



Fillmore Central School District Reserve Funds

Report of Examination

Period Covered:

July 1, 2013 – September 12, 2016

2016M-386



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State of New York Office of the State Comptroller

Division of Local Government and School Accountability

January 2017

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 district operations and Board of Education governance. Audits also can identify strategies to reduce district costs and to strengthen controls intended to safeguard district assets.

Following is a report of our audit of the Fillmore 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 New York State 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 Fillmore Central School District (District) is located in the Towns of Allen, Birdsall, Caneadea, Centerville, Granger and Hume in Allegany County and the Towns of Genesee Falls and Pike in Wyoming County. The District is governed by the Board of Education (Board), which is composed of five elected members and is responsible for the general management and control of the District's financial and educational affairs. The Superintendent of Schools 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 District operates one school with approximately 675 students and 115 employees. The District's budgeted appropriations for the 2016-17 fiscal year are \$14.8 million, which are funded primarily with State aid, real property taxes and grants.

Objective

The objective of our audit was to evaluate the District's reservation of fund balance. Our audit addressed the following related question:

- Does the District properly manage reserves in accordance with statutes?

Scope and Methodology

We examined the District's reserve funds for the period July 1, 2013 through September 12, 2016. We extended our scope period back to July 1, 1996 to review reserve activity. 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 are included in Appendix C 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. Appendix B includes our comments on issues raised in the District's response letter.

The Board has the responsibility to initiate corrective action. Pursuant to Section 35 of General Municipal Law, Section 2116-a (3)(c) of New York State 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

The Board may establish reserve funds and retain portions of fund balance, which represents the cumulative residual resources from prior years, for certain future purposes (for example, capital projects or retirement expenditures) in compliance with statutory requirements. While school districts are generally not limited as to how much money can be held in reserves, balances should be reasonable. The Board should periodically assess the reasonableness of the amounts accumulated in each reserve and, when warranted, reduce reserve balances to a reasonable level or discontinue a reserve that is no longer needed or whose purpose has been achieved.

When the Board establishes reserve funds, it is important that it develop a plan for funding the reserves, determining how much should be accumulated and how and when the funds will be used to finance the related costs. Such a plan should guide the Board in accumulating and using reserve funds and would help inform District residents about how District resources will be used.¹

As of June 30, 2016, the District reported five general fund reserves (unemployment insurance, retirement contribution, insurance, tax certiorari and employee benefit accrued liability) with balances totaling approximately \$1.4 million and a debt reserve in the debt service fund totaling approximately \$1.2 million. The reserve balances represented approximately 18 percent of the District's budget.

The Board and District officials did not properly manage reserve funds. Further, the Board and District officials did not follow the District's reserve policy and were unable to provide us with evidence that they documented the financial need or purpose for the unemployment insurance, retirement contribution, insurance and tax certiorari reserves (with balances totaling approximately \$1.2 million), the conditions under which these reserves will be used or replenished and the rationale used to determine each reserve's appropriate funding level.

In addition, District officials were unable to provide us with evidence showing that they periodically assessed the reasonableness of reserve balances. While the Board annually budgeted for the use of debt reserve funds, due to annual operating surpluses, no debt reserve funds were actually used to finance related debt payments. Further,

¹ For more information, please refer to our *Local Government Management Guide*: <http://www.osc.state.ny.us/localgov/pubs/lgmg/reservefunds.pdf>.

as a result of annual operating surpluses, money retained in the unemployment insurance, retirement contribution, insurance and tax certiorari reserves was not actually used to finance related reserve expenditures. As a result, these reserves were overfunded.

Debt Reserve – School districts are required to establish a debt reserve to account for unexpended bond proceeds from closed capital improvement projects, and funds must be used to pay for debt service on the related obligations or for capital expenditures associated with the project for which the debt was issued. As of June 30, 2016, the District reported a balance of approximately \$1.2 million in this reserve. While the Board annually budgeted to appropriate funds from this reserve to pay debt service costs, no evidence was provided to us to show that the funds retained in this reserve were ever used toward debt service payments since the District first reported this reserve in its records in 1996.

