Testimony before the

House Committee on Education

on

HB 2430

by

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Kansas Association of School Boards

January 18, 2012

Mr. Chair, Members of the Committee:

Thanks you for the opportunity to testify on **HB 2430**, which would allow districts to have a maximum contingency fund of 10% of the school district general fund for three additional years, through 2014-15. Without this bill, the maximum amount in this fund will drop back to 6%, the level prior to 2007-08. The 2009 Legislature approved a temporary increase in the maximum amount to allow districts more flexibility in managing their resources as state funding was reduced during the economic recession.

KASB appears as a proponent of this bill, based on the policy adopted by our Delegate Assembly, which reads: **"Contingency Reserves.** Districts should have the ability to carry a reasonable contingency reserve from one fiscal year to the next."

This statement does not call for a specific maximum percentage, but we support allowing local school boards the maximum flexibility to manage their district. We base this on (1) the constitutional duty of school boards to maintain, develop and operate public schools, (2) Kansans' strong belief in local control, and (3) the principle that the best decisions are usually made by those who know the specific circumstances best.

The Legislature allows districts wide latitude in using revenues it places in the contingency fund as follows: "The fund shall be maintained for payment of expenses of a district attributable to financial contingencies as determined by the board."

Because of increasing attention on the general issue of school district balances and cash reserves in recent years, we would like to share the following information with the committee.

First, the contingency reserve fund is a small part of a district's budget. The total statewide school district general fund (the base budget per pupil multiplied by actual students plus weightings and special education aid) is only 52% of total school district budgets. Adding local option budgets brings the total to just under 70%. The rest of the budget includes all federal funding (about 8%), KPERS contributions (6%) and all other local revenues and capital improvement aid (17%), which includes everything from bond payments and capital outlay spending to textbook fees and lunch money.

Second, the contingency fund is a relatively small part of the total "cash on hand" for school districts at the beginning of the fiscal year. On July 1, 2011, the start of the current fiscal year, districts had $198.8 million in the contingency fund, which was just 11.6% of total cash on hand of $1,714 billion. Prior to passage of the 10% limit, contingency funds were 8.7% of the total.

Third, therefore, whether this bill passes or not makes little difference in the total cash carryover of school districts. That is because there are numerous other funds where districts can carry cash balances. **All of those funds have been created by the Legislature to segregate funds for accountability purposes.** The contingency fund is available to meet general operating needs when unplanned circumstances arise.

Fourth, although districts have significant cash on hand at the beginning of the fiscal year, most of the resources are not actually available to spend as the district pleases. (See attached table on district fund balances on page 4.)

- Approximately 60% of cash on July 1, 2011, was either constitutionally restricted to specific purposes because it was raised by a dedicated mill levy, or effectively restricted for other reasons. These included bond and interest payments, capital outlay funds, federal funds, reserves for insurance or retirement, and textbook fees.

- Another 18.7% was in funds that either have costs over the summer, or require an adequate balance to operate programs until state or local revenues arrive. Most of this is in special education, where state aid is usually not paid until October.

- As a result only about 21% of "cash on hand" is really available. This $362 million presents just 8.4% of general operating expenditures of $4,327 billion, or approximately one month's worth of expenditures. An independent study by a CPA firm came to similar conclusions, finding that school districts have less than one month of effective cash reserves, and noting that governmental accounting standards recommend that government agencies generally have at least two months in reserve. A copy of this report is attached.

Fifth, while school budgets grew substantially from 2006 to 2009 after the *Montoy* school finance court decisions, overall funding has been essentially flat from 2009 to 2012, and general operating budgets declined from $4.128 billion in 2009 to $3,928, a reduction of $200 million or nearly 5%, while the consumer price index increased 6%. At the same time, district cash on hand has been increasing, from about 25% of total expenditures in 2006 to 30.1% in 2012. Why would districts increase their cash balances when funding is being reduced?

- Decisions on cash balances and district budgets are made by locally elected school boards based on their fiduciary responsibilities and judgments.

