

**Presentation to the Board of Education by the
Santa Monica-Malibu Unified School District Financial Oversight Committee**

Paul J. Silvern, Chair

June 7, 2007

Good evening Members of the Board of Education. On behalf of your Financial Oversight Committee (FOC), we welcome this opportunity to review the FOC's work during the past year and to offer our observations about certain District financial matters.

Introduction

The Financial Oversight Committee, now in its sixth year of operation, is a nine-member committee of professional and community members appointed by the Board to provide you and District management with advice and counsel on a variety of financial matters. According to the charge you gave us, our responsibilities include:

- Reviewing and commenting on the District's annual financial audit, the annual budget and annual enrollment projections;
- Assisting in the development of a long-term financial plan for the District;
- Reviewing issues that could have an adverse impact on District finances before the Board makes decisions about them;
- Serving as the Taxpayer Oversight Committee charged with reviewing the District's administration of and compliance with the terms of Measure S, the 2003 parcel tax approved by District voters in June 2003;
- Monitoring and advising about the funding agreements between the District and the City of Santa Monica and the City of Malibu; and
- Assisting the District to educate the general public about school finance issues.

It is ironic that during a year in which questions have been raised about the transparency of the District's budget and financial practices, that there has probably been more public information about, and press attention to, the District's finances than at any time that the FOC has been in operation. In addition, in response to serious questions that were raised about one particular labor contract settlement, the District took the bold and commendable step of commissioning an independent expert review of its finances by the State-sponsored Fiscal Crisis and Management Assistant Team (FCMAT).

While the FOC has not always agreed with the Board's decisions this year on certain financial matters, those decisions and the professional staff and independent analysis on which the Board relied, have all been considered in the full light of public hearings and workshops, often following additional public discussion at the FOC's monthly meetings.

It is also worth noting, as I explained to the City Council recently, that the District's finances are subject to extensive external reviews that are unique to California school districts, including:

- *Annual Audits.* Annual audits are prepared by an independent Certified Public Accountant, which are reviewed by the FOC and Board in public session.
- *Los Angeles County Office of Education (LACOE) Reviews.* LACOE, on behalf of the State Department of Education, performs periodic, independent reviews of the District's financial position, including the proposed budget for each new fiscal, and at least two interim budget status reports. All of these reviews include multi-year projections of revenues and expenditures, and evaluation against a set of financial performance benchmarks. LACOE also reviews the estimated actual revenues and expenditures for the prior fiscal year when those figures become available each fall.
- *Review of Proposed Labor Settlements.* The District is required to prepare multi-year financial analysis of all proposed labor settlements, known as the AB1200 process, and these analyses are also independently reviewed and commented on by LACOE. The AB 1200 analysis and LACOE comments must be available to the public prior to Board action on the proposed settlements.

The FOC believes the District is on a relatively firm financial footing as a result of all of these efforts, and the actions taken by the Board this year. There are however, many financial challenges that the Board will need to confront, and we will say more about those.

The remaining topics I will cover this evening include the following:

1. A brief summary of FOC's activities during FY 2006-07;
2. Our report on Measure S expenditures during FY 2005-06 and proposed expenditures for FY 2007-08;
3. Comments on the current draft of the FY 2007-08 District budget; and
4. Recommendations on several specific financial issues.

FOC's Activities During FY 2006-07

This year has been a particularly active one for the FOC, during which we accomplished the following:

- Met with the District's auditor to review the FY 2005-06 audit of District finances and Measure S expenditures;
- Reviewed the 1st and 2nd Interim Reports, the P-1 and P-2 enrollment counts, projections of enrollment and Average Daily Attendance (ADA), and various proposed budget transfers;
- Reviewed and discussed the initial draft of the District's FY 2007-08 budget, including plans for expenditures from Measure "S" revenues;

- Reviewed, discussed and provided comments to the Board on a variety of other financial matters, including the proposed settlement with the SMMCTA, the FCMAT analysis, and the Adjustment Conference for the Master Facility Use Agreement with the City of Santa Monica.
- Participated in interviews with candidates for both the interim and permanent CFO positions.
- Monitored the development of the District's Facilities Master Plan and implementation of the successful Measure "BB" facilities bond program.

