Budgeting Summary of Guidance

Below is a summary of facts, recent research, guidance and opinions impacting the daunting task of LEA budgeting in today's environment. Sources include: CCSESA's External Services Committee, FCMAT, Charter Schools Development Center, School Services, and Capitol Advisors. Now is the time to act based on an evaluation of the impact on LEA budgets of California's crisis-driven recession.

Current Conditions

For a few years now, our state policy makers have been warning us that the recovery from the Great Recession (2007-2009) has been the longest in recorded history, and that a recession could be just around the corner. Although never anticipated to happen so precipitously, all indications are that the COVID-19 pandemic is pushing us into a recession—worldwide, nationwide, and statewide.

State Budget = Workload Budget - Department of Finance (DOF) Director stated that state revenue intake for the 2019-20 and 2020-21 fiscal years are likely to come in significantly below estimates in Governor Newsom's January budget proposal. DOF has directed all state agencies and departments to submit workload budget requests, which are just skeletal structures of what a typical budget year resembles. Given the timing of the COVID-19 emergency and the unknown depth of the impending recession, the Governor's May revised budget will only be a "bare-bones" structure of the full 2020-21 budget.

Proposition 25 requires the Legislature to adopt an on-time budget. The minimal workload budget will likely be the version that gets passed by the statutory June 15 deadline. A subsequent, more thorough version of the 2020-21 budget can be passed through trailer bill language during the latter part of the legislative session. Based on the new July 15 deadline for filing income taxes, they will likely revisit it in August once the revenue picture is clearer.

State Cash Reserves - The state currently has approximately $17.5 billion in reserves, $900 million in the Safety Net Reserves and $16.5 billion in the Budget Stabilization Account (BSA). The BSA, while it carries a significant balance, is a general-purpose reserve and can be used for any priority of the legislature. The BSA can be accessed "in the case of a fiscal emergency" up to the lesser of: (1) the amount needed to maintain General Fund spending at the highest level of the past three enacted budget acts, or (2) 50 percent of the BSA balance. California also maintains a reserve for schools; however, the first deposit into the school-specific reserve occurred in 2019–20, totaling $377 million, less than one percent of state spending on schools in 2019–20.

A Legislative Analyst's Office (LAO) report concludes that although state reserves are at an historically high level, the impact of the current pandemic will bring reserves lower than what was projected in the January proposed budget. The LAO points out that LEA reserves will be necessary to provide a buffer to maintain on-going expenditures, but that few LEAs have sufficient reserves to maintain current service levels for an extended period. The report concludes that in spite of historically high levels of reserves maintained by the state, and an average reserve of nearly two months of expenditures at the local level, state and school leaders face a precarious outlook for 2020–21.

Looking inward, budget planning for 2020-21 was well underway when, from one day to the next, schools were empty. The economic environment has abruptly changed, for both the current year and next year, and to what extent is largely unknown. In response, your LEA must make a corresponding budgetary pivot, assessing the impact of a range of potential revenue, expenditure and cash flow scenarios.

Last Time
Looking back to the Great Recession we lived through in 2007-2009 gives a glimpse at what may happen as the Governor and Legislature respond to significantly reduced state revenues.

