



Medina Central School District

Reserve Funds

Report of Examination

Period Covered:

July 1, 2008 — March 25, 2014

2014M-155



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 Medina Central School District, entitled Reserve Funds. 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 Medina Central School District (District) is located in the Towns of Shelby and Ridgeway in Orleans County. The District is governed by a Board of Education (Board), which comprises nine elected members. The Board is responsible for the general management and control of the District's financial and educational affairs. The Superintendent of Schools is the chief executive officer of the District and is responsible, along with other administrative staff, for the day-to-day management of the District under the direction of the Board. The School Business Administrator is responsible for accounting for the District's finances, maintaining accounting records and preparing financial reports.

The District has three schools in operation, with an enrollment of approximately 1,750 students. The District's budgeted appropriations for the 2013-14 fiscal year totaled \$33.8 million and were funded primarily with real property taxes and State aid.

Objective

The objective of our audit was to examine the District's reserve funds and selected financial management practices. Our audit addressed the following related question:

- Does the Board properly manage District finances by properly establishing, maintaining and using reserve funds?

Scope and Methodology

We examined the District's reserve funds and selected financial management practices for the period July 1, 2008 through March 25, 2014.

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 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.

Reserve Funds

Fund balance represents the cumulative residual resources from prior fiscal years. A district may retain a portion of fund balance allowed by New York State Real Property Tax Law. A district also can legally set aside and reserve portions of fund balance to finance future costs for a variety of specified objects or purposes.

Reserve funds may be established by Board action or voter approval, pursuant to various laws and can be used to finance specific purposes. The statutes pursuant to which the reserves are established determine how the reserves may be funded, expended or discontinued. Generally, school districts are not limited as to how much money they can maintain in reserves. However, school districts should maintain reserve balances that are reasonable. Funding reserves at greater than reasonable levels essentially results in real property tax levies being higher than necessary.

The District maintains 10 reserves. The total balance of the reserves in the last five years has increased from \$1.2 million to \$12.5 million. At this point, the District's reserves represent 37 percent of the current budget. For the last five fiscal years ending June 30, 2013, the District generated approximately \$11 million in operating surpluses, which it used to fund reserves.

We reviewed these reserve funds for adherence to statutory requirements and reviewed the reasonableness of those balances. We found issues with the establishment, funding and use of certain reserves. For example, the District funded a repair reserve to \$2.9 million without the required voter approval. The District also established and funded a liability reserve totaling \$800,000 for a purpose that was not permissible. Furthermore, some reserve balances were excessive compared to the potential costs for which those reserves were established. These excess funds could be transferred to other legally established reserves, as applicable, or used to reduce the tax levy. In addition, these reserves were not used in the last five years.

Repair Reserve – The Board established the reserve in June 2010 and subsequently funded it with \$1.5 million. In the fiscal year ended June 30, 2012, an additional \$1.4 million was added to the reserve. The balance has remained \$2.9 million since then. For school districts, voter approval is required to fund the reserve. However, the District funded this reserve without voter approval. Since the repair reserve has typically not been used, we question whether funding the

reserve to this significant level has been in the best interest of District taxpayers.

Liability Reserve – Education Law authorizes school districts to establish and maintain reserves, not to exceed 3 percent of the annual budget, to cover property loss and liability claims. The primary purpose of this statute is to provide the ability to “self-insure” for all or portions of claims that would typically be covered by insurance, to reduce a school district’s insurance costs. Once established, these reserves may not be reduced below the total amounts estimated to be necessary to cover incurred but unsettled claims or suits. The portion of the reserve fund not allocated for unsettled claims or suits may be used upon dissolution of a district’s self-insurance plan to pay insurance premiums on policies purchased to insure subsequent losses in areas previously self-insured.

The Board established this reserve on April 1997. However, the District anticipated using these funds to reimburse the State for transportation aid that was incorrectly claimed and paid in previous years. This is not an allowable use of this reserve. Transportation aid that may need to be reimbursed to the State does not create either a property loss or a liability claim that would be covered by insurance, as is intended by the statute. As of June 30, 2013, the reserve had a balance of \$800,000. Because the District does not have any outstanding liability claims that could be paid with the reserve, the balance should be reduced to a reasonable level.

Unemployment Reserve – This reserve is used to reimburse the State Unemployment Insurance Fund for payments made to claimants where a school district has elected to use the “benefit reimbursement” method. If, at the end of any fiscal year, the moneys in the fund exceed amounts required to be paid into the State Unemployment Insurance Fund by an amount equivalent to the amount of benefits paid to claimants and charged to the account of the school district, plus any additional amounts required to pay all pending claims, the governing board, within 60 days of the close of the fiscal year, may elect to transfer all or part of the excess amounts to certain other reserve funds or apply all or part of the excess to the budget appropriation of the next fiscal year.