- School districts increased this balance because of chronic late payments by the state in recent years. As the state's general fund ending balance dropped from the statutory 7.5% or more to zero or below, the state delayed aid payments to schools, which required districts to have cash on hand to meet their own expenses, such as payroll, on time. In effect, higher school district balances substituted for the state's general fund balance for cash flow purposes.

- Districts may have identified savings last year and increased beginning balances in order to reduce transfers into various funds during the current year. In other words, higher beginning balances in these special funds can free up resources for other operating costs.

- Districts may be making cuts in on-going expenditures rather than using one-time cash balance transfers because they will be unable to replace those transfers in the future.

- Like many businesses, districts may be maintaining or increasing cash balances because of economic uncertainty. Boards adopted budgets this summer in the following circumstances:

    - Fears of a "double-dip" recession that could reduce state revenues and require further budget cuts.

    - Scheduled expiration of the one-cent sales tax increase next year and calls for elimination of the state income tax would significantly reduce state revenue.

    - Proposals to alter the school finance formula without additional funding could result in significant reductions for some districts, such as last session's proposal to cut $140 million in at-risk funding. Although Governor Brownback's proposed school finance change would provide each district with a baseline budget level equal to the current formula, that proposal had not been released this summer. Moreover, the Governor's plan provides no increase in funding over the current level next year (FY 2013) except in the areas of vocational education, and many districts (with the most students) would receive no additional state funding in FY 2014. These districts will have to operate well below their 2009 operating budget levels after five years, despite inflation and higher achievement targets.

    - Congressional action to reduce the national deficit could result in substantial cuts in federal education aid.

In conclusion, we believe school boards have acted as responsible stewards of public fund, including the management of cash balances and contingency reserves. Extending the current authority as districts face continuing financial uncertainly is a reasonable and prudent step.

Thank you for your consideration.

School District Cash Balances July 1 - 2006-2011

		Non-USD Funds Administered by USDs				
	USD Total	Historical Museum	Public Lib. Bd.	Pub. Lib. Emp. Ben.	Rec. Comm.	Rec. Com. Emp. Ben.
2006	1,163,505,241	23,088	5,279,368	669,345	9,417,521	1,216,312
2007	1,241,380,417	33,508	5,058,974	876,961	8,938,645	1,488,840
2008	1,375,139,138	36,223	5,194,133	850,339	9,599,757	1,299,345
2009	1,504,829,912	45,233	4,246,678	789,872	9,628,162	1,311,813
2010	1,572,903,869	53,913	5,112,979	742,542	9,348,332	1,181,335
2011	1,713,870,651	59,856	6,209,908	986,851	9,693,551	1,302,004
$ Change	550,365,410	36,768	930,540	317,506	276,030	85,692
% Change	47.3%	159.3%	17.6%	47.4%	2.9%	7.0%

Constitutionally Restricted Funds (Local Mill Levies)

	Capital Outlay	Bond & Interest 1	Bond & Interest 2	Special Liability	No Fund Warrants	Special Assess.	Adult Education	Group Total	% of Cash Total
2006	364,204,808	283,535,871	15,610,800	7,339,589	49,436	5,865,401	2,505,807	679,111,712	58.4%
2007	383,995,018	290,843,116	16,529,146	8,480,038	50,116	4,991,340	1,217,386	706,106,160	56.9%
2008	449,291,653	300,989,612	19,551,173	8,733,690	0	5,982,252	1,300,921	785,849,301	57.1%
2009	451,672,840	327,700,705	16,550,982	8,693,872	0	5,926,934	1,368,027	811,913,360	54.0%
2010	429,794,605	349,486,618	12,355,705	7,230,830	42,902	5,041,797	1,237,066	805,189,523	51.2%
2011	470,822,923	352,745,579	13,415,458	6,851,816	127,016	3,706,427	983,074	848,652,293	49.5%
$ Change	106,618,115	69,209,708	-2,195,342	-487,773	77,580	-2,158,974	-1,522,733		
% Change	29.3%	24.4%	-14.1%	-6.6%	156.9%	-36.8%	-60.8%		