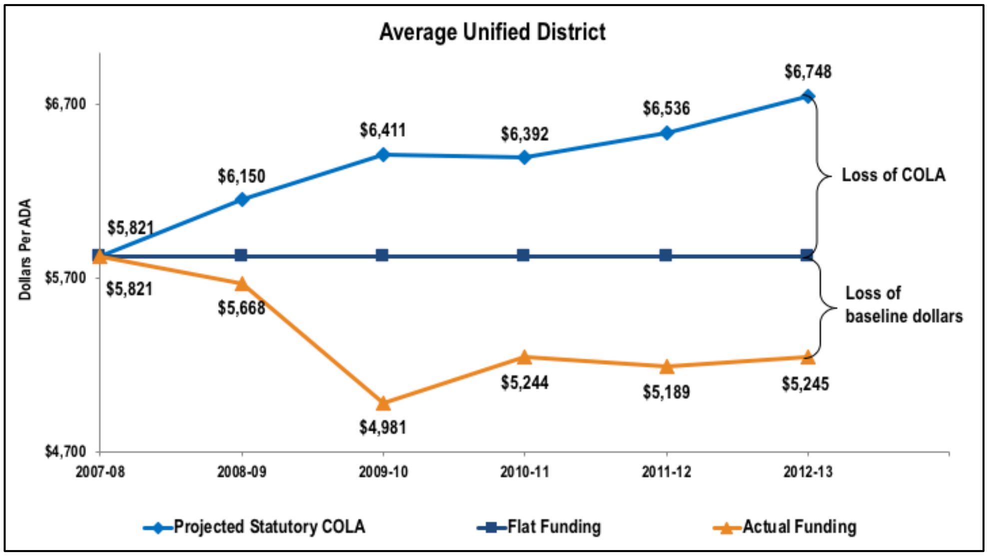
Some of the solutions implemented in the education budgets during those years:

- Not funding, or only partially funding, the statutory cost-of-living adjustment (COLA) on revenue limits and categorical programs
- Changing the principal apportionment schedule to slow down cash to LEAs—this was a permanent change and still applies
- In addition to changing the apportionment schedule the state also deferred (delayed) cash apportionments to LEAs, some within the same year and some to the next year
- Cutting revenue limit funding—most of the time at the beginning of the year, but also in the middle of the year
- Cutting categorical funding by almost 20% over two years
- Deferring reimbursements for state-mandated programs—which still continues to this day, to a lesser degree

Through the lens of an average unified schools district:

- From 2007–08 moving into 2008–09, the COLA would have provided an additional $329 per ADA, a 5.66% increase.
- Instead, the COLA was zeroed out, plus a cut of $162 per ADA from the prior year's funding was applied.
- The combined impact for 2008–09 was a $491 per ADA (approximately 8%) reduction in purchasing power.
- In 2009–10 it got worse. The COLA for 2009–10 of 4.25% was also zeroed out, and an additional cut in prior year funding of $253 per ADA was applied.
- This brought funding in 2009–10 down $1,177; more than 18% below what 2009–10 would have been if the state had honored the statutory COLA to maintain 2007–08 LEA purchasing power.

This chart displays per-ADA spending – the amount funded versus the amount that should have been funded – during the Great Recession.



The state literally pushed its cash flow issues to LEAs, who were required to borrow significant amounts of money just to fund payroll and other normal operating costs. By the time full funding of the LCFF targets was reached in 2018–19, LEAs were finally restored to the purchasing power of 2007–08. From this perspective, education is starting out behind the curve facing the coming recession.

Some of the flexibility granted during those years:

- Ability to sweep ending balances from some categorical programs and restricted funds to the unrestricted General Fund
- Ability for LEAs to apply for an exemption from some cash deferrals
- Lay off window extended to August 15 (whenever there is less than a 2% COLA)
- Delayed compliance with instructional materials adoptions
- Waiver of penalties for exceeding class sizes in grades K–8 (related to EC § 41376–41378)
- Reduced or eliminated (depending on the year) the required contribution to Routine Restricted Maintenance
- Ability to reduce the instructional year by up to five days (from 180 days to 175 days), with a commensurate reduction in the instructional minute requirements, all with no penalties assessed
- Reducing the local minimum reserve requirement
- Allow revenue from the sale of surplus property to be deposited into the General Fund (rather than being restricted for facilities only)

LEAs still found it necessary to implement massive layoffs of both certificated and classified staff, as well as reduce employer contributions to health benefits, freeze step and column movement, cut hours, and implement unpaid furlough days for remaining staff.

Current Year

Budget year and out-year planning must start from as solid a foundation as possible in the current year. The importance of this premise is intensified when the future is uncertain. Focus on what is known and likely before approaching the unknowns of next year and beyond. Consider impacts on the current budget year and nail them down as tightly as possible.

