FCMAT
FISCAL CRISIS & MANAGEMENT ASSISTANCE TEAM
CSIS California School Information Services

Alert

October 10, 2008

Investing and Safeguarding District Funds

Prudent Fiscal Reporting Requirements and Information

Background

The financial crisis on Wall Street has resulted in market conditions that are causing substantial investment losses throughout the country, including declining returns for some California county treasurers' investment portfolios. Over the last few days, several counties have reported that because their investment portfolios contained holdings in bankrupt financial institutions such as Lehman Brothers, AIG and Washington Mutual, they have experienced losses that will be redistributed to local educational agencies (LEAs) for the first quarter of the 2008-09 fiscal year.

As confidence continues to erode among consumers and on Wall Street, safeguarding cash investments should move to the forefront of a LEA's fiduciary responsibilities and should be carried out using prudent investment standards in accordance with government code.

Legal requirements

The legal reporting requirements for investing and managing public funds were amended by SB 866 and added to Government Code 53600. These include subsection 53600.3, the "prudent investor" standard; subsection 53600.5, mandating and prioritizing the three objectives of investing public funds (i.e. safety, liquidity and yield); and subsection 53600.6, declaring the deposit and investment practices of local agencies to be an issue of statewide concern. Government Code Section 53600.5 prescribes the legal requirements for investing public funds as follows (emphasis added):

> When investing, reinvesting, purchasing, acquiring, exchanging, selling, or managing public funds, the primary objective of a trustee shall be to **safeguard the principal** of the funds under its control. The secondary objective shall be to meet the **liquidity** needs of the depositor. The third objective shall be to achieve a **return** on the funds under its control.

Authorized investments

The following investments may be made in accordance with Government Code Sections 16429, 53601 and 53635:

1. Local Agency Investment Fund demand deposits (LAIF, a State Pool, G.C. 16429.1).
2. Bonds, notes and warrants of a local agency pursuant to Government Code Sections 53601and 53635.
3. United States Treasury notes, bonds and bills (G. C. 53601).

4. Registered California state warrants or treasury notes or bonds (G.C. 53601).
5. Bankers acceptance (G.C. 53601).
6. Certificates of deposit or time deposits (G.C. 53601).
7. Repurchase agreements (G.C. 53601).
8. Passbook savings account demand deposits.
9. Other securities, such as commercial securities and securities of the U.S. government.
10. Paper of "prime" quality, as authorized in the government code (sections 53601 and 53635).

Reporting requirements of the county treasurer's office

In accordance with Government Code Section 53646, the treasurer shall submit a quarterly report indicating the types of investment by fund, institution, date of maturity, and amount of deposit, and shall provide the current market value of all securities with a maturity of more than 12 months, rates of interest, and expected yield to maturity. Some county treasurers may provide even more detail via electronic reports. **While our research indicates that many treasurer's offices complete and submit a monthly report due to the current volatility in the market and as a standard reporting protocol, the government code only requires a quarterly report**.

Actions LEAs should take now to protect cash investments

1 The county office of education should meet with the county treasurer's office at least monthly and review the monthly or quarterly treasurer's report to determine the **immediate** financial impact, if any, on each agency. The review should include, but not be limited to, the following:

   - Types of investments, including short-term and long-term investment strategies.
   - Asset distribution by sector (e.g. bonds, stock market).
   - Credit rating by percent of book value.
   - Maturity distribution.
   - Quarterly income distribution.
   - Quarterly performance versus selected benchmarks as reported and invested by the treasurer and authorized staff.

   School districts should check with their county office of education for information regarding the treasurer's report and its financial impact, if any.

   The county treasurer could also be invited to meet collectively with school district chief business officials (CBOs) at the county office of education's monthly CBO meeting to provide information on the county's investment pool and gain a better understanding of districts' needs. Districts that have particular investment needs may need to meet individually with the county treasurer.

2. Review the investment portfolio to ensure that all investments are in compliance with the government code and the treasurer's investment policy. Many counties are able to electronically transfer the monthly investment reports directly to the district or county office.

3. Although not required by law, FCMAT recommends that each LEA monitor its cash at least monthly, and as often as weekly if necessary. This includes districts that use a clearing account

at a local bank to deposit funds until the funds can be transferred to the county treasurer's office. Districts should review their policies and processes so that funds do not reside in the clearing account for an extended period of time. Districts should also investigate using an account that maximizes the interest on the balance.

4. Although not required by law, FCMAT recommends that each LEA report the monthly status of the county treasurer's investment portfolio to their respective boards.
5. If an LEA is located in a county that is experiencing investment losses, the financial impact should be reported at the next board meeting.
6. Each LEA should review budgeted amounts in all funds for object 8660, Interest Earnings, and adjust the budget accordingly.
7. LEAs should use Object 8662, Net Increase (Decrease) in the Fair Value of Investments, to report gains and losses on investments, including changes in the fair value of investments that include the realized and unrealized gains and losses. Procedure 425 in the California School Accounting Manual (CSAM) states:

> The designation of fund balance should be reported in Object 9775, Designated for the Unrealized Gains of Investments and Cash in County Treasury.
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> Generally accepted accounting principles (GAAP) require that LEAs report their cash in the county treasury at fair value. However, like all other GASB statements, GASB Statement 31 states that it does not apply to nonmaterial items. For many LEAs, the difference between the fair value and the book value of their cash in the county treasury may not be material.
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> If an LEA chooses not to record the adjustment necessary to report its cash with the county treasurer at fair value, the LEA's independent auditor must determine whether the omission is material enough to the financial statements to require an adjustment and whether the LEA's departure from GAAP is significant enough to impact the auditor's opinion on the financial statements."

Cash management strategies and time lines

Internal or external borrowing for cash management purposes may require additional time because it requires a LEA to go outside its own agency for funds. Options for cash management include the following:

- **Internal borrowing between district funds** is authorized by Education Code Section 42603, which allows LEAs to borrow between funds temporarily to address cash flow shortages. This situation will need to be assessed monthly and will depend upon the LEA's spending patterns during the last three months of the fiscal year. This is the most common method used by LEAs; however, it works only if there is cash in other funds.

  This type of borrowing has several limitations. No more than 75% of the money held in any fund during the current fiscal year may be transferred. In addition, if the transfer is completed prior to the last 120 days of the fiscal year, the funds must be repaid by June 30 of the same fiscal year. If funds are transferred within the last 120 days of the fiscal year, repayment must be made prior to June 30 of the subsequent fiscal year.
- **LEAs may borrow from the county office of education in accordance with Education Code Sections 42621 and 42622.** However, this option depends on the county office being willing and

able to provide funds. Based on the current economic outlook, this may not be an option because county offices of education are monitoring their own cash balances and are often unable to meet this type of request.

- **Education Code Section 42620 also allows LEAs to borrow from the county treasurer.** Under Article XVI, Section 6 of the California Constitution, the county treasurer *must* provide funds to an LEA if the LEA is not able to meet its obligations. *However, the county treasurer cannot loan districts money after the last Monday in April of the current fiscal year.* In addition, this type of borrowing requires the approval of the governing board by formal resolution. The loan cannot exceed 85% of direct taxes levied on behalf of the school district. The advantage of having the county treasurer provide the funds is that the treasurer is able to take repayment directly from property tax receipts prior to any distribution to the LEA. Repayment must be made from the first monies received by the school district before any other obligation is paid.

Additional assistance

For additional assistance, LEAs should contact their respective oversight agencies or visit FCMAT's Web site at www.fcmat.org and submit an online request for assistance.