

Preparing Budget Scenarios for 2020-21

This fiscal alert addresses considerations for and approaches to budget preparation for 2020-21 during this time of uncertainty. Although definitive information on COVID-19 impacts and the many implications for state revenue assumptions is lacking, FCMAT recommends local educational agencies (LEAs) run multiple budget scenarios to help them begin to understand the financial impacts.

To generate scenarios for the budget year, the first step is to update the 2019-20 assumptions, which may have changed drastically since the last official reporting at second interim. Updated funding proposals from the state have not yet been released, but additional expenditures and trends are known, and those trends can lead to informed scenarios that will enable LEAs to begin formulating options for 2020-21. Time is of the essence to prepare, analyze and review potential funding impacts that could result from the various scenarios.

This alert is for all LEAs, including county superintendents serving in their fiscal oversight role. Further, this alert is a companion to a previous fiscal alert on effective cash management (see FCMAT [Fiscal Alert Effective Cash Management During Uncertain Times](#)).

LEAs need to keep in mind that Proposition 98 funding considerations by the state may not be clear at the May Revision or the June adopted budget. In fact, with rapidly declining state revenues and a delay in tax receipts, Proposition 98 funding levels likely will not be determined until fall. Early in the Great Recession, state tax receipts fell so rapidly that multiple state budgets were adopted during one fiscal year, setting the stage for mid-year changes for Proposition 98 as well.

This fiscal alert is lengthy, providing guidance on what FCMAT believes is prudent financial planning. The best practices outlined here are applicable irrespective of the times. The guidance presented is built on realistic considerations based on available data, which will be updated with the May Revision, June state budget adoption, and likely mid-year changes (a second adoption) in the fall.

Current Year Budget Updates and Third Interim Reports

Education Code Section 42131(e) requires each school district that files a qualified or negative certification for the second interim period, or that is classified as qualified or negative by the county superintendent of schools, to provide financial statement projections of the school district's fund and cash balances through June 30 for the period ending April 30. This additional filing

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is known as the third interim report and is due to the county superintendent of schools, the Controller, and the Superintendent of Public Instruction no later than June 1. There is no requirement to self-certify as “positive,” “qualified,” or “negative” when submitting this June 1 financial report.

Although it is required for districts with qualified or negative second interim reports, it is best practice, and FCMAT always encourages, all school districts to develop a similar financial report for internal monitoring and use when developing the beginning fund balances for the upcoming fiscal year.

A third interim report will allow LEAs to conduct a thorough update of current year budgets through a familiar process. An update will support more accurate current year revenue and expenditure projections for estimated actuals that are part of the adopted budget document in June. This practice has never been more important than in an environment of rapidly changing circumstances like we face today. Since second interim financial reports were prepared, many districts have changed their fourth quarter spending plans dramatically, including making unplanned investments in technology and covering deficits in the cafeteria fund. At the same time, revenue adjustments are necessary for a variety of considerations such as:

- Federal CARES Act funding — potentially attributable to 2019-20, but received in 2020-21.
- Other state revenue
 - Senate Bill 117 funding for COVID-19 LEA Response Funds apportioned on March 30.
 - Lottery — third and fourth quarter sales have decreased.
- Other local revenues
 - Nutrition, childcare and transportation programs will all have decreases in revenues.
 - Facility leases and facility use fees have decreased.

Remember the basic budget formula: beginning balance plus revenues/sources minus expenditures/outgo equals ending fund balance. The components of the ending fund balance are critically important. LEAs must understand which of those components are available if needed. The budget year will be difficult. The stronger an LEA's reserve levels are going into 2020-21, and the more they are available if needed, the more flexibility and peace of mind the LEA will have to weather the storm ahead.

Budget updates should not be limited to internal distribution, but should also be shared with county offices of education, the LEA's governing board, and the community. Maintaining open communication and efforts to keep all stakeholders informed is vital. The need to communicate about financial planning has never been greater.

Budget Year Considerations

When it comes to funding considerations, California's K-14 community works best when there is a significant element of certainty. For most LEAs, the budget planning cycle began in January with the governor's January 10 budget proposals. But COVID-19 impacts on both revenue projections and school operations for 2020-21 have caused uncertainty and forced LEAs to start the budget planning cycle over. All are facing the same challenge: little information is available, and what is known is changing daily. One may ask, "How do I develop a 2020-21 budget without knowing the basics?" The answer is that one must build a baseline budget with multiple alternative scenarios until more definitive information is available. Alternative scenarios should be built by assigning various documented values to the basic building blocks of the budget. To begin, it is likely that the largest variable that will define the different scenarios is funded cost of living adjustment (COLA).

