REPORT BY THE

AUDITOR GENERAL

OF CALIFORNIA

AN ESTIMATE OF OAKLAND UNIFIED SCHOOL DISTRICT'S CURRENT AND FUTURE FINANCIAL CONDITION

F-931

AUGUST 1989

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August 21, 1989 F-931

Honorable Elihu Harris, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 2148
Sacramento, California 95814

Dear Mr. Chairman and Members:

We were asked to review the Oakland Unified School District's management and financial operations for fiscal years 1987-88 and 1988-89 as well as its budget projections for fiscal year 1989-90. Our review revealed that the district continues to have financial difficulties. The district ended fiscal year 1987-88 with a general fund balance of $452,318, and its unaudited actual general fund balance at June 30, 1989, was approximately $1.8 million. We project that the district will have a general fund deficit of approximately $2.6 million by June 30, 1990.

The district has analyzed two external financing alternatives to alleviate its financial difficulties: obtaining a state loan and issuing certificates of participation. We found that the costs associated with a state loan, which include the cost of a State-appointed trustee, are slightly greater than the costs for an issue of certificates of participation that would yield equivalent proceeds. However, Assembly Bill 2525, which is currently being considered by the Legislature, would require a State-appointed trustee whether or not the district accepts a state loan. If the bill is passed, the least expensive financing option would be a state loan.

The district's board of education is opposed to a State-appointed trustee and is considering issuing certificates of participation that would yield $20 million. The district plans to use the proceeds from the certificates to establish cash reserves by designating portions of its general fund balance for uncertainties and future uses. However, without implementing a comprehensive plan to reduce its expenditures, increase its revenue, or both, the district will not improve its overall financial condition by obtaining a state loan or by issuing certificates of participation. In fact, the district may not be able to repay either of these financing options without reducing its general fund balance.

Background

The Oakland Unified School District (district) is administered by a superintendent in accordance with policies approved by the district's seven-member board of education (board). The board members, elected officials serving staggered four-year terms, appoint the superintendent, who is responsible for preparing and submitting to the board a budget for each fiscal year. Since December 1988, an interim superintendent has directed the district's operations.

During the 1988-89 school year, the district was the sixth largest in California, with an average daily attendance of approximately 53,000 pupils. For the 1988-89 school year, it operated 59 elementary schools, 16 middle and junior high schools, and 11 senior high and vocational education schools. The district also maintained 20 child development centers, 4 opportunity schools and centers for redirection, and 4 adult education schools. The district currently employs approximately 6,900 people. In fiscal year 1988-89, the district had a general fund operating budget of approximately $206 million.

The Alameda County superintendent of schools (county superintendent) reviews and approves the district's final budget each year. The county superintendent also reviews and approves the district's disbursements and deposits the majority of the district's receipts with the Alameda County Treasurer's Office. The Alameda County Treasurer's Office acts as a banker for the district, disbursing cash for outstanding warrants and investing any surplus funds in interest-bearing accounts.

The district has experienced financial difficulties for a number of years. In May 1986, we reported that the district's budgeted expenditures exceeded its anticipated revenues for fiscal year 1985-86. At that time we did not recommend that the district obtain an emergency loan from the State because it had sufficient cash balances to meet its existing needs. However, we reported that, unless the district received additional revenue or substantially reduced its expenditures, it would have general fund deficits in fiscal years 1986-87 and 1987-88. We identified similar problems in the district in March 1987. The district's actual general fund balances at June 30, 1986, 1987, and 1988, were approximately $4.9 million, $4.4 million, and $452,000, respectively.

In August 1986, the district issued approximately $58 million in certificates of participation. The district intended to use the certificates to finance capital improvements, equipment, and deferred maintenance. The agreement for the certificates provided that a nonprofit corporation would hold title to the improvements and would then lease the improvements to the district. However, the district did not make all of the intended improvements, so the majority of the proceeds were held in a bank, enabling the district to earn interest that was higher than the interest it had to pay on the certificates. We estimate that the district will receive a net interest gain of $607,000 by the time all of the certificates are retired.

In March 1989, the Deloitte Haskins & Sells (DH&S) accounting firm reported to the county superintendent that the district continues to experience financial difficulties. The report stated that the district could end fiscal year 1988-89 with a general fund deficit of up to $5.2 million. The report also predicted that at the end of fiscal year 1989-90, the district may have insufficient cash to meet its obligations and may have a general fund balance deficit of up to $12 million.

On April 20, 1989, Assemblyman Elihu Harris introduced Assembly Bill 2525 (AB 2525), which would provide a $10 million emergency loan to the district. This bill would also require the State's superintendent of public instruction to appoint a trustee to monitor and review the district's operations, whether or not the district chooses to accept the emergency loan. In an attempt to alleviate its financial difficulties, as an alternative to accepting a state loan and a State-appointed trustee, the district is considering issuing additional certificates of participation that would yield proceeds of $20 million.

Scope and Methodology

The purpose of our audit was to review the management and financial operations of the district for fiscal years 1987-88 and 1988-89 as well as the district's budget projections for fiscal year 1989-90. This report, the first on the results of our review, shows the district's general fund balance for fiscal year 1987-88, its estimated general fund balance for fiscal year 1988-89, and its projected general fund balance for fiscal year 1989-90. This report also compares the cost of a state loan with the cost of an issue of certificates of participation that would yield equivalent proceeds. Finally, this report compares the effect of a state loan and of the certificates on the district's financial condition. We will continue to review the district's management and financial operations and report the results at a later time.

We reviewed the district's audited financial statements for fiscal year 1987-88; the DH&S March 1989 report and the related working papers regarding the district's financial status; the district's first and second interim reports for fiscal year 1988-89; the district's unaudited actual financial report for fiscal year 1988-89, dated August 8, 1989; and the district's tentative budget for fiscal year 1989-90. We also reviewed a letter from the district's external auditor that responded to the DH&S report.

We reviewed the district's unaudited actual general fund balance for reasonableness, and we compared it to the district's estimated general fund balance at June 30, 1989. Next, we projected the district's balance for June 30, 1990. To be consistent with the district's external auditor, we combined the general fund with the self-insurance fund, which is used to account for monies designated for losses and payments on district property, for self-insurance programs, and for noninsured perils.

Further, we analyzed and compared the costs to the district of two financing alternatives available to the district: a state loan and an issue of certificates of participation. We also analyzed and compared the repayment schedules of the two financing options. Finally, we compared the effect that a state loan and the certificates would have on the district's overall financial condition.

During the audit, we contacted staff at the State Department of Education, the State Controller's Office, the Office of Local

Assistance at the State Department of General Services, the Alameda County Office of Education, and the district's office. We also contacted staff at other districts that have encountered financial difficulties in the past few years.

Because the procedures cited above were not sufficient to constitute an examination of the financial statements made in accordance with generally accepted auditing standards, we do not express an opinion on any of the financial statements referred to in this report.

The District Continues To Have Financial Difficulties

The district ended fiscal year 1987-88 with a balance of $452,318 in its general fund. However, the district's unaudited financial report dated June 28, 1989, showed that the district had spent more than it received in fiscal year 1988-89, resulting in an estimated zero general fund balance at June 30, 1989. On August 8, 1989, the district provided us with its final unaudited financial report for fiscal year 1988-89. This report showed that the district had a balance of approximately $1.8 million in its general fund at June 30, 1989. We reviewed the revenue and expenditure amounts shown in this revised report and determined that the district's representation of its general fund balance at June 30, 1989, appeared reasonable.

In its tentative fiscal year 1989-90 budget dated June 28, 1989, the district projected a $44 million general fund balance at June 30, 1990. This projection is based on the assumption that the district will issue certificates of participation that will yield proceeds of $20 million and that, in its restricted programs, revenue and other sources will exceed expenditures and other uses by $21.967 million. We reviewed the district's revenue and expenditure projections for the 1989-90 fiscal year and project that the district will have a general fund deficit of approximately $2.6 million by June 30, 1990.

Table 1 presents the district's actual general fund balance as of June 30, 1988 (as determined by the district's external auditor); the district's estimate of the general fund balance as of June 30, 1989; the district's unaudited actual general fund balance as of June 30, 1989; and both the district's and the auditor general's projection of the district's general fund balance as of June 30, 1990.

