



Lackawanna City School District Financial Condition

Report of Examination

Period Covered:

July 1, 2012 — March 31, 2014

2014M-119



Thomas P. DiNapoli

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State of New York Office of the State Comptroller

Division of Local Government and School Accountability

August 2014

Dear School District Officials:

A top priority of the Office of the State Comptroller is to help school district officials manage their districts efficiently and effectively and, by so doing, provide accountability for tax dollars spent to support district operations. The Comptroller oversees the fiscal affairs of districts statewide, as well as districts' compliance with relevant statutes and observance of good business practices. This fiscal oversight is accomplished, in part, through our audits, which identify opportunities for improving operations and Board of Education governance. Audits also can identify strategies to reduce costs and to strengthen controls intended to safeguard district assets.

Following is a report of our audit of the Lackawanna City School District, entitled Financial Condition. This audit was conducted pursuant to Article V, Section 1 of the State Constitution and the State Comptroller's authority as set forth in Article 3 of the General Municipal Law.

This audit's results and recommendations are resources for district officials to use in effectively managing operations and in meeting the expectations of their constituents. If you have questions about this report, please feel free to contact the local regional office for your county, as listed at the end of this report.

Respectfully submitted,

*Office of the State Comptroller
Division of Local Government
and School Accountability*

Introduction

Background

The Lackawanna City School District (District) is located in the City of Lackawanna, Erie County. The District is governed by the Board of Education (Board) which comprises seven elected members. The Board is responsible for the general management and control of the District's financial and educational affairs. The Superintendent of Schools (Superintendent) is the District's chief executive officer and is responsible, along with other administrative staff, for the District's day-to-day management under the Board's direction. The Assistant Superintendent for Administrative Services oversees the daily operations of the Business Office.

The District operates four schools with approximately 1,700 students. In the last four years the District's enrollment has decreased by approximately 200 students. The District's general fund budgeted appropriations for the 2013-14 fiscal year are \$47 million, funded primarily with State aid, real property taxes, sales tax and other miscellaneous revenues.

Objective

The objective of our audit was to assess the District's financial condition. Our audit addressed the following related question:

- Did the Board and District management effectively manage the District's financial condition?

Scope and Methodology

We examined the District's financial condition for the period July 1, 2012 through March 31, 2014. We expanded our scope period to the 2009-10 fiscal year to analyze the District's year-end fund balance, budgeting practices and financial trends. In addition, we examined the current fiscal year's budget and spending to March 31, 2014, the 2013-14 fiscal year end financial projections and the ensuing fiscal year's preliminary budget projections. Subsequent to the end of field work, we updated our analysis to include the 2014-15 adopted budget.

We conducted our audit in accordance with generally accepted government auditing standards (GAGAS). More information on such standards and the methodology used in performing this audit is included in Appendix B of this report.

Comments of District Officials and Corrective Action

The results of our audit and recommendations have been discussed with District officials and their comments, which appear in Appendix A, have been considered in preparing this report. District officials generally agreed with our recommendations and have initiated, or indicated they planned to initiate, corrective action.

The Board has the responsibility to initiate corrective action. Pursuant to Section 35 of the General Municipal Law, Section 2116-a (3)(c) of the Education Law and Section 170.12 of the Regulations of the Commissioner of Education, a written corrective action plan (CAP) that addresses the findings and recommendations in this report must be prepared and provided to our office within 90 days, with a copy forwarded to the Commissioner of Education. To the extent practicable, implementation of the CAP must begin by the end of the next fiscal year. For more information on preparing and filing your CAP, please refer to our brochure, *Responding to an OSC Audit Report*, which you received with the draft audit report. The Board should make the CAP available for public review in the District Clerk's office.

Financial Condition

The Board and District officials are accountable to taxpayers for the use of District resources and for effectively planning and managing the District's financial operations. They are responsible for adopting budgets that include realistic estimates of expenditures and the resources available to fund them. Sound budgeting practices, coupled with prudent fund balance management, ensure that the District consistently generates sufficient, recurring revenues to finance anticipated expenditures. Multiyear operational planning is also essential for maintaining sound financial health. A proactive approach to fiscal management is especially important for districts that have sizable operations that are largely funded with State aid and are experiencing declining financial positions.

The District had a fund balance deficit of \$1.4 million at the end of the 2012-13 fiscal year due to operating deficits over multiple years. Over the past four fiscal years (2009-10 to 2012-13), and for the 2013-14 fiscal year, the Board has relied on fund balance to finance the budget, appropriating approximately \$5 million each year. The Board and District officials overestimated expenditures and underestimated revenues, which allowed them to rollover unspent appropriated funds to fund the ensuing year's budget. However, these budgetary practices have reduced unexpended surplus funds¹ from \$2.5 million in the 2009-10 fiscal year to the point that the Board appropriated \$1.4 million more than was available for the 2013-14 fiscal year. Because the Board has relied on fund balance over the past five years, the District had a recurring structural budget deficit. Although the Board reduced appropriations by over \$2 million in the 2014-15 fiscal year budget, there is a risk that a significant structural gap remains that will need to be addressed.