Starting with updated 2019-20 data (since the second interim budget was created), create a baseline budget that uses the basic building blocks of a budget. Those building blocks include:

- Components of the estimated beginning balance.
- Caseload: Enrollment and average daily attendance (ADA) projections, disaggregated to support Local Control Funding Formula (LCFF) calculations by grade span, regular education and special education, prepared using best practices (note: for now, use the traditional P2 ADA calculation for LCFF).
- Revenue: The January 10 budget proposal is no longer relevant. Baseline budgets should assume no COLA, no special education funding revisions, and no new one-time programs (COLA will be discussed further below).
- Expenditures: Apply all normal assumptions using provisions of current law, including consumer price index and enrollment changes. Due to the delay in adopting the Local Control and Accountability Plan (LCAP), the LCAP and the budget will be unlinked from one another for the first half of the fiscal year, realigning at first interim report. Expenditure plans should leave enough flexibility to incorporate any new or revised goals and actions that may be adopted in the fall.
- Components of the projected ending balance.

Once a baseline budget projection is prepared, an LEA should consider multiple alternative scenarios driven by state and federal revenue assumptions. Although readers of this alert should not consider the following scenarios definitive, they do represent realistic considerations based on available data:

- LCFF and other COLA-adjusted state funding: COLA comes in two steps, and caution is urged because the first step of the COLA computation process is known and is a positive number. First, the United States Department of Commerce issued the implicit price deflator for government goods and

services for the twelve months ending March 31. The resulting COLA calculation is 2.31% (a positive number), not influenced by the economic impacts from COVID-19. This is the statutory COLA. Second, the state will need to determine how much, if any, of the COLA derived from national data, will be funded. The amount the state can fund is not yet known but will be influenced significantly by the rapid degradation of state revenue as a result of COVID-19. FCMAT expects this number will be negative, not positive. This is the funded COLA. Although the method for applying a negative funded COLA to LCFF and other COLA-adjusted state funding will need to be developed, LEAs can build alternative scenarios now using a simplified approach of applying a negative COLA (or a deficit factor) to the LCFF base grant and using the adjusted base grant per-ADA, per-grade span to flow through all the components of the LCFF.

Potential funded COLA rates have moved downward as more data has become available about state revenue projections for 2020-21. FCMAT recommends developing a minimum of three alternative scenarios from an LEA's baseline projection. As indicated above, the baseline should consider a 0% funded COLA. The three alternative scenarios should span from best case to worst case, and all should consider a negative funded COLA, deficit factor or other means that lowers the overall LCFF on a per-student basis. The purpose of these scenarios is to allow the leadership team at an LEA to analyze and discuss the impacts and begin, to the extent possible, to prepare contingency plans.

At this time, FCMAT believes best case funded COLA could be in the -2% range, and worst case in the -10% range, depending on a multitude of considerations including:

- The overall size of the state revenue reductions and the resulting impact on Proposition 98
- The size of interyear apportionment deferrals
- The size of non-LCFF Proposition 98 program cuts (e.g., preschool, grants)
- Relief from non-Proposition 98 funding sources such as the Budget Stabilization Account (state's rainy day fund) for either revenue increases or expenditure reduction

The answers to these considerations lie partially in financial data and analysis, and partially in political decisions. At this time, FCMAT has more confidence in the best case value of -2% than it does in the worst case value of -10%, but -10% is not unrealistic given the economic cliff that is being experienced.

A negative funded COLA, or deficit, is not expected for Assembly Bill 602 special education funding because that affects federal maintenance of effort compliance along with the interplay of LEA unrestricted contributions.

- Lottery: As mentioned above, K-14 lottery revenue will decrease in third and fourth quarter 2019-20. That downward trend is projected to continue into

2020-21. Lottery revenue allocations to K-12 fell by 15% in the first two years of the Great Recession.

- **Federal revenues:** Federal revenues are likely to be the only sources trending in a positive direction and will provide valuable relief for many LEAs. Current Congressionally-adopted COVID-19 assistance will be available for carryover with added flexibility on spending guidelines. Discussions also continue in Washington D.C. about additional relief for state and local governments that may include LEAs. Scenarios for federal revenues should be informed based on apportionment rates and methodology from the California Department of Education. The additional federal aid will have to be appropriated by the legislature, which could occur before June 30 or as part of the 2020-21 budget.
- **Other Local Revenue:** Depending on each LEA's circumstances, other local revenue could be adversely affected in the budget year. Revenue from leases, use of facilities, and parent-paid programs may all decrease. In addition, interest earnings will be driven lower, both based on investment rates and the amount of cash on hand due to apportionment deferrals.

Remember, a baseline budget and alternative scenarios are built upon assumptions for each of the budget building blocks. It is critical to fully document LEA assumptions for ease of transparency and future updates. The scenario-based approach is helpful when information is lacking, with the number of alternative scenarios decreasing as more information becomes available.