TABLE 1

OAKLAND UNIFIED SCHOOL DISTRICT
ACTUAL, ESTIMATED, AND PROJECTED GENERAL FUND BALANCE
FOR THE YEARS ENDING JUNE 30, 1988, 1989, 1990
(IN THOUSANDS)

	1988	1989			1990		
	Audited Actual	District Estimate as of 6-28-89	Unaudited Actual as of 8-8-89	Increase (Decrease)	District Projection as of 6-28-89	Auditor General Adjustment	Auditor General Projection
Revenues							
Revenue limit	$133,803	$137,364	$136,021	$(1,343)	$147,177		$147,177
Federal revenue	14,070	15,627	14,357	(1,270)	15,092		15,092
Other state revenue	43,637	51,008	53,083	2,075	43,862	$ 2,900	46,762
Other local revenue	1,765	1,312	1,990	678	22,252	(21,600)	652
Prior year revenue adjustments	21						
Total Revenues	193,296	205,311	205,451	140	228,383	(18,700)	209,683
Expenditures							
Certificated salaries	98,189	105,732	104,762	(970)	95,266	11,099	106,365
Classified salaries	33,977	34,552	34,895	343	27,471	8,820	36,291
Employee benefits	36,004	37,988	36,726	(1,262)	32,924	5,344	38,268
Books and supplies	6,569	8,130	6,418	(1,712)	5,086	2,039	7,125
Contracted services	16,538	18,110	16,956	(1,154)	17,807	1,603	19,410
Other operating expenses		1,516	1,466	(50)			
Capital outlay	2,790	2,013	1,595	(418)	802	1,264	2,066
Other outgo	2,430				1,658	(536)	1,122
Direct support and indirect costs		(2,243)	2,000	243	(2,692)	2,692	
Prior year expenditures	93						
Total Expenditures	196,590	205,798	200,818	(4,980)	178,322	32,325	210,647
Other Financing Sources (Uses)							
Other financing sources		3,331		(3,331)			
Transfers in	1,413		253	253			
Transfers out	(2,094)	(3,296)	(3,560)	(264)	(6,191)	2,821	(3,370)
Total Other Financing Sources (Uses)	(681)	35	(3,307)	(3,342)	(6,191)	2,821	(3,370)
Excess of revenues and other sources over (under) expenditures and other uses	(3,975)	(452)	1,326	1,778	43,870	(48,204)	(4,334)
Fund Balance, Beginning of Year	4,427	452	452	0	200	1,578	1,778
Fund Balance, End of Year	$ 452	$ 0	$ 1,778	$ 1,778	$ 44,070	$(46,626)	$ (2,556)

Differences Between the District's Estimate of the June 30, 1989, Fund Balance and the Unaudited Actual Balance

Revenues Increased by $140,000. The district's revenue estimate as of June 28, 1989, was overstated. However, the June estimate does not include approximately $3.6 million in other state revenue that the district did not become aware of until after June 28, 1989. Therefore, the district's total unaudited actual revenue on August 8, 1989, including the additional $3.6 million, increased by only $140,000 over its June estimate.

The additional revenue of $3.6 million includes $2.7 million of revenue from Proposition 98, which was passed by the California voters in November 1988 and requires the State to distribute any tax revenue in excess of its appropriations to public schools and community colleges rather than return it to taxpayers. The district was notified by the State Department of Education (SDE) on July 28, 1989, that the district's share of the State's 1988-89 fiscal year excess revenues is $2.7 million. This should be considered one-time revenue to the district, since the district can not be assured that the State will have excess revenues each year.

The remaining $900,000 in other state revenue that was not included in the district's estimate at June 28, 1989, represents the district's revised estimate of the lottery revenue it will receive for fiscal year 1988-89. On June 30, 1989, the SDE notified the district of the total lottery revenue that the district could expect for fiscal year 1988-89. This estimated total is approximately $900,000 above the district's estimate in its financial report dated June 28, 1989.

Expenditures Decreased by $4.980 Million. The district's actual expenditures for fiscal year 1988-89 were approximately $5.0 million less than its estimated expenditures on June 28, 1989. Certificated salaries, employee benefits, books and supplies, and contracted services were the main categories that were overestimated.

Other Financing Sources Decreased by $3.331 Million. The district's estimate of its general fund balance at June 30, 1989, included $3.331 million in other financing sources from an advance for the Voluntary Integration Program (VIP). The VIP is a State-funded program designed to remedy the harmful effects of racial segregation. The district submitted a VIP plan to the State Controller's Office (SCO) for its approval in July 1988. The major component of this plan was a program to reduce class size in the district's racially isolated schools by hiring 202 new teachers. The SCO provisionally approved the district's plan after it made several adjustments, and it advanced $5.7 million to the district to implement the plan.

The SCO visited the district in May 1989 to determine what costs the district had incurred for the VIP and which of these costs would be reimbursable by the State. The reviewers determined that the district had not fully implemented its VIP plan and had hired only 30 new teachers instead of 202. The reviewers estimated that the district probably had only $1.2 million in allowable expenditures. However, the district has until November 1989 to submit a claim for reimbursement to the SCO identifying all the district's expenditures for VIP. At that time, the SCO will audit the district's claim to determine the actual amount of reimbursable expenditures. If the district does not have $5.7 million of allowable expenditures, it will have to return the portion of the initial advance that is not allowable.

However, the district has not yet decided whether it will submit a claim for VIP reimbursement for fiscal year 1988-89. Because fiscal year 1988-89 was the first year that the district implemented a VIP, it would be considered the district's "base year" if a claim is submitted. That is, the amount of state reimbursement in each subsequent year would be limited by the amount spent in fiscal year 1988-89. Since the allowable expenditures for fiscal year 1988-89 will probably be only $1.2 million, the district's claim for this year would limit its reimbursement for VIP funds in future years.

The district included approximately $3.331 million from the VIP advance in its unaudited financial report for fiscal year 1988-89 dated June 28, 1989. This amount represents the portion of the $5.7 million VIP advance that the district needed to avoid a general fund deficit. Based on the SCO field visit discussed above, we believe that the most reasonable estimate of allowable VIP expenditures is approximately $1.2 million. If $1.2 million, rather than $3.331 million, of recognizable VIP revenue had been included in the district's estimate as of June 28, 1989, the district's estimate would have shown a $2.1 million general fund deficit at June 30, 1989. However, if the district decides not to file a VIP claim for fiscal year 1988-89, it will not be able to recognize any of the $5.7 million VIP advance. If no VIP revenue had been recognized in the district's June 28, 1989, estimate, the general fund balance would have been reduced by $3.331 million, resulting in an estimated deficit of approximately $3.331 million at June 30.

The district's actual unaudited general fund balance for fiscal year 1988-89, as of August 8, 1989, does not include any of the $5.7 million advance from the VIP in its other financing sources. However, if the district does decide to submit a claim for the VIP, the district would probably have an additional $1.2 million of recognizable revenue for fiscal year 1988-89.

Differences Between the District's Projection of the June 30, 1990, Fund Balance and the Auditor General's Projection

Revenue Decreased by $18.700 Million. The district's tentative budget includes $20 million in revenue from the proposed issue of certificates of participation. However, the board has not yet approved this issue, and the county superintendent informed the district that he will not approve a final budget that uses certificates to fund the district's operating costs. Our review of certificates of participation revealed that they are traditionally used to finance capital projects or to purchase equipment. We are aware of only one other California school district that recently issued certificates of participation to avoid a general fund deficit. For these reasons, we reduced the district's revenue by $20 million.

In addition, the district's budget includes $1.6 million in revenue from the proceeds of the anticipated sale of one of the district's surplus properties. However, this sale has not been completed. Even if it is completed, Section 39363 of the California Education Code prohibits the district from depositing revenue from the sale of surplus property in the general fund and using it for operations without the approval of the State Allocation Board. This approval is granted only under certain circumstances. Therefore, we reduced the district's revenue by $1.6 million.

Further, we believe the district underestimated its other state revenues for fiscal year 1989-90 because it did not include prior year carryovers. Therefore, we increased the district's projection of other state revenues by $2.900 million.

<u>Expenditures Increased by $32.325 Million</u>. The district's fiscal year 1989-90 budget also includes approximately $56 million in revenue for restricted programs but does not include all of the corresponding expenditures. Any portion of this amount that is not spent on restricted programs may be refundable to the federal or state agency that advanced the funds. Therefore, we increased all of the district's expenditure categories for fiscal year 1989-90. Increases in salaries and benefits agree with the actual expenditures in these categories for fiscal year 1988-89; increases in all other categories are based on the trend of expenditures in prior years. However, as discussed in subsequent paragraphs, we further adjusted salaries and benefits for recent layoffs and cost-of-living adjustments.