The Board has not developed a multiyear operational plan to provide a framework for future budgets and facilitate management of financial operations. By developing such a plan, District officials will have

¹ The Governmental Accounting Standards Board (GASB) issued Statement 54, which replaces the fund balance classifications of reserved and unreserved with new classifications: non-spendable, restricted and unrestricted (comprising committed, assigned and unassigned funds). The requirements of Statement 54 are effective for fiscal years ending June 30, 2011 and beyond. To ease comparability between fiscal years ending before and after the implementation of Statement 54, we will use the term "unexpended surplus funds" to refer to that portion of fund balance that was classified as unreserved, unappropriated (prior to Statement 54) and is now classified as unrestricted, minus appropriated fund balance, amounts reserved for insurance recovery and tax reduction and encumbrances included in committed and assigned fund balance (post-Statement 54).

a roadmap to help identify and manage future costs and resources. Because the Board did not have multiyear operational plan, it did not foresee the District's deteriorating financial condition.

Budgeting Practices

It is essential for Board members to know the District's financial condition and develop realistic, structurally balanced budgets. In preparing the budget, the Board and District officials must ensure that projections are accurate and reasonable. Expenditure and revenue estimates should be developed based on prior years' operating results, past trends and anticipated future needs. The use of multiyear planning helps ensure that the Board and District officials finance anticipated expenditures with recurring revenues and that budgeting trends are realistic and sustainable in the long run without relying on one-time revenues or funding sources or borrowing.

We compared the District's general fund appropriations with actual results of operations for the last four years and found that the Board and District officials consistently overestimated expenditures by an average of \$3.1 million, totaling over \$12.4 million. Expenditures that were consistently overestimated included instructional programs, special education and employee benefit-related costs. District officials indicated that they budget conservatively to ensure appropriations will be available for unanticipated expenditures. When preparing the budget, District officials have prior years' budget-to-actual results which should be used, in part, to better estimate the ensuing year's expenditures.

We also compared the District's general fund estimated revenues with actual results of operations for the 2009-10 through 2012-13 fiscal years. We found that revenues were underestimated by a total \$3.2 million. Total revenues were underestimated by \$2 million in 2009-10 and \$1.2 million in 2011-12. State aid revenues were underestimated by \$1.6 million in 2009-10 and by \$1.1 million in 2011-12. For the other two years, revenue estimates were accurate.

Although the Board and District officials overestimated expenditures and underestimated revenues, the District experienced operating deficits for all but one of the four years. Therefore, the District used some of the fund balance that was appropriated in those years. These budgeting practices have depleted the District's fund balance and will impact its ability to provide services to the students.

Fund Balance

One of the key measures of a school district's financial condition is its fund balance, which represents assets remaining from prior years. The Board can designate a portion of fund balance to help finance the next year's budget. However, it should ensure that the level of fund balance maintained is sufficient to provide adequate cash flow and

address unforeseen circumstances. The Board and District officials should be cognizant that continued reliance on the appropriation of significant amounts of fund balance over several years to fund the budget results in structurally unbalanced budgets and a budget gap when the fund balance is depleted. Officials are then left with having to identify new revenue or financing sources to balance the budget or having to reduce expenditures.

To assist in managing financial operations and ensuring orderly operations, the District should maintain a reasonable level of fund balance as a financial cushion for unanticipated expenditures or revenue shortfalls. Annual operating results are a measure of the District’s recent financial operations and its financial strength. Multiple years of operating deficits are an indication that the District’s budget is not structurally balanced – that its current revenues are not sufficient to support current expenditures. A good financial management practice is for the Board to adopt budgets that are based on realistic estimates of revenues and expenditures so that fund balance can be maintained at reasonable levels and within statutory limits.