The FOC's work this year benefited from a productive working relationship with the Superintendent, former CFO Winston Braham, Interim CFO Dr. Steve Hodgson, the District's outstanding fiscal staff, other senior District staff, and several members of the administrative staff. Once again, we want to acknowledge Dawn Smithfield, in particular, who provides administrative support to the FOC and who continued to handle the Measure S senior exemption program with unusual diligence and tact.

We were also very fortunate to have active participation in our meetings by our Board liaisons, currently Maria Leon Vazquez and Kelly Pye, who provide invaluable insights about Board policy. We want to thank several other community leaders and members of the public for their active participation in our meetings, including former FOC member Christopher Harding, Shari Davis, Rebecca Kennerly, Ralph Mechur, Gleam Davis and Jim Jaffe. We also want to commend the press for covering these issues so thoroughly this year and contributing to the complete transparency of the District's finances.

Measure S Expenditures

The Quality Public Education Preservation Act of 2003, more commonly known as Measure "S," is the parcel tax that was approved by District voters in June 2003, by 67.6 percent, barely exceeding the minimum two-thirds threshold needed for adoption. Measure "S" imposes a \$225 tax on each parcel of land in Santa Monica and Malibu within the District's boundaries, with exemptions for qualifying seniors. The tax remains in effect through June 2009.

With a total of about 32,400 parcels, and after deductions for the estimated number of senior exemptions and tax payment delinquencies, Measure "S" generates about \$6.5 million annually for the District. Under the terms of Measure "S" these funds are to be used to:

- Restore/replace programs cut due to State funding reductions;
- Sustain student achievement and fulfill the District's core curriculum, including music, arts and athletics; and
- Provide independent expenditure accountability.

The Board assigned the FOC a role in providing independent expenditure oversight, including review of the proposed annual expenditures, and prior year actual expenditures, for consistency with the Measure's purposes. To do so, we look at Measure "S" expenditures at two points during the school year.

First, we review the independent audit of last year’s actual Measure “S” expenditures. The District’s auditor concluded that actual expenditures were consistent with the Board’s adopted expenditure plan that was included in the FY 2005-06 budget, both as to dollar amounts and distribution by category. That spending plan included the allocations shown in Table 1.

**Table 1
Measure "S" Expenditure Plan, FY 2005-06**

	Budgeted			Reported		
	FTEs	Amount	Percent	FTEs	Amount	Percent
Revenues Collected		\$ 6,573,000	100.0%		\$ 6,435,476	100.0%
Expenditures						
Teachers Salaries & Benefits						
K-3 Class Size Reduction	19.50	\$ 1,525,988	23.2%	21.00	\$ 1,664,505	25.9%
Middle Schools	10.00	\$ 784,111	11.9%	10.00	\$ 784,111	12.2%
High Schools	<u>18.00</u>	<u>\$ 1,411,400</u>	<u>21.5%</u>	<u>20.00</u>	<u>\$ 1,267,631</u>	<u>19.7%</u>
Subtotal	47.50	\$ 3,721,499	56.6%	51.00	\$ 3,716,247	57.7%
Music Program		\$ 988,189	15.0%		\$ 977,725	15.2%
Physical Education Program		\$ 620,124	9.4%		\$ 541,802	8.4%
Library Program		\$ 1,199,438	18.2%		\$ 1,155,952	18.0%
Measure "S" Admin.		\$ 39,000	0.6%		\$ 39,000	0.6%
Audit Cost		<u>\$ 4,750</u>	<u>0.1%</u>		<u>\$ 4,750</u>	<u>0.1%</u>
Subtotal		\$ 2,851,501	43.4%		\$ 2,719,229	42.3%
Total Expenditures		\$ 6,573,000	100.0%		\$ 6,435,476	100.0%
Total Revenues (Over)/Under Expenditures		\$ -			\$ -	

Source: Roy J. Blair, CPA, FY 2005-06 Measure "S" Audit, p.2

Accurate tracking of these expenditures was made possible by assigning them the specific account code number 91221. There were no audit exceptions or recommendations from the auditor for changes to Measure “S” accounting procedures or practices. Thus, the Board and public can be assured that last year’s expenditures were consistent with what the District’s voters approved in 2003.