<u>Revenue</u> – The Second Principal Apportionment (P-2) and Annual hold harmless on average daily attendance (ADA) means a solid estimate of LCFF revenues can be prepared. However, that is not going to be the case for the last two quarters of state Lottery revenues, nor will it apply to many local sources of revenues which will decline as a result of the pandemic. For example, fees for the use of facilities are likely nonexistent now, developer fees have likely declined, revenue from paid meals and transportation fees have ceased, and local donations have been significantly throttled back as families and community members deal with their own personal and professional challenges.

<u>Expenditures</u> – You are continuing to pay employees. However, there may be some adjustments to make in the budget for extra pay, substitutes, overtime, or other types of variable wages. There may also be premium pay for employees continuing to work during this time. It’s time to make further adjustments to salaries and benefits for vacancy savings, negotiated compensation settlements, or other changes since the 2019–20 Second Interim report was completed.

In order to determine if a hiring freeze or frost is warranted in the near-term, we recommend the following human resource activities:

- Review statistical data of teacher attrition rates by credential-type over the last three fiscal years.
- Examine class size by credential-type to identify opportunities to exercise flexibility in staffing needs.
- Complete a cabinet-level assessment of all credential area needs to assist in the designation of essential and non-essential hiring categories.

The technology budget will need to be scrutinized to determine what the current-year impact will be of purchasing and issuing technology to students for distance learning and to staff for working remotely, including the cost of additional internet access or wireless network devices. There are likely adjustments to be considered in other expenditure categories, such as professional or consulting services, contracted services for repairs, professional development providers, and travel and conferences. The expenditure budget for books, supplies, and food for student meals should all be evaluated. Normal purchasing of books and supplies may have throttled back, but likely food expenditures have increased.

<u>Cash Flow/Current Year</u> – To avoid over-appropriating the constitutional Proposition 98 funding guarantee, the state may very well need to defer some state aid from the current, 2019-20 fiscal year into the 2020-21 year. This might include both May and June or just the June Principal Apportionments. Use the time now, before the May Revision, to analyze and plan for this current year cash impact. Using recently completed second interim cash flow projections as the starting point, update the projections with February and March actuals, and build necessary changes into the forecast for April, May and June, considering the new realities. Include the cash impact of lost revenue in the current year from sources like those noted above (e.g. parent fee/donation collections for lunches, child care programs, enrichment programs, transportation fees, etc.).

Contingency & Cash Flow Planning

In times of uncertain revenue streams and unknown future expenditures, the only way to stay nimble enough to respond quickly is to consider multiple outcomes. It is important to develop, analyze and plan for various scenarios that could reasonably affect your LEA. You just completed a multi-year plan (MYP) a month ago as part of Second Interim. But the world has changed in a matter of weeks. Inasmuch as MYPs form the basis for evaluating an LEA's financial condition now and into the near future, it is time to take another look at your MYP to be ready to respond to what we expect will be significantly negative financial news.

<u>Scenario Based Budgeting</u> – Budget planning is part data analysis and part fortune-telling, each an element in the process of establishing a reasonable forecast for the future. The fortune-telling piece is exceedingly more complex when faced with unprecedented events that leave in their wake an unknown future. This is where scenario planning comes in. It's a strategy that can help remove some – and only some – of the uncertainty from a budget. However, removing some uncertainty is exponentially more beneficial than removing none.

Each scenario demands a different set of corresponding actions necessary to balance revenues and sustain adequate reserve levels. At minimum, for initial impact assessment purposes, one scenario should utilize a zero cost of living adjustment (COLA) in fiscal years 2020-21 and 2021-22. Other scenarios could include a funded COLA, and another a 10-20% cut in LCFF funding. Use the factual data from the Great Recession reported above to create scenarios with permutations of these factors and analyze the results on your LEA.

