

San Dieguito Union High School District:

Its Expenditures for Community Facilities District 94-2 Were Generally Appropriate, but It Did Not Fully Disclose Some of Its Financial Issues

June 2010 Report 2009-116



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June 15, 2010

2009-116

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the California State Auditor presents this audit report concerning San Dieguito Union High School District's (school district) use of Community Facilities District 94-2 (facilities district 94-2) funds and its responsiveness to requests for information under the California Public Records Act.

This report concludes that from 1998 through 2009, the school district spent funds from facilities district 94-2 almost entirely on appropriate facilities and services. Our test of 60 expenditure items valued at \$16.4 million charged to facilities district 94-2 revealed \$451,000 in inappropriate expenditures; otherwise, the funds went to school facilities and bond-related activities allowed in the resolution of formation that created the facilities district. Therefore, these expenditures were appropriate.

The school district did not make clear in its school board agendas and minutes the financial problems that it encountered in early 2008, its plans for dealing with these problems, or the eventual cost of resolving them. Specifically, the school district did not adequately reveal to the public in 2008 that it faced substantial problems with community facilities district bonds and risked running out of funds for making bond payments within a year. Furthermore, it did not disclose that its community facilities districts would have to pay a significant amount, eventually totaling \$8.1 million, to resolve the problems with the bonds. In addition, the school district did not make all required disclosures related to these bonds in its fiscal year 2006-07 financial statements.

Finally, although we found that the school district generally met the legally required deadlines for responding to requests for information, deficiencies in the school district's records often prevented us from determining whether the information provided by the school district responded adequately to requests.

Respectfully submitted,



ELAINE M. HOWLE, CPA
State Auditor

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Summary

Results in Brief

Since 1998, in financing the purchase and improvement of certain school facilities, California's San Dieguito Union High School District (school district) has generally spent funds for Community Facilities District 94-2 (facilities district 94-2) in appropriate ways. The school district established facilities district 94-2 in 1994 in accordance with the requirements of the Mello-Roos Community Facilities Act of 1982 (Act), which authorizes local governments in the State of California, including school districts, to set up community facilities districts to finance the acquisition of capital assets. To pay for school improvements and the construction of school facilities, the school district has issued more than \$93 million in revenue bonds since 1998, and it has allocated about \$29.1 million in bond-related funds to facilities district 94-2. In early 2008 the school district encountered significant financial difficulties with its bonds, but it did not clearly communicate these problems to the public. In addition, the school district did not disclose certain required financial information associated with bonds that it issued in 2006. Finally, although the school district's responses to public requests for records usually met legally mandated deadlines, deficiencies in the school district's records often prevented us from determining whether the school district provided the requested documents.

To finance the purchase and improvement of school facilities, the school district's public facilities authority issued bonds in 1998, 2004, and 2006. To pay off the bonds, the school district levied special taxes on the owners of property located within the boundaries of the nine community facilities districts. The school district now receives about \$1.8 million annually, and since 1994 it has collected a total of \$14.9 million in special taxes from property owners in facilities district 94-2. The school district has used these special taxes primarily to pay principal and interest on the bonds.

With three exceptions, projects and expenditures for facilities district 94-2 have been appropriate. More specifically, between 1998 and 2009, a large majority of expenditures for facilities district 94-2 were for school facilities specified in the resolution of formation that created this facilities district. For example, the school district spent \$9 million for projects at La Costa Canyon High School and \$1.9 million for projects at Oak Crest Middle School; the resolution of formation lists both as approved schools on which the school district may spend facilities district 94-2 funds. The first exception we noted concerns about \$294,000 in payments for relocatable classrooms on the property of Sunset High School that the school district has used as district administrative offices

Audit Highlights . . .

Our review of the San Dieguito Union High School District's (school district) use of Community Facilities District 94-2 (facilities district 94-2) funds revealed that the school district:

- » *Issued more than \$93 million in revenue bonds since 1998 to pay for school construction and improvements.*
- » *Has allocated about \$29.1 million in bond-related funds to facilities district 94-2.*
- » *Spent facilities district 94-2 funds in appropriate ways except for certain relocatable facilities and for housing and demographic studies costing in total \$451,000.*
- » *Did not clearly communicate to the public the significant financial difficulties it encountered in early 2008 associated with its bonds, including the risk that funds to make bond payments would run out within a year.*
- » *Did not disclose certain required financial information concerning the economic gain or loss resulting from bonds it issued in 2006, and the potential risks from a key financial agreement associated with the bonds.*

since the classrooms' installation. The resolution of formation for facilities district 94-2 does not allow the facilities district to pay for such facilities. The second and third exceptions concern the school district's charging facilities district 94-2 approximately \$157,000, or 49 percent, of the \$322,000 in costs for housing and demographic studies. The school district did so even though the studies pertained to all nine of the school district's community facilities districts and to the school district as a whole. We believe that the charges to facilities district 94-2 were inappropriate because the school district did not allocate study costs reasonably across all community facilities districts and to the school district as a whole. After 2007 the school district began using a district-wide fund to pay for its housing and demographic studies, according to the school district's director of planning and financial management.

In early 2008 the school district did not communicate adequately to the public that interest costs on bonds for its community facilities districts had increased substantially and that the school district faced a risk that funds to make bond payments would run out by March 2009. Despite this serious financial situation, the agendas and minutes for meetings of the school district's board of trustees (school board) did not reflect the problems that the district was facing or its plans for addressing them. Because the school district did not provide detailed information, members of the public who did not attend school board meetings had little access to the information necessary to provide comments and recommendations to the school board and to hold it accountable.

Further, for fiscal year 2006–07, the school district did not make certain disclosures required by applicable financial reporting standards related to bonds and other financial instruments. For example, the school district did not include information in its financial statements concerning the economic gain or loss resulting from its refunding bonds, which are the bonds issued in 2006 to redeem the school district's outstanding 1998 and 2004 bonds. Moreover, the school district failed to describe the potential risks from a key financial agreement associated with the bonds. Because the school district's financial statements lacked these disclosures, interested citizens were less able to assess the financial position of the district.

Between 2007 and 2009, the school district received 19 requests for information regarding facilities district 94-2. Nearly all of the requests came from a citizens group concerned about the school district's management of facilities district 94-2. The school district's responses to the requests generally complied with the deadlines in the California Public Records Act (records act), but a lack of documentation frequently prevented us from determining whether the school district provided all the requested documents.

In three of the 19 instances, the school district exceeded by three to six days the initial 10-day deadline for responding to requests. However, the district often did not maintain a record of the documents that it had deemed responsive to a request, so we could not determine for eight of the 19 requests whether the information that the school district made available met the requests.

Using facilities district 94-2 funds, the school district purchased land known as the *La Costa Valley site* in 1999 as a potential location for a middle school in the northern part of the district, but the school district has not yet built a school there. Since that time, at meetings of the school board and at public meetings with local groups, the school district has indicated consistently that enrollment projections have not supported the need for a middle school and that it has not been clear when a school would be needed. However, a facilities task force that has been updating the school district's facilities plan recommended to the school board in March 2010 that the school district build a middle school on the La Costa Valley site.

Recommendations

To ensure that it uses facilities district 94-2 funds for appropriate purposes only, the school district should either reimburse the facilities district \$451,000 for the erroneous payments for administrative facilities and demographic studies, or it should adjust the charges to this facilities district so that the charges reflect only appropriate expenditures.

To provide members of the public with information that they can use to participate in the school district's decision-making process and to hold school board and other school district officials accountable, the school district should do the following:

- Ensure that descriptions of the school board's meeting agenda items and minutes contain sufficient information to convey the substance of the items accurately, and post to the school district's Web site all relevant documents and presentations related to agenda items.
- Make certain that it follows all relevant standards for financial reporting.