Our second annual review of Measure “S” involves expenditures planned for next fiscal year. For FY 2007-08, FOC reviewed the proposed Measure “S” expenditure plan developed as part of the revised proposed budget that will presented to the Board tonight. We found that the proposal is, once again, very similar to the expenditure plan in each of the last three years (see Table 2), and consistent with the terms of the Measure. The FOC therefore recommends that Board approve the FY 2007-08 Measure “S” expenditure plan.

Table 2
Measure "S" Expenditure Plans, FY 2004-05, FY 2005-06, FY 2006-07 and Proposed FY 2007-08

Expenditure Category	FY 2004-05 Actual			FY 2005-06 Actual			FY 2006-07 Budget ¹			FY 2007-08 Proposed		
	FTEs	Amount	Percent	FTEs	Amount	Percent	FTEs	Amount	Percent	FTEs	Amount	Percent
Teachers Salaries & Benefits												
K-3 Class Size Reduction	19.500	\$ 1,502,812	23.0%	21.000	\$ 1,664,505	25.9%	22.000	\$ 1,862,684	27.1%	19.000	\$ 1,612,035	24.5%
Middle Schools	10.000	\$ 771,333	11.8%	10.000	\$ 784,111	12.2%	11.000	\$ 930,204	13.6%	11.500	\$ 978,731	14.9%
High Schools	<u>20.000</u>	<u>\$ 1,542,666</u>	<u>23.6%</u>	<u>20.000</u>	<u>\$ 1,267,631</u>	<u>19.7%</u>	<u>14.000</u>	<u>\$ 1,183,896</u>	<u>17.3%</u>	<u>12.000</u>	<u>\$ 1,021,284</u>	<u>15.5%</u>
Subtotal (49.5 FTEs)	49.500	\$ 3,816,811	58.3%	51.000	\$ 3,716,247	57.7%	47.000	\$ 3,976,784	57.9%	42.500	\$ 3,612,050	55.0%
Music Program	NA	\$ 952,239	14.6%	NA	\$ 977,725	15.2%	13.460	\$ 1,084,583	15.8%	13.88	\$ 1,074,536	16.3%
Physical Education Program	NA	\$ 602,013	9.2%	NA	\$ 541,802	8.4%	12.995	\$ 509,476	7.4%	12.995	\$ 550,468	8.4%
Library Program	NA	\$ 1,165,647	17.8%	NA	\$ 1,155,952	18.0%	<u>20.375</u>	\$ 1,228,652	17.9%	<u>20.375</u>	\$ 1,273,478	19.4%
Measure "S" Admin.		\$ -	0.0%		\$ 39,000	0.6%		\$ 57,469	0.8%		\$ 57,469	0.9%
Audit Costs		\$ <u>4,686</u>	<u>0.1%</u>		\$ <u>4,750</u>	<u>0.1%</u>		\$ <u>5,000</u>	<u>0.1%</u>		\$ <u>5,000</u>	<u>0.1%</u>
Subtotal		\$ 2,724,585	41.7%		\$ 2,719,229	42.3%	46.830	\$ 2,885,180	42.0%	47.250	\$ 2,960,951	45.0%
Total		\$ 6,541,396	100.0%		\$ 6,435,476	100.0%	93.830	\$ 6,861,964	100.0%	89.750	\$ 6,573,001	100.0%

¹ Includes unanticipated periodic "catch up" revenue resulting from property tax penalties and other adjustments made by the County Auditor-Controller.