The intent is to be thinking about how to address a multitude of situations your LEA may find itself in once the full and actual impact of the pandemic is determined. Although recessions tend to last 10-15 months, the effect on public school funding can be longer lasting. Whether you use FCMAT's Projection-Pro software, SACS or a spreadsheet, the importance of planning for various scenarios cannot be overstated and those plans should be kept current throughout times of fiscal crisis and unpredictable revenues.

Cash Flow Planning – Clearly, cash flow will be a critical issue moving forward and ensuring the availability of adequate cash reserves is a vital function for all LEAs. Budgets and cash flow projections vary in their nature, data and analysis. LEA budgets are a set of annual data with a focus on June 30. Cash flow is presented in shorter periods of time, typically monthly, but weekly and daily in some cases depending on circumstances. At a minimum, cash projections should be prepared extending through the current and into the next year. In periods of economic distress and funding uncertainties, the frequency and depth of cash flow projections and analysis should be increased.

Significant variances in cash flow actuals to projections generally serve as the first indicator of fiscal distress. Deficit cash positions determine the timing and amounts of the need for tapping alternative liquidity sources. The general fund, which is the focus of most budgets, is only one of an LEA's funds. Cash is transferable and may be commingled; therefore, project and analyze all funds. Do not limit the analysis and monitoring to the general fund.

State and federal COVID related aid will flow to most LEAs, but these funds are for mitigating new costs related to the pandemic and are relatively minor given the challenges that lie ahead. It is imperative to review anticipated cash receipts and cash outflows as a component of each of the budget scenarios mentioned above, including zero COLA and funding cuts. The May Revision, and likely the June adopted budget, will likely not provide definitive answers about budget and associated apportionment plans, necessitating the need to wait until a revised state budget is adopted in August/September to receive a more complete funding plan for the 2020-21 fiscal year. Regardless of when they may be announced, inter-year deferrals are a high probability because Proposition 98 spending can be modified by the state toward the end of the fiscal year by shifting appropriations from the end of June to the beginning of July.

Considerations regarding cash receipts must look beyond state apportionments for LCFF. Even though they carry a smaller impact, cash flow analysis must also include:

- Property taxes – April is a significant month for property tax receipts. Monitor and analyze apportionments from the county auditor/controller and treasurer/tax collector against the existing cash flow projections. Most California counties operate under the Teeter Plan for tax collection apportionments to local agencies, in which the tax levy is apportioned without regard to delinquencies, shielding local agencies from the impacts of late and non-payments. LEAs should consult frequently with their county auditor/controller and treasurer/tax collector to understand cash flow expectations and adjust cash flow projections accordingly.
- Local cash receipts from a variety of sources are also adversely affected, including:
    - Parent-paid nutrition programs, childcare programs, and transportation programs.
    - Facility leases and use of facilities fees
- Lottery sales are impacted from the stay-at-home orders. While new lottery revenue forecasts for third and fourth quarters have not been released, cash flows should assume a decreased third quarter payment (and fourth quarter accrual).

Regarding cash payments, most LEAs are experiencing unplanned, extraordinary expenditures including:

- The shift to distance learning including procuring technology and network access devices
- Maintaining salaries and in some cases increasing compensation for disaster service workers
- Accounting for interfund cash lending or deficit absorption in the general fund to cover cafeteria fund and childcare program deficits

LEAs should also consider delaying any nonessential payments and discretionary purchases to preserve available cash for critical operational functions. Savings should also be accounted for, including utilities, fuel, some contracted services, and other variables related to the physical operations of campuses (using summer months as an example).

If the cash flow projection for the LEA shows negative for any period (month, week, or day), corrective action must be taken to ensure sufficient cash resources are made available to eliminate this negative position. In some counties, county treasurers automatically provide safeguards by allowing short-term negative cash balances in one fund if they are offset by other LEA funds. You should clearly understand how your county treasurer functions when it comes to LEA cash balances. If corrective action is required, it may include the use of alternative liquidity resources and adjustments to expenditure plans, or a combination of both.