Since our projection for salary and benefit expenditures is based on prior year expenditures, we had to reduce our projected expenses for certificated and classified salaries and benefits to reflect the estimated savings from the district's recent layoffs. However, as of July 24, 1989, the district had not removed from its payroll 63 of the 143 certificated teachers it stated it would lay off. Although the district estimated that it would save $5.1 million as a result of reducing its staff of certificated teachers, we reduced our projection by only $2.821 million. We used the district's method of calculating employee benefits by assuming that benefits cost 26.825 percent of the cost of salaries.

In addition, the district will not realize all of the savings it estimates it will achieve by eliminating certificated administrative positions. The district reassigned at least seven certificated administrators whose positions had been eliminated to other positions. In most cases, these administrators were reassigned to positions that had been filled by employees who earned lower salaries than these reassigned administrators will earn. For example, the district reassigned one of the administrators whose position had been eliminated to a teaching position. The district will pay this reassigned administrator $4,014 per month in the teaching position; the district paid only $2,420 per month to the previous teacher, who is one of the teachers the district has stated it will lay off. Therefore, we reduced our projection for certificated salaries and benefits for administrators by only $549,000, whereas the district estimated it would achieve a $1.1 million reduction in salaries and benefits by eliminating certificated administrative positions.[1]

In November 1988, the district removed three classified administrators from the payroll and reassigned one classified administrator. (Classified employees are those whose jobs do not require credentials or permits issued by the Commission on Teacher Credentialing.) Assuming that the district does not rehire these individuals or hire others to fill their positions, we estimate that the district will save $59,200 in classified salaries and benefits in fiscal year 1989-90. We included this savings in our projection. Although the board also approved the layoff of additional classified personnel, we were unable to determine when the savings from these layoffs would actually occur. Therefore, we made no adjustment to classified salaries and benefits for savings from these layoffs.

Further, the district's budget includes cost-of-living adjustments (COLAs) to the salaries and benefits of its certificated or classified employees for only one bargaining unit. As of June 28, 1989, this was the only one of the 12 employee bargaining units in the district with which the district had settled its negotiations for fiscal year 1989-90. This bargaining unit received a 4.14 percent COLA increase for fiscal year 1989-90. We anticipate that the other units will receive similar COLA increases. Therefore, we increased both certificated and classified salaries by 4.14 percent, a total of approximately $5.7 million.

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[1]On August 9, 1989, the district's superintendent submitted several personnel actions to the board. One of these actions will retroactively reinstate one of the eliminated administrative positions. In addition, seven other certificated administrators are to be reassigned effective August 21, 1989. One of these employees is the administrator reassigned to a teaching position, referred to in the example above, who would be earning more in that position than the previous teacher did. Finally, on August 16, 1989, the district's board voted to rehire 77 of the 143 certificated teachers it previously stated it would lay off. Although these proposed personnel actions will probably result in even lower savings to the district, we have not changed our estimate of how much the district will save as a result of laying off teachers and eliminating certificated administrative positions because these changes were proposed after the end of our fieldwork.

Other Financing Uses Decreased by $2.821 Million. The district's budget also included some transfers from the general fund to the Cafeteria Fund, the Child Development Fund, and other funds. However, based on the amounts transferred to these funds in the past, we believe the amounts were underestimated. Therefore, we added approximately $1.1 million to transfers out of the general fund.

Since we combined the self-insurance fund with the general fund for our projection, the budgeted $4.0 million transfer from the general fund to the self-insurance fund is eliminated in the combined presentation.

Fund Balance, Beginning of Year Increased to $1.778 Million. Finally, since the district's unaudited actual general fund balance at June 30, 1989, was $1.778 million, as discussed above, we adjusted the district's beginning fund balance for fiscal year 1989-90 to this same amount.

The Attachment to this letter summarizes the assumptions we used to prepare the fund balance projection for June 30, 1990.

Two External Financing Options Available to the District

The two financing alternatives that the district has analyzed are to obtain a state loan and to issue certificates of participation. Under the first option, the district could request an emergency loan from the State's General Fund through the State's superintendent of public instruction. AB 2525, if adopted as written at our last review on July 31, 1989, would provide an emergency loan of $10 million to the district and would require the State's superintendent of public instruction to appoint a trustee to monitor and review the district's operations. The district pays the expenses incurred by the trustee, including compensation, incidental expenses, and bonding. State law requires the district to repay the loan, plus interest, over five years. To repay the emergency loan and the appointed trustee's costs, the SCO reduces the district's annual apportionment from the SDE. As of July 31, 1989, AB 2525 would require the interest rate on the loan to be based on the most current investment rate of the State's Pooled Money Investment Account, which was earning 9.2 percent interest as of June 1989. Most of the district's board members are opposed to a state loan and a State-appointed trustee.

The second option that the district is considering is the issue of certificates of participation that would yield proceeds of $20 million with a ten-year repayment period. The certificates that the district is considering are tax-exempt securities, the proceeds of which the district plans to use to establish certain cash reserves by designating for future uses portions of the district's general fund balance. According to the terms of the proposed certificates, the district will sell or lease existing facilities to a nonprofit corporation and lease back the property at annual lease payments equal to the debt service payments on the certificates. A trustee will be appointed to sell the certificates to investors, with annual interest rates varying from 6.6 percent to 7.2 percent. The trustee pays the investors their principal and interest from the lease payments made by the district. If the district defaults on the payments, the investors could take possession of the leased property.

If the district follows through with this plan, it will actually issue certificates worth more than $20 million. The excess proceeds are needed to pay underwriter fees, legal fees, the cost of issue, capitalized interest, debt service reserves, and the cost of the trustee for the first year. The debt service reserve represents 10 percent of the total issue amount, which is set aside for payments to investors if the district defaults on its lease payments. This amount is deposited in a bank, and the interest it earns can be applied to the district's annual lease payments. The final payment the district would have to make would be reduced by the amount of money remaining in the debt service reserve account.

The district prepared an analysis comparing the costs of the $10 million state loan and an issue of certificates yielding equivalent proceeds, both to be repaid in five years. The district estimated that the state loan would cost approximately $1.3 million more than the certificates. We compared the costs of the $10 million state loan and an issue of certificates yielding equivalent proceeds, both with a five-year repayment period, by analyzing the actual costs incurred by other districts that have either received state loans or have issued certificates. We found that the district's cost over the five-year life of the state loan, including the cost of a State-appointed trustee, would be approximately $381,500 greater than the cost for an issue of certificates.

Table 2 presents our estimates of the costs of both a $10 million state loan and an issue of certificates that would yield $10 million in proceeds to the district with a five-year repayment period.

TABLE 2

OAKLAND UNIFIED SCHOOL DISTRICT
COSTS FOR A $10 MILLION STATE LOAN COMPARED TO COSTS FOR AN ISSUE OF CERTIFICATES YIELDING EQUIVALENT PROCEEDS
FIVE-YEAR REPAYMENT PERIOD
(IN THOUSANDS)

$10 MILLION STATE LOAN

Fiscal Year	Initial Loan Cost	Loan Payment Interest	Loan Payment Principal	Payment to State-Appointed Trustee	Total Annual Payment
1	$85	$ 488	$ 2,000	$ 77.5	$ 2,650.5
2		713	2,000	77.5	2,790.5
3		529	2,000	77.5	2,606.5
4		345	2,000	77.5	2,422.5
5		161	2,000	77.5	2,238.5
Total	$85	$2,236	$10,000	$387.5	$12,708.5

ISSUE OF CERTIFICATES YIELDING $10 MILLION

Fiscal Year	Lease Payment Interest	Lease Payment Principal	Payment to Trustee	Lease Payment Reduction From Debt Service Reserve	Total Annual Payment
1	$ 382			$ 38	$ 344.0
2	699	$ 2,005		77	2,627.0
3	563	2,135	$ 3.5	77	2,624.5
4	416	2,275	3.5	77	2,617.5
5	258	2,430	3.5	77	2,614.5
6	88	2,590	3.5	1,182	1,499.5
Total	$2,406	$11,435	$14.0	$1,528	$12,327.0

Cost of State Loan

Our analysis of the cost of the state loan is based on several assumptions. First, state law requires the district to repay the loan with an interest rate equal to the investment rate of the Pooled Money Investment Account (PMIA) at the time of the loan. Therefore, we used the PMIA's most current rate of 9.2 percent as of June 1989. The three most recent emergency loans, provided in fiscal year 1986-87, had interest rates of between 7.12 and 7.74 percent. Before fiscal year 1986-87, the interest rates for emergency loans ranged between 9.56 and 12.54 percent.

