

AUDITOR OF STATE BULLETIN 97-009
May 21, 1997

TO: ALL SCHOOL DISTRICT TREASURERS
INDEPENDENT PUBLIC ACCOUNTANTS

SUBJECT: FINANCIAL STATEMENT DISCLOSURES - SCHOOL FUNDING DECISION

On March 24, 1997, the Ohio Supreme Court issued its decision in the school finance case, DeRolph vs. The State of Ohio, ___ Ohio St.3d___, (1997). The Court instructed the Ohio General Assembly to create a new mechanism for funding Ohio's school systems. The Court decided that Ohio's elementary and secondary public school financing system violates Ohio Constitution, Article VI, Section 2. This provision requires the General Assembly to secure a "thorough and efficient system of common schools throughout the State." Although the Supreme Court recognized that there will always be disparities between districts, the Court held that the current system is neither thorough nor efficient. The Court pointed out the fact that the Constitution places the responsibility of education on the State and not on the local districts.

The Court declared certain provisions of the Ohio Revised Code unconstitutional. Among those provisions were the sections dealing with:

- ▶ The "spending reserve" borrowing authority;
- ▶ The emergency school loan provisions;
- ▶ The school foundation program; and
- ▶ The classroom facilities act (to the extent of under-funding).

In addition, although they did not declare it unconstitutional, the Supreme Court criticized the excessive reliance on local property taxes by the State in the current funding formula.

Although the Court did not give any direction to the General Assembly as to how to correct the problem, they did hold the decision in abeyance for one year in order to enable corrective action to be initiated.

Disclosure

Because of the significance of this decision, we believe certain disclosures should be made in the financial statements of public schools in Ohio.

Foundation

All school districts in Ohio receive school foundation money. We suggest that a standard note to the financial statements be issued to describe the possible impact of this case on each district.

A suggested note is:

On March 24, 1997, the Ohio Supreme Court rendered a decision declaring certain portions of the Ohio school funding plan unconstitutional. The Court stayed the effect of its ruling for one year to allow the State's legislature to design a plan to remedy the perceived defects in that system. Declared unconstitutional was the State's "school foundation program", which provides significant amounts of monetary support to this District. During the fiscal year ended June 30, 19NN, the District received \$_____ of school foundation support for its general fund, and \$_____ in total (all funds) support. As of the date of these financial statements, the District is unable to determine what effect, if any, this decision will have on its future state funding under this Program.

Other Provisions

Certain districts may have availed themselves of any or all of the other three funding provisions. If the district is participating in any of the other provisions declared unconstitutional, then it should consider disclosing that, too. Disclosure might include:

In addition, the Court declared [*the "spending reserve" borrowing authority program; the emergency school loan assistance program; the classroom facilities act program*] unconstitutional.

The "spending reserve" borrowing authority program allowed the District to borrow against amounts anticipated to be collected from tangible personal property taxes after the District's June 30 fiscal year end. During the year ended June 30, 19NN, the District borrowed \$_____ under this program.

The emergency school loan assistance program allowed the District to borrow money from a commercial financial institution, with repayment coming directly to the lender from the State through withholding a portion of the District's future foundation payments.. As of June 30, 19NN, the District has borrowed \$_____ under this program. The amount of this debt and its anticipated date(s) of payment are further described in Note XX to these financial statements.

The classroom facilities act program provided money for repairing and upgrading the District's physical plant. As of June 30, 19NN, the District had received a total of \$_____ under this program.

As of the date of these financial statements, the District is unable to determine what effect, if any, this decision will have on its financial operations.

If the district has yet to issue its financial statements for years ended June 30, 1996 or earlier, then these notes probably are describing significant subsequent events (after March 24, 1997).

Auditors should consider whether disclosure is adequate in the circumstances.¹ If disclosure is not adequate, auditors are required to qualify their report on the District's financial statements.

SEC Rule 15c2-12

Securities and Exchange Commission rules at 17 C.F.R. 240.15c2-12 (7/3/95) impose certain disclosure requirements on governments that have issued debts held and traded publicly. Among other things, these rules require the issuer to timely disclose, to a Nationally Recognized Municipal Securities Information Repository (NRMSIR), or equivalent bodies, certain "material events" Among those listed "material events" are

- " ...adverse tax...events affecting the tax-exempt status of the security"; and
- "...modifications to the rights of security holders..."

As the Ohio Supreme Court has declared certain borrowing provisions unconstitutional, it is possible that either or both of these events have occurred. We suggest the school district, if it has significant publicly held debt subject to these provisions, consult with appropriate legal counsel and, if necessary,

¹ Although SAS 79, concerning contingencies disclosures and auditor's opinions when significant contingencies exist does not apply to governmental financial statements, the AICPA has implicitly adopted it anyway for governments. See the May, 1996, *Audits of State and Local Governmental Units* audit guide, page 261.

provide the appropriate disclosures to the NRMSIR or its equivalent. Auditors should also determine whether timely required disclosures under these rules have been made.

Preparers and auditors should also review those provisions for possible adequacy of disclosure and/or reclassification of debts. For example, if the debt were to be considered taxable for federal income tax purposes, or if the debt repayment schedule were accelerated, there might be significant disclosures required to be made to make the financial statements not misleading. In some cases, debt may have to be reclassified from the Long Term Obligations Account Group to an appropriate fund.

See Auditor of State bulletin 95-018 for further information regarding the SEC rule.

Bond and Note Covenants

The school district should review its bond and note debt covenants to see if any provisions might require district action in light of this decision. Preparers and auditors should also review those provisions for possible adequacy of disclosure and/or reclassification of debts.

If you have questions about the legal effects of this case, if any, upon your district, we suggest you consult with your statutory or appointed legal counsel. If you have questions about the suggested financial statement disclosures or the effects upon the audit opinions in your particular circumstances, please feel free to contact your regional Auditor of State office or our Accounting and Auditing Support division at 800-282-0370 or directly at 614-466-5085.