To enable the school district to demonstrate its responsiveness to requests submitted under the records act, the school district should maintain a record of documents that it makes available to requesters.

Agency Comments

The school district generally agreed with our recommendations and says it is taking steps to implement them.

Introduction

Background

Formed in 1936, San Dieguito Union High School District (school district) covers approximately 85 square miles in northern San Diego County. The school district has more than 12,000 students in four middle schools and six high schools, including an alternative high school and a continuation high school. The school district serves students from the cities of Carlsbad, Del Mar, Encinitas, San Diego, and Solana Beach as well as from the communities of Rancho Santa Fe and Fairbanks Ranch.

In addition to using developer fees and funds from the State of California (State), the school district draws on funds from community facilities districts to finance the acquisition and improvement of school facilities. The State's Mello-Roos Community Facilities Act of 1982 (Act) allows local governments, including school districts, to form community facilities districts to finance public capital facilities and services, as shown in the text box. Through community facilities districts, local governments may finance the acquisition, construction, and improvement of facilities, including local park facilities, libraries, and elementary and secondary school sites and structures. In accordance with the Act, the school district has established policies for using funds from community facilities districts, levying taxes, and issuing bonds. The school district's policies do not set specific priorities for using the funds from community facilities districts; rather, the policies state that the school district intends to support projects that address the greatest public need and provide the greatest public benefit—first to the residents of community facilities districts, and second to the residents of the school district at large.

Allowable Purposes for Community Facilities District Funds

For real or other tangible property with an estimated useful life of five years or longer, community facilities district funds may be used to finance the following:

- Purchase
- Construction
- Expansion
- Improvement
- Rehabilitation
- Related planning and design work

Funds may also be used to pay for incidental costs, such as those related to the issuance of bonds and the collection of taxes.

Source: California's Mello-Roos Community Facilities Act of 1982.

The School District Created Community Facilities District 94-2 in Response to Expected Population Growth

Since 1994 the school district has established nine community facilities districts, including Community Facilities District 94-2 (facilities district 94-2). This facilities district grew out of a 1994 agreement between the school district and a developer to mitigate the impact of 2,700 new homes in a real estate development in

Encinitas and Carlsbad. The agreement included multiple provisions, including one that gave the school district the opportunity to purchase for \$5.8 million a 28-acre site for a new junior high school in Carlsbad¹. The school district purchased this land, known as the La Costa Valley site, but it has not yet built a school on it. A citizens group of residents from northern San Diego County has raised questions about the school district's communications regarding the site and the school and about the school district's intentions for future use of the site. The Audit Results section of this report discusses school district communications and actions related to this site.

Permissible Uses of Funds From Community Facilities District 94-2

Funds may be used for the following facilities:

- Oakcrest Junior High School
- Diegueño Junior High School
- A new junior high school in south Carlsbad
- San Dieguito High School
- Sunset High School
- A new high school in south Carlsbad
- Continuation high school facilities
- Adult education school facilities

Funds may also be used to pay for:

- Principal and interest on bonds
- All incidental expenses and fees related to bonds
- Administrative costs

Source: Community Facilities District 94-2 Resolution of Formation.

The resolution of formation for facilities district 94-2, which was developed in accordance with the Act, limits the use of funds to the specific facilities noted in the text box. However, according to the school district's director of planning and financial management, the school district's use of funds for the other facilities districts do not have similar limits, and the school district may use these funds on any of the school district's facilities. Figure 1 shows the location of facilities district 94-2 and of all the schools within the school district.

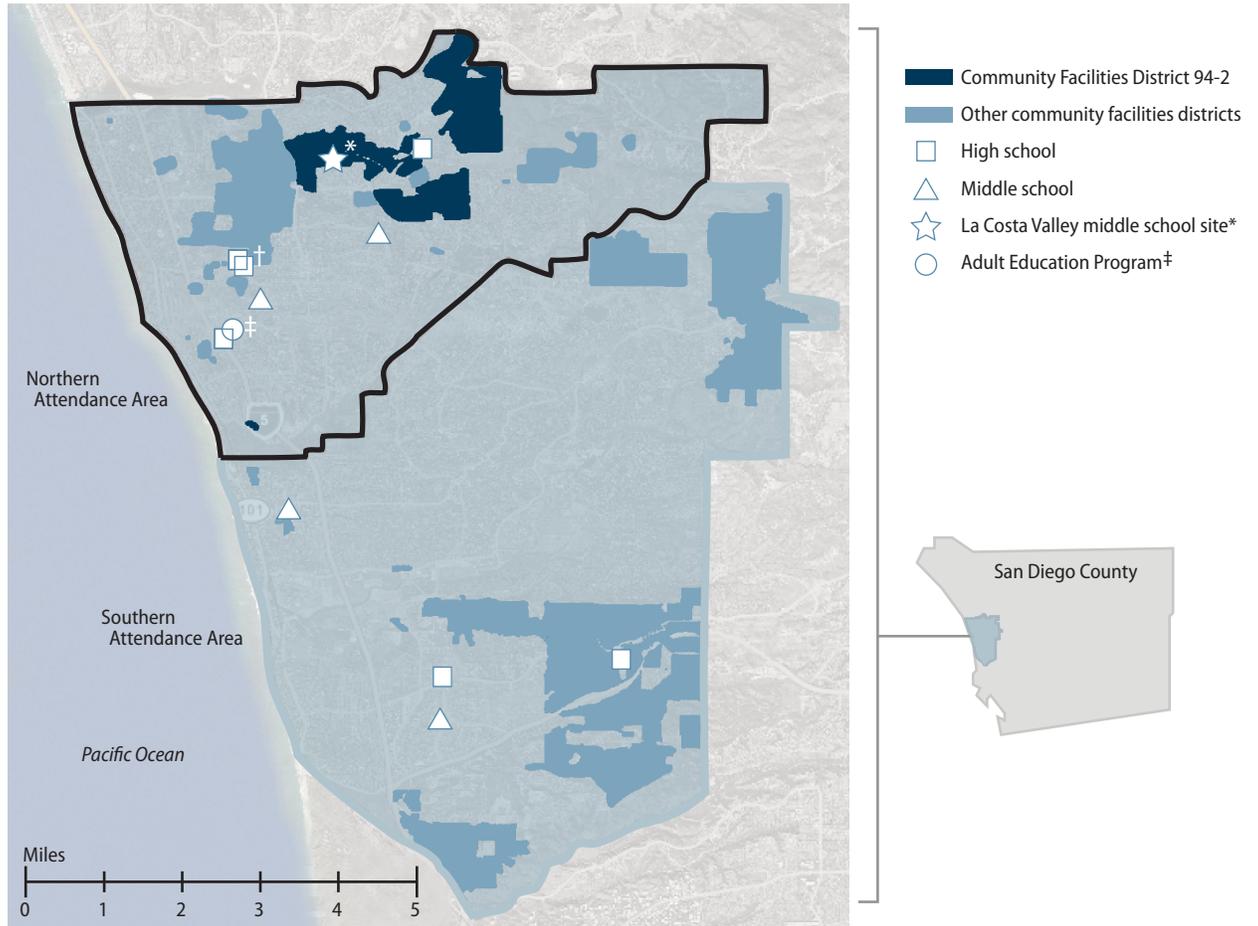
The School District Issued Revenue Bonds to Finance Its School Facilities Projects

To help pay for construction and improvements of school facilities, the school district created a public facilities authority in 1998 to issue revenue bonds backed by special taxes on property owners in the community facilities districts. The officers of the school district's board of trustees (school board) also serve as the officers of the public facilities authority. After the public facilities authority issued the bonds, the school

district allocated bond proceeds among the community facilities districts based on the amount of special taxes that each community facilities district received in proportion to the total special taxes received for all community facilities districts.

¹ When the resolution of formation for facilities district 94-2 was written in 1994, the school district had facilities that it classified as *junior high schools*. The school district later classified these facilities as *middle schools*.