District officials provided us with documentation showing that funds in this reserve totaling approximately \$394,000 were from unexpended bond proceeds and related interest and that \$251,000 was from State building aid received in 2003. However, officials were unable to identify the source of the remaining balance retained. We question why the Board did not use the funds that were legally required (\$394,000) to be restricted in this reserve to pay for related debt service payments, as statutorily required.

Retirement Contribution Reserve – This reserve is authorized to pay retirement contributions to the New York State and Local Retirement System (NYSLRS). As of June 30, 2016, the District reported a balance of more than \$716,000 in this reserve. On average, over the last three years, the District paid approximately \$240,000 each year to NYSLRS. However the District has not used any reserve funds towards these expenditures. We question why the Board has not used the funds in the reserve to pay for retirement contributions rather than levy real property taxes to do so.

Insurance Reserve – This reserve is authorized to fund certain uninsured losses, claims, actions or judgments for which a school district is authorized or required to purchase insurance. As of June 30, 2016, the District reported a balance of approximately \$218,000 in this reserve. While District officials told us they would use these funds for insurance deductibles and claims that were not fully covered by the District's insurance, District officials were unable to provide us with any evidence to indicate that this reserve has ever been used since it was established in 1997.

Unemployment Insurance Reserve – This reserve is authorized to fund payments made when a school district elects to reimburse the New York State Unemployment Insurance Fund for actual claims filed. As of June 30, 2016, the District reported a balance of almost \$123,000 in this reserve. On average, over the last three years, the District included approximately \$700 each year in the annual general fund budget to pay for unemployment claims rather than use the funds from this reserve. We question why this reserve is needed and funded at this level.

Tax Certiorari Reserve – This reserve is authorized to fund payments for judgments and claims in tax certiorari proceedings in accordance with New York State Real Property Tax Law (RPTL). As of June 30, 2016, the District reported a balance of approximately \$102,000 in this reserve. District officials indicated that there were no anticipated judgments and claims from tax certiorari proceedings to support the balance retained in this reserve. Therefore, this amount should be returned to the general fund as unrestricted fund balance.

The Board adopted a written reserve policy that requires District officials prepare and submit to the Board an annual report on reserves that includes the types and descriptions, dates of establishment, financial activity (increases or decreases), an analysis of the projected needs in the upcoming fiscal year and a recommendation regarding the funding of those projected needs. While District officials provided such a report to the Board, the report did not contain all the elements required by the policy.

We reviewed District officials' 2015-16 report on reserves and found that it did not include the date the reserves were established, amounts transferred into the reserves and interest earned, dates and amounts of withdrawals, an analysis of the projected needs for the upcoming year or a recommendation regarding those projected needs.

If District officials intend to levy real property taxes to pay for expenditures that could be, or as in the case of the debt reserve must be, paid for with reserve funds, we question the purpose of maintaining these excessively funded reserves. While it is fiscally prudent to provide for unforeseen circumstances, retaining excessive reserve balances often results in a tax levy that is higher than necessary.

Recommendations

The Board and District officials should:

1. Review all reserves at least annually to determine if the amounts reserved are necessary and reasonably funded. Any excess funds should be transferred to unrestricted fund balance²

² RPTL limits unrestricted fund balance to no more than 4 percent of the subsequent year's appropriations. Unrestricted fund balance above this amount must be used to reduce the real property tax levy or for legally permitted reserve funds.

(where allowed by law) or to other reserves established and maintained in compliance with statutory directives.

2. Use debt reserve money to pay related debt service expenditures in compliance with statutory requirements. If all associated debt has been repaid, the balance should be used to repay other debt or transferred to the general fund.

District officials should:

3. Prepare and provide an annual report to the Board for reserves that includes all the required elements of the Board's reserve policy.

