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Re: The Interfund Loan of General Obligation Bond Proceeds

Dear Mr. Montero and Ms. Plumbtree:

Our office has been asked to prepare an opinion on the temporary borrowing of general obligation bond proceeds that are to be temporarily placed in another fund within a school district, such as its general fund. We conclude that school districts may use temporary interfund loans to bring about a positive balance in accounts, noted by a due to/due from accounting entry. School districts, however, have an obligation to reimburse the lending fund in accordance with applicable laws, including the California Education Code as described below. Further, such an interfund loan of bond proceeds would be improper if such a transfer was to imperil the ability of the school district to fund its voter approved bond program.

The California Education Code and the California Constitution provide guidance on the use of bond proceeds. In this regard, the California Education Code requires that "bond proceeds withdrawn [from the county's building fund of the school district] shall not be applied to any other purposes than those for which the bonds were issued." (California Education Code section 15146(f).) Additionally, Proposition 39 amended the California Constitution to provide that the one percent property tax rate limitation does not apply to certain voter approved bonded indebtedness as long as certain accountability requirements are set forth in the bond measure. These requirements include "a requirement that the proceeds from the sale of the bonds be used only for the purposes specified in the California Constitution's Article XIIIA, Section 1(b)(3), and not for any other purpose, including teacher and administrator salaries and other school operating expenses." (California Constitution Article XIIIA, section 1.)

In this regard, Proposition 39, which amended the California Constitution and led to the adoption of the "Strict Accountability in Local School Construction Bonds Act of 2000" (see California Education Code sections 15264 through 15288) in part, establishes an alternative threshold for voter approval of a school bond measure (55% rather than 2/3) and in turn requires specific accountability measures to ensure clarity for taxpayers and voters on how bond proceeds are to be spent. The California Constitution has always required that general obligation bond proceeds be spent only for the purposes authorized by the voters. It was the Legislature's intent in implementing Proposition 39, that "vigorous efforts are undertaken to ensure that the *expenditure* of bond measures, including those authorized pursuant to [Proposition 39] are in strict conformity with the law." (California Education Code section 15264)(Emphasis added.) The purpose of the Act is to ensure "that unauthorized *expenditures* of school construction bond revenues are vigorously investigated, prosecuted, and that the courts act swiftly to restrain any improper *expenditures*." (*Ibid.*) (Emphasis added.) The establishment of a citizens' oversight committee process was intended to "inform the public concerning the expenditure of bond revenues" and "actively report on the proper expenditure" of bond funds. (California Education Code section 15278.)

However, as explained below and as described in the California Education Code and the California School Accounting Manual, an interfund loan or transfer does not constitute an *expenditure* of bond proceeds. Rather, an interfund loan is accounted for as a due to/due from entry, reflecting a temporary shifting of moneys between accounts that will be reversed. As long as a school district replenishes the borrowed bond proceeds, including any interest, within the statutorily prescribed time period, the shifting of moneys constitutes a temporary interfund *borrowing* and not an *expenditure* or improper use of bond proceeds.

1. <u>Interfund Loans Constitute Temporary Borrowing Between Funds or Accounts</u>.

The California Education Code provides school districts with direct guidelines for temporary interfund loans. The California Education Code at section 42603 states that:

> The governing board of any school district may direct that moneys held in any fund or account may be temporarily transferred to another fund or account of the district for payment of obligations. The transfer shall be accounted for as temporary borrowing between funds or accounts and shall not be available for appropriation or be considered income to the borrowing fund or accounts. Amounts transferred shall be repaid either in the same fiscal year, or in the following fiscal year if the transfer takes place within the final 120 calendar days of a fiscal year. Borrowing shall occur only when the fund or account receiving the money will earn sufficient income, during the current fiscal year, to repay the amount transferred. No more than 75 percent of the maximum moneys held in any fund or account during a current fiscal year may be transferred.

> The accounting is a debit to Object Code 9310 *Due from Other Funds* and a credit to *Cash* in the lending fund, and a debit to *Cash* and a credit to Object Code 9610 *Due to Other Funds* in the borrowing fund. These amounts will be carried on the balance sheet until the entry is reversed when the funds are repaid. Note that temporary borrowings are not accounted for as interfund transfers, and do not affect the fund balance for either the borrowing or lending fund.