Second, we assume that the earliest the district would be able to obtain the proceeds from either a state loan or certificates of participation would be November 1, 1989, and that the district would make equal principal payments in each of the five years starting in fiscal year 1989-90 to repay the state loan.

Further, we determined the cost for a trustee by reviewing contracts the SDE negotiates with State-appointed trustees for compensation of services, including incidental, travel, and miscellaneous expenses. In recent contracts, the SDE has based the trustee's compensation on 80 percent of the salary of the district's superintendent. The interim superintendent's salary is $90,000 per year; 80 percent of $90,000 is $72,000. The SDE has also allowed $1,000 per year for incidental expenses. Average travel and miscellaneous expenses claimed by other trustees have totaled approximately $4,150 per year. The district must also pay for the trustee's bonding, which is approximately $350 per year. Therefore, we estimate that the district's total annual expense for the trustee would be approximately $77,500.

Finally, before it can receive the loan, the district must have an audit of its current financial and budgetary condition and a management review. The district must pay for both the audit and the review. We assume that the recent DH&S audit, which was paid for by the SDE, will satisfy the requirement for an audit of the district's financial and budgetary condition. However, the State may require an update of the DH&S report. Based on discussions with SDE staff and on the costs incurred by two other districts for an updated audit report and a management review, we estimate that an update could cost the district $25,000 and a management review could cost approximately $60,000.

Cost of Certificates of Participation

Our analysis of the cost of issuing certificates is also based on several assumptions. First, to receive proceeds of $10 million, the district must actually issue certificates in a greater amount to cover the issue costs. We compared the costs identified by the district's underwriter with the costs of a similar issue of certificates and determined that the costs were similar. Based on this analysis, the district would need to issue approximately $11.4 million worth of certificates to cover issue costs and still have approximately $10 million available.

Second, the rates we used to calculate the interest paid on the certificates are the rates provided by the district's underwriter. We compared these rates with those on a similar issue of certificates, and the rates were similar.

Further, the proposed issue of certificates provides for a trustee to receive the proceeds from the sale of the certificates and to transfer the proceeds to the district. Taking into account the underwriter's estimate and the actual cost of the trustee for a similar issue of certificates, we estimate the annual cost of a trustee to be $3,500.

If the interest earned by the district from the debt service reserve exceeds the interest it pays on the certificates, that difference may be subject to rebate to the Internal Revenue Service in accordance with the Federal Tax Reform Act of 1986. Therefore, we used the interest rate paid on the certificates to calculate the interest earned on the money in the debt service account. The interest earned on the debt service reserve reduces the district's annual lease payments.

Since AB 2525 requires a trustee for the district whether or not the district requests a state loan, the district would have to bear the cost of a State-appointed trustee as well as the cost of the certificates if this bill is passed. However, because the bill has not passed as of July 31, 1989, we did not add the cost of the State-appointed trustee, which we estimate is approximately $77,500 per year, in our analysis of the cost of the certificates.

Our comparison of the costs of a $10 million state loan and an issue of certificates yielding $10 million shows that the cost associated with the certificates is 3 percent lower than the cost associated with the state loan. However, if over the five-year repayment period we include the cost of the State-appointed trustee, the cost of the certificates increases from approximately $12.3 million to approximately $12.7 million, raising the total cost of the certificates slightly above that of the state loan.

Even though the district compared a $10 million state loan with an issue of certificates yielding $10 million, in our analysis of the district's budget, we determined that the district is actually considering an issue of certificates that would yield $20 million in proceeds with a ten-year repayment period. Therefore, using the same assumptions we did for the issue of certificates yielding $10 million, we analyzed an issue that would yield $20 million with a ten-year repayment period. To receive proceeds of $20 million, the district must issue certificates of approximately $26 million to cover underwriter fees, legal fees, issue costs, the debt service reserve, and capitalized interest. We determined that the total cost to the district for an issue of certificates that would yield $20 million is approximately $10.4 million above the $20 million proceeds that the district will receive. This amount is approximately $8.1 million higher than the cost associated with a $10 million, five-year issue and approximately $7.7 million higher than the cost associated with the $10 million, five-year state loan and a State-appointed trustee.

The district could earn more interest while the proceeds from the certificates are in the county treasury than it could earn on a $10 million, five-year state loan. However, it is possible that any interest earned on proceeds from the certificates in excess of the interest paid on the certificates will be subject to rebate in accordance with the Federal Tax Reform Act of 1986. This excess interest is referred to as "arbitrage." According to 26 United States Code, Section 148(a), a bond that is part of an issue is an arbitrage bond if the issuer reasonably expects--at the time of issuance of the bond--to use any portion of the proceeds to acquire higher-yielding investments or if the issuer intentionally uses--at any time--any portion of the proceeds to acquire higher-yielding investments. Holders of arbitrage bonds may lose the right to exclude interest earned on the bonds from their gross income.

Table 3 presents our estimates of the costs of an issue of certificates that would yield $20 million in proceeds and would be repaid over ten years.

TABLE 3

**OAKLAND UNIFIED SCHOOL DISTRICT
COSTS FOR AN ISSUE OF CERTIFICATES OF PARTICIPATION
THAT WOULD YIELD PROCEEDS OF $20 MILLION
TEN-YEAR REPAYMENT PERIOD
(IN THOUSANDS)**

Fiscal Year	Lease Payment Interest	Lease Payment Principal	Payment to Trustee	Lease Payment Reduction from Debt Service Reserve	Total Annual Payment
1	$ 907			$ 907	
2	1,815			1,815	
3	1,741	$ 2,215	$ 5	1,018	$ 2,943
4	1,589	2,360	5	182	3,772
5	1,425	2,520	5	182	3,768
6	1,249	2,690	5	182	3,762
7	1,059	2,870	5	182	3,752
8	855	3,065	5	182	3,743
9	634	3,280	5	182	3,737
10	395	3,510	5	182	3,728
11	135	3,755	5	2,718	1,177
Total	$11,804	$26,265	$45	$7,732	$30,382

Effect of Each Financing Option on
the District's Financial Condition

The proceeds of either the state loan or the certificates of participation would be categorized as other financing sources to the district. However, under either option, the district would receive cash that it would have to repay with interest in future periods. Although, for accounting purposes, the proceeds from the loan or the certificates would be recorded in the district's general fund as other financing sources, either financing option would be considered a long-term debt and would be recorded as such in the general long-term debt account group, not in the general fund. As a result, the proceeds from either the loan or the certificates would appear to have the same effect as revenue on the district's general fund balance, and the general fund financial position would appear stronger than it actually is. However, the debt from either financing option would be repaid from the general fund. Table 4 shows the effect of an issue of certificates yielding proceeds of $20 million on the general fund, the general long-term debt account group, and the district as a whole.

TABLE 4

OAKLAND UNIFIED SCHOOL DISTRICT
THE FINANCIAL EFFECT TO THE DISTRICT OF AN ISSUE OF CERTIFICATES OF PARTICIPATION YIELDING $20 MILLION
(IN THOUSANDS)

EFFECT ON THE GENERAL FUND AND THE GENERAL LONG-TERM DEBT ACCOUNT GROUP

	General Fund	Long-Term Debt Account Group
Assets		
Cash in county treasury	$20,000	
Amount to be provided for retirement of general long-term debt		$20,000
Total Assets	$20,000	$20,000
Liabilities and Fund Equity		
Certificates of participation payable		$20,000
Fund balance	$20,000	
Total Liabilities and Fund Equity	$20,000	$20,000

ACTUAL EFFECT ON THE DISTRICT

Cash recorded in the general fund	$20,000
Liability recorded in the general long-term debt account group	(20,000)
Actual Effect on the District	$ 0

As shown in Table 4, if the district issues certificates of participation, the proceeds from the certificates will not improve the district's overall financial condition, since the debt incurred has to be repaid. If the district receives a state loan, the actual effect on the district's overall financial condition will be similar.