APPENDIX A

RESPONSE FROM DISTRICT OFFICIALS

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

FILLMORE CENTRAL SCHOOL

12/21/2016

Jeffrey D. Mazula, Chief Examiner
Office of the State Comptroller
295 Main Street, Suite 1032
Buffalo, New York 14203-2510

RE: Fillmore Central School District
Reserve Funds - Report of Examination

Dear Mr. Mazula:

The Fillmore Central School has received your letter dated November 22, 2016 including the Draft Report of Examination of the Reserve Funds of Fillmore Central School. The exit discussion on December 2, 2016 was attended by our Board President, Tom Parmenter, Business Manager, Tom Ricketts, [REDACTED] and myself. District administration and the Board of Education have reviewed the draft and have the following response:

The Administration and Board of Education of Fillmore Central School thank the Office of the Comptroller and the Examiners who worked on our audit. Any audit is additional work and stressful but your professional demeanor and reasonable schedule were appreciated. An audit should be an opportunity to learn, grow and find opportunities to make the financial governance of the district more efficient. This review of district reserves is exactly that.

We agree with the audit findings that the appropriate creation and use of district reserve funds must be an important part of the financial management of the district. Fillmore Central School District has used the reserve funds to save money when possible to provide economic stability to the district. District reporting and analysis of the reserve funds did not meet all of the requirements in the current policy but Board Members did receive a report of reserve fund cash balances at each monthly meeting and a more detailed report once each year. This report will now include details per the district policy on reserves and become part of the budgeting process.

General Municipal Law in New York allows school boards to reserve excess funds, when possible, for some very specific and limited uses. Although these reserves are not generally available for usual expenses, they do provide a cash safety net that can help the Board navigate through troubling financial times. Fillmore School District is similar to other high need districts who rely heavily on state aid as the major source of annual revenue. When state aid is reduced the school's revenue is reduced and the only way to maintain fiscal stability is to have adequate savings in reserves and fund balance to offset the loss. From 2010-2015 Fillmore School District was able to maintain fiscal stability in spite of losing \$2.48 million dollars in state aid revenue.

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Fillmore School District has a current budget of around \$14,810,871. In 2016-17, the local tax revenue makes up \$2,429,058 or 16.4% of the total budget. This means that Fillmore School relies on state aid for nearly 84% of our revenue within a single budget year. Therefore, a 1% reduction in state aid for Fillmore next year would mean a revenue loss of \$121,709. In 2010, state aid to Fillmore was reduced by \$440,303, in 2011 state aid was reduced by \$884,888, in 2012 state aid was reduced by \$663,666, in 2013 state aid was reduced by \$378,290, and in 2014 state aid was reduced by \$113,487 totaling a loss of revenue equaling \$2,480,634 in five years. When state revenues are this volatile and the losses in revenue are this large, schools are forced to save more money in order to maintain fiscal stability.

This is especially difficult to impossible to overcome when coupled with the tax cap formula that only allows districts to increase local revenue through the tax levy by 2% or less. A 2% tax levy increase for Fillmore results in a mere \$43,000 in revenue. Therefore, Fillmore School can only raise revenues up to \$43,000 in a single year and still face a loss in revenue that is \$884,888. This is exactly what happened in 2010. This is exactly why New York statute needs to change in the future to allow schools to save more money so they can be fiscally stable in spite of tremendous cuts in state aid.

Current New York State law allows school districts to save a meager 4% of their total budget and place it into fund balance. This equates to \$592,434. This audit recommends we reduce reserve balances and move it into fund balance. The problem is that in accordance with NYS statute we could only move up to 4% of this money into fund balance. Saving a meager 4% in fund balance when recent history has shown that schools may face losses beyond 4% in back to back years caused by New York State Aid cuts is not reasonable. If Fillmore School had spent down our reserves and maintained a fund balance of only 4% we would have been insolvent by 2011. We do not believe this is what the New York State Comptroller's Office has in mind when they audit schools and enforce these statutes. This is why the laws involving school reserves and fund balance need to change.

See
Note 1
Page 13

In fact, Fillmore School has been able to maintain fiscal stability because of our savings in reserves and fund balance. From 2010-2015, when Fillmore School lost 2.48 million in state revenues, the school avoided asking taxpayers to exceed the tax cap and we did not cut programs that are vital to educating our students because we had enough savings to do so. Our New York State Legislature needs to re-consider only allowing public schools to save 4% of their total budget. Increasing the number of reserves allowable would be helpful as well. For example, cities, towns and counties are allowed to maintain a contingency and tax stabilization reserve but schools are not authorized to use this reserve. Schools would also benefit from having a retiree health insurance benefits reserve.