Figure 1
San Dieguito Union High School District
Locations of Community Facilities Districts and School Sites



Source: The business services department of San Dieguito Union High School District.

Note: The school district may use Community Facilities District 94-2 funds on school sites in the northern attendance area.

* The school district purchased this site for a middle school, but it has not built the school.

† This site has two high schools; one is a continuation high school, and the other is an alternative high school.

‡ The San Dieguito High School Academy campus houses the school district's adult education program.

From 1998 to 2006, the school district's public facilities authority issued bonds three times. The special taxes paid by property owners in the community facilities districts support the principal and interest payments for the bonds. As Table 1 on the following page shows, all community facilities districts received \$92.3 million, and facilities district 94-2 received \$29.1 million related to the first two bond issuances. A subsequent issuance of *refunding bonds* redeemed the outstanding bonds from the previous two bond issuances.

Table 1
San Dieguito Union High School District
Bond Funds Allocated to Community Facilities Districts
From July 1, 1998, Through June 30, 2009
(Dollars in Thousands)

TYPE OF BOND	FACE VALUE OF BONDS ISSUED*	FUNDS FOR ALL COMMUNITY FACILITIES DISTRICTS	FUNDS FOR FACILITIES DISTRICT 94-2
1998 revenue bonds	\$44,660	\$43,086	\$15,191
2004 revenue bonds	48,440	49,183 [†]	13,881 [†]
2006 revenue refunding bonds	91,125	–	–
Totals		\$92,269	\$29,072

Sources: Official statements for each bond issuance, as well as special tax certificates and bond closing memos.

* The San Dieguito Union High School District used a portion of the bond proceeds to pay for costs of issuance and insurance premiums.

[†] Allocations related to the 2004 revenue bonds included interest earnings. For all community facilities districts, allocated interest earnings amounted to \$2.1 million; for Community Facilities District 94-2, they amounted to \$0.7 million.

To ensure that the school district did not spend the bond funds until sufficient taxes were available to make interest and principal payments on the bonds, the bond agreements required the school district to maintain escrow accounts. The school district initially put substantial amounts of the bond proceeds from the 1998 and 2004 bond sales into escrow accounts. In 1998 the school district's public facilities authority issued \$44.7 million in revenue bonds, and the school district placed \$32.3 million into an escrow account. As real estate developments in the community facilities districts were completed and as the district began receiving special taxes from those properties, the school district released funds for construction and improvement projects from the escrow accounts to the community facilities districts. The school district released escrowed funds from the 1998 bonds four times through October 2002, by which time it had released all escrow funds.

With all of its bond funds released, the school district's public facilities authority issued \$48.4 million in new bonds in 2004. As in the case of the 1998 bonds, the school district placed \$30.3 million of the bond proceeds into an escrow account. In October 2004 and September 2005, as special taxes grew, the school district released some of the 2004 escrow funds. However, in 2006, with \$16.8 million remaining in the escrow account, the district became concerned that it would not be able to access remaining escrow funds quickly enough to use them for construction and improvement projects. Its concern was based on slower growth in special tax revenues that resulted from a slowdown in building permits and housing sales. As specified in the official statement for the 2004 bonds, the school district had to use any escrow funds

remaining after February 2009 to make early redemptions of the 2004 bonds; thus, there was a risk that these funds would not be available to spend on school facilities.

Partly to avoid losing the use of the escrowed funds, the school district issued in 2006 the previously mentioned \$91.1 million in refunding bonds, or bonds that redeemed the outstanding 1998 and 2004 bonds. Unlike the 1998 and 2004 bonds that paid a fixed interest rate, the 2006 bonds paid an interest rate that was reset every 28 days and that was initially 3.65 percent. New rates were determined by an auction at which potential purchasers bid for the bonds by specifying the quantity of securities they wished to buy and the minimum interest rate they would accept. If too few purchasers bid on the bonds so that some bonds remained, the auction would fail, and the interest rate on the bonds would rise to 12 percent. Another difference between the 2006 refunding bonds and the 1998 and 2004 bonds was that the 2006 bonds did not require an escrow account. Therefore, the school district did not have to hold back 2006 bond proceeds, and it could also release the remaining 2004 escrow funds.

The 2006 bond issuance also included an *interest rate swap agreement* (swap agreement) between the school district and the bond underwriter. The agreement required that the school district pay the underwriter a fixed interest rate of 3.75 percent in return for the underwriter's variable interest rate payment based on a fixed percent of the London Interbank Offered Rate, or LIBOR,² an industry benchmark. The underwriter's payments were expected to approximately equal the variable interest payments that the school district had to make for the 2006 bonds. Because of this arrangement, the bonds had a *synthetic fixed interest rate*. However, when the interest rate on the school district's bonds increased significantly in 2008, the underwriter's payments to the school district were only sufficient to cover a portion of the interest payments on the bonds, and the community facilities districts were forced to cover the difference. This situation eventually led to the termination of the swap agreement and the remarketing of the 2006 bonds as fixed rate bonds in 2008.

The School District Levies Special Taxes to Pay for Its Revenue Bonds

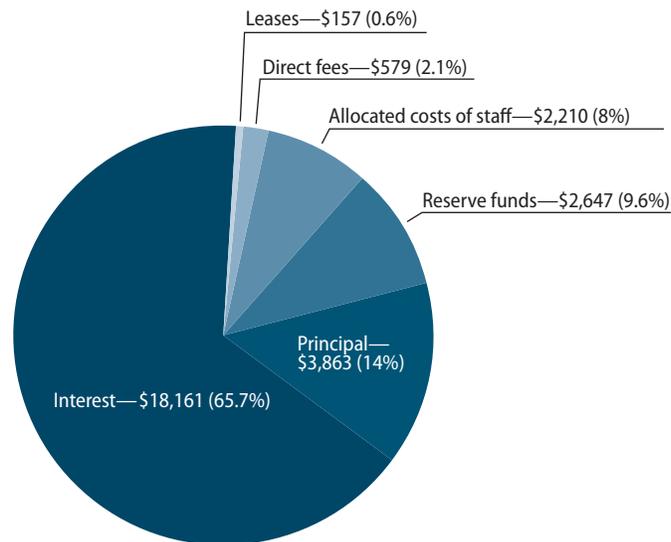
As mentioned previously, the school district levies special taxes on property owners to pay for community facilities district bonds. Immediately following the 1994 formation of facilities district 94-2,

² LIBOR is a reference rate for international banking markets, and it is commonly the basis on which lending margins are fixed.

developed property within this facilities district became subject to annual special taxes at the rate of \$800 for single-family dwellings and \$218 for multifamily dwellings. As of June 30, 2009, the school district had received nearly \$14.9 million in special taxes from property owners in facilities district 94-2. In fiscal year 2008–09, the school district took in about \$1.8 million in special taxes from facilities district 94-2, and it received a total of \$6 million in special taxes from all of its community facilities districts.

After receiving the special taxes from the community facilities districts, the school district places the tax revenues in a common fund that it uses to pay the principal and interest on the revenue bonds, pay administrative costs, and maintain reserve funds. As Figure 2 shows, most of the \$27.6 million in payments from this fund between fiscal years 2004–05 and 2008–09 have gone toward principal and interest.

Figure 2
San Dieguito Union High School District
Uses of Special Tax Revenues From Community Facilities Districts
Fiscal Years 2004–05 Through 2008–09
(Dollars in Thousands)



Sources: San Dieguito Union High School District's bank statements and accounting records for fiscal years 2004–05 through 2008–09.