Reserve Levels

Strong reserve levels are critical during periods of uncertainty. LEAs often cannot respond well to mid-year downward budget adjustments. While reserves do not solve problems created by funding gaps, they do buy limited time to allow an LEA to respond to economic and operational changes. Entering the 2020-21 fiscal year with strong reserves will be a key component of the flexibility that an LEA must consider when building its budget. Now is not the time to deplete reserves, but to ensure reserves are available for further changes as the year progresses and the economy impacts LEAs in 2021-22 and beyond.

As noted in the fiscal alert on effective cash management referenced above, reserves should be backed by cash. This becomes more difficult if cash deferrals occur. Reserves without the ability to spend them (e.g., cash equivalents are less than the actual reserve level) satisfy statutory requirements but do not help an LEA.

Multiyear Financial Projections

Best practice is to update multiyear financial projections (MYFPs) frequently, especially as assumptions change in the budget building blocks. The most recent official update to MYFPs was as part of the second interim report. As noted above, many conditions have changed since then, and assumptions for both the current and budget years are different now. MYFPs must be updated to reflect the current and forecasted conditions as they

are known. Like the budget, MYFPs are created based on assumptions built on current law and with the best information available at the time of preparation. Separate MYFPs should be built for each budget scenario, starting with the current year and looking out a minimum of two subsequent years. All the typical budget building blocks are considered in an MYFP. Tax receipts in the budget year (2020-21) will not reflect the full impact of the downward spiral in the economy. Depending on the amount of time in a recessionary condition and individual and corporate responses to conditions, it is likely that 2021-22 state tax receipts and COLA calculations will be harder hit than 2020-21 and therefore the funded COLA even lower.

LEAs are skilled at looking at and analyzing data. In an environment of data-informed decisions, LCAPs, dashboards and other forms of accountability, student-centric data analysis is an important and regular activity. The same importance should always be applied to an LEA's financial data and projections. The effects of today's operations and financial decisions are indelibly printed on the future. History clearly tells us that the cause of most LEA insolvencies can be traced to a bad financial decision made during prosperous times that came back to haunt the district during lean financial times. Remember to exercise caution as LEAs are faced with lean financial times. To prevent repeating history, MYFPs should be available at both the board dais and cabinet table, and all decisions should be made through the added lens of the MYFP and the impact – positive or negative – on the district's overall financial health.

FCMAT's Projection-Pro multiyear financial planning and cash flow projection tool is available for free on the FCMAT website at <https://www.fcmat.org/projection-pro>. It is a powerful planning tool for preparing MYFPs and cash flow scenarios.

Budget Adoption

Each day that passes will bring additional data to help inform the proposed 2020-21 budget for LEAs to adopt. But planning for a baseline and alternative scenarios must begin now. The governor's Executive Order N-56-20 on April 22, 2020 effectively unlinks the 2020-21 LCAP from the 2020-21 budget, but only for the first half of the fiscal year. A one-year alternative LCAP must be developed and filed with county superintendents and charter authorizers by December 15 in alignment with the due date for first interim financial reports. Therefore, budgets submitted for local board adoption in June must contain sufficient flexibility to account for a yet-undeveloped LCAP. To do otherwise ignores the tremendous value that stakeholder engagement provides in the development of the LCAP. Further, budget revisions at first interim report will be far more reflective of current conditions than the June adopted budget.

Because the LCAP and budget adoption are unlinked at June, districts are no longer required to hold public hearings for their budgets on a different date than the budget adoption (Education Code sections 42103, 42127). However, while this may simplify board of education meetings during a time of physical distancing, FCMAT reminds LEAs that the point of the required public hearing is to allow for stakeholders to express support and concerns about the proposed budget. It is disingenuous to consider a budget for

adoption in the same meeting at which the public hearing is held because it does not allow revisions or other considerations raised at the public hearing to be incorporated into the budget in its proper form (Education Code 42126). LEAs should consider the intended purpose and process of the public hearing and adoption when developing and advertising their schedule (Education Code section 42103).

Conclusion

LEAs have undergone remarkable adjustments in the last six weeks. Second interim reports show what was known in February and early March, but are of limited value now. New 2019-20 financial projections must be created that include anticipated revenue changes and, for many, extraordinary, unplanned expenditures. Reserve levels may be affected, and the liquidity of each component of the fund balance must be known.

The May Revision will be available soon, but not soon enough for LEAs to develop adequate financial plans that are responsive to the impacts of COVID-19. The May Revision may not even contain definitive Proposition 98 funding levels because tax receipt data remains elusive. Time is of the essence. Development of updated current year data leading to 2020-21 baseline and alternative budget scenarios must begin now despite the lack of definitive state funding data. There is no question that Proposition 98 funding will be lower than LEAs were expecting in earlier projections. LEAs must realize that the economic impacts from COVID-19 will extend beyond one year. The associated analysis of impacts and development of contingency plans must begin now. Transparency and robust conversations about the information are critical to educate everyone about the financial implications of the pandemic on California's public school system.