CDIAC

CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

California School Finance: The Practice of Borrowing from Bond Proceeds

INTRODUCTION

Nonprofit and governmental entities are obligated to show in their financial statements and reports how money is spent rather than how much profit was earned. Unlike for-profit businesses, which use a single set of self-balancing accounts, governmental organizations can have more than one general ledger (or fund), depending on their organizational and financial reporting requirements. Monies within each fund are managed according to the program and financial objectives associated with that fund. These same agencies may be authorized to borrow monies held in one fund as a way to meet cash flow shortfalls in another fund. This practice, known as interfund borrowing, is common to California school districts. California Education Code Section 42603 allows the governing board of a school district to temporarily transfer monies held in a fund of the school district to pay recognized obligations in another fund. Section 42603 does not limit this authority to particular funds.

Under certain circumstances, the practice of interfund borrowing by school districts makes both practical and financial sense provided that the interfund loan is properly documented and is authorized by the district's financial policies. However, the benefits of these borrowings may be overshadowed by the risks the district assumes when it transfers voter-approved and restricted general obligation bond proceeds to satisfy temporary shortfalls in operating funds, including its general fund. The California Constitution and California statutes set forth strict requirements on the use of voter-approved school district general obligation bond proceeds, specifically restricting the use of such proceeds to "capital" related projects such as new construction and improvement of existing facilities. Furthermore, U.S. Treasury Regulations include restrictions on tax-exempt general obligation proceeds for short-term "working capital" purposes.

This issue brief identifies the risks school districts assume when they choose to manage cash flow shortfalls by borrowing from bond funds. CDIAC contends that these risks outweigh the benefits gained and strongly recommends against this practice.

BACKGROUND

Short-term Borrowing by California Local Education Agencies

Short-term borrowing by school districts in California increased significantly during the Great Recession and through the early part of the recovery. Traditionally, the purpose of such borrowing was to finance temporary cash shortfalls that occurred before property taxes were received. But, school districts have also had to manage shortfalls created by delays in state apportionments. During the Great Recession, the state withheld as much as 20 percent of school funding for up to a year. By Fiscal Year 2011-12, inter-year deferrals for K-12 schools reached a high of $9.5 billion.[1]

The source and timing of school district revenues and expenses exposes districts to on-going cash management risk. The major source of local revenue for school districts - roughly 20 percent of total funding - is property taxes. These are received twice a year. Their major expense is personnel – generally, an expense fixed in advance and paid through monthly disbursements in roughly constant amounts. The disharmony between the timing of revenues and expenditures can create wide swings in the district's cash balances. The delays or holdbacks in state allocations, when they occur, only serve to accentuate a district's cash management problems. When cash on hand is insufficient to pay for fixed, current liabilities such as personnel expenses, a district may need to borrow to meet operating expenses.

Districts that have funds available (funds that may held in non-operating accounts) may prefer to borrow internally than from a financial institution, such as a bank. Why? Because it's faster and less costly to do so in most cases. To initiate an interfund borrowing, a district must prepare a *Resolution to Establish Interfund Transfers of Special or Restricted Fund Moneys* and present the resolution to the governing board for approval.[2] Once the clerk of the governing board certifies the resolution, the district superintendent is authorized to temporarily transfer

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1 Governor's Budget Summary 2013-14: K thru 12 Education 15, available at www.ebudget.ca.gov/2013-14/pdf/BudgetSummary/Kthru12Education.pdf.

2 Fiscal Crisis & Management Assistance Team publishes a fiscal procedurals manual for California County Offices of Education, including procedures for preparing the resolution. It can be found at http://fcmat.org/wp-content/uploads/sites/4/2019/02/COE-manual-2019-final.pdf.

money between the district's funds.[3] During the Great Recession many districts routinely passed resolutions even if they did not subsequently undertake a transfer.

California Education Code Section 42603 requires that districts account for transfer of monies between two internal funds as a temporary borrowing. The Department of Education requires districts to account for the transfers as "due to/due from" entries in their financial reports. Districts report the "due to/due from" entries on the Balance Sheets in their Financial Statements issued at the end of each fiscal year. "Due from" entries are listed under "Assets" and "due to" entries as "Liabilities" on the *Governmental Funds Balance Sheet* or *Proprietary Funds Statement of Net Position*.[4]

School districts must use borrowed funds to pay off existing obligations and cannot appropriate the funds for other uses. Section 42603 limits districts from effecting a transfer between accounts if the receiving account will not receive enough income in the current fiscal year to repay the borrowed funds. Generally, transferred funds must be repaid within the same fiscal year. The funds may be repaid in the following fiscal year only if borrowed within the last 120 days of the current fiscal year. Transfers are limited to 75% of the maximum balance in the lending account.

School districts generally disclose an interfund borrowing in its official statements used in connection with the sale of bonds.[5] These disclosures are normally found in an appendix containing the district's most recent fiscal year's audited financial statements.[6] The audited financial statements include information about the district's use of interfund borrowing on its Balance Sheet. Additionally, some districts include information about interfund borrowing in the official statements for TRANs, under a heading such as *Interfund Borrowing* or *Interfund and Intrafund Borrowing*.[7]

Alternatives to Interfund Borrowing

School districts may use other means than interfund borrowing to resolve cash flow shortfalls. The most common is a Tax and Revenue Anticipation Note (TRAN), a short-term note that may be issued by the district or the county board of supervisors, on its behalf, and secured by anticipated tax revenues to be collected in the same fiscal year.[8] TRAN funds, typically held in a "proceeds" fund or account, may be used for any purpose, including current expenses, capital expenditures, repayment of indebtedness, and investment.[9]

A school district may borrow from the county superintendent of schools.[10] A county superintendent, with the approval of the county board of education, can loan funds to a district for the specified purpose of covering current operating expense shortfalls.[11] Funds are issued at the county office's discretion and are subject to availability. Borrowers must repay such loans within the same fiscal year.

School districts may also seek to borrow against future payments to carry out facilities repairs. To do so, the district must submit a resolution to the county board of supervisors requesting a loan. Following the board's approval, the county treasurer's office disburses the funds to the district in an amount not to exceed 85% of the amount of money accruing to the district during the current fiscal year.

Districts may also address cash shortfalls by undertaking a constitutional advance of property tax revenues.[12] The governing board of a school district may submit a resolution to the country treasurer requesting an advance on tax revenues. Repayment of the advance is made from tax revenues accruing to the district later in the fiscal year. The advance may not exceed 85% of the district's anticipated property tax revenues for the forthcoming fiscal year.

RISKS ASSOCIATED WITH BORROWING FROM BOND PROCEEDS

Using bond proceeds for the purpose of meeting short-term cash shortfalls in operating funds poses certain risks to issuers, bondholders, as well as other creditors of the borrower. These risks include the loss of the tax-exempt status for district-issued bonds, loss of the direct subsidy paid for bonds is-

[3] Although the resolution template allows for the funds subject to interfund transfers to be listed, many districts pass resolutions without listing those funds. Even where districts do list the funds, some do not indicate which accounts are lenders and which are borrowers. There is no requirement for the district to document which accounts are used for transfers, how much was transferred, or whether a transfer was made.

[4] The due to/due from entries may be more aptly named as interfund payables and interfund receivables. The interfund transfers may also be noted in the *Statement of Revenues, Expenditures and Change in Fund Balances* as operating transfers under "Other financing sources."

[5] Districts generally cite California Education Code Section 42603 as authority for these transfers.

[6] This information is generally provided in the Official Statement's Appendix A.

[7] These disclosures may report the fact that the district routinely requests authorization for interfund transfers and provide a projected interfund borrowing capacity for the upcoming fiscal year.

[8] The issuance of a TRAN may be precipitated by an earlier transfer of funds. CDIAC learned of more than one case in which a district was forced to issue a TRAN in order to repay a loan made by a school district against its bond proceeds.

[9] California school districts may issue TRANs in an amount no greater than 85% of the estimated total amount of the uncollected taxes, income, revenue, and all other sources of repayment.

[10] California Education Code Sections 42621-42622 and 42620 respectively.

[11] Loans cannot exceed 85 percent of the amount of money accruing to the district at the time of the transfer.

[12] California Constitution Article XVI Section 6.

sued pursuant to the American Recovery and Reinvestment Act, violations of federal and state law, downgrades in credit ratings, and the loss of public trust.[13] In addition, the use of interfund borrowing may complicate a school district's financial management as it would burden staff and decision makers with additional responsibilities required to manage borrowed funds in compliance with tax and treasury regulations.

Loss of Tax-Exempt Status

Bonds that have been issued as tax-exempt investments may lose this tax status if the proceeds of the bonds are not spent in accordance with U.S. Treasury regulations. The exemption from income tax provided to holders of public debt depends on how the borrowed money was spent rather than on the type of entity that did the borrowing. Bond proceeds generally may not be used outside of the designated project(s), including being used as "working capital" to cover the issuer's general operating expenses.[14]

Once a tax-exempt bond is deemed to be taxable, interest payments to bondholders are no longer tax deductible, affecting both the price and marketability of the bonds. Such events are catastrophic for investors who purchased bonds expecting to shelter their interest income from taxes. In response to such an event, investors often seek to recover losses directly from the issuer. In addition, the Internal Revenue Service (IRS) may undertake additional inquiries on the use of tax-exempt bond proceeds by the issuer. Subsequent reviews will likely consider the issuer's disclosure documents, such as the Official Statement, where a failure to disclose activity that might result in the loss of the tax exemption could be construed as a material omission of fact in violation of federal anti-fraud regulations. In addition, an issuer may be required to pay more for future tax-exempt borrowings due to investor concerns that the issuer will not take reasonable action to prevent its bonds from becoming taxable.

Loss of Direct Subsidy

In the case of Qualified School Construction Bonds (QSCBs) and Build America Bonds (BABs), interfund borrowing may result in the loss of the direct subsidy payments. The provisions governing the use of QSCBs and BABs proceeds require that they be used in furtherance of a designated project, such as "construction, rehabilitation, or repair of a public school facility or for the acquisition of land on which such a facility is to be constructed."[15] Failure to comply with the Treasury regulations' allocation requirements may disqualify the bond issue and result in a loss of the direct subsidy for the remaining term of the issue. Issuers who lose their subsidies are still obligated to meet their debt service obligations, but now possibly from other program funds. Investors who hold direct subsidy bonds would suffer a loss in the asset value of the bonds as well. Because of the security underlying these bonds, they are often rated higher than similar credits. Removing this security erodes the credit quality and likely the market value of these bonds.[16] The failure to meet Treasury regulations with regard to the use of BABs proceeds may also expose the issuer to greater scrutiny by the IRS.[17]

Violations of Law

The use of bond proceeds outside of their intended capital purpose, even if only on a temporary basis, may violate state law as well. School districts may issue general obligation bonds under the authority of Proposition 39 or Proposition 46. Proposition 39, which amended Article XIII A of the California Constitution, requires that an issuer specify the purposes of general obligation bond proceeds and may not spend these proceeds "for any other purpose, including teacher and administrator salaries and other school operating expenses." Similarly, Proposition 46 allows local agencies to issue general obligation bonds, but restricts the use of proceeds to "real property and improvements."[18] Funding working capital fails to meet this test and, as a result, covering temporary working capital shortfalls may also create legal risk.

Bonds issued under either Proposition 46 or 39 are also subject to provisions of the California Education Code. Section 15100 of the Education Code sets forth permitted purposes for proceeds including construction, repair, restoration, furnishment, and equipment. Section 15146 prohibits the use of general obligation bond proceeds for purposes other than those specified at the bond's issuance. Therefore, interfund borrowing involving a transfer of general obligation bond proceeds to funds with expenditures outside of the designated capital project for which the bonds were issued may violate these sections of the Education Code.

Education Code Section 42603 broadly allows for the temporary transfer of funds in any fund or account for payment of ob-

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[13] The American Recovery and Reinvestment Act (ARRA) established the Qualified School Construction Bond and Build America Bond programs.

[14] Treasury Regulation 1.148-6(d)(3)(i). While Treasury Regulations allow for funds to be used for the administrative costs of the capital improvements, funds may not be used as "working capital" outside of that limited purpose.

[15] U.S. Treasury Regulation 54F governs QSCBs and Regulation 54AA governs BABs.

[16] Trading of direct subsidy bonds that have been affected by the reduction of their subsidies as a result of sequestration would bear this out.

[17] BABs are typically audited at a higher rate than other locally issued tax-exempt debt and thus, using those bond proceeds in violation of Treasury Regulations carries a higher risk. In 2012 the IRS audited the city of Half Moon Bay, California and disputed whether the use of BABs proceeds complied with federal regulations. The dispute resulted in the city paying a $174,000 settlement and reducing its subsidy payment.

[18] Proposition 46 was a statewide initiative approved in 1986 and requires 2/3 of the electorate to approve a general obligation bond. Proposition 39 was also a statewide initiative, approved in 2000. It requires only 55% of the electorate to approve general obligation bonds and is now the predominant means of authorizing those bonds.

ligations. However, this Section may be contradicted by the restrictions imposed by Sections 15100 and 15146. Section 42603 may also be in conflict with the California Constitution, Article XIII A in the event that an interfund borrowing involves general obligation bond proceeds transferred to a general operating account that pays teacher and administrator salaries or pays for operating expenses, no matter how temporary such transfers might be. Based on principles of statutory construction, under which specific language overrides potentially contradictory general language in the same or a different statute, the authority provided districts by Section 42603 to conduct interfund borrowing may be preempted and inapplicable to the extent that it conflicts with federal law or the California Constitution.

Whether a general obligation bond is issued as a BAB or QSCB or in accordance with Proposition 46 or 39, the proceeds are restricted for use on capital projects. Temporarily transferring funds from these bond funds to be used outside the capital project may contravene the purpose of those bonds and exposes the school district to legal challenges from investors or regulators. The financial and organizational costs of defending against these challenges pose substantial risks to districts.

Violation of Disclosure Requirements

Federal regulations impose specific disclosure and anti-fraud requirements on certain municipal market participants. Failure to annually disclose operating information and audited financial statements violates Securities and Exchange Commission (SEC) Rule 15c2-12. Additionally, if a municipal entity does not disclose the full amount or effect of material information, such as a transfer of bond proceeds, in bond offering documents it may also constitute a material misrepresentation or omission. Material misrepresentations and omissions violate Section 17(a) of the Securities Act of 1933, and Sections 10(b) and 10(b)-5 of the Securities Exchange Act of 1934.

Since the passage of the Dodd-Frank Act, the SEC has increased scrutiny of municipal securities with a focus on disclosure. School districts should thoroughly assess whether they may be violating disclosure requirements by not reporting interfund borrowings. Should the SEC deem these omissions to be a failure to disclose material facts, it may initiate an enforcement action against the district.[19] Defending against such actions imposes substantial financial and organizational risk.

Other Considerations

School districts should consider the broader implications of regularly practicing transfers between funds or accounts to meet cash shortfall. Apart from legal and regulatory requirements, interfund borrowing may negatively affect a district's access to the capital markets and the community's support of its educational and facility goals.

In analyzing the probability that an issuer will repay the entire principal to an investor, the major credit rating agencies – Standard & Poor's, Moody's, and Fitch – identify interfund borrowing as a criterion in their ratings. In various ratings reports, these rating agencies cited significant or increased reliance on interfund borrowing as an indicator of the issuer's weakened financial position and used this fact, in part, to justify a ratings downgrade.[20] The Fiscal Crisis & Management Assistance Team (FCMAT), an independent and external state agency created in 1992 to provide fiscal, business, and management reviews to local education agencies in California, considers interfund borrowing when analyzing a district's fiscal condition. FCMAT recognizes that interfund borrowings may be an indicator of existing or emerging financial problems.

Ratings downgrades send out a ripple of adverse impacts and suggest that the bond carries a higher risk of timely or full repayment. As a result, the price of outstanding bonds falls and the cost of "yet-to-be-issued" bonds rises. Both the issuer and the investor are harmed as a consequence. Moreover, the district's stakeholders may end up paying higher taxes – or with fewer capital assets – as a result of such increased borrowing costs in the future.

School districts that engage in interfund borrowing also risk losing the public's trust. Failure to use bond proceeds as specified in the bond resolution breaches the trust of the voters who authorized the issuance of bonds for specific purposes. The public may perceive interfund borrowing of bond proceeds to be a mismanagement of these funds. A cynical electorate that distrusts or disapproves of its district's use of bond proceeds may be unsupportive of that district's bond initiatives in the future. Finally, poorly timed transfers from bond funds can cause delays to projects funded by proceeds. These delays may generate additional costs either from project financing or penalties for failing to meet project timelines.

CONCLUSION

While recognizing that interfund borrowing can be a useful means for school districts to remedy cash flow shortfalls, CDIAC takes the position that interfund borrowing that involves a transfer of gen-

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[19] The Securities and Exchange Commission (SEC) has recently increased its regulation of the municipal market and filed several enforcement actions against municipal issuers. In *SEC v. City of Miami, Florida* the SEC alleges that the city failed to disclose the full amount and effect of interfund transfers in its bond offering documents, constituting material misrepresentations and omissions. The SEC also recently filed an enforcement action against a district for failure to meet continuing disclosure obligations in *SEC v. West Clark Community Schools*.

[20] Rating agencies are likely to be view the use of bond proceeds for operations differently. A school district's debt position may be negatively impacted by a transfer of bond proceeds if the district is unable to repay that loan within the required time period and is forced to issue additional debt to balance its accounts. With regard to school general obligation bonds specifically, the district's failure to comply with Propositions 46 and 39, may affect a rating agency's "rating-favorable" conclusion that the relevant restricted tax revenues that repay school general obligation bonds are considered "special revenues" under the Bankruptcy Code.

eral obligation bond proceeds to a general operating fund poses a substantial risk to issuers. Transfers of bond proceeds to operating funds may result in a loss of the bond's tax-exemption or direct subsidy, leading to higher costs to taxpayers and bondholders. Interfund transfers of bond proceeds exposes issuers and other market participants to inquiries about disclosure and the fair treatment of investors. Both issuers and regulated entities, such as underwriters and municipal advisors, must consider their practice of interfund borrowing in their disclosures and financial reports. Such borrowings may contribute to a credit rating downgrade, producing market losses for investors and potentially higher financing costs for the issuer's future debt. School districts that misuse bond proceeds may suffer a loss of public trust and, losing that support, find it harder in the future to finance needed school construction projects. CDIAC recommends that districts do not, under any circumstances, carry out interfund borrowings that transfer bond proceeds to fund general operation purposes, even if these transfers are carried out on a temporary basis. CDIAC believes districts have alternatives to meet cash flow shortfalls, including TRANs or loans from the county office of education or the county treasurer's office.

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