Scope and Methodology

The Joint Legislative Audit Committee (audit committee) requested that the Bureau of State Audits (bureau) review the school district's use of facilities district 94-2 funds. Specifically, the audit committee asked the bureau to determine whether the purpose for facilities district 94-2 and the school district's use of facilities district 94-2 funds are adequately and consistently described and prioritized, and allowable under the Act. The audit committee also asked the bureau to determine whether adequate controls exist at the school district to ensure that the facilities district's funds are used for authorized purposes only. In addition, the audit committee requested that we review a sample of the projects, services, and expenditures funded by facilities district 94-2 to determine whether they were only for the purposes authorized. Further, the audit committee requested that the bureau identify the total revenues collected through assessed fees and bond proceeds for the past five years and determine by major expenditure category how the school district spent these funds. Lastly, the audit committee asked that the bureau determine whether the school district has properly responded to requests for information under the California Public Records Act (records act) regarding facilities district 94-2.

To determine whether the purpose for facilities district 94-2 and the school district's use of facilities district 94-2 funds are adequately and consistently described, prioritized, and allowable under the Act, we reviewed and evaluated the Act and the formation documents for facilities district 94-2. Additionally, we examined the school district's policies and procedures for establishing community facilities districts as well as the minutes of school board meetings.

To determine whether the projects, services, and expenditures funded by facilities district 94-2 were for authorized purposes only, we reviewed the formation documents and minutes of school board meetings, and we interviewed members of a local citizens group concerned with the school district's management of facilities district 94-2 funds. Further, we interviewed district staff to determine whether adequate controls exist to ensure that the facilities district's funds are used only for appropriate purposes. We also analyzed school district data from 1998 to 2009 concerning expenditures of facilities district 94-2 funds for projects and services. During our analysis of projects and expenditures, we reviewed all agendas and minutes for all meetings of the school board since 1999, including regular and special school board meetings, as well as school board workshop meetings, for references to the La Costa Valley site.

When assessing the reliability of some of the school district's electronic financial records, we identified significant issues; however, we were able to correct for these issues.

The U.S. Government Accountability Office, whose standards we follow, requires us to assess the sufficiency and appropriateness of computer-processed data. Accordingly, we assessed the accuracy and completeness of the school district's project accounting database to identify expenditures charged to facilities district 94-2. Although this database was not expressly designed to track these expenditures, it does contain relevant expenditures, and it is the best source of transaction-level data. In our testing, we found that the database was missing a few key transactions, and we also identified several miscoded transactions. Therefore, we determined that the project accounting database was not sufficiently reliable for the purposes of identifying expenditures charged to facilities district 94-2. However, using this database in conjunction with other school district records, we were able to identify and correct many of these inaccuracies. The data presented in this report includes all transactions that we were able to identify as facilities district 94-2 transactions, but it does not include any adjustments that the school district made to these transactions. As all adjustments totaled approximately \$62,000, we deemed them immaterial and excluded them from our analysis.

Even though the audit committee requested that the bureau review a sample of expenditures for facilities district 94-2 for the past five years, we expanded our period of review to 11 years—from 1998 through 2009—because the school district spent most of the funds more than five years ago. To select our sample, we first reviewed the school district's project accounting database and identified expenditures for facilities district 94-2. We then separated facilities district 94-2 expenditures into three groups: The first group consisted of the 16 expenditures that each exceeded \$200,000; the second group comprised 25 expenditures paid through a school district trust account for construction payments; and the third group consisted of all other expenditures. Our sample of 60 expenditures included all 16 items from the first group, a random sample of 15 items from the second group, and a sample of 29 items from the third group. The sample of 29 items from the third group included 21 items selected at random and eight large expenditures selected judgmentally from the six vendors who each had more than \$400,000 in aggregate expenditures. We verified whether the projects or services associated with the expenditures we selected were appropriate, and then we traced the expenditures in the sample to invoices, purchase documents, contracts, and agendas and minutes for school board meetings to determine whether the expenditures were properly supported and authorized.

In our testing of the expenditures greater than \$200,000, we were unable to test one expenditure of \$2 million that was 11 years old. The few available documents related to this expenditure indicate that it was for construction and equipment for La Costa Canyon High School, which is a school that qualifies as an appropriate project for facilities district 94-2 funds; however, insufficient documentation prevented us from validating the expenditures for these purposes.

To establish the total revenues collected through assessed fees and how they were spent, we examined bank statements, school district accounting records, and official documents from the San Diego County Auditor and Controller for fiscal years 2004–05 through 2008–09.

To identify total amounts received from bond issuances, we interviewed school district officials and examined the official statements and closing memoranda for the district's bond sales, special tax certificates, and bank statements. To ascertain how the school district spent the bond proceeds, we aggregated data we obtained during our testing of expenditures.

To determine whether the school district has properly responded to requests for information regarding facilities district 94-2, we reviewed applicable statutes as well as guidance on the records act from California's Office of the Attorney General. We also interviewed district officials and individuals from a citizens group that filed requests for public records with the school district, and we reviewed and evaluated the school district's policies and procedures relating to public records requests. Finally, we examined all 19 requests for information regarding facilities district 94-2 that the school district had received as of December 31, 2009, to assess whether the school district met the statutory deadlines for responding to records act requests and whether the records that the school district made available to requesters responded adequately to the requests.

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Audit Results

San Dieguito Union High School District's Expenditures for Community Facilities District 94-2 Were Generally Appropriate

From 1998 through 2009, San Dieguito Union High School District (school district) spent funds from Community Facilities District 94-2 (facilities district 94-2) almost entirely on appropriate facilities and services. As of December 31, 2009, the school district had spent \$27.9 million of the \$29.1 million in bond funds allocated to facilities district 94-2. Our test of 60 expenditure items valued at \$16.4 million charged to facilities district 94-2 revealed that all but three items, totaling \$300,000, went to school facilities and bond-related activities allowed in the resolution of formation for the facilities district; therefore, these expenditures were appropriate.

The School District Has Adequate Internal Controls Over Facilities District 94-2 Expenditures

The school district uses adequate internal controls to ensure the appropriateness of its expenditures of facilities district 94-2 funds, and these controls are operating effectively. Key elements of control are the multiple levels of required review and approval for projects and expenditures. For example, all projects and contracts require the approval of the school district's board of trustees (school board). Moreover, for district-managed construction projects, school district staff—such as the executive director of maintenance and operations, contract analysts, maintenance supervisors, and the director of planning and financial management—work with an architect to provide multiple levels of oversight. For large construction projects, such as the construction of a new school or the modernization of an existing school, an inspector approved by California's Division of the State Architect and a contracted construction manager supply additional oversight.

Furthermore, the preparation, approval, and issuance of payments made with facilities district 94-2 funds are subject to various levels of review and control. Specifically, the school district's finance and purchasing staff review invoices before forwarding them to the school district's business services unit, in which staff prepare requisitions for payment. In addition, the project architect, construction manager, and inspector for the project review for accuracy and completeness the invoices for large construction projects. After business services staff prepare requisitions for payment, school district administrative staff and executives review and approve the requisitions before forwarding them to the bond trustee, a bank, for payment.

Almost All Tested Expenditures for Facilities District 94-2 Were Appropriate

As of December 31, 2009, the school district had spent \$27.9 million of the \$29.1 million in bond funds that it had allocated to facilities district 94-2. Table 2 shows that the school district has recorded a total of approximately \$31.1 million as spent on projects for facilities district 94-2. Of the additional \$3.2 million in expenditures, \$835,000 was covered by prepaid taxes for facilities district 94-2, and \$2.4 million was covered by the bond funds allocated to the school district's other community facilities districts. According to the school district's director of planning and financial management, expenditures by the other community facilities districts were allowable because the other facilities districts do not have restrictions regarding the school facilities for which the school district may use the facilities districts' funds. After reducing this total by the \$451,000 in expenditures that we identified as inappropriate, the remaining balance of \$30.7 million still exceeds the amount of funds provided by facilities district 94-2.