Alternate Liquidity Sources

Alternative liquidity is the identification of available cash resources outside of the LEA's general fund. Therefore, expanding the cash projections and monitoring across all funds is essential. LEAs should immediately begin to prepare alternative liquidity schedules that show the projected cash flow and cash balance for each fund by month, and in some cases by week. Alternative liquidity analyses should also look beyond the LEA's funds on deposit in the county treasury and determine what short-term borrowing options exist for cash flow and working capital needs.

Regarding interfund borrowing, LEAs should analyze the various forms of alternative liquidity against the provisions of Education Code Section 42603. Borrowing from other funds to satisfy temporary shortfalls in operating cash is common practice among California LEAs. With increasing uncertainty about the state apportionment plans, refresh your knowledge on proper interfund borrowing. Now is the time to prepare temporary borrowing resolutions for your board to consider for approval. This authorization will enable LEA business officials to quickly access the cash resources in other funds by temporarily transferring those resources to where they are needed. A best practice is to adopt a resolution at the start of each fiscal year to authorize interfund borrowing throughout the year; but if such authorization does not currently exist through June 30, 2020, a resolution should be prepared now for the current year.

LEAs need to be mindful of the interfund borrowing repayment requirements specified in code. Failure to repay a lending fund in accordance with the statutory provisions can damage the trust of the LEA's stakeholders and should be identified as a deficiency in the LEA's annual audit report.

The Education Code does not limit interfund borrowing authority to particular funds and includes no specific exclusions for funds holding restricted dollars. Borrowing from bond proceeds is not a preferred liquidity solution and, in some cases, depending on bond official statement offering documents, may be inappropriate. This includes the potential loss of tax-exempt status for the bonds, the loss of the direct subsidy payments, possible disclosure violations, and other legal considerations that should be avoided. As mentioned, alternative liquidity is not limited to interfund borrowing but includes other options available to some LEAs in need of temporary cash as follows:

1. County Superintendent of Schools (Education Code sections 42621 and 42622): An LEA may borrow from the county superintendent of schools with the approval of the county board of education. Funds loaned by the county superintendent are subject to availability of excess funds held by the county superintendent. Funds must be repaid within the same fiscal year. Similar provisions exist for the county superintendent of schools to make a conditional apportionment to an LEA that may be paid back to the county superintendent in the subsequent fiscal year.

2. County Treasurer: To borrow from the county treasurer, an LEA must submit a resolution to the county board of supervisors requesting a loan. Following the board's approval, the county treasurer's office disburses to the LEA an amount not to exceed 85% of the amount of money accruing to the LEA during the current fiscal year. Repayment of the advance is made from tax revenues accruing to the LEA later in the fiscal year.

3. Several sources of private liquidity exist. The most common forms are direct loans and the sale of receivables based on anticipated funding.

Summary

The watchwords moving forward are "collaboration" and "transparency". Involve your stakeholders now, supplying them with information about the causation and necessary responses, immediately and upcoming. Ask for their attention, understanding and assistance in facing and reacting to these challenges.

Stakeholder partnership is a long-term commitment to a relationship based on understanding each partner's expectations and values, dedication to common goals, and trust. Being a partner can redefine the way you interact with your stakeholders. The goal is to move away from what can quickly devolve into an adversarial relationship and move toward a collaborative and innovative partnership.

Best practice research suggests:

1. Trust is at the heart of a strong partnership and transparency is the key to building trust.
2. Foster communication by listening, listening, listening and asking open-ended, "what-if type" questions. In responding, avoiding jargon, acronyms and terms of art.
3. Display leadership by communicating an understanding of each stakeholder group's needs, wants and desires. Tell them the truth and develop alternatives for consideration.
4. Demonstrate consistency by being predictable and reliable. Communicate often, within a consistent framework, and let your stakeholders know about changing conditions and your progress.

"Action is a great restorer and builder of confidence. Inaction is not only the result, but the cause, of fear." …Norman Vincent Peale