	2009-10	2010-11	2011-12	2012-13
Beginning Fund Balance	\$7,066,492	\$8,146,385	\$6,508,113	\$5,951,643
Revenues	\$40,389,976	\$39,341,749	\$40,495,735	\$40,329,394
Expenditures	\$39,310,083	\$40,980,021	\$41,052,205	\$42,058,144
Operating Surplus/(Deficit)	\$1,079,893	\$(1,638,272)	\$(556,470)	\$(1,728,750)
Year-End Fund Balance	\$8,146,385	\$6,508,113	\$5,951,643	\$4,222,893
Less: Non-spendable and Restricted Fund Balance and Encumbrances	\$1,633,381	\$274,312	\$497,259	\$303,348
Available for Appropriation for Ensuing Year’s Budget	\$6,513,004	\$6,233,801	\$5,454,384	\$3,919,545
Less: Fund Balance Appropriated for Ensuing Year	\$4,000,000	\$5,300,000	\$5,300,000	\$5,290,000
Unexpended Surplus Funds	\$2,513,004	\$933,801	\$154,384	\$(1,370,455)

The District had operating deficits in three out of four years. While District officials had a planned operating deficit of over \$4 million in each year, actual operating deficits were \$1.6 million, \$0.6 million and \$1.7 million for 2010-11, 2011-12 and 2012-13, respectively. Had the operating deficits occurred as planned, the District would have depleted its fund balance in the 2010-11 fiscal year.

The District’s unexpended surplus funds were over \$2.5 million at the end of the 2009-10 fiscal year. However, the continued use of fund balance has depleted the funds to a deficit of approximately \$1.4 million at the end of the 2012-13 fiscal year. In the 2011-12 fiscal year

the Board appropriated over \$5.3 million, reducing the unexpended surplus funds to \$154,384. The Board appropriated another \$5.3 million for the 2013-14 fiscal year budget. However, available fund balance was \$3.9 million. Therefore, the Board appropriated \$1.4 million more than was available.

District officials are projecting an operating deficit of \$2.8 million for the 2013-14 fiscal year. Therefore, the District would need to use \$2.8 million of the \$3.9 million of available appropriated fund balance. If these projections are accurate, the District will end the 2013-14 fiscal year with fund balance of approximately \$1 million. The District's appropriations for 2014-15 are \$45 million, which is a reduction of over \$2 million from the prior year. These budgeted appropriations are funded with estimated revenues of approximately \$44 million and over \$1 million of appropriated fund balance. This will exhaust all of the District's remaining fund balance. Furthermore, there is a risk that a significant structural gap remains that will need to be addressed.

The Board will have to identify new revenue sources to finance operations because fund balance has been exhausted. The District relies heavily on State aid to fund its operations (approximately 70 percent) and is somewhat limited in its capacity to raise funds locally. For perspective, the District's real property tax revenues for the 2013-14 fiscal year were approximately \$7 million. In the future, if the Board chooses to address the budget gap through property taxes, the increase could be significant and require a voter-approved override of the property tax cap. As an alternative, the Board could use a combination of increased revenues and decreased expenditures. In the more immediate future, the Board and District officials need to actively monitor the budget and financial activity.

The Real Property Tax Law currently limits unexpended surplus funds to no more than 4 percent of the ensuing year's budget or approximately \$1.9 million for the District. The legally retained unexpended surplus fund balance provides cash flow and could be available to meet unanticipated expenditures. The District's budget for the 2014-15 fiscal year does not provide funding to replenish unexpended surplus funds. Therefore, the District may not be able to effectively manage unexpected occurrences.

District officials do not prepare cash flow statements and therefore cannot assess the District's ability to generate sufficient cash inflow to meet its obligations in a timely manner. Because the District will have exhausted all its unexpended surplus funds, a slight timing difference in cash inflows and outflows could result in cash constraints forcing the District to rely on short-term borrowings.

Multiyear Financial Planning

Multiyear financial planning is a tool school districts can use to improve the budget development process. Planning on a multiyear basis will enable the Board and District officials to identify developing revenue and expenditure trends, establish long-term priorities and goals and consider the impact of near-term budgeting decisions on future fiscal years. It also allows the Board and District officials to assess the merits of alternative approaches, such as using fund balance to finance operations. Any long-term financial plan should be monitored and updated on a continuing basis to provide a reliable framework for preparing budgets and to ensure that information used to guide decisions is current and accurate.

The Board and District officials have not yet developed a multiyear financial plan. They indicated that they have held discussions about incorporating multiyear planning into the budgeting processes. Had such a plan been in place, it would have been a useful tool for the Board to use to address budgeting deficiencies and the dependence on appropriating fund balance, a non-recurring revenue, to fund ongoing District operations. It would have assisted the Board in planning alternative funding to maintain the same level of services.

Recommendations

1. The Board should adopt structurally balanced budgets that fund recurring expenditures with recurring revenues.
2. The Board and District officials should reduce reliance on fund balance as a financing source and continue to evaluate and explore ways to cut costs or increase revenues.
3. The Board should develop a realistic plan to accumulate unexpended surplus funds, within the legal limit, so that the District is prepared for unexpected expenditures or revenue shortfalls.
4. District officials should prepare cash flow statements to ensure the District has sufficient cash inflows to pay its obligations in a timely manner.
5. District officials should develop, and the Board should implement, a multiyear financial plan to provide a framework for future budgets and facilitate management of the District's financial operations. The plan should be updated annually.