Table 2
San Dieguito Union High School District
Expenditures for Community Facilities District 94-2
From July 1, 1998, Through December 31, 2009
(Dollars in Thousands)

PROJECTS AND FACILITIES	EXPENDITURES
La Costa Canyon High School*	\$9,011
San Dieguito High School Academy†	8,720
La Costa Valley site‡	5,884
Termination payment for 2006 bonds	2,459
Oak Crest Middle School	1,918
Sunset High School	393
Diegueño Middle School	81
Miscellaneous	185
Untestable amount§	2,042
Inappropriate expenditures	451
Total	\$31,144

Sources: San Dieguito Union High School District (school district) project accounting database and expenditure records.

* In 1996 the school district opened La Costa Canyon High School in south Carlsbad.

† In 1996 the school district added the word *Academy* to San Dieguito High School's name.

‡ The school district purchased the La Costa Valley site in 1999 as the location for a new middle school in south Carlsbad.

§ The few available school district records indicate that these 1999 expenditures were for La Costa Canyon High School. However, insufficient documentation prevented us from validating the expenditures' purposes.

|| These expenditures relate to housing and demographic studies and to relocatable buildings used for administrative purposes.

In our sample of 60 invoices totaling \$16.4 million in expenditures of facilities district 94-2 funds, we found three invoices, totaling \$300,000, that were inappropriate. Through further investigation, we identified other invoices related to the three exceptions, and these invoice amounts increased to \$451,000 the total payments that were inappropriate. These expenditures were improper either because they were for facilities not specified in the resolution of formation for facilities district 94-2 or because they applied to services that benefited the entire school district and therefore should have been charged accordingly.

One of the three exceptions concerned the school district's charging approximately \$294,000 to facilities district 94-2 in 2006 for three relocatable classrooms and one relocatable restroom on the Sunset High School site even though the school district's purchasing/warehouse department has used these units since they were installed. In early 2005 the school board voted to purchase these units for the school district to use on an interim basis as general office space for its purchasing department and as storage space for its warehouse operation. According to information accompanying the school board's resolution approving this action, when the school district found a permanent location for the purchasing/warehouse department, the school district could then use the three relocatable classrooms to increase capacity at the high school or to replace older modular buildings at other school sites. However, the school district never found a permanent location for the purchasing/warehouse department. The resolution of formation for facilities district 94-2 does not allow expenditures for school district offices. Therefore, the school district charged the facilities district inappropriately for the cost of these buildings.

The other inappropriate expenditures concerned the school district's charging facilities district 94-2 nearly \$157,000, or 49 percent, of the \$322,000 it incurred for housing and demographic studies used in its facilities planning processes between 1999 and 2007. These studies applied to the entire school district, including the other eight community facilities districts, which contributed only about \$20,000 for the analyses. The school district paid the remaining \$145,000 from funds unrelated to the community facilities districts. The charges to facilities district 94-2 were inappropriate because the study costs were not reasonably allocated across all community facilities districts and across the school district as a whole. According to the school district's director of planning and financial management, district staff considered it appropriate to charge facilities district 94-2 approximately half of the costs for housing and demographic studies because the school facilities specified in the resolution of formation for facilities district 94-2 constitute half of the district's schools—and all of the schools in the northern half of the district. The associate

We identified a total of \$451,000 in payments that were inappropriate—the majority concerned charges for three relocatable classrooms and one relocatable restroom on the Sunset High School site being used by the school district's purchasing/warehouse department.

In its communications, the school district did not meet its own standards of openness and accountability to the public—it did not make clear the financial problems it encountered in early 2008 associated with the district's 2006 bonds.

superintendent for business services (associate superintendent) indicated that the school district did not become aware that charging the studies' cost in this way was an issue until the school district received a report in 2008 from an external consultant that it had hired to review expenditures for facilities district 94-2. According to the director of planning and financial management, to avoid concerns over the use of community facilities district funds, going forward staff elected to pay for demographic studies from a districtwide fund. Consequently, the school district did not charge facilities district 94-2 for housing and demographic studies after 2007. The school district, however, did not reimburse facilities district 94-2 for the earlier charges or otherwise adjust the costs that it had accumulated for this facilities district.

In Some Instances, the School District Did Not Adequately Disclose Important Financial Issues to the Public

The school district did not adequately reveal to the public the significant problems that it had with its bonds, nor did it provide key information about the economic benefits and risks associated with these bonds. Specifically, in its communications, the school district did not meet its own standards of openness and accountability to the public; it did not disclose the difficulties, including escalating interest payments, that it faced in early 2008 related to the variable rate of the 2006 bonds. Further, the school district's financial statements for fiscal year 2006–07 did not meet all applicable disclosure requirements for these refunding bonds, which the school district had issued in 2006 to redeem, or refund, its outstanding 1998 and 2004 bonds. These requirements included those related to presenting the economic gain or loss from the bonds' issuance and disclosing the risks associated with the school district's use of an interest rate swap agreement (swap agreement) to create a synthetic fixed interest rate, which we describe in the Introduction.

The School District Did Not Clearly Communicate Its Financial Problems Related to the 2006 Bonds

Despite its policies for keeping the public informed and the community involved, the school district did not make clear in its school board meeting agendas and minutes the financial problems that it encountered in early 2008, its plans for dealing with these problems, or the eventual cost of resolving them. Between January 23, 2008, and May 6, 2008, when the school district remarketed its 2006 bonds, various aspects of the financial problems associated with these bonds were discussed at school board meetings, but none of the agendas and related attachments

or the minutes for these meetings mention any problems or the potential cost of resolving the problems. Instead, these documents contain brief, general descriptions of items related to the 2006 bonds. Although these brief descriptions may satisfy the minimal requirements of the Ralph M. Brown Act—a California law meant to facilitate public participation in local government decisions—they do not convey the significance of the issues faced by the school district. The school district's Web site shows agendas and related materials provided by e-mail to school board members and interested parties before school board meetings, and it displays the minutes of such meetings; however, the Web site does not provide the documents distributed to school board members during the meetings. Some of these documents could have enlightened the public about the significant problems that the school district was facing in making payments on its 2006 bonds.

As the Introduction explains, in 2006 the school district issued bonds with variable interest rates that were reset at auction every 28 days, and it simultaneously entered into a swap agreement with the bond underwriter that created a synthetic fixed interest rate. Before issuing the bonds, the school district adopted a master swap policy that includes all of the elements of a comprehensive policy— except a way of determining the maximum amount of *derivative*³ contracts—that the Government Finance Officers Association⁴ recommends in its best practice guidance on the use of debt-related derivative products. The master swap policy also recognizes the various types of risk associated with swaps, and it includes processes for evaluating, documenting, monitoring, and reporting on swaps. Further, shortly after the public facilities authority issued the 2006 bonds, the school board hired a consultant to provide monitoring services for the interest rate swap.

One of the risks that the school district faced from having auction rate bonds tied to an interest rate swap was that the payments received by the district under the swap might be insufficient to make the auction rate payments on the bonds. This situation could occur if auction rates rose unexpectedly or if the district experienced a failed auction, causing a significant divergence with the swap's interest rate. According to a 2008 publication by the Federal Reserve Bank of Chicago, in early 2008, as banks suffered significant credit losses and mortgage write-downs stemming from

One of the risks the school district faced was that payments received by the district under the interest rate swap agreement might be insufficient to make the auction rate payments on the bonds.

³ *Derivatives* are financial arrangements in which two parties agree to make payments to each other under different obligation scenarios. These arrangements have values or cash payments based on what happens in separate transactions; thus, derivatives are affected by changes in market prices, in bond or commodity prices, or in indexes.

⁴ The Government Finance Officers Association is the professional association of state, provincial, and local finance officers in the United States and Canada. Its purpose is to enhance professional management of governments by identifying, developing, and promoting financial policies and practices.

