is briefly elaborated upon below.

CEO disclosure can be utilized by the board for compliance in several ways. He or she could, for example, certify *in writing* that the accounting duties have been segregated. Regular financial statements should be another part of the disclosure required by the board.

External reports include things like having an auditor or other expert examine school documents and practices for compliance.

Direct inspection by a board member can work if the board member tasked with the responsibility of reporting his or her findings to the board is knowledgeable and reliable. (A key point about direct inspection: Tightly limit the authority of the board member doing the inspecting so that he or she isn't in a position to give directions to the CEO. Only the board as a whole should do that.)

How much monitoring should a board do? Enough to be reasonably certain that its fiscal policies are being followed.

A final word of caution is in order. In some schools, where the CEO is the founder for example, the board may be reluctant to ask too many questions about finances. Founder or not, a competent and honest CEO will expect the board to provide appropriate oversight because he or she knows that such oversight keeps him or her, the school, and the board above reproach.

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Practice #3 Developing Financial Reporting Interpretation Skills

Εάν δεν μπορείτε να καταλάβετε τις οικονομικές εκθέσεις, μπορούν επίσης να γραφτούν στα ελληνικά. (If you can't understand financial reports, they may as well be written in Greek.)

Every board member should develop the ability to understand four financial reports:

1. Balance sheet
2. Income and expense statement
3. Budget vs. actual expenses
4. Cash flow projection

Unfortunately limited space in this paper precludes an extended discussion of how to interpret these reports. Instead, let me make the following points.

First, the board should require these reports to be submitted on a regular basis. Failure to receive these four reports on at least a quarterly basis is dangerous.

Second, the board should develop the skills needed to interpret financials. It is legitimate for the board to authorize reasonable expenditures for training or materials to help it acquire these skills.

Third, just because financial statements are presented, it doesn't mean the board is obligated to adopt them. The board should never adopt any financial statement until it is 100 percent comfortable with its accuracy and its meaning.

Finally, resist the temptation to defer to any one board member the responsibility for monitoring and understanding financial statements. The entire board should develop at least basic financial interpretation skills.

Practice #4 Developing Accurate Budgets

A budget is a plan to spend. A board-adopted budget is required of charter schools by most if not all state laws. Even if it weren't, a budget is essential to sound management because a budget is more than a way to track revenue and expense: It should reflect the school's mission priorities.

If the school, for example, has technological education as part of its mission, the budget should reflect significant expenditures on technology. If the school is college preparatory, one might question a budget that contains expenses for lawnmower repair classes.

Furthermore, effective annual budgeting is part of a larger forecasting process. A good budget should be part of a bigger picture. Three years is a good look-ahead window for school budgeting.

Once the budget is in place, spending should follow the plan. The board should require an approval process when there are variances to the budget.

The guidelines in the preceding three paragraphs on developing accurate budgets can be summarized as follows:

1. The mission of the school should drive the budget.
2. The annual budget should be part of a multi-year plan.
3. Budget variances will occur but they should be approved by the board.

Finally, when it comes to developing accurate budgets, it's helpful to remember that a budget is more like a guided missile than a bomb. A bomb lands wherever it was dropped. A guided missile makes many on-board calculations and adjustments *while in flight* in order to hit its intended target.

In the same way, your budget will require adjustments, especially in the early years of the school as you accumulate spending and revenue data.

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Practice #5
Recognizing Red Flags

The following list of things are potential indicators that everything may not be well with your school's finances. While they don't necessarily indicate fraud or incompetence, they should serve as red flags for the board to probe the issue further:

1. A CEO who appears offended or expresses dismay (e.g., "Don't you trust me?") when board members ask questions about the school's finances.
2. Irregularity in receiving required financial reports. Excuses like, "We're getting new computers or new software" may be valid once in a blue moon but not every meeting.
3. Non-existence or violation of segregation of duties policies.
4. A sole bookkeeper who works for years without a vacation or who is resistant to opening up the books to others.
5. A CEO who cannot give crystal clear explanations to board questions about *every* aspect of the school's finances.
6. An auditor who is not completely independent of the management (for example, an auditor who audits multiple schools for the same management company).
7. Financial contributors to the school who are anonymous to the board. Otherwise, how would the board know the amount actually contributed?
8. Peculiar practices like the CEO requiring all mail, including bank statements, to be placed on his or her desk unopened.

If these red flags sound theoretical—they're not. Almost every one of them occurred in the embezzlement scenario which I described on page one.

Ask your auditor about red flags. On the basis of their experience, auditors can usually give many more examples.

Practice #6
Minimizing Risk

There are many things a board can do to minimize risk to itself and the school.