The District's Planned Uses for Proceeds From Financing Options

The district plans to use the cash received from the financing options to establish certain fund balance designations for uncertainties and future uses. However, as Table 1 shows, we project that the district will have a general fund deficit of approximately $2.6 million by June 30, 1990. Therefore, the district may not be able to establish all of its intended designations. Table 5 shows projections made by the district and the auditor general of the components of the general fund balance as of June 30, 1990.

TABLE 5

OAKLAND UNIFIED SCHOOL DISTRICT
PROJECTED COMPONENTS OF THE GENERAL FUND BALANCE
INCLUDING $20 MILLION FROM CERTIFICATES OF PARTICIPATION
JUNE 30, 1990
(IN THOUSANDS)

	District's Projection	Auditor General's Projection
Projected fund balance (deficit)	$ 2,103	$(2,556)
Cash proceeds from certificates	20,000	20,000
Projected Fund Balance With $20 Million Proceeds From Certificates	$22,103[a]	$17,444
Fund Balance Components:		
Reserved		
Revolving fund cash	$ 65	$ 65
Stores	1,000	1,000
Prepaid expenditures	500	500
Unreserved		
Designated for:		
Economic uncertainty	4,503	4,280[b]
Self insurance	1,600	1,600
Future uses (proceeds from certificates)	13,935	9,499
Improvement reserve	500	500
Undesignated	0	0
Total	$22,103	$17,444

a This amount differs from the district's projected fund balance on Table 1 because we eliminated the district's designation of $21.967 million for excess restricted program revenue.

b We adjusted the district's designation for economic uncertainty to 2 percent of our projection of the total for expenditures and other uses.

Included in the district's designation for future uses are a $4 million transfer to the self-insurance fund, a $2 million reserve for asbestos maintenance, a $3 million reserve for bad debts, approximately $1 million for the completion of intrusion alarm systems, and $810,000 for several automated systems. However, our projection indicates that the district may not be able to use the proceeds for all the items designated for future uses because it may have to use some of the proceeds to eliminate the general fund deficit.

If the district requests a $10 million state loan, we project that the district would end fiscal year 1989-90 with a $7.444 million fund balance. In addition, the district would not be able to establish any of the designations for future uses, and it would have to reduce its other designations by a total of $501,000.

<u>District's Ability To Repay the Debt</u>

As shown in Table 2 and Table 3, the annual loan and lease payments for both a state loan and an issue of certificates of participation include repayments of the initial proceeds. As the district makes these repayments over the life of the financing options, the cash proceeds, as well as the fund balance designations relating to the proceeds, will be steadily declining. Therefore, if the district issues certificates that yield proceeds of $20 million, in future periods it will have to reduce its expenditures, increase its revenues, or both, to meet the annual repayment schedule and to maintain the level of fund balance designations shown in Table 6. To do this, the district will have to receive revenue that exceeds its expenditures by the amount of the annual payment shown on Table 3 (over $3 million in most years). If the district receives a $10 million state loan, to maintain the projected $7.444 million balance discussed above, it will have to receive revenue that exceeds its expenditures by the amount of the annual repayment shown on Table 2 (over $2 million).

As Table 6 shows, the district's revenue has not historically exceeded its expenditures by $2 to $3 million each year; in fact, in some years, the district has had insufficient revenue to cover its expenditures. Therefore, the district may not be able to repay either financing option without further reducing its general fund balance unless it significantly increases revenue or decreases expenditures. As of August 7, 1989, the district was unable to provide us with an analysis clearly showing that it could repay either a state loan or certificates of participation.

TABLE 6

OAKLAND UNIFIED SCHOOL DISTRICT
EXCESS (DEFICIENCY) OF REVENUES AND OTHER SOURCES OVER EXPENDITURES AND OTHER USES
FISCAL YEARS 1981-82 THROUGH 1987-88
(IN THOUSANDS)

Fiscal Year	Revenues and Other Sources	Expenditures and Other Uses	Excess (Deficiency)
1981-82	$137,376	$133,317	$ 4,059
1982-83	133,405	135,900	(2,495)
1983-84	142,870	141,269	1,601
1984-85	162,590	166,318	(3,728)
1985-86	178,645	175,895	2,750
1986-87	188,606	189,060	(454)
1987-88	194,710	198,684	(3,974)

In May 1989, the district prepared a preliminary report on its development of a five-year instructional and financial plan. This plan identifies various options that the district is considering to generate revenue or reduce expenditures. These options include establishing a full-time grant-writing position, generating additional local revenues, applying for state funding for new school construction, assessing developer fees, combining and closing small schools, selling surplus property, and reducing contributions to the district's annuity program and health plan programs for its employees. Because these are proposed options and we do not know whether they will be implemented, we have not evaluated the feasibility or the financial effects of any of them at this time.

Conclusion

Oakland Unified School District continues to have financial difficulties. The district ended fiscal year 1987-88 with a general fund balance of $452,318, and its unaudited actual general fund balance for fiscal year 1988-89 was approximately $1.8 million. We project that the district will have a general fund deficit of approximately $2.6 million by June 30, 1990.

The district has analyzed two external financing alternatives to alleviate its financial difficulties: obtaining a state loan and issuing certificates of participation. We found that the cost of a state loan, which includes the cost of a State-appointed trustee, is slightly greater than the cost of an issue of certificates that would yield equivalent proceeds. However, Assembly Bill 2525, which is currently being considered by the Legislature, would require a State-appointed trustee whether or not the district accepts a state loan. If the bill is passed, the least expensive financing option would be a state loan.

The district's board of education is opposed to a State-appointed trustee and is considering issuing certificates of participation that would yield $20 million. The district plans to use the proceeds from the certificates to establish cash reserves by designating portions of its general fund balance for uncertainties and future uses. However, without implementing a comprehensive plan to reduce its expenditures, increase its revenue, or both, the district will not improve its overall financial condition by obtaining a state loan or by issuing certificates. In fact, the district may not be able to repay either of these financing options without reducing its general fund balance.

We conducted this review under the authority vested in the auditor general by Section 10500 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this letter.

Respectfully submitted,

KURT R. SJOBERG
Acting Auditor General

Attachment

The Oakland Unified School District's response to this letter

Office of the Auditor General's comments on the response by the Oakland Unified School District

ATTACHMENT

ASSUMPTIONS USED IN PREPARING THE DISTRICT'S 1989-90 FUND BALANCE PROJECTION

In preparing the fund balance projection for June 30, 1990, we made the following material assumptions and adjustments:

1. We assumed that the district would not receive $20 million from the issue of certificates of participation.

2. We eliminated the district's projected revenue of $1.6 million from the anticipated sale of surplus property because the sale has not been completed.

3. Because the district understated its projected expenditures, we increased the district's projected expenditures for fiscal year 1989-90 to either the amount spent in fiscal year 1988-89 or to an amount based on the trend of expenditures in prior years.

4. Since we increased the district's projected salary and benefit expenditures as described in #3 above, we reduced our projected expenses for certificated and classified salaries and benefits by the estimated savings from the district's recent layoffs. The reduction to certificated salaries was $2.6 million, the adjustment to classified salaries was $47,000, and the adjustment to benefits was $717,000.

5. We increased our projected expenses for certificated and classified salaries and benefits determined through #3 and #4 above for the estimated cost-of-living adjustment to the salaries of the district personnel for fiscal year 1989-90. The increase to certificated salaries was $4.2 million, the increase to classified salaries was $1.4 million, and the increase to benefits was $2.3 million.

6. We increased the district's projected transfers to other funds by approximately $1.1 million to bring the projected transfers in line with the transfers made in previous years.

7. The district did not include the self-insurance fund in its projection. We have determined that the self-insurance fund is part of the general fund and, thus, included it in our projection.

8. We increased the district's projected beginning fund balance to approximately $1.8 million, the unaudited actual fund balance at June 30, 1989.

Our financial forecast is based on assumptions concerning future events and circumstances. Because some assumptions may not materialize and unanticipated events and circumstances may occur after the date of this forecast, the actual results during the forecast period may differ from the forecasted results. These differences may be material.