Rising interest rates, due to the failure to find enough purchasers for the March 2008 bond auction, caused the school district's interest payments to increase from \$263,000 per month in January 2008 to \$843,000 per month just two months later.

the collapse of the subprime mortgage market, banks became less willing to commit funds to support auctions in danger of failing. By February 2008 fears of auction failure became self-fulfilling as potential investors withdrew from the market. The school district's February 2008 bond auction was successful, but it resulted in a 9.95 percent interest rate, well above the 3.75 percent rate of the month before. In March 2008 disruptions in the auction rate market and the uncertain future of the bonds' insurer led to the downgrade of the district's bonds. The subsequent failure to find enough purchasers for the school district's March 2008 bond auction resulted in the interest rates rising even higher, to the maximum rate of 12 percent. These circumstances caused the school district's interest payments to increase from \$263,000 per month in January 2008 to \$843,000 per month in March 2008. During the same period, the payments that the school district received based on the interest rate swap decreased because the rate that determined the payments—the London Interbank Offered Rate, or LIBOR—actually went down.

The school district's associate superintendent notified the school board in early March 2008 about problems specific to the 2006 bonds and the bonds' rating downgrade. A few days later, the school board authorized its finance team to pursue options to resolve the problems, and the team then developed a solution that involved remarketing the 2006 bonds as fixed rate bonds and ending the swap agreement. Terminating the swap agreement required the district to pay an \$8.1 million fee, which it covered with community facilities district funds, including \$2.5 million from facilities district 94-2. The use of community facilities district funds to pay the penalty fee was appropriate because the Mello-Roos Community Facilities Act of 1982 allows the school district to use these funds for bond-related costs, and the swap agreement was part of the 2006 bond issuance.

School district policies state that the school board "appreciates the importance of community involvement and shall strive to keep the community informed of developments within the school system in timely and understandable ways." The school district's policy on accountability also says that "opportunities for feedback from students, parents/guardians, staff and community members shall be made available as part of the district's review and evaluation process." Moreover, the school board's bylaws state that one of its major roles is "ensuring accountability to the local community including personnel, programmatic and fiscal accountability." For these policies to be effective, the school district needs to make sure that the public is well informed about problems that the school district is encountering and about possible solutions to

these problems. In other words, the school district needed to make available to the public more information pertaining to financial difficulties related to bonds that it had issued.

In reviewing this issue, we obtained several memoranda that underscored the significant problems with the 2006 bonds that the school district was facing. For example, a February 20, 2008, memorandum to the associate superintendent from the school district's financial advisor for the bonds discussed the reluctance of investors to participate in bond auctions, and it recommended changing the interest rate mode or refinancing the bonds. In addition, a memorandum dated March 3, 2008, to school board members from the associate superintendent warned that if bond auctions failed and if the school district was required to pay the maximum interest rate of 12 percent, in about one year the school district would run out of community facilities district funds to make bond payments.

The only evidence we identified concerning problems specific to the 2006 bonds that the school district shared publicly was a presentation by the school district's investment bankers at a school board meeting on March 20, 2008; this presentation indicated that the school district would go into *technical default*⁵ if it took no action to restructure the bonds. The investment bankers pointed out that a serious negative effect of the school district's going into technical default would be its difficulty in accessing capital markets in the future. However, even in this case, the agenda for the school board meeting did not communicate any sense of the gravity of the situation, and it referred to this agenda item only as a "Bond Update." Moreover, the meeting minutes indicate only that the school district's financial advisor and investment banker "gave a current market analysis overview and addressed the restructuring bond options being considered by the school district." The presentation was not available on the district's Web site.

The associate superintendent agreed that the published agendas for the board meetings during this period were very generic, but he indicated that this was the result of the ambiguities and uncertainties in the marketplace. In retrospect, he said, the school district could have been more specific in its school board agendas, but only after the district was fully informed of the changing conditions. In addition, the executive assistant for the school district superintendent indicated that the district prepared agendas and minutes for the board meetings that were consistent with guidance from the California School Boards Association.

In March 2008 the associate superintendent warned that the school district would run out of funds to make bond payments in about one year if required to pay the maximum interest rate of 12 percent on the 2006 bonds.

⁵ *Technical default* is an issuer's failure to meet the requirements of its bond covenant. This type of default does not necessarily result in losses to bond holders.

The existence of uncertainties does not relieve governments of the responsibility to notify citizens about events that may affect the public negatively.

We disagree with the school district's reasoning that it could not or should not have provided more information in the agendas and minutes for the school board meetings regarding the financial problems that the district was facing. Uncertainties often surround difficult issues; however, the existence of such uncertainties does not relieve governments of the responsibility to notify citizens about events that may affect the public negatively. Further, the guidance from the California School Boards Association provides significant latitude in school districts' determining the specificity of agendas and minutes for school board meetings. Therefore, given the significant issues raised throughout early 2008, the school district should have better informed the public about the financial difficulties it was facing. Because the school district did not provide detailed information, members of the public who did not attend key school board meetings had little access to the information necessary to offer comments and recommendations to the school board and to hold school board members and district officials accountable.

The School District Did Not Make All Required Financial Statement Disclosures

In addition to omitting on published agendas and meeting minutes any detailed information about its 2008 bond problems, the school district also did not make all of the financial statement disclosures required by the Governmental Accounting Standards Board (GASB)⁶ related to the school district's July 2006 issuance of variable rate bonds and its use of these proceeds to refund outstanding fixed rate debt. According to GASB standards for this type of debt issuance, financial disclosures should include a description of the refunding and recognition of the old debt's redemption, both of which were included in the school district's fiscal year 2006–07 financial statements. However, the GASB standards also require financial disclosures showing the difference between the cash flows required to service the old debt and the cash flows required to service the new debt and complete the refunding. These disclosures should also show the economic gain or loss resulting from the transaction. Moreover, the standards specify that when new variable rate debt replaces old fixed rate debt, the government entity should disclose the range of potential savings if the variable rate debt has minimum and maximum interest rate limits. If such limits are absent, the entity's financial disclosures should discuss the interest fluctuation risks involved in variable rate offerings. The district did not make any of these additional disclosures.

⁶ The GASB is the independent organization that establishes standards of accounting and financial reporting for state and local governments in the United States. It is recognized as the official source of generally accepted accounting principles for these governments.

Further, GASB requires governments that are parties to a derivative—such as the swap agreement entered into by the school district—to disclose the derivative’s objective, its fair value, the significant terms of the transaction, the net cash flow⁷ of the derivative, and the party’s exposure to certain risks. Among the types of risk that must be disclosed are *basis risk* and *termination risk*. *Basis risk* arises when interest rates on a derivative and a bond are based on different indexes—a situation that could prevent the realization of expected payments. *Termination risk* occurs when a derivative’s unscheduled end could present a government entity with termination payments that are potentially significant and unscheduled. The school district did not make all of the disclosures related to derivatives in its fiscal year 2006–07 financial statements. Although the management’s discussion and analysis section of the financial statements describes significant terms of the school district’s derivative transactions, the other required disclosures previously noted are missing from the financial statements.

According to the school district’s director of planning and financial management, the financial statements did not include all the required disclosures because this was the school district’s first refunding using a synthetic fixed rate structure and the school district was unacquainted with the necessary reporting requirements. He said that he informed the district’s auditors of the situation and relied on them for assistance. When we asked the school district’s external auditors for the fiscal year 2006–07 financial statements about the missing disclosures, they said that while it appears not all disclosures were made, the statements were fairly stated and were not misleading in any way.