Other Effectively Restricted Funds

	Federal Funds	Gifts/Grants	School Retire.	Special Reserve	Textbook	Group Total	% of Cash Total
2006	150,948	21,269,478	314,918	56,697,898	39,054,872	117,488,114	10.1%
2007	2,744,259	23,557,447	257,432	54,221,927	39,971,840	120,752,905	9.7%
2008	3,666,675	22,756,045	438,674	70,604,187	37,781,758	135,247,339	9.8%
2009	3,827,639	23,468,699	504,675	86,098,237	43,286,401	157,185,651	10.4%
2010	1,067,258	24,022,841	440,206	102,361,425	50,621,897	178,513,627	11.3%
2011	4,786,796	20,381,080	889,717	103,063,982	54,257,210	183,378,785	10.7%
$ Change	4,635,848	-888,398	574,799	46,366,084	15,202,338		
% Change	3071.2%	-4.2%	182.5%	81.8%	38.9%		

Funds to Cover Expenses until Revenues are Received; Funds with Summer Expenses

	Special Ed.	Sped Coop	Summer Sch.	Food Service	Group Total	% of Cash Total
2006	130,416,781	19,056,607	8,202,858	33,900,433	191,576,679	16.5%
2007	149,536,176	22,649,907	7,735,683	38,077,263	217,999,029	17.6%
2008	163,666,930	27,090,889	6,964,103	36,928,843	234,650,765	17.1%
2009	183,341,090	24,114,960	5,971,828	41,223,348	254,651,226	16.9%
2010	181,078,898	35,121,588	5,099,631	46,082,491	267,382,608	17.0%
2011	209,691,371	51,495,094	4,646,232	53,931,627	319,764,324	18.7%
$ Change	79,274,590	32,438,487	-3,556,626	20,031,194		
% Change	60.8%	170.2%	-43.4%	59.1%		

General Education Operating Funds

	Contingency Res.	General Fund	Supp. General	Virtual Ed.	Declining Enroll.	Cost of Living	Ancillary	Prof. Develop.	Tuition Reimb.	Activities
2006	97,636,498	1,600,933	39,358,766		0	0		10,184,305	209,739	
2007	107,425,894	1,281,800	38,845,906		0	0		11,644,420	336,372	
2008	119,016,020	1,381,116	42,148,769		0	0		12,617,382	44,409	
2009	175,712,033	1,435,657	42,183,718	915,204	0	0		13,400,850	65,878	
2010	194,276,118	598,170	43,091,299	2,112,120	0	0		15,165,095	14,349	
2011	198,767,766	1,670,107	40,873,956	4,064,565	661,279	1,183,772	2,571,600	15,055,381	15,822	8,250,908
$ Change	101,131,268	69,174	1,515,190	4,064,565	661,279	1,183,772	2,571,600	4,871,076	-193,917	8,250,908
% Change	103.6%	4.3%	3.8%	N.A.	N.A.	N.A.	N.A.	47.8%	-92.5%	N.A.

Special Education; Restricted Weightings; Early Childhood

	At Risk (4yr Old)	At Risk (K-12)	Bilingual	Extra Sch.	Voc. Ed.	Area Vocational	PAT	Adult Supp. Ed.	Driver Training	Group Total
2006	602,051	3,720,615	661,051	2,178,502	2,668,059	6,891,671	2,005,311	233,599	7,377,636	175,328,736
2007	1,082,436	9,625,158	1,324,905	2,332,468	4,497,365	7,880,680	2,275,155	233,430	7,736,334	196,522,323
2008	1,741,581	12,572,940	1,668,342	2,659,790	6,575,701	8,558,360	2,130,185	204,911	8,072,227	219,391,733
2009	2,532,263	17,388,282	3,435,130	2,385,556	10,827,870		2,220,704	252,131	8,324,399	281,079,675
2010	3,651,510	28,565,629	5,832,170	2,389,785	15,771,083		2,516,827	267,311	7,566,645	321,818,111
2011	4,835,973	41,527,138	6,858,050	3,368,448	20,989,708		3,145,624	290,794	7,944,358	362,075,249
$ Change	4,233,922	37,806,523	6,196,999	1,189,946	18,321,649	-6,891,671	1,140,313	57,195	566,722	
% Change	703.2%	1016.1%	937.4%	54.6%	686.7%	-100.0%	56.9%	24.5%	7.7%	