Sources: FY 2004-05 and FY 2005-06 Measure "S" Audits; FY 2006-07 2nd Interim; Proposed FY 2007-08 Budget (6-5-07)

Proposed FY 2007-08 District Budget

The general financial context for considering the FY 2007-08 budget is relatively stable as compared to prior years. As School Services of California puts it: a year of "maintenance level funding." There is no significant growth in education funding, but no "take backs" either. The Governor's May Revision includes a slightly higher and fully funded Cost of Living Adjustment and some new categorical programs on the one hand, but still no funding for unfunded mandates and no relief for declining enrollment being faced by most districts in the State. The District's budget could still be affected in unknown ways by the final State budget negotiations between the Governor and the Legislature. It remains unclear, for example, how they will resolve a \$350 million budget error identified by the Legislative Analyst, or respond to continued uncertainty about the direction of the State's economy.

Nevertheless, the District must adopt its budget by the end of this month. The FOC is in a much better position to provide comment to the Board on the proposed budget, due to outstanding work by Dr. Hodgson and the fiscal staff, despite significant time pressures, and the fact that the Board has discussed the budget in several previous meetings and special workshops. This represents a significant improvement in the budget preparation process.

The FOC applauds the diligent effort to analyze staffing ratios and make the staffing reduction recommendations that are needed to correspond with the continued decline in student enrollment resulting from Board policy to limit out-of-District permits. We also support the other "budgetary solution strategies" proposed by staff and endorsed by the Board.

We remain very concerned, however, about the projected scale and growth of the deficit in the Unrestricted General Fund, which is the District's primary operating account. The three-year projection shows a deficit of about -\$0.8 million next fiscal year that grows to about -\$2.3 million in FY 2009-10, for a cumulative total of -\$4.9 million. Although the scale of the deficit is significantly less than in previous drafts of the budget, it is still unacceptably large. The result is at odds with the Board's very first adopted budgeting principle, which is to maintain balance between current and future year income and expenditures so as to ensure the long-term financial integrity of the District. The Los Angeles County Office of Education has also cautioned the District about the need to reduce its projected operating deficit.

The scale of the deficit is a problem in general, but particularly in a year when the District will be asking for a rating on its Measure “BB” bonds, and may be asking the voters to approve extension of the Measure “S” parcel tax, which expires on June 30, 2009. While the proposed budget indicates that the District will be able to fund the three percent reserve for economic uncertainties throughout the projection period, this results in steady shrinking of the unappropriated balance. We also note that School Services of California has completed new research which shows that persistent deficit spending may be a better indicator of future fiscal difficulty than the official minimum three percent reserve benchmark. We urge the staff and Board to continue searching for additional ways to reduce costs, increase revenues, or both, including the identified, but not yet quantified, “budgetary solution strategies.”

It should also be remembered that the proposed budget is a best case scenario, because it assumes, among other things, no additional cost increases resulting from future labor negotiations with any of the District’s bargaining units, assumes renewal of the Measure “S” parcel tax, and makes no allowance for any new requirements to reserve against unfunded future liabilities for retiree health care benefit costs.

Although we are mindful of the time pressure that staff has faced this year in preparing the budget, we are compelled to reiterate several suggestions about the budget process that have not yet been acted on:

- *Show Information on All Funds.* We continue to recommend that the draft budget presentation include a summary of all District funds, and not just the Unrestricted General Fund. While the General Fund, including both its unrestricted and restricted funds is clearly the most significant component of the total budget, we believe the Board and public should see a more complete picture of the District’s total budget.
- *Budget to Meet Specific District Objectives.* We also continue to recommend that the budget be presented in the context of the educational and management objectives and priorities for the coming year. We believe that doing so will assist the Board to better align expenditure decisions with its planning objectives, and provide more clarity to the public.
- *Improve Public Communication.* Finally, we once again recommend that the budget presentation make better use of graphics to help explain the proposed District budget. School district finance in California is particularly complicated and difficult for the average citizen to grasp. Although the school- and program-based budgets have been useful, the agenda reports to the Board do not explain the budget structure as clearly as it could. As we look toward possible renewal of the parcel taxes next year, we should be using every opportunity to educate voters and the public in general about the condition of District finances.