The external auditors’ statement minimizes the importance of disclosures in the notes to financial statements. Notes to financial statements are essential to a user’s understanding of financial position, and, as with the statements themselves, they play a major role in fulfilling a government’s duty to be publicly accountable. Moreover, in explaining the need for additional disclosures, the GASB indicates that the key disclosures in a refunding transaction are those concerning the economic gain or loss and the difference in cash-flow requirements, and it states that disclosures related to derivatives are intended to provide information that will assist in assessing the amounts, timing, and uncertainty of future cash flows. Further, making disclosures concerning the refunding bonds seems all the more important given that they represented 97 percent of the school district’s \$94 million in total liabilities as of June 30, 2007. In addition, the size of the rate swap termination fee—\$8.1 million—that the district paid the next

The school district did not make all of the required disclosures in its fiscal year 2006–07 financial statements related to the refunding bonds even though they represented 97 percent of the school district’s \$94 million in total liabilities.

⁷ The net cash flow equals cash receipts minus cash payments over a given period.

year underscores the significance of the district's risks related to derivatives. Because the school district's fiscal year 2006–07 financial statements lacked the additional disclosures, members of the public were less able to assess the financial position of the school district or to hold the school board and other school district officials accountable for their fiscal management decisions.

The School District Usually Met Deadlines for Responding to Public Requests for Records, but It Did Not Document Consistently the Records That It Provided

Although the school district generally met the legally required deadlines for responding to requests for information, deficiencies in the school district's records often prevented us from determining whether the information the school district provided responded adequately to the requests. From March 2007 through November 2009, the school district received 19 public records requests relating to facilities district 94-2. A citizens group concerned about the school district's management of facilities district 94-2 submitted 18 of these requests, and a reporter for an online San Diego newspaper made the additional request. The public records requests concerned such issues as the formation of the facilities district, notifications to property owners about special taxes, and the expenditure of bond proceeds.

The California Public Records Act (records act) requires government agencies, in responding to a public records request, to inform the requester within 10 days whether they have documents responsive to the request. In unusual circumstances, such as when the request requires an agency to search for, collect, and examine a voluminous amount of records, the agency may extend the time frame by 14 days, but it must notify the requester of the reason for the extension and the date when it will make the documents available for inspection. The extended date must be within 24 days from the date that the government agency receives the public records request.

The school district has generally implemented its processes for ensuring that it responds to requests for information within statutory time limits.

The school district has generally implemented its processes for ensuring that it responds to requesters within statutory time limits. Specifically, for the 12 requests that did not necessitate extensions, the school district met the 10-day deadline nine times. For the remaining three cases without extensions, it exceeded the deadline by three to six days. For the seven public records requests that received 14-day extensions, the school district made documents available within 24 days.

According to the school district's executive director of business services (business services director), the school district has a practice of keeping copies of any records that it provides in response to public records requests. However, our review indicated that the school district frequently has not followed this practice. Specifically, for eight of the 19 requests, we could not determine whether the documents provided by staff satisfied the requests because school district records are vague about these documents. The business services director said that the vast majority of public records requests that the school district has received have been limited in scope and have called for the staff to produce a small number of records. He explained, however, that initial requests from the citizens group were so broad in scope that the district did not follow its practice of retaining copies of the records it provided because doing so would have been a hardship on staff and would have been cost-prohibitive.

The records act does not expressly require the school district to maintain a record of documents that it produces in response to a public records request; however, we believe that this recordkeeping is a best practice that the school district should follow so that school personnel know which information it has released and so that the school district can demonstrate, in the event of a legal challenge, that it has produced the requested information. The executive director indicated that in the future, to document its good faith efforts to comply with the records act, the school district will either make backup copies or keep logs of the documents that it provides, depending on the size of the request.

The School District Has Not Built a Middle School on Its La Costa Valley Site, but a Facilities Task Force Recently Recommended Doing So

Since its 1999 purchase of a 28-acre parcel in Carlsbad's La Costa Valley area with facilities district 94-2 funds, the school district has stated consistently that it was not certain when a middle school would be needed there. However, a facilities task force (task force) updating the school district's facilities plan recommended to the school board in March 2010 that a middle school be built on this parcel, called the *La Costa Valley site*.

As the Introduction explains, one of the permissible uses of facilities district 94-2 funds is the construction of a new middle school in south Carlsbad. In September 1999 the school district acquired the La Costa Valley site as the future location for a middle school in this area. Minutes from the school board's meetings from November 1999 through April 2001 indicate that the school district had not determined a date for constructing the school because

For eight of the 19 public records requests we reviewed, we could not determine whether the documents provided by staff satisfied the requests because the school district's records are vague.

it was unclear when the school would be needed. Minutes from school board meetings between April 2001 and September 2004 show no further discussion about the status of the La Costa Valley site; instead, the minutes indicate that school district staff provided updates on projects where construction activity was in progress or imminent.

The next public discussion on the status of the La Costa Valley site occurred in September 2004 at a school board meeting at which school district staff presented the district's most recent enrollment projections and discussed their impact on facilities. According to documents from the meeting, projections showed that little enrollment growth would take place over the next seven years at middle schools in the northern region of the district and that existing middle schools would be able to accommodate anticipated enrollment growth. Therefore, school district staff indicated that the district might not need a middle school at the La Costa Valley site for seven years.

In 2005 the school district hired a consultant to conduct an asset management study that analyzed the capacity and projected enrollment of the school district's school facilities. The consultant presented recommendations at a facilities meeting in December 2005. One recommendation called for the school district to determine the potential value of the La Costa Valley site and to consider different asset management techniques, including the lease or outright sale of the property. Subsequent school board meeting minutes do not reflect school district staff taking this step, and the associate superintendent confirmed that school district staff did not implement the consultant's recommendation related to the La Costa Valley site.

Both the school board and school district staff have confirmed the district's intention to retain the La Costa Valley site.

Both the school board and school district staff have confirmed the district's intention to retain the La Costa Valley site. In October 2006, according to the associate superintendent, school district staff gave a presentation to the La Costa Valley Homeowners Association concerning facilities district 94-2 and the school district's position on the La Costa Valley site. Staff indicated that the enrollment at existing middle schools was below capacity, so a new middle school at the La Costa Valley site was not warranted at that time. They also affirmed that the school board was not considering selling the site. Nevertheless, in March 2007 a law firm made a presentation to the school board about the process that the school district would need to undertake in declaring a school site as surplus, which is a first step to selling or leasing the property. According to the associate superintendent, the law firm made this presentation to ensure that the school board was aware of the process, but the school district did not initiate or further investigate using the process for any district property. In fact, at a

meeting in November 2008, the school board adopted a resolution of assurance concerning the La Costa Valley site, declaring its commitment to preserve the site for a future school facility when demographic projections make it appropriate to do so and when the school district can secure funding.

According to the school district's associate superintendent, in January 2008 the school district hired a consultant to assist in the development of a facilities action plan intended to analyze the school district's long-term needs for facilities. The associate superintendent said that before 2008, school district staff and consultants were primarily responsible for developing the school district's master facilities plan, with the public having the opportunity to provide input through periodic facilities meetings. Beginning in 2008, the school district asked community members to participate in a task force responsible for determining the facilities needs of the school district, evaluating options for meeting such needs, and developing a funding strategy. The school district's superintendent, who was hired in February 2008, stated that he worked with school district staff to design a planning process that included community, school, and district representation because he foresaw the need to establish a base of support for potential funding options.

In determining the school district's long-term needs, the task force has considered numerous factors, including enrollment projections; the capacity of existing schools; and the condition of core facilities, such as libraries, at different schools. Additionally, the task force has evaluated options for meeting these needs, including the construction of new school facilities, and it has examined potential funding mechanisms, such as the issuance of general obligation bonds, which are secured by a government agency's general credit and revenue-raising powers. At a facilities meeting in March 2010, the task force submitted to the school board an update to the facilities action plan that describes a preferred scenario that includes construction of a middle school at the La Costa Valley site. According to minutes from this meeting, the next steps will include the development of a facilities action plan that will consider the feasibility of issuing general obligation bonds.