OAKLAND UNIFIED SCHOOL DISTRICT

OFFICE OF THE SUPERINTENDENT

ADMINISTRATION BUILDING
1025 Second Avenue
Oakland, California 94606
(415) 836-8200

CONFIDENTIAL

August 17, 1989

Mr. Kurt R. Sjoberg
Acting Auditor General
State of California
Office of the Auditor General
660 J Street, Suite 300
Sacramento CA 95814

Dear Mr. Sjoberg:

Presented below is the Oakland Unified School District's (OUSD) response to the August 1989 draft audit report issued by the Auditor General's Office (AGO). The report entitled, "An Estimate of Oakland Unified School District's Current and Future Financial Condition" (Revised - F-931), was received Tuesday morning, August 15. Your office has indicated that the District's response is due at 5:00 p.m., today, August 17.

For convenience, the principal assertions and issues included in the draft audit report are repeated in condensed form and are followed by the District's specific responses:

Page

1 ENDING BALANCE - 1988-1989

AGO - The District will end up with an unaudited General Fund Balance of approximately $1.8 million.

OUSD - Concur.

1 ENDING BALANCE - 1989-1990

AGO - The District will have a General Fund deficit of approximately $2.6 million by June 30, 1990.

OUSD - Disagree. One of the bases for the AGO's estimate of a $2.6 million 1989-1990 deficit is the result of that office's inclusion of $5.7 million increase in District expenditures for an "anticipate(d)" 4.14 percent salary increase for all bargaining units. Arbitrarily adding this $5.7 million expenditure to the District's budget led the AGO audit team to forecast a 1989-1990 General Fund deficit. 1 *

*The Office of the Auditor General's comments on specific points begin after the Oakland Unified School District's response.

The District contends that there is no basis for the AGO's assumption on salary increases. Members of the audit team did not talk to either Board members or administrators on this matter and thus arrived at an erroneous conclusion.

Another basis for the AGO's conclusion that the District would end up with a 1989-1990 General Fund deficit is the audit team's estimate of District savings related to personnel cuts (see p. 10). The District currently estimates a savings of $7.5 million - the AGO's estimate is approximately $3.4 million, a difference of $4.1 million (see p. 10). Similar to issue of salaries, the reduced estimate of savings from layoffs led the AGO team to conclude the District would have a 1989-1990 General Fund deficit.

The AGO staff used July 24, 1989 data to conclude that the "district had not removed from its payroll 63 of the 143 certificated teachers it would lay off" (p. 10).

The District's savings from the 143 layoffs based upon actual salaries is estimated to be $5.1 million. The AGO's estimate is $2.8 million in savings for a difference of $2.3 million ($5.1 - $2.8).

During an August 8 meeting with members of the audit team, the District's Interim Business Manager, John J. Hills, stated that the information used by the audit team was incomplete. He further noted that current August data clearly demonstrated that the 143 layoffs had taken place, and that these data showed a $5.1 million in savings based upon actual salaries. The audit team apparently did not review this August information. Accordingly, Mr. Hills will review it with the audit team during the hand delivery of this report today. He will also present additional information on the other 1989-1990 layoffs. 2

Page

STATE LOAN/CERTIFICATES OF PARTICIPATION (COPs)

1 AGO - The AGO report indicated that the costs of a State loan would be "slightly greater" than the costs from the yield from the sale of Certificates of Participation (COPs). The report stated further that if Assembly Bill 2525 passed, ". . . .the least expensive financing option would be a state loan."

OUSD - The AGO report devotes 14 pages of its 28-page report almost exclusively to the State Loan/COPs issue (pp. 12-25).* This issue is also discussed on additional pages in the report. Thus, the AGO devoted more than 50 percent of its commentary to this single State Loan vs. COPs issue. 3 District responses covering these pages are presented below. However, it is important to note at the outset that the AGO audit team apparently made a significant error in calculating the cost of a State loan.

On page 13**(Table 2) of its report, the AGO indicated that first-year interest (9.2 percent) costs for a $10 million five-year State loan would be $488,000. This is in error. The estimated interest cost for a $10 million, five-year State loan @ 9.2 percent is $920,000. Thus, the AGO audit team understated the cost of the State loan by $432,000 ($920,000 - $488,000). 4

The $432,000 underestimate of the cost of a five-year $10 million State loan affects the AGO's entire critique on the State loan vs. COPs issue. Thus, each statement in its report that the cost of a State loan is less expensive than a comparable COPs issue must be corrected by the $432,000 error.

GENERAL FUND BALANCE, 1988-1989

5 AGO - The District's "representation of its general fund balance at June 30, 1989, appeared reasonable."

OUSD - This affirms the District's final 1988-1989 unaudited financial report. 5

* These page numbers are incorrect. The range is from page 12 through 24.

** This page number has changed. The new page number is 14.

Page

6 GENERAL FUND BALANCE, 1989-1990

AGO - Table I - this indicates a projected 1989-1990 General Fund deficit of $2.6 million.

OUSD - Disagree. See District's responses above.

Page

TITLE V (VOLUNTARY INTEGRATION PROGRAM - VIP)

8 AGO - The District included $3.3 million in Title V (Voluntary Integration Program - VIP) funds in its unaudited 1988-1989 (June 28, 1989) financial report.

OUSD - The District did not include Title V (VIP) funds in its unaudited 1988-1989 financial report. Instead, the District established a liability for $5.7 million. 6

Should the Board of Education decide to submit Title V (VIP) claims for 1988-1989, the final amount of approved funding for this program would, of course, be based upon the audit of these claims by the State Controller General's Office.

SAVINGS FROM POSITION CUTS/REDUCTIONS

10-11 AGO - The savings from all position cuts/reductions is estimated at $3.4 million.

OUSD - As of August 15, 1989, the District estimated a savings of $7,462,872 from position cuts and reductions. Certificated teacher cuts are in place which will save $5,100,000 million as noted earlier in this report. Reductions in certificated managers have also been completed for an estimated savings of $655,740. Reductions in classified management and classified staff are in process. Estimated savings for these two reduction categories are estimated at $1,707,132. The District's revised total savings from position cuts/reductions are currently estimated at $7,462,872 or $4,062,872 higher than the AGO estimate ($7,462,872 - $3,400,000).* 7

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*As a result of action by the Board of Education at last night's Budget Worksession, the savings estimate will be revised.

Page

STATE LOAN/COPs

12 - 25 AGO - As indicated earlier in this response, the AGO audit team devoted more than 50 percent of its report to the State Loan/COPs issue. Points made by the audit team include the following:

1) Arbitrage - Arbitrage of prior-year COPs issues netted an estimated $607,000 (p. 3).

2) Elimination of COPs from Budget - The AGO did eliminate COPs from the 1989-1990 Budget on the premise that COPs are "traditionally used to finance capital projects or to purchase equipment (and that). . .we (AGO) are aware of only one other California school district that recently issued certificates of participation to avoid a general fund deficit. For these reasons, we reduced the district's revenue by $20 million." (p. 9)

3) State Loan Is Less Costly - If AB 2525 passes, a State loan would be less costly (pp. 13, 25).

4) Annual Trustee Cost - The AGO estimated that the annual cost for a trustee would be approximately $77,500 (p. 15).

5) Repayment of Debt - The AGO stated that the District may not be able to pay back either a State loan or the cost of COPs (p. 23).

OUSD - Responses to the specific issues listed above are as follows:

1) Arbitrage - The current figure for the net arbitrage earned from prior-year COPs issues is approximately $700,000. 8

2) Elimination of COPs from Budget - The premise used by the AGO to eliminate COPs from the District's 1989-1990 General Fund Budget indicates the team may not be aware

of a July 12, 1988 ruling from the General Counsel's Office of the State Department of Education which concluded that:

"A school district may deposit into its general fund for any purpose, including elimination of a deficit in that fund, proceeds from the sale of certificates of participation based on a lease and lease-back of its real property." 9

A copy of this legal opinion is attached to this response.

3. State Loan Is Less Costly - As indicated earlier in this response, the AGO audit team apparently made a significant error in calculating the costs of a State Loan. On Table 2, p. 14, the AGO indicated that the first-year interest cost on a $10 million, five-year State loan @ 9.2 percent interest was $488,000. It can be seen that this interest cost should have been $920,000. Thus, the AGO understated the cost of a State loan by $432,000. This significant error requires that all statements made by the AGO about a State loan being less costly must be withdrawn.

   Even not including the costs of a trustee, and comparing the costs of a $10 million five-year loan on an interest-to-interest basis, the costs for a COP issuance would be approximately $813,000 less than a State loan:

State Loan (corrected)	$13,140,000
COPs	12,327,000
Difference	813,000 4

4. Annual Trustee Cost - The $77,500 is considered excessively conservative. It is recognized that the AGO audit team based its trustee cost data on the experience of much smaller districts.