Allen, Gibbs & Houlik, L.C.
CPAs & Advisors

This white paper was created to help readers understand the complex but critical issue of school finance unencumbered cash balances. Developed by Allen, Gibbs & Houlik, L.C. (AGH) to demystify recent debate over school district budgets, this analysis uses plain-English business and accounting concepts to provide context. It is offered in two sections: the first two pages provide a quick overview; the second two pages give a more in-depth look for those who would like a more detailed review of the data. We offer both as a public service and hope they will prove useful to public officials, school districts and members of the community.

The white paper is based on an in-depth analysis of Kansas school districts' budgets and financials conducted by Mark Dick, a certified public accountant and certified fraud examiner with Allen, Gibbs & Houlik, L.C. who has specialized in public sector auditing for more than 40 years. He has testified on school finance for the Kansas Legislature and holds the Certified Government Financial Manager credential from the Association of Government Accountants. Mr. Dick's expertise in not-for-profit and governmental accounting is recognized nationally; he has served as an expert witness in litigation cases across the country.

For more information, please contact Mark Dick at (316) 267-7231 or mark.dick@aghlc.com. For a copy of this white paper, please visit AGH's website at www.aghlc.com.

ANALYZING SCHOOL DISTRICT UNENCUMBERED CASH BALANCES – AN OVERVIEW

Recent debate over school finance has zeroed in on funds left in school districts' reserves at the end of the June 30 fiscal year, called *unencumbered cash balances*. Based on an extensive study of Kansas school districts' budgets and financials, this white paper does not express an opinion on the "suitable funding" of Kansas schools, but simply provides an accounting context for school districts' unencumbered cash balances at fiscal year-end.

Some observers regard these balances as rationale to cut school district budgets, viewing funds remaining in the reserves on June 30 as evidence of too much spending. It's a flawed argument because it mixes up the very different issues of *cash* reserves and *the determination of "suitable funding" as required by the state constitution.*

Making sure you have enough cash on hand to pay your bills and keep the doors open in between revenue inflows is sound *cash management.* A financially healthy organization – whether commercial or not-for-profit – must maintain enough cash in reserve (sometimes referred to as working capital or operating liquidity) to operate the entity for a period of time until new revenue comes in. The Government Financial Officers Association best practices document recommends that entities maintain, at a minimum, an unrestricted fund balance of no less than two months of general fund operating revenues.

The amount of cash-on-hand at the districts' fiscal year-end reflects the districts' cash-management abilities – not whether the school district has suitable funding. The relevant question for unencumbered cash balances is "How many days of cash-on-hand should the school districts have in their reserves at any given time to pay bills and keep the doors open?" That is a distinctly separate and different question than "Do the school districts have the right amount of funding in their budgets?"

School District Cash Flow and Your Monthly Finances: An Analogy

This personal-finance analogy illustrates the cash flow timing issues school districts face.

If you worked for a company which paid about half of your salary in two lump-sum payments twice a year – say, in January and June – you would need to watch your cash carefully between those two paydays. When you are paid, you're obligated to fund commitments already made, such as your mortgage, car payment and so on. What's left over after that is your expendable income to cover "operating expenses" until the next payday – items such as groceries and gas.

