TO: Illinois State Board of Education

FROM: Robert E. Schiller, Superintendent
       David Wood, Director

Agenda Topic: Action Item: Adoption of the 2002 School District Financial Profile Designation Lists

Materials: Designation Lists by Alpha and Designation Order
          To be distributed at Board meeting

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Purpose of Agenda Item:

To provide the Board the 2002 School District Financial Profile designations, including the Financial Early Warning and Financial Watch Lists. Present information to the Board on the financial condition of school districts, issues associated with how the Financial Profile documents the financial condition of school districts, and the services and research activities of the agency associated with the financial condition of schools.

Expected Outcome(s) of Agenda Item

The Board will adopt the 2002 School District Financial Profile designation lists. The Board will understand the services to be provided through the School Business and Support Service Division's Regional Financial Consultants.

Results of the Financial Profile

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<th>FY01</th>
<th>FY02</th>
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<tbody>
<tr>
<td>Recognition</td>
<td>416</td>
<td>315</td>
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<tr>
<td>Review</td>
<td>263</td>
<td>277</td>
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<tr>
<td>Warning</td>
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<td>Watch</td>
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It is clear that even before the state reduced school funding in FY03 that school districts were beginning to feel the effects of the recession and slowed growth in state assistance. The percent of districts in the lowest two designation categories grew by 87 or 40%. Nearly 34% of school districts are now in the lowest two designation categories. Moreover, if we look only at the deficit numbers for the three education funds used by the Financial Profile (similar to the olds FAAS ratio), the number of schools in deficit for three or more consecutive years grew from 164 to 233 an increase
of 42%. The growth of districts in deficit for two or more years grew from 273 to 441 an increase of 61.5%. In FY02 nearly 74% of all school districts are in deficit.

Deficit information however can be misleading. Deficits are not always bad. A school district may have a large one-time expenditure or may be in the process of balancing it’s budget across a multi-year period by seeking local tax increases or making reductions in expenditures. Districts have a multitude of borrowing options and fund balances to help them get through tight financial times. In fact, while the total school district deficit in FY02 was $883.5 M, these 657 districts also had over $2.6 B in fund balances and nearly an additional $1.5 B in working cash available. Even the 145 districts in deficit for four consecutive years in FY02 had fund balances of $422.8 M and working cash of $472.2 M to cover their combined deficits of $319.7 M. The inadequacy of deficit information alone was one of the main reasons the Board decided to create the Financial Profile and increase the number of financial information and measures it considered.

Background Information

Section 1A-8 of the School Code states, “To promote the financial integrity of school districts, the State Board of Education shall be provided the necessary powers to promote sound financial management and continue operation of the public schools.” The School District Financial Profile was designed to better illustrate information on school district finances and to establish financial designation lists for all school districts. The designation categories in descending order are Financial Recognition, Financial Review, Financial Early Warning, and Financial Watch.

The Profile was approved by the Board in November 2002 after more than a year long process of development and discussion with external partners. The goal was to establish a series of measures to improve the quantity and quality of information available on school district finances when compared to the single FAAS measure that was currently being used.

The development of the Financial Profile involved focus groups to established both the measures and their weightings and cut scores. Initial discussion to establish the appropriate measures occurred with a broad cross section of school district financial practitioners, including business officials, superintendents, lawyers, finance consultants, investment bankers, etc. Many State Board partner groups participated including, LUDA, IASA, ED-RED, and IASBO. Subsequent discussions with these same participants and others began to detail the actual scoring and weighting of the measures. Once the basic Financial Profile was established, a series of explanatory meetings were held with ROE, school business administrators and others. Finally, the FY01 data was sent to each school district. Changes were made and issues were noted at each step. In fact, the Expenditure to Revenue Ratio was changed as a result of comments received after the distribution of FY01 data to school districts. Once the 2002 Annual Financial Report data was in, school districts were sent their individual data for review and explanatory comments.

While the Financial Profile is better than the FAAS ratio it replaced, it is not without controversy and issues. Many of the issues first noted in the development process continue. Some can not be dealt with in the actual measure or scoring and weighting but can be dealt with in the future by adjusting the way data is collected on the AFR.
Others can be dealt with in the comment section of the Financial Profile. Others are differences of opinion on the use of the Financial Profile.