The District has increased this reserve from \$45,000 as of July 1, 2008 to \$1.8 million as of June 30, 2013. We reviewed unemployment reimbursement paid to the State Unemployment Insurance Fund for the last five fiscal years and found that it totaled \$237,000, with an annual average of \$47,000 and the highest payment being \$134,000 in the 2011-12 fiscal year. The reserve balance was 38 times the average annual cost over the last five years. In addition, the District did not

use any of this reserve as the District budgeted for these expenditures in the general fund and therefore levied taxes to fund them.

Retirement Contribution Reserve – For school districts, this reserve is for the payment of retirement contributions which are defined as all or any portion of the amount payable to the New York State and Local Retirement System (NYSLRS). The Board established this reserve on June 23, 2010 and funded \$1.5 million in that fiscal year and \$505,350 in the next fiscal year. The reserve amount has remained approximately \$2 million since that time and no reserve moneys have been used to pay retirement contributions.

The District receives a bill from NYSLRS annually. The latest bill covering the period from April 1, 2013 through March 31, 2014 was \$528,939. With a reserve balance of \$2 million as of June 30, 2013, the District had sufficient funds to pay at least three years' contributions – assuming these costs remained at the same level. Further, the District budgeted for these costs in the general fund and, therefore, levied real property taxes to fund them.

Debt Reserve – Certain proceeds are required by law to be set aside to be used to pay related debt. We reviewed the last five years' debt service fund activities and found that the District has \$1.3 million in a debt reserve that is not being used to pay related debt as required.

Tax Certiorari Reserve – This reserve is to pay judgments and claims in tax certiorari proceedings in accordance with the Real Property Tax Law. The total amount in this reserve fund may not exceed the amount that might reasonably be deemed necessary to meet anticipated tax certiorari judgments and claims. Funds reserved for tax certiorari judgments and claims that are not expended for the payment of judgments or claims arising out of tax certiorari proceedings for the tax roll in the year the moneys are deposited to the fund or that will not be “reasonably required to pay any such judgment or claim” must be returned to the general fund on or before the first day of the fourth fiscal year following the deposit of such moneys to the reserve fund.

The District established this reserve in April 1997. As of June 30, 2008, the reserve amount was \$26,000 and increased to \$800,000 in the 2009-10 fiscal year, and the balance has remained the same since then. We compared the list of property tax certiorari cases on file. The potential tax certiorari liability from those cases totals \$181,000; however, this amount also includes tax challenge cases back to the 2005-06 fiscal year. The School Business Administrator stated that they will verify the status of those old cases.

We also reviewed the two capital reserves, an insurance reserve and the employee benefit accrued liability reserve. Those four reserves had balances totaling \$2.9 million as of the end of the 2012-13 fiscal year. We found they were properly established and reasonably funded.

The District improperly establishing, funding and planning to use certain reserve funds was due to a misunderstanding of the related statutory provisions. The Board also did not establish a reserve fund policy. Excessive funding in some reserves was due to the District's budgeting practices. In the five fiscal years ending June 30, 2013, the Board and District officials underestimated revenues by a total of \$1.6 million and overestimated expenditures by a total of \$14.7 million. These budgeting practices generated approximately \$11 million in operating surpluses.

Real Property Tax Law currently limits unexpended surplus funds¹ to no more than 4 percent of the ensuing fiscal year's budget, or approximately \$1.4 million for this District. To ensure unexpended surplus funds did not exceed the statutory limit each year, the District used those operating surpluses to fund reserves. Although District officials annually appropriated fund balance and reserve funds, they were not used because the budgeting practices generated operating surpluses. The total balance of the reserves in the last five years has increased from \$1.2 million to \$12.5 million. As a result, some reserves are significantly overfunded and tax levies have been higher than necessary. For perspective, during this period the average annual real property tax levy was about \$9.7 million and the average annual operating surplus was about \$2.2 million, approximately 23 percent of the tax levy.

Recommendations

The Board and District officials should:

1. Review the Local Government Management Guide on reserve funds, which is promulgated by Office of the State Comptroller and can be accessed at <http://www.osc.state.ny.us/localgov/pubs/lmgm/reservefunds.pdf>.

¹ The Governmental Accounting Standards Board (GASB) issued Statement 54, which replaces the fund balance classifications of reserved and unreserved with new classifications: nonspendable, restricted and unrestricted (composed of 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).