Specific Recommendations for FY 2007-08

The FOC makes the following specific recommendations, based in particular on the events of this year:

- *Redouble Efforts to Identify and Select a Highly Qualified CFO.* We are aware of the District's difficulty in selecting a competent CFO. Some of these are self-inflicted, because of the controversy surrounding Mr. Braham's resignation, and some are a function of the limited market and competition from other Districts. But, it is clear from Dr. Hodgson's outstanding performance this year under very difficult circumstances, how critical it is to have a high-quality professional in that position. It will be particularly important to have such a person in place when the District seeks a rating for its Measure "BB" bonds. And, if enrollment continues to decline, the District will need the kind of skill and leadership that Dr. Hodgson has provided to help manage the District through the necessary changes.
- *Minimum Analysis Required for Future Labor Negotiations.* We recommend that, at minimum, the Board require staff or other experts to prepare multi-year financial projections for a range of settlement scenarios using either the AB1200 process and/or FCMAT's Budget Explorer software to project financial impacts before reaching a tentative agreement. If the Board and/or Superintendent and the CFO disagree about these financial impacts, the Board should seek independent third-party analysis before signing a tentative agreement. The Board should also be provided with independent comparisons of compensation with other comparable unified school districts. We are heartened by the work we have seen along these lines for the recent tentative agreement with the Unrepresented Unit. We also believe that any proposed increase in salary and benefits must be matched by corresponding increases in revenue and/or expenditure reductions, and not simply a reduction in unappropriated reserves, or worse, wishful thinking about the scale of future year carryovers.
- *Plan to Eliminate the Operating Deficit Within Five Years.* We recommend that the Board set this objective and fashion its budget strategy around it. We see limited value in making isolated adjustments to revenues and expenditures without a long-term strategy firmly in mind. Accordingly, and now that the staff has access to FCMAT's Budget Explorer software, we recommend that the District routinely prepare five-year budget forecasts, not just the two year projections applicable to the AB 1200 and 1st and 2nd Interims, or the three-year projections for the annual budget.
- *Reconcile Conflicting Enrollment Forecasts.* The short-term enrollment projection prepared for the District by FCMAT is at odds with the more optimistic projection prepared for the Facilities Master Plan. Because the District's financial and facilities strategies depend heavily on an accurate picture of future enrollment changes, it is critical that these differences be evaluated and reconciled.
- *Initiate a Financial Evaluation of the Special Education Strategy.* Last year we recommended that the District initiate an evaluation of the plan that was put in place a few years ago to slow the rate of increase in the costs of Special Education. To our knowledge, no action has been taken on that front yet. We believe this has taken on a new urgency in light of concerns that have been raised about the settlement agreement component of that strategy and its cost implications. We realize that proper evaluation may require more time than has elapsed thus far. But we believe the process should be initiated next year, and that the performance benchmarks for evaluation should be defined. We also believe that the evaluation will be seen as more credible in the community if it is conducted by an independent third party with the requisite expertise.

- *Strengthen the “Accountability” Provisions in the City-District Agreement.* Finally, and again considering recent controversies, we recommend that the “accountability” provision in the Master Facilities Use Agreement between the City and the District should be strengthened. In addition to implementing the public reporting process already contained in the Agreement, we recommend that the District take affirmative steps to improve public communication about the status of the District budget and its budget challenges. We also recommend that the Board add an opportunity for the FOC to address the Board on financial issues as a regular part of its agenda. This could be accomplished by adding the FOC to the Communications section of the agenda, so that there can be more opportunities for discussion with the Board that are not constrained by the typical public hearing format.

On behalf the Financial Oversight Committee, thank you for the opportunity to serve the Santa Monica-Malibu Unified School District.