School finance is a complicated topic and by adding additional measures, the financial designation system became more complex. Given this complexity and the financial and accounting differences among the 894 Illinois school districts, there will likely always be issues with how finances are characterized. Some districts claim that they are ranked higher than they should be. Other districts claim they are ranked lower than they should be. Some claim that their finances are misrepresented by the measures themselves while others claim the weightings and cut scores are the issue. Still others claim that the timing of the data collection is flawed. The issues most often identified include:

- Timing of revenues (e.g. early receipt of local taxes or late state payments)
- Including large one time expenditures as part of an annual operating deficit (e.g. capital improvements)
- Treatment of loans where the revenues are not included because they must be repaid but the expenditures for the end product are included (e.g. technology revolving loan)
- Cash on Hand does not include Working Cash
- Weighting a deficit more than short term borrowing (incentive to borrow without really improving the financial condition)
- Treatment of sale and lease back situation where expenditures and revenues are not always consistent (e.g. buses)

Despite these issues, we believe the Financial Profile is a good snapshot of most districts at the end of school year 01-02. We will continue to work with school districts and others to see if there is a way to address these concerns in the future but, in the mean time, issues can be noted in the comment and explanation section of the Financial Profile. We believe it is important to continue to move forward with the Financial Profile as the number of school districts facing serious financial issues grows. While the score of any particular district can be argued, the overall view it provides of the financial condition of school districts is important. It is clear that looking at the changes between 2001 and 2002 that more and more schools are starting to face tough financial decisions.

The Financial Profile designation is merely one bit of information that school districts and communities should use to judge the financial management and condition of their school district. It is merely a starting point to provide some basic indication of where the school district stands and what it may be facing. If people do not read the entire Financial Profile, including the comments and go beyond the Financial Profile to review and analyze other information, they do the school district and its management a big disservice.

As an example, it is important to note that the Financial Profile lags the real school finance system. Thus, school districts did not face actual reductions in state aid until FY03 and this will not show up on the profile until this time next year. Canton school district is in Recognition status this year but could drop two places to Financial Early Warning next year on this basis alone.

The overall purpose of the Financial Profile is to identify school districts with financial trends that could lead to financial crisis if they are not addressed. The goal is to not only characterize the financial situation of a school district but also to provide some consistent basic information that can be used, in addition to other more detailed
information developed by the school district, to help the local community understand the situation and take appropriate local decisions necessary to return to and maintain financial health.

The Financial Profile now includes a great deal of information on all aspects of school districts finance and the financial designation lists are based on five specific measures:
- Fund Balance to Revenue Ratio (FBRR) in the Education, Operations & Maintenance, Transportation and Working Cash Funds
- Expenditures to Revenue Ratio (ERR) for the three education funds but excluding working cash
- Days Cash on Hand
- Percent of Short-term Borrowing Remaining (from Maximum TAW)
- Percent of Long-term Debt Remaining (from Maximum)

Each measure for a district will score 4, 3, 2, or 1. This score is then weighted. FBRR and ERR are weighted heavier, at 35% each, and the remaining indicators are each weighted at 10%. The five weighted scores are then added together to arrive at the Total Financial Profile Score. These scores are ranked into four categories: Financial Recognition, Financial Review, Financial Early Warning, and Financial Watch.

A district's designation does not have state and federal consequences similar to the academic designations. The only changes will be increased ISBE requests for financial information and increased ISBE services from technical assistance from a Regional Financial Consultant in analyzing financial data, staffing inventories, enrollment projections, and interpreting funding legislation to establishing a Financial Oversight Panel or School Finance Authority. Specifically we propose:

Financial Recognition:
- District will receive a commendatory certificate

Financial Review:
- Recommend a 3-year financial projection of operating funds
- Recommend school district establish a Finance Committee within the local board
- Recommend a staffing plan and personnel inventory
- Recommend a 3-year EAV projection and tax levy analysis

Financial Early Warning:
- Recommendations above in Financial Review
- Request a cash flow analysis of current fiscal year
- Request a balanced budget for the next fiscal year on ISBE template
- Request enrollment projections for next 3 years
- Request detailed analysis of short- and long-term debt
- Request school district reorganization and incentive study, if appropriate
- Review school district financial records to determine eligibility for certification as per section 1A-8 of the School Code and for eligibility for Emergency Grant Funds

Financial Watch:
- Require everything above (however, there is no statutory basis to enforce this)
Generally the services the State Board is authorized to make are inadequate to prevent schools from having financial troubles. Section 1A-8 and Article 1B of the School Code and the powers recently added for School Finance Authorities in Round Lake and Hazel Crest only deal with school districts already in significant financial difficulty.

State and agency resources for grants and loans are not generally available. Moreover, what is currently authorized does not provide the appropriate incentives for school districts to operate appropriately.

Given Illinois strong local control history, there are few if any requirements defining appropriate school district financial behavior. For example, districts do not have to balance their budgets, they are permitted multiple borrowing options, and they do not have to budget and account in a consistent way.

**Superintendent’s Recommendation**

The Superintendent recommends that the Board adopt the 2002 School District Financial Profile Designation Lists, including the Financial Early Warning and Financial Watch Lists.

**Next Steps**

Review the issues raised in this first year with our external partners and take all appropriate steps to adjust and improve the way data is gathered and used and the score is calculated.

If resources permit, move the Financial Profile to an internet based application to present the full scope of materials to the public.

Align school finance research and activities of the School Business and Support Services staff with the designation lists.