APPENDIX A

RESPONSE FROM DISTRICT OFFICIALS

The District officials' response to this audit can be found on the following pages.

Lackawanna City School District

Business Office

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July 25, 2014

Office of the State Comptroller
Jeffrey D. Mazula, Chief Examiner
295 Main Street, Suite 1032
Buffalo, NY 14003-2510

Dear Mr. Mazula,

The following constitutes the Lackawanna City School District's response to the Report of Examination issued by your office entitled "Financial Condition." The Report of Examination covers the District's fiscal operations during the period July 1, 2012 through March 31, 2014.

The District would like to express our appreciation for the professional and courteous manner in which your staff conducted its audit as well as the suggestions that were made to improve our operations.

The District's Board of Education and Administration are in agreement with your audit findings. Plans to address your findings are listed in the corrective action plan below. Both the Board of Education and Administration are committed to use the tools below to improve our budgeting practices to ensure that the District's budgets will be structurally balanced, do not produce deficits and allow us to plan for fund balance.

Our corrective action plan is as follows:

Item #1: *The Board should adopt structurally balanced budgets that fund recurring expenditures with recurring revenues.*

Response: The Board and Administration will develop budgets based upon prior years' revenue and expenditures, past trends and anticipated needs. This process began with the 2014-15 budget and will continue with future budgets. We will also use multiyear planning to identify revenue and expenditure trends, establish both short and long term priorities and assess the impact of current budgeting decisions on future budgets. The Assistant Superintendent will be responsible for producing reports and projections which will be incorporated into the budgeting process.

Item #2: *The Board and District officials should reduce reliance on fund balance as a financing source and continue to evaluate and explore ways to cut costs and/or increase revenues.*

Response: The Board and District will continue to seek ways in which to cut costs and increase revenues in order to reduce the reliance on fund balance as a source of financing. This was started with the 2014-15 budget, which was reduced by

\$2,500,000 from the previous year because fund balance has been used up. This will be an ongoing process for which the Board of Education and Administrators will be responsible.

Item #3: *The Board should develop a realistic plan to accumulate unexpended surplus funds, within the legal limit, so that the District is prepared for unexpected expenditures or revenue shortfalls.*

Response: As recommended during the audit, the District will plan and budget for fund balance rather than relying on using the combination of overestimating expenditures and underestimating revenues in order to generate fund balance. This will begin during the budgeting process for the 2015-16 school year. The Board of Education and the Assistant Superintendent for Administrative Services will assume this responsibility.

Item #4: *District officials should prepare cash flow statements to ensure the District has sufficient cash inflows to pay its obligations in a timely manner.*

Response: The Board of Education and Administration understand the importance of preparing cash flow projections. The new District Treasurer and Assistant Superintendent for Administrative Services will prepare cash flow projections in order to determine if we have sufficient cash on hand to meet our financial obligations in a timely manner. It is anticipated that cash flow projections will be available before the end of the current fiscal year.

Item #5: *District officials should develop, and the Board should implement, a multiyear financial plan to provide a framework for future budgets and facilitate management of the District's financial operations. The plan should be updated annually.*

Response: The District and Board agree with this recommendation and understand the importance of this tool to identify trends, establish goals and evaluate the impact of budgeting decisions. The Assistant Superintendent for Administrative Services will be responsible for preparing a multiyear financial plan which will be updated annually. It is anticipated that this plan will be available before the end of the current fiscal year.

In conclusion, the District will continue to work towards improving the fiscal management and financial condition of the Lackawanna City School District. We will use your recommendations as a resource to help us strengthen our budgeting practices and to effectively plan and manage the District's financial operations.

Sincerely,

Lisa A. Almasi
Assistant Superintendent for Administrative Services

APPENDIX B

AUDIT METHODOLOGY AND STANDARDS

The objective of our audit was to assess the District's financial management and condition. To accomplish the objective of our audit and obtain valid audit evidence, our procedures included the following:

- We interviewed District officials to determine what processes were in place for budgetary practices and to gain an understanding of the District's financial position.
- We reviewed Board minutes, policies and procedures relating to budgeting.
- We compared the District's accounting records to the annual update document (ST-3) and the audited financial statements.
- We reviewed and analyzed the District's financial records and reports, including balance sheets, budget reports and statements of revenues and expenditures.
- We reviewed and analyzed the District's reserves and fund balances to ensure they complied with applicable statutes and were reasonable.
- We interviewed District officials to determine if the District developed a multiyear operational plan.

We conducted this performance audit in accordance with GAGAS. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

APPENDIX C

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