Accordingly, the CDE further supports the conclusion that a temporary interfund borrowing is the shifting of cash between accounts and should correctly be noted by a due to/due from accounting entry.

Section 42603 of the California Education Code states that temporary borrowing between accounts "shall not be available for appropriation or be considered income to the borrowing fund or account." The temporary transfer of cash between accounts, as recorded by a due to/due from accounting entry, does not constitute income to the borrowing account but rather constitutes a temporary shift of moneys to balance accounts.

2. <u>An Interfund Loan Does Not Constitute an Expenditure of Bond Proceeds</u>.

In discussing bond proceeds under specific circumstances, an issuer does not "spend" or "expend" bond proceeds, but rather may allocate bond proceeds to expenditures. (Treasury Regulation 1.148-6(d)(1); see also Frederic L. Ballard, Jr., *ABCs of Arbitrage*, Chapter 6.) An issuer may allocate proceeds to expenditures according to any reasonable, consistently applied accounting method. (See Treasury Regulation 1.148-6(a)(1).) An issuer may use a different accounting method for a particular item provided it does so consistently and has a "bona fide governmental purpose." (Treasury Regulation 1.148-6(a)(2).)

Even though an expenditure may be considered to be a decrease in net spendable resources (see CSAM, supra at 551-1), an interfund loan does not constitute an expenditure or an allocation to an expenditure since the proceeds are shifted between a school district's accounts rather than spent or allocated to an expenditure. In this regard, there is no decrease in a district's accounts, but rather a shifting of moneys within accounts. Moreover, "interfund transfers and designations of fund balances are not expenditures for purposes of generally accepted accounting principles." (*Id.* at 785-9, discussing postemployment retirement benefits.) An interfund transfer or loan is generally not considered to be an expenditure by a school district since the action does not result in a decrease in net spendable resources.

The California Court of Appeal examined an appellant's claim that a school district's transfer of bond proceeds into a deferred maintenance account and subsequently into its general fund where it was used for general operating expenses including salaries was improper. The appellant cited evidence that bond proceeds were transferred between accounts. Nevertheless, the Court determined that the specific transfer of the moneys themselves did not demonstrate impropriety. (*San Lorenzo Valley Community Advocates for Responsible Education v. San Lorenzo Valley Unified School District* (2006) 139 Cal.App.4th 1356, 1405.) The transfer represented an "audit adjustment" entry to avoid an impermissible year-end deficit and the money was transferred back. (*Ibid.*) Although the court acknowledged a transfer of moneys from the bond proceeds fund to the deferred maintenance and general fund, it did not find the shifting of funds to be improper where the transfers were eventually reversed. In *San Lorenz*, the school district took action to temporarily transfer, or loan the amount between the bond proceeds fund and the general fund, but the moneys were repaid, and thus no bond proceeds were expended. In its decision, the Court of Appeal did not find improper the school district's action of temporarily transferring money from the bond proceeds account and eventually to the general fund where the lending account was repaid.

In a separate decision, the California Court of Appeal determined that a temporary transfer between funds was not a diversion of revenue from the purposes for which it was provided. (*Fawcett v. Ball* (1926) 80 Cal.App. 131, 137.) In determining this, the Court of Appeal quoted the Supreme Court of Washington which found that "a temporary transfer from the general fund to another fund with an assured income is not an appropriation or diversion." (*Ibid.*) There is no expenditure and no improper diversion of funds when the moneys are temporarily transferred between funds, with the assurance to be repaid.

In summary, a temporary interfund loan from a bond proceeds account will not violate State or federal law if the requirements for accounting and reimbursement are carried out in a manner consistent with the procedures outlined above. In accordance with California Education Code section 42603, (1) the borrowed amount must be repaid within the fiscal year, or in the following fiscal year if the transfer takes place within the final 120 calendar days of the fiscal year, (2) the borrowing may only occur if the fund receiving the money will earn sufficient income to repay the borrowed amount, and (3) no more than 75 percent of the moneys held in any fund may be transferred. However, as noted above, failure to pay back the temporary loan consistent with the statutory requirements would constitute an impermissible expenditure of bond proceeds.

Please feel free to contact our office with any further questions on this matter.

Very truly yours,

P. ADDISON COVERT

cc: Lori Raineri
Meghan Covert Russell