2. Establish a reserve fund policy.
3. Ensure that the repair reserve is reasonably funded, obtain voter approval to validate the moneys in the reserve and consult with the District's legal counsel if needed.
4. Establish the liability reserve for permissible purposes and reduce the reserve balance to a more reasonable level.
5. Reduce the unemployment reserve and the retirement contribution reserve balances to more reasonable levels which reflect more realistic future expenditure needs.
6. Use moneys in the debt reserve to pay related debt.
7. Evaluate potential tax claims to determine the appropriate amounts that will be needed in the tax certiorari reserve to settle potential tax claims and return other moneys to unexpended surplus funds in the general fund.
8. Develop realistic revenue and expenditure estimates for the annual budget and monitor financial activity to ensure that operations closely mirror the budget.

APPENDIX A

RESPONSE FROM DISTRICT OFFICIALS

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



MEDINA CENTRAL SCHOOL DISTRICT

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Jeffrey M. Evoy
Superintendent of Schools

August 12, 2014

Officer of the State Comptroller
Attn: Mr. Jeffrey D. Mazula
Chief Examiner of Local Government and School Accountability
295 Main Street, Suite 1032
Buffalo, NY 14203-2510

RE: Acknowledgement of Audit of Medina Reserve Funds

Dear Chief Examiner Mazula:

I would like to thank you for visiting Medina Central School District and appreciate the recommendations as set forth in your audit report of the District's reserve funds covering the period July 1, 2008 through March 25, 2014. Please accept this as the District's initial response and acknowledgement of receipt of the audit. A complete corrective action plan will be developed and provided to your office within the time frame requested.

As is the case in so many other school districts, Medina has struggled in the last six years trying to meet the fiscal challenges it has confronted. These challenges have been addressed in positive ways which has enabled us to plan effectively for the future. Your audit report offers additional guidance and recommendations which will further assist our efforts.

As was likely clear in your review, Medina has come together more than ever to focus on transparency in all areas of education, from supports to instruction. We have endured reductions in staff, closed an instructional building and collectively create ways to share services, while making sure our students and community would not feel the burden.

The financial stability our District has created and maintained began seven years ago. In 2006-07, Medina carried less than a 4% fund balance with no reserves. Since then, the District has improved reserves while addressing issues of declining enrollment and corresponding decreases in State Aid. The District now finds itself in a better fiscal position than it did half a decade ago.

Although prior administration took an aggressive approach to build our reserves, a greater concern arose when the reduction in State Aid began. Because of the uncertainty in our largest funding source, the District chose to make strategic staffing cuts throughout the District. In addition, due to declining enrollment the decision was made to close a building. We were maintaining our existing reserves while cutting costs to further prepare for the reduction in State Aid.

Higher Standards • Higher Expectations

In recognition that our reserves were above average, as your audit noted, we have been working in the two areas that the NYS Comptroller suggest be addressed; tax levy and debt. We are pleased to have had four (4) years of a 0% tax levy increase and in 2013-14 and 2014-15, the Board of Education supported a reduction in our tax levy of -1% and -2%, respectively. We are pleased to be able to make such reductions. Prior to the recent years, the District felt the volatility of State Aid and uncertainty related to Gap Elimination Adjustment chose not to make reductions in the tax levy prudent. Our effective reserves also allowed us in June, 2013, to make an additional principal payment on debt of \$750,000. Again, this was due to prudent use of reserves.

The Board of Education and administration will review all of your recommendations, guidance materials and District policies referenced in your audit. Additionally, we will consult with our auditors and attorney to ensure proper creation, funding and usage of all reserves. From this the District will implement a corrective action plan. Part of that plan will be to bridge the gap from budget to actual expenditures. We will create a comprehensive strategic plan.

Sincerely,

Jeffrey M. Evoy
Superintendent

APPENDIX B

AUDIT METHODOLOGY AND STANDARDS

Our objective was to examine the District's reserve funds and selected financial management practices. To accomplish our objective, we performed the following procedures:

- We interviewed District officials to obtain an understanding of the District's financial management practices, including budgeting and establishing, funding and using reserve funds.
- We reviewed all 10 reserve funds for the last five fiscal years and evaluated whether they were properly established, funded and used in accordance with statute. We also analyzed the reserves' intended uses and potential obligations to determine whether they were permissible and reasonably funded.
- We reviewed Board meeting minutes, Board resolutions, budget propositions and voter approvals.
- We reviewed debt service fund activity in the last five fiscal years to get a better understanding of the debt reserve.

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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