1. If school credit cards are issued to employees, never issue any without limits placed on the card at the bank's end.
2. Never sign any authorization to establish a bank account for the school without copying the front and back of the signature card and placing it in the official minutes of the school.
3. Rather than issuing school cell phones to employees, consider a flat-rate monthly stipend.
4. Take extra precaution to ensure that the board's director and officer liability insurance policy is always up-to-date.
5. Never sign a check for the school without clear supporting documentation.
6. Request the school's bank to always send out two copies of the bank statement. One to the school and one to a board member (at his or her residence or place of business).

Most of these are just smart practices. While there is no such thing as zero risk, these are *easy* things the board can do to minimize risk.

Practice #7
Hiring *Its Own* Independent Auditor

One of the fundamental issues of board leadership is in understanding that the board governs in behalf of an owner (Carpenter, 2006; Carver, 1997).

Sometimes in the charter school sector, however, the ownership issue can seem unclear. Consider the following example: Anytown Charter School operates in a building which was built by the education service provider, and all the teachers and the principal are employed by the same company. The same provider owns the curriculum, the chalkboards and the computers. So, who owns the school?

Answer: The public owns the school. Granted, the management company may own the building, etc., but they do not own the school. Worded slightly differently, the public supplies the funds *to the board* to operate the school on its behalf. Under appropriate state law, the board may choose to contract some or all of its operations to a management company but it cannot contract its fiduciary responsibility to provide oversight of a management company.

For this reason, the board should retain its own auditor for the school's annual audit. (I strongly recommend an annual audit, not merely a compilation or review of the school's finances.) And like every other aspect of the school, the board should understand clearly that the auditor is working for them—not for the management of the school.

Furthermore, the auditor hired by the board should certify to the board in writing that he or she does not have any financial interest in the performance of the management company. For example, I recommend that boards not use an auditor that performs other audits for a particular service provider.

Using a completely neutral third party is imperative in the auditing process so that the board is assured that any issues raised by the auditor are not minimized or excluded in his or her report to the board.

It also helps to build a relationship with a reputable auditor. The board may from time to time during the course of the year, have questions that they would like an outside expert to answer. Being able to tap the knowledge of the board's auditor can be a good way to acquire that knowledge.

A final word about auditors themselves. Like any other service provider, not all of them charge the same level of fees or perform at the same level of expertise. The board should be sure to check references and only retain an auditor that does a thorough, timely job. While such services aren't cheap, in the long run the board will have taken reasonable steps to ensure the fiscal propriety of the school. You will probably find that, like all other services, you get what you pay for.

Besides ensuring fiscal soundness in your school, an annual audit helps enable the school to pursue foundation grants and bank loans. This is because such organizations whose job it is to deal with money expect to understand the fiscal soundness of their prospective clients. Should you expect any less as a charter school board member?

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In Conclusion

The two fundamental responsibilities of every charter school board are to ensure that the students are achieving what they should and that the funds which are entrusted to the school by the public are being properly handled. When the board fails to do either or both of these, it jeopardizes the existence of the school and brings the broader movement into disrepute (p. 1).

To accomplish sound fiscal management, the board should first understand that it is ultimately responsible for the school, even if it contracts with an education service provider or management company for various services (p. 2).

The board needs sound fiscal internal controls established by policy (p. 3), and it needs to regularly monitor compliance with those policies (p. 4).

The key to understanding internal controls is to understand their purpose: to prevent an individual from having *both* the opportunity to perpetrate wrongdoing with school funds and to subsequently conceal it. Failure by the board to establish such controls is a failure to exercise its basic fiduciary responsibility.

Part of the monitoring process involves reading and understanding regular financial reporting. If a board does not receive regular reports or it does not understand what they mean, it cannot properly monitor the school's finances. For most boards to perform this most important role, it will necessitate funding some training to acquire these skills (pp. 4-5). Reasonable expenses to do so are legitimate.

Part of sound fiscal management is in developing accurate budgets. A budget should reflect the mission of the school and it should be part of a larger plan (p. 5). Invariably, especially in the start-up years, adjustments to the budget will have to be approved. This is fine as long as the board understands what created the variance. The board should regularly compare budgeted amounts to actual amounts.

It is also helpful for boards to recognize red flags. Although they don't necessarily indicate wrongdoing or incompetence, they should arouse the board's interest to investigate further. If something seems wrong, find out why (p. 6).

The board can also work proactively to minimize risks to the school by following some commonsense practices (p. 6). These are easy steps that can go a long way in protecting the school.

Finally, the board should always hire its own independent auditor. Complete objectivity is the goal (p. 7). The returns are well worth the auditing fees.

For more information, see the list of references below or contact the National Charter Schools Institute.

References & Recommended Resources

Carpenter, B. L. (2006). *The five dysfunctions of charter school boards*: National Charter Schools Institute. (Free copies available to charter schools by calling the National Charter Schools Institute)

Carver, J. (1997). *Boards that make a difference: a new design for leadership in nonprofit and public organizations* (2nd ed.). San Francisco, Calif.: Jossey-Bass.

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