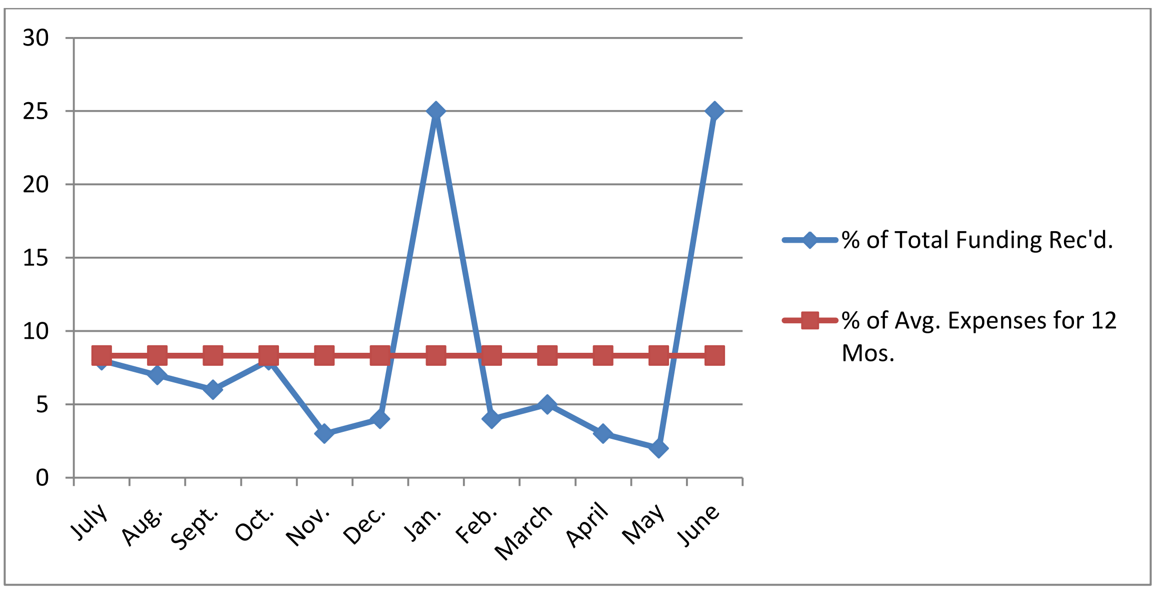
School districts must also conserve cash between "paydays." A review of several representative school districts shows that although their fiscal year ends June 30, districts receive about 25% of their total ***unrestricted*** funding in January and about 25% in June, with a smaller amount trickling in each month in between. Some federal, state and other funding has restrictions on how it can be spent, and so is not available for ongoing operating expenses. Although schools obviously spend more from August through May, significant expenses continue in the summer, including staffing, facilities, and preparation for the next school year.

In brief, school districts must stretch the "payday" of unrestricted funding they receive in June until the next significant funding arrives the following January, long after school begins. By comparison, if the State of Kansas, which receives a major funding infusion in April, had a fiscal year end of April 30, the State would also end its fiscal year with significant unencumbered cash balances.

The following comparison of funding dates compared to year-round expenses illustrates the cash flow of revenues of a typical school district. This chart focuses on unrestricted funding only, since that is the data available.

SCHOOL DISTRICT CASH FLOW ILLUSTRATION THROUGH A FISCAL YEAR
Based on data for unrestricted funds from Kansas school districts for FY 2010

	July	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.	March	April	May	June
% of Total Funding Received	8	7	6	8	3	4	25	4	5	3	2	25
% of Avg. Expenses for 12 Mos.*	8.33	8.33	8.33	8.33	8.33	8.33	8.33	8.33	8.33	8.33	8.33	8.33



*KSDE data provided did not include monthly expenses, so an average was used.

IN-DEPTH EXAMINATION OF SCHOOL DISTRICT UNENCUMBERED CASH BALANCES

Some controversy over the unencumbered cash balances school districts hold at their fiscal year-end has arisen in the past two years. Allen, Gibbs & Houlik, L.C. believes the debate has gotten off-track by mixing two key concepts: *cash* reserves and the "suitable funding" of Kansas schools. This in-depth study of school district unencumbered balances was developed to clarify the discussion and provide context.

School district cash balances may be considered from two perspectives. The first could be considered a "moving picture" of the cash balances, which fluctuate daily based on the daily receipts and disbursements of the school. The second perspective is the "snapshot" of the cash balances at any point in time during the year. Comparing the increase or decrease in the cash balances at a specific point sheds light on school districts' cash management abilities – but not on whether they are suitably funded.