   It should be noted, for example, that trustee costs for Peralta Community College totalled $152,000 in 1988-1989 and $100,000 in 1987-1988.

The District has estimated the costs of a trustee to average $150,000 annually over a five-year period. This cost estimate is considered conservative. Besides the cost of a trustee, it would include all related expenses such as required audits and other reports, travel, clerical, and other staff and miscellaneous costs. (10)

5. Repayment of Debt - The District has a proposed plan to pay back a COP issuance of $10 million should this issuance take place. This would include the use of interest earned from the proceeds of leases or sales of properties; it would also include utilization of a small percentage of anticipated COLA increases. A copy of this proposed payback plan will be presented to the AGO by the Interim Business Manager with the delivery of this response. (11)

If there are any additional questions, please feel free to call either me (415) 836-8200 or Mr. Hills (415) 836-8103.

Sincerely,

Edna E. Washington

Edna E. Washington
Acting Superintendent of Schools

c: Alfreda Abbott, President
Board of Education

Memorandum

To : Pat Keegan

Date: July 12, 1988

File No.

From : ROGER D. WOLFERTZ, Assistant General Counsel
Legal Office, Room 552 (5-4694)

RDW

Subject: Use of Certificates of Participation To Fund a School District's General Fund Deficit

In your memorandum of March 30, 1988 you advise that the Richmond Unified School District is projecting a 1988/89 deficit in excess of $3.5 million which it intends to finance by issuing $8.5 million in certificates of participation (COPs). Your question is whether a school district may legally issue COPs to finance a general fund deficit.

CONCLUSION

A school district may deposit into its general fund for any purpose, including elimination of a deficit in that fund, proceeds from the sale of certificates of participation based on a lease and lease-back of its real property.

ANALYSIS

In general, the issuance of certificates of participation (COPs) is a financing device designed to develop an immediate asset, the cost of which is repaid with interest to the certificate holders over a number of years. Local governments frequently finance public projects, such as municipal golf courses, through the issuance of COPs.

On May 1, 1988, Richmond Unified School District (Richmond) issued its Official Statement of Information announcing the issuance of $9.8 million in COPs. The anticipated proceeds and accrued interest from the sale of the COPs are to be allocated for the benefit of Richmond as follows:

Construction of Multi-purpose rooms	$1,000,000
Purchase of computerized mgmnt system	$ 800,000
Deposit in District's General Fund	$6,700,000
Deposit to COPs reserve fund	$ 954,520
Misc	$ 379,329
Total	$9,833,849

The mechanics of the COPs issuance involves the creation of the non-profit Richmond Unified School District Financing Corporation (Corporation), and a trust agreement between Richmond, the Corporation and Security Pacific National Bank (Trustee). Under this arrangement, Richmond leases specified unneeded non-classroom facilities to the Corporation. Richmond then leases those facilities back from the Corporation. The Corporation assigns the lease agreements to the Trustee who sells the COPs to the public, collects the proceeds and pays principal and interest to the COPs holders, such payments coming from the lease payments made by Richmond. COPs holders each have an undivided interest in the lease payments. Richmond receives the proceeds from sale of the $9.8 million in COPs.

According to the proposed bond counsel legal opinion stated in the Official Statement, the lease and trust agreements are valid and binding obligations of Richmond; the obligation of Richmond to make lease payments does not constitute a debt of the district nor the State of California within the meaning of any constitutional or statutory debt limit or restriction, and does not constitute an obligation for which Richmond is required to levy or pledge any form of taxation or for which Richmond has levied or pledged any form of taxation.

It is significant to understand that Richmond School District is not the issuer of the COPs. The Trustee is the issuer. Thus, Richmond is not in the securities business. The legal authority for Richmond to be a party to the COPs program is its legal authority to lease out its own buildings and lease them back.

Under the statutory scheme in Education Code section 39360 et seq. relating to the sale or lease of real property, a school district may lease out any of its real property which will not be needed for classroom space, for a maximum term of 99 years. Proceeds from such a lease must be used for capital outlay. However, if the district has no anticipated need for additional sites or building construction for the five-year period following the lease, the proceeds may be deposited in the general fund of the district (Education Code section 39363). Pursuant to Education Code section 39300 et seq., a district may lease the property back. Had Richmond simply leased its property to a third party without more, the proceeds would be received in lease payment installments over the multi-year term of the lease and would not have generated enough in fiscal year 1988/89 to cover the general fund deficit. By issuing certificates of participation based on the lease arrangements, the entire value of the lease is converted to cash immediately and the general fund deficit is covered with Richmond paying the proceeds back to the COPs holders with interest over a period of 10 years. The result is that Richmond has both its buildings and the principal value of the building leases in cash at the same time. Nothing in the Education Code nor any other law prohibits this kind of deficit financing.

RDW

cc: Robert Agee

OAKLAND UNIFIED SCHOOL DISTRICT

COP ISSUE REPAYMENT PROPOSALS BASED ON $10,000,000 FOR TEN YEARS

	1989-90	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000
Payments Required											
8/15 (Principal)	0	0	1,110,000	1,552,752	1,593,222	1,635,697	1,684,967	1,730,647	1,782,689	1,840,290	588,487
2/15 (Interest)	0	0	372,752	333,222	290,967	244,967	195,647	142,689	85,290	22,987	0
TOTAL PAYMENT REQUIRED	0	0	1,482,752	1,885,974	1,884,189	1,880,664	1,880,614	1,873,336	1,867,979	1,863,277	588,487
Revenue Sources											
Part I - Interest or Lease Receipts											
1) Properties Interest or Lease	72,000	581,000	711,000	711,000	711,000	711,000	711,000	711,000	711,000	711,000	588,487
2) COPS Interest	55,000	63,000	63,000	63,000	63,000	63,000	63,000	63,000	63,000	63,000	0
3) Interest FY1 Principal	0	11,500	11,500	11,500	11,500	11,500	11,500	11,500	11,500	11,500	0
4) Interest FY2 Principal	0	0	60,000	60,000	60,000	60,000	60,000	60,000	60,000	60,000	0
TOTAL	127,000	655,500	845,500	845,500	845,500	845,500	845,500	845,500	845,500	845,500	588,487
Part II - Additional Resources											
1) Interest from $4,000,000 Reserve for Contingency	0	0	160,000	160,000	160,000	160,000	160,000	160,000	160,000	160,000	0
2) Percent of annual COLA (Est 12% 1992-93 to 1998-99)	0	0	477,252	880,474	878,689	875,164	875,114	867,836	862,479	857,777	0
TOTAL OTHER RESOURCES	0	0	637,252	1,040,474	1,038,689	1,035,164	1,035,114	1,027,836	1,022,479	1,017,777	0
TOTAL REVENUE	127,000	655,500	1,482,752	1,885,974	1,884,189	1,880,664	1,880,614	1,873,336	1,867,979	1,863,277	588,487

8/16/89

Estimated Property Lease or Interest Income Based on 9% Rate

	1989-90	1990-91	1991-92 to 1998-99	1999-2000
North Oak Knoll	72,000 (.5 yr)	144,000	144,000	144,000
Dag Hammarskjold	00	196,000 (.75 yr)	261,000	261,000
Clawson	00	45,000	45,000	45,000
Grant	00	196,000 (.75 yr)	261,000	138,487
TOTAL	72,000	581,000	711,000	588,487

THE OFFICE OF THE AUDITOR GENERAL'S COMMENTS ON THE RESPONSE BY THE OAKLAND UNIFIED SCHOOL DISTRICT

1 Our assumption regarding cost-of-living adjustments (COLAs) for district employees was not an arbitrary decision. As stated on page 11 of the letter, we assumed that the district would give all of its bargaining units similar salary increases. We made this assumption because in the past the district has given all its employees similar COLAs. Because the district has already agreed to give its administrators who belong to the United Administrators of Oakland Schools a 4.14 percent COLA for fiscal year 1989-90, we assumed that it would give all its employees the same COLA. To assume the district would only give one of their 12 bargaining units a salary increase would have been inconsistent.