Recommendations

To make certain that it uses funds from facilities district 94-2 for appropriate purposes only, the school district should reimburse the facilities district for the \$451,000 in erroneous payments for administrative facilities and demographic studies, or the school district should adjust the charges to this facilities district so that they reflect only appropriate expenditures.

To provide the public with information that it can use to participate in the school district's decision-making process and to hold school board and other school district officials accountable, the school district should take the following steps:

- Ensure that descriptions for agenda items and minutes for school board meetings contain sufficient information to convey the substance of the items accurately, and post to the school district's Web site all relevant documents and presentations related to agenda items.
- Ensure that it follows all relevant standards for financial reporting. To facilitate this effort, the school district should consider using a checklist, such as the Government Finance Officers Association's School District Preparer Checklist, which is designed to assist in preparing comprehensive annual financial reports of school districts.

To enable it to demonstrate its responsiveness to public record requests, the school district should maintain a record of documents that it makes available to requesters.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. We limited our review to those areas specified in the audit scope section of the report.

Respectfully submitted,



ELAINE M. HOWLE, CPA
State Auditor

Date: June 15, 2010

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For questions regarding the contents of this report, please contact Margarita Fernández, Chief of Public Affairs, at (916) 445-0255.

(Agency response provided as text only.)

San Dieguito Union High School District
710 Encinitas Boulevard
Encinitas, CA 92024

June 1, 2010

Ms. Elaine M. Howle
State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, CA 95814

Dear Ms. Howle:

The San Dieguito Union High School District (District) has reviewed the draft report prepared by the Bureau of State Audits (BSA) concerning Community Facilities District 94-2 (CFD 94-2). We are extremely pleased that our staff's work withstood the scrutiny of the BSA which is a watchdog for the taxpayers. This audit validated the business practices utilized by our district. We are grateful for this opportunity to respond.

Over the years, serious charges have been made against the District regarding CFD 94-2. For instance, a representative of small group of community members made claims before the Joint Legislative Audit Committee and in other public forums and that the District spent several million dollars to build schools 26 miles away from CFD 94-2 and millions of dollars on projects not allowable under the mitigation agreement which formed CFD 94-2. We are pleased that the BSA found no evidence to support these wild accusations.

The BSA establishes quite clearly that the District has met its obligations to the homeowners paying the special taxes in CFD 94-2. What is particularly gratifying is the finding that the expenditures were not only appropriate, but CFD 94-2 has actually benefitted by receiving more funds for construction projects at schools serving that community than are provided for in the bond covenant.

Specifically, the report affirms that while the District has allocated \$29.1 million in bond proceeds toward schools listed in the CFD formation documents, it has spent a total of \$30.7 million on those facilities. The report also correctly states that of the \$30.7 million spent, \$27.9 million came from proceeds associated with CFD 94-2. The remaining balance of bond funds dedicated toward CFD 94-2 facilities is currently committed toward construction of the San Dieguito Academy Performing Arts Center.

The report also confirms that the District has adequate internal controls over CFD 94-2 expenditures. This refutes the allegations made by the community group and the requestor of the audit that the District has mismanaged CFD funds.

Finally, the report correctly concludes that the District took no action to declare the La Costa Valley site as surplus.

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We respond to the recommendations contained in the report as follows:

Recommendation 1:

To ensure that CFD 94-2 funds are used only for appropriate purposes, the school district should reimburse the facilities district \$451,000 for erroneous payments for administrative facilities and demographic studies or otherwise adjust the charges to this facilities district so that they only reflect appropriate expenditures.

District Response:

The BSA has confirmed that the district expended, or is committed to expend, more bond proceeds on 94-2 qualified facilities than is required under the bond covenant. As a result, the district has reclassified the expenses related to the relocatable buildings at Sunset High School and the demographics reports as non-qualified CFD 94-2 expenditures without compromising the bond covenant.

Recommendation 2:

To provide the public with information it can use to participate in the school district's decision making process and to hold the school board and other school district officials accountable, the school district should:

- *Ensure that descriptions for school board meeting agenda items and minutes contain sufficient information to accurately convey the substance of the items, and post to the school district's web site all relevant documents and presentations related to the agenda items*
- *Ensure that it follows all relevant standards for financial reporting. To assist in this effort, the school district should consider a checklist such as the School District Preparer Checklist of the Government Finance Officials Association, which is designed to assist in the preparation of comprehensive annual financial reports of school districts.*

We acknowledge that the descriptions contained in the Board agenda and minutes referencing the status and remarketing of the 2006 series bonds, while meeting the standards of the Ralph M. Brown Act, could have provided more detail for the public to fully understand the scope of the complex discussion during the public meeting. We are absolutely committed to conducting the people's business in public. As noted in the report, the actions taken by the Board of Trustees relating to the restructuring of the bonds as respects CFD 94-2 were appropriate under the terms of the formation documents.

The District has a practice of briefly stating agenda items and minutes at the recommendation of the California School Boards Association. Unprecedented volatility in the bond market and the sudden collapse of the bond insurer during the spring of 2008 was such that conditions were changing rapidly. All discussions relating to the conversion of the bonds which required Board action were discussed in open session.

The Board of Trustees annually contracts with an independent auditing firm which the State Controller's Office deems as qualified to conduct audits of school districts. The audits are conducted in accordance

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with standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States and also the state's audit guide, *Standards and Procedures for Audits of California K-12 Local Education Agencies* published by the Education Audit Appeals Panel. The 2006–07 audit was performed by Wilkinson, Hadley & Co, LLP. All of the district's financial information was fully disclosed to Wilkinson & Hadley, who represented to the Board of Trustees that the financial statements contained in their audit report presented the financial position of the district fairly in all material aspects in each major fund and were in conformity with generally accepted accounting principles. When the district converted its bonds to auction rate securities, it relied upon the advice of Wilkinson & Hadley to prepare all relevant financial statements and disclosures. The only section of the 2006–07 audit report prepared by the District is the Management Discussion & Analysis section, which does include discussion of the bond remarketing and entering into the derivative agreement. We understand that the notes to the financial statements prepared by Wilkinson & Hadley should have included further disclosures regarding the conversion of the 2004 series bonds to auction rate securities and on the swap agreement as well. This matter is no longer an issue as the 2006 series bonds were converted to fixed rate securities in 2008 as noted in your report.

District Response:

The District will review its practices for appropriately publicizing agenda items and preparation of meeting minutes. Supplemental materials made available at meetings of the Board of Trustees will be included in the minutes.

We appreciate the Bureau's recommendation and will consider using a checklist in preparation for the external audit performed each year. The district will research available tools from organizations familiar with California school district audit procedures and determine which would be most beneficial to use. The District will also seek proposals from qualified audit firms at the end of the current contract for the 2009–10 audit to ensure the best qualified firm is preparing the District's annual audit report.

Recommendation 3:

To enable the school district to demonstrate its responsiveness to record act requests, it should maintain a record of documents it makes available to requestors.

The audit report correctly states that it is the district's usual practice to maintain copies of records requested under the California Public Records Act. It was cost-prohibitive and impractical to make such copies of the thousands of documents requested by Concerned Citizens Protecting La Costa Valley / Friends of North County.

District Response:

While there is no requirement under the California Public Records Act to do so, the district will maintain a record of documents made available to persons under the act. Depending on the scope of the request, the district will either continue its practice of making a back-up copy of records provided under the act or, in the case of a voluminous request, a general description of records provided will be documented.

San Dieguito Union High School District
June 1, 2010
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As a final note, we wish to recognize and thank you for the professional courtesies extended by your staff throughout the period of this audit. Should you or your staff require any further information, please do not hesitate to contact us.

Sincerely,

(Signed by: Ken Noah)

Ken Noah
Superintendent

cc: Members of the Legislature
Office of the Lieutenant Governor
Milton Marks Commission on California State
Government Organization and Economy
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
California Research Bureau
Capitol Press