All businesses, including school districts, need working capital. Net working capital is calculated as current assets minus current liabilities which, in the case of school districts, are equal to unencumbered cash balances. Working capital provides operating liquidity and allows the entity to pay bills promptly when they come due.

The Government Finance Officers Association (GFOA) of the United States and Canada has published best-practice recommendations for "appropriate level of unrestricted fund balance in the general fund." The GFOA states that "it is essential that governments maintain adequate levels of fund balance to mitigate current and future risks (e.g., revenue shortfalls and unanticipated expenditures) and to ensure stable tax rates. Fund balances are a crucial consideration, too, in long-term financial planning." While the level of unrestricted fund balance in the general fund should be based on the entity's specific circumstances, ***GFOA recommends that, "at a minimum … general-purpose governments, regardless of size, maintain unrestricted fund balance in their general fund of no less than two months of regular general fund operating revenues."***

One useful way to put working capital into perspective is to calculate the ratio of the ending cash balances to annual expenses. The result is a measurement of the percentage of annual expenditures the entity has in reserve and available to pay ongoing expenses. Providing this measurement of the working capital school districts have at year-end is a meaningful way to help a reader put the cash balances in perspective. School district financial data used to provide this information was studied in the following way:

- All financial data for the fiscal year ended June 30, 2011 was obtained from the Kansas State Department of Education. School districts were placed into five groups based on student enrollment:
    - Group 1 consists of the state's largest five districts.
    - The remaining districts were placed in quartiles based on student enrollment.

- Each district's funds were placed into five categories. Each district's authority over unencumbered cash is limited to two fund categories: unrestricted funds and funds within the Senate Bill 111 category. The remaining categories are subject to State, Federal or capital outlay and debt service restrictions.

Senate Bill 111 allows school districts to transfer ending balances as of June 30, 2012 back to the General fund up to a maximum of $232 per student excluding special education students. The provisions of Senate Bill 111 are not effective until the end of the current fiscal year which is June 30, 2012. Consequently, this analysis is focused on the unrestricted fund group and all funds excluding capital outlay and debt service type funds.

- **Unrestricted** – The available balance can be used for any legal purpose.
- **Restricted by State Legislation** – Funds whose use is restricted by Kansas law
- **Federal Restricted** – Funds whose use is restricted by Federal law
- **Senate Bill 111 Funds** – Funds identified in Senate Bill 111 which, for the fiscal year ending June 30, 2012, enables school districts to transfer ending balances back to the General fund subject to a maximum amount determined by legislators
- **Capital Outlay and Debt Service** – Funds legally restricted for use in capital improvements and payment of bond principal and interest

- Ending unencumbered cash balances were summarized by school district group and fund categories.

- Annual expenditures were summarized by school district group and fund categories. Transfers out of the General and Supplemental General funds were eliminated from expenditures to arrive at the operating expenditures of the fund.

Our study revealed some interesting facts and trends.

- The five largest school districts had the smallest percentage of working capital, while the percentage of working capital increased as school district size decreased – suggesting that larger school districts may require lower cash balances, perhaps due to stronger financial controls and budgeting experience.
- The average percentage of working capital in unrestricted funds by school district group ranged from 7.31% to 12.27%. The average for all school districts was 8.89% – enough for approximately one month of operating expenses. The average percentage of working capital for all funds excluding capital outlay and debt service funds was 16.58% – of which a significant portion is not available for unrestricted purposes due to state legislative restrictions.

The combined totals for all school districts' cash balances except for funds (excluding capital outlay and debt service funds) was $872.2 million. Of that total number, the cash balance for unrestricted funds was $241.3 million; the majority of the other funds had restrictions in place, such as legislative or Federal directives on how the money could be spent.

Seen as a stand-alone number, that's a significant cash balance. Put in perspective using the average daily operating expenses of the school districts, the $241.3 million in unrestricted funds would pay the school districts' bills for about 23 days. Would a business owner consider 23 days of working capital adequate cash on hand? **That's a valid question – and one on which AGH does not offer an opinion – but it is a completely separate question than whether school district are suitably funded.**