2 The district's response is both misleading and untrue. The district states that it had laid off all 143 employees. At a meeting on August 16, 1989, the day before the district's response to our report, the school board voted to rehire 77 of the 143 certificated teachers it previously stated it would lay off. At that meeting, the district's staff reported that it estimated it would cost the district approximately $3.9 million to rehire these 77 teachers. However, even if the district had removed all 143 teachers from its payroll by August 16, 1989, the board's rehiring of 77 teachers would increase the number of employees the district had not laid off beyond the 63 employees we stated had not been removed from the payroll. Therefore, the district's savings are even less than we estimated. In addition, during the August 8 meeting, the district's interim business manager did not state that our information regarding the number of teachers that had been removed from the payroll was incomplete or inaccurate; he merely stated that he would review the district's payroll information. Further, when the interim business manager delivered the district's response to the auditor general's office, he did not ask to speak to members of the audit staff to review the August data, nor did he deliver any additional documentation or information regarding layoffs.

3 We did devote 13 pages of our 28-page letter to the state loan versus certificates of participation issue. We believe that, since both the district's board and the Legislature will be making decisions in the near future regarding this issue, it is important to provide detailed information on this issue. It should also be noted that the number of pages devoted to the state loan versus certificates of participation issue does not measure the amount of time and effort spent on the issue. The time and effort spent on analyzing the district's general fund balance for fiscal year 1988-89 and projecting the general fund balance for fiscal year 1989-90 was substantial.

(4) The district is incorrect; we did not make an error in our calculation of the first-year interest for a $10 million five-year state loan. The district's calculation of $920,000 for the first-year interest is simplistic and does not take into account the timing of either the receipt of the loan or the repayment of the principal. To calculate the cost of the $10 million state loan with a five-year repayment period, we assumed that the district could not receive the proceeds from the loan until November 1, 1989. Therefore, we did not begin calculating interest in the first fiscal year until four months after the beginning of the fiscal year. We clarified this assumption on page 15 of our letter. Also, based on discussions with the State Department of Education and a review of the repayment schedules used by other districts that have received state loans, the district probably would repay $500,000 of principal from the loan on the 20th of February, March, April, and May of each year. Therefore, the interest on the outstanding loan balance would be less towards the end of the fiscal year when the outstanding loan balance is decreasing.

(5) The district misunderstands the meaning of our statement that the district's "representation of its general fund balance at June 30, 1989, appeared reasonable." We in no way affirm the accuracy of the district's final unaudited financial report for fiscal year 1988-89; we are only accepting the amounts on the report as reasonable based on a comparison with prior year amounts. As stated on page 5 of this letter, the audit procedures we performed were not sufficient to constitute an examination of the financial statements made in accordance with generally accepted auditing standards and, therefore, we are not expressing an opinion on the district's general fund balance at June 30, 1989.

(6) The district is incorrect; it did not establish a liability for the $5.7 million advanced for the Voluntary Integration Program (VIP) until at least July 24, 1989, the date the entry was approved by the district's interim business manager. This date was after the June 28, 1989, estimate. The district's staff indicated that to achieve a zero fund balance in its June 28, 1989, estimate, the district had to include $3.314 million from the VIP advance. However, as stated on page 9 of our letter, the district did not include any revenue from the VIP in its unaudited actual general fund balance as of August 8, 1989.

(7) We disagree with the district's August 15, 1989, estimate of savings from eliminating administrative positions and layoffs. As we state in comment 2 on the district's response, on August 16, 1989, the board resolved to rehire 77 of the 143 teachers it previously stated it would lay off. The district's staff estimated that rehiring these teachers would cost approximately $3.9 million, which reduces the district's estimate

of its savings from $7.5 million to $3.6 million. We estimated that the district would save $3.408 million as a result of eliminating administrative positions and making layoffs. However, we made our estimate before the district reinstated one administrative position, as noted in our footnote on page 11 of this letter, and before the district's board resolved to rehire 77 certificated teachers. We will continue to monitor the district's savings from staff reductions.

8 Both the district's figure and our figure for the net arbitrage earned from prior-year certificates of participation are estimates. Our estimate of $607,000 differs from the district's estimate of $700,000 because we chose a more conservative interest rate for money-market investments.

9 The district misunderstands; we did not state that the district could not use the proceeds from certificates of participation in its general fund; we merely stated on page 9 of this letter that this is not the normal use of the proceeds and that we knew of only one other school district (Richmond Unified) that used the proceeds in this way. The main reason we did not include the proceeds from the certificates in our projection of the general fund balance for fiscal year 1989-90 is because the county superintendent stated in his letter dated July 24, 1989, that he would not approve the district's fiscal year 1989-90 budget if the proceeds were included. Also, for comparative purposes with the other fiscal years presented in Table 1 on page 6 of this letter, we wanted to show the district's general fund balance for fiscal year 1989-90 without the proceeds from any external financing.

It should also be noted that on page 2 of the attached ruling from the assistant general counsel of the State Department of Education, the assistant general counsel cites Section 39363 of the Education Code as a basis for his ruling. This section states that the proceeds from a sale or lease of district property may be deposited in the general fund of the district for any general fund purpose if the district and the State Allocation Board have determined that the district has no anticipated need for additional sites or building construction for the five-year period following the lease, and the district has no major deferred maintenance requirements. Thus, by using the proceeds from the sale of certificates of participation based on a lease and lease-back of its real property, the district would be stating that it has no need for additional sites or building construction or major deferred maintenance requirements for the next five years. This would preclude the district from participation in deferred maintenance and improvement programs offered by the State Allocation Board. Therefore, the real cost of using the proceeds from the certificates in the general fund would be the annual interest and principal payments plus the revenues forfeited from the State Allocation Board programs. The State Allocation Board awarded over $1.0 million from two of its programs to the district in fiscal year 1988-89.

10 The district's comparison of the trustee costs for Peralta Community College is not relevant. Community colleges are governed by the California Community Colleges, Chancellor's Office, not by the State Department of Education (SDE). The SDE negotiates contracts for trustees appointed to K-12 school districts and, thus, our estimate of the trustee costs is based on the actual costs incurred by other K-12 school districts that have had trustees appointed by the SDE. We reviewed the trustee costs filed at the SDE and contacted several school districts to obtain information on the trustee costs they incurred. Our estimate of the trustee expenses includes the trustee's compensation for services, including incidental, travel, and miscellaneous expenses, as we have stated in our letter on page 15. As we have shown in a separate column on Table 2 of our letter, we have also included the initial cost of the audit report and management review that the district must have before receiving a state loan. We did consider the size of Oakland Unified School District in comparison with the other districts and increased our estimate accordingly.

11 The district's repayment plan is flawed. The district did not provide us with a copy of the repayment plan until after we completed our fieldwork and held our exit conference. However, based on our limited review, we have identified several questionable items in that plan. Specifically, under Revenue Sources, Part I, line 1), the district anticipates earning interest or lease income from four properties. However, as we discuss in comment 9, the district must have the State Allocation Board's permission to deposit the proceeds from the leases in the general fund, which could be used to repay the certificates. Further, using the interest or lease income from the properties to repay the certificates would have a detrimental effect of reducing or eliminating the amount of funds available to the district from state-aided programs administered by the State Allocation Board. The State Allocation Board awarded over $1.0 million from two of its programs to the district in fiscal year 1988-89.

In addition, all or a portion of the $160,000 annual interest income the district is planning to use to repay the certificates may have to be rebated to the Internal Revenue Service. Part II, line 1) of the repayment plan shows interest income of $160,000 a year from $4 million of the certificates' proceeds set aside in a reserve for contingency. As discussed on page 16 of this letter, if the interest earned by the district from the debt service reserve exceeds the interest it pays on the certificates, that difference may be subject to rebate to the Internal Revenue Service in accordance with the Federal Tax Reform Act of 1986.

Finally, under Part II, line 2, the district anticipates using part of its State apportionment money to pay for the certificates. The district's calculation assumes it will receive a 5 percent cost-of-living adjustment annually to the State apportionment, and it anticipates using approximately 12 percent of this adjustment each year to make payments on the certificates. However, the district is not assured of receiving a 5 percent cost-of-living adjustment each year. Furthermore, the district will be repaying the certificates with funds typically used to provide salary increases and to supplement purchases for books and supplies.

Based on the district's repayment plan, we are even more convinced that the district may not be able to repay the certificates without using general fund monies. The district's plan to use apportionment funds will reduce funds available to the other general fund expenditures. In fact, over 40 percent of the funds planned to pay the certificates come from the general fund.

cc: Members of the Legislature
Office of the Lieutenant Governor
Attorney General
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps