



Research Report

Fiscal Distress

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Prepared for

**THE HOUSE INTERIM COMMITTEE ON EDUCATION
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BUREAU OF LEGISLATIVE RESEARCH

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INTRODUCTION

Fiscal distress is the state classification used to identify and correct school districts that are struggling to maintain fiscal stability. Under state statute, the Arkansas Department of Education (ADE) is responsible for identifying districts in fiscal distress. The State Board of Education (SBOE) has the authority to approve or deny the identification and to classify the district as being in fiscal distress. The Commissioner of Education has the authority to take corrective actions in districts in fiscal distress, as well as petition the SBOE to annex or consolidate the district.

HISTORY

Fiscal distress was originally established in statute by Act 915 of 1995. Act 915 created the fiscal distress program, as well as three phases of fiscal distress. Act 1467 of 2003 modified the fiscal distress program and eliminated the phases. The fiscal distress program allows ADE to identify districts in fiscal distress if they demonstrate a declining balance, if they commit an act or violation that jeopardizes the district's fiscal integrity, or for any other fiscal condition of a school district that can have a detrimental negative impact on the district's ability to provide educational services.

In 2013, the General Assembly passed Act 600, which extended the time districts can remain in fiscal distress from two consecutive years to five consecutive years.

During a given year, school districts are able to move into, and out of, the fiscal distress classification. Since 1996, there have been a total of 76 school districts classified as being in fiscal distress. To date, ADE has not identified any charter schools in fiscal distress, and SBOE has not classified any charter schools in distress. According to ADE, since the law on fiscal distress is silent on charter schools, charter school fiscal issues are handled through the Charter Authorizing Panel, which has the authority to place charters on probation for fiscal issues.

Of the 76 districts that have been placed in distress, 56 have been in fiscal distress only once. Of the remaining 20 districts, 18 have been in distress twice. Earle and Heber Springs have both been classified as being in fiscal distress three times.

Of the total 76 school districts that have been classified as being in fiscal distress, only 56 still exist. Twenty of the 76 districts have been consolidated or annexed to other districts. The vast majority of the districts that no longer exist were consolidated or annexed because the district's average daily membership fell below 350 for two consecutive school years.

CLASSIFYING DISTRICTS IN FISCAL DISTRESS

Arkansas Code § 6-20-1904 lists the indicators of fiscal distress. ADE may identify a district in distress if the district has any of the indicators. The indicators include:

- Declining balance determined to jeopardize the fiscal integrity of the district
- An act or violation determined to jeopardize the fiscal integrity of the district
- Any other fiscal condition of a school district deemed to have a detrimental negative impact on the continuation of educational services by the district

Such acts, violations, and conditions include:

- Material failure to maintain school facilities, provide timely and accurate financial reports to specific state agencies, meet minimum teacher salaries, comply with state purchasing, bid agreements, or audit requirements
- Material violation of local, state, or federal fire, health, safety, or construction codes
- Material default on any school district debt obligation

- Material discrepancy between budgeted and actual expenditures
- Insufficient funds to cover payroll, salary, employment benefits, or legal tax obligations

According to ADE, audit findings and a pattern of declining balances are two of the most common indicators of fiscal distress. ADE noted that often audit findings and a pattern of declining balances are related problems in a district. ADE looks at the reasons for declining balances (transfers, building projects, declining growth) when determining whether a district should be identified in as a district in fiscal distress. ADE may identify districts in distress at any time.

Once ADE has identified a district in distress, ADE is required to notify the district in writing. Once the district receives the notification from ADE, the district has thirty days to appeal to the SBOE. SBOE must hear the appeal within sixty days after receiving the appeal from the district. If the district chooses not to appeal, SBOE must still vote to classify the district in distress. While ADE *identifies* districts in distress, SBOE must vote to *classify* the district in distress.

DECLINING BALANCES

Act 741 of 2007 specifies that capital outlay expenditures for academic facilities—which result in a declining balance—cannot be used alone to place a district in fiscal distress.

In 2017, the General Assembly passed Act 1105. The act requires that once a district's net legal balance exceeds a certain threshold, the district must reduce the balance below a certain threshold within five years. Net legal balance is the total of fund balances of teacher salary fund, operating fund, and debt service fund minus categorical fund balances and escrow balance of federal qualified bonds.

Act 1105 gives ADE the authority to monitor districts' compliance and withhold state funding if districts do not comply. Districts may request waivers from the reduction requirements for unusual and limited circumstances. The Commissioner of Education may grant the waivers if the Commissioner determines that the request is based on unusual and limited circumstances.

According to ADE, ADE will pull a final report at the end of fiscal year 2017-2018 to determine which districts have balances exceeding the threshold.

POSSIBLE SANCTIONS/CORRECTIVE ACTIONS

A district that has been classified in fiscal distress must:

- File an improvement plan with ADE that includes specific ways to correct fiscal deficiencies
- Allow on-site technical evaluations and other assistance conducted by members of the ADE Fiscal Services and Support Unit
- Adhere to recommendations from ADE to improve staffing and fiscal policy practices
- Report the reason for fiscal distress to the newspaper
- Obtain written permission from ADE before incurring additional debt

State law also gives ADE and the Commissioner of Education authority to take additional measures against the school district, including:

- Removing and replacing the superintendent
- Suspending or removing the local school board
- Appointing a community advisory board (with approval of SBOE)
- Requiring fiscal training for the district staff or local board
- Petitioning to the SBOE to annex, consolidate, or reconstitute the district
- Imposing additional reporting requirements on the district

EARLY WARNING

In 2009, the General Assembly passed Act 798, which required ADE to observe districts for earlier signs of fiscal problems and notify districts with two or more nonmaterial violations in one year. According to ADE rules, a nonmaterial violation is something that does not directly jeopardize the fiscal integrity of a school district but has the potential to put the school district in fiscal distress. According to ADE, an example of a nonmaterial violation would be failure to reconcile bank statements in APSCN. To help identify potential problems, ADE provides an early intervention checklist to school districts, which most districts complete. This tool helps districts identify issues that could lead to a fiscal distress classification if left unaddressed. Districts may request support from ADE to help deal with any problems uncovered as a result of filling out this questionnaire.

As with fiscal distress, a district may move into, or out of, the early intervention designation in any given school year. Districts currently in early warning are Bauxite, Cleveland County, Clinton, Huntsville, Lee County, Marvell-Elaine, and Pine Bluff.

Since the creation of the early warning system in 2009, 35 districts, including Dollarway and Earle, have been placed in early warning. Six of those districts, including Dollarway, have been placed in early warning twice. The last district to be classified in fiscal distress after being on the early warning list was Earle. However, prior to Earle being classified in fiscal distress in October 2017, no district had moved from early intervention to the fiscal distress classification since 2014.

The number of districts in fiscal distress has declined since the beginning of the early warning system. Since 2009, the year with the highest number of districts in distress at the end of the calendar year was 2012, with 11 districts in distress. Since the beginning of the fiscal distress program, 2017 is the year with the lowest number of districts in distress at the end of the calendar year, with only Earle and Dollarway remaining in distress. ADE attributes some of this change to a change in the way ADE approaches fiscal distress; ADE has moved from a compliance system to a system of attempting to provide support for districts prior to districts entering fiscal distress in an effort to avoid identifying districts in fiscal distress.

REMOVAL

To be removed from fiscal distress, a school district must demonstrate that all causes of fiscal distress have been corrected. SBOE must vote to remove a district from distress. Act 600 of 2013 increased the number of consecutive years a school district may remain in fiscal distress from two to five. If a school district is not removed from fiscal distress within five years, the SBOE is required to annex, consolidate, or reconstitute the district. If the district is unable to be removed from fiscal distress due to conditions beyond its control, the law allows the SBOE to grant additional time. According to ADE, an example of a condition beyond a district's control would be a change in superintendent close to the five-year mark.

Currently, no school districts are approaching the five-year mark in fiscal distress.

DISTRICTS CURRENTLY IN FISCAL DISTRESS

As of May 2018, there were two districts in fiscal distress, Dollarway and Earle.

The Dollarway School District has been under the control of the Commissioner of Education since December 2015 due to schools in the district being classified as being in academic distress (now a district in need of Level 5 support). Dollarway was previously in fiscal distress from April 2005 to April 2007. Dollarway was also previously on the early warning intervention list twice (see page 2 for more information about early warning), beginning in February 2011 and March 2012.

The SBOE classified the Dollarway School District as being in fiscal distress on April 14, 2016. ADE had identified Dollarway as a district in fiscal distress due to declining balances and material audit findings. The audit findings included overpayments to staff members, unauthorized payments on district credit cards, improper and untimely recording of receipts in APSCN, failure to reconcile gate admission fees for athletic events, failure to reconcile the district's operating bank account, failure to timely deposit checks, failure to document payroll liabilities, employees working without contracts, employee contracts that did not match the salary schedule, and numerous recording issues. Recording issues included failure to maintain receipt books, receipt ranges not indicated on deposit slips, posting errors to incorrect accounts, and receipt numbers not indicated on deposit slips.

Dollarway did not contest the fiscal distress classification.

In Dollarway, ADE has assisted in making transparent policies and procedures, building capacity in federal programs funding, and providing support to the superintendent.

The SBOE classified the Earle School District as being in fiscal distress on October 12, 2017. ADE identified the district as an early intervention school in October 2016 based on the early intervention checklist the district completed in July 2016. An audit of the district released June 30, 2017, listed several material violations. Those included internal control weaknesses, purchase of gift cards without documentation, credit card purchases without documentation and approval (purchases included hotels, supplies, meals, cell phone, vacuum cleaner, computer, and other items), overpayments to staff, payments to staff not consistent with the salary schedule, National School Lunch categorical funds used to pay ineligible salaries, travel reimbursements without approval or documentations, bank fees related to insufficient funds, salary increases made without required Board approval, and fund balances at a deficit in violation of Arkansas statutes.

Based on the audit, ADE identified Earle as a district in fiscal distress and, as required, sent the school district a letter on August 31. The district declined to submit an appeal to SBOE.

At the October 12, 2017, meeting, SBOE classified the school district as being in fiscal distress based on the ADE recommendation. At that time, ADE indicated that it was preparing an internal audit to be sent to the Commissioner to determine whether to take control of the Earle School District. On November 6, 2017, the Commissioner took control of the school district. The district remains in fiscal distress and under state control.

SBOE has classified Earle as a district in fiscal distress a total of three times, beginning in 1996. However, ADE has identified Earle as a district in distress four times. In 2004, ADE identified Earle as one of ten districts as being in fiscal distress. The SBOE voted at its meeting on June 14, 2004, not to classify Earle as being in fiscal distress. ADE representatives at the meeting relayed that ADE identified Earle as being in fiscal distress because of declining balances over three consecutive years. However, after the school district received the notification, the school district provided additional information to ADE, showing that the declining balances were the result of planned construction expenditures. Therefore, ADE recommended that Earle should not be placed in fiscal distress, and the State Board voted to follow that recommendation.

In this most recent fiscal distress classification of Earle, ADE has assisted in establishing appropriate processes for requisitions, minimizing new debt, becoming current with bills, training staff, and maintaining the day-to-day finances of the district. In addition, Earle's superintendent was replaced when the Commissioner took control of the school district.

Characteristics of Districts in Fiscal Distress ¹					
District	Total Enrollment	Percent ELL	Percent IEP	Percent NSL	Declining Enrollment Funding
Dollarway	1202	0	9.9%	93.26%	\$45,758
Earle	599	0	9.7%	94.82%	\$336,952

CONCLUSION

The fiscal distress designation, established in Act 915 of 1995 and revised in Act 1467 of 2003, is the state mechanism for identifying and providing assistance to school districts with ongoing financial difficulties. Districts are able to move into, and out of, fiscal distress at any time. Once a district is in fiscal distress, it must submit an improvement plan to ADE, allow on-site technical evaluations, adhere to any ADE recommendations made about fiscal distress, and publish the designation in a local newspaper. If a district remains in fiscal distress for five years, SBOE must consolidate, annex, or reconstitute the district. Currently, only two districts (Dollarway and Earle) are classified in district. Neither district is close to the five-year limit for being in fiscal distress.

¹ The data in the chart is for school year 2016-2017. Percentages were calculated using total enrollment.