Over the last twenty years, public schools have endured state budgets that were never passed on time, caps on state aid, New York State budget gap elimination cuts in funding, the Tax Cap, and a myriad of expensive mandates that increased the cost of operating a public school. How did the reserves help school districts survive these financial obstacles? By providing a safety net of savings that could be used to offset these unexpected expenses. By allowing boards of education to present reasonable, reliable budgets to the voters knowing that if there was a crisis there was some cash in reserve or fund balance. Staffing cuts do not have to be made if you have sufficient reserves. Large tax levy increases do not have to be made if you have sufficient reserves. Athletic programs do not have to be eliminated if you have sufficient

reserves. The purchase of new school buses does not have to be delayed if you have reserves. The cash reserves maintained by the Fillmore Central School district provide reliability, predictability and stability to the financial support of the district. Reasonable cash reserves support stability in educational programs, reduce reliance on property tax, and provide resources to maintain the safety and security of the school building.

A perfect example of one way district reserves can be used is found in the financing plan of our recent building project. Capital projects are expensive and most of the money is borrowed in the form of long term bonds. New York State aids the cost of capital projects through a complicated formula that provides an amount of “building aid” each year as the bonds are paid off. For many districts the building aid paid by the state each year does not equal the annual debt payments. This difference is called the “local share” or the amount of the bonds that will have to be paid for by the local tax payers. In years gone by this “local share” would have been paid by increasing taxes. With the Property Tax Cap this is not possible. The small allowable property tax increases have to be used for district operations. The only way Fillmore could do a capital project with NO local share to the district residents was to pay cash for part of the project. This is exactly what we did, using \$938,000 in cash from our Reserve for Repairs to pay for part of the \$9,190,000 capital project. The result will be building aid paid every year to the district that will be adequate to cover 100% of the cost of principal and interest on the bonds. The Board will now plan to use other available reserves to fund the next building project. This allows for repair and improvements without property tax increases.

Debt Reserve

The rules regarding funding the Debt Reserve are clear; any money left over from the building projects or any interest earned on construction funds during the project must go into the Debt Reserve. This money must be used to pay the local share of the principal and interest on the bonds. Fillmore was fortunate to have a generous PILOT payment from the local Co-Gen facility that covered the local cost of these projects for twenty years. Now that the original PILOT has expired and the payment is greatly reduced the Debt Reserve will be expended over the next 12 years to pay principal and interest on the remaining bonds. No property tax increase will be necessary to pay off these projects.

Retirement Contribution Reserve

Indeed the district could have use the funds in the Retirement Contribution Reserve when both the Teachers Retirement System and the Employees Retirement System had large increases over the last five years. However, the district had cash available to cover these costs by using fund balance. It was deemed more appropriate to use excess fund balance to cover these costs than to use up allowable reserves.

See
Note 2
Page 13

New York State has in the past offered state wide retirement incentives to both teachers and non-teaching staff. These incentives have proven to reduce district costs in the long run but in the short term the district must pay a large share of the incentive costs. Should a state sponsored incentive be offered this reserve will be used to pay those costs.

As the Board will do with each reserve, the Retirement Contribution Reserve will be reviewed and used to the greatest benefit of the district.

Insurance Reserve

Although the district maintains a comprehensive liability insurance policy there is always the possibility that losses may occur outside the scope or limits of that policy. This reserve secures some cash that is available to pay for these unexpected losses as well as deductibles. Particularly in legal proceedings costs can quickly escalate above insured limits. This reserve protects the district from fiscal stress from liability issues.

Unemployment Insurance Reserve

It is correct that Fillmore Central School rarely has to pay unemployment. Rather than pay into the state unemployment fund every year, the district has opted to self fund for unemployment and maintain a reserve to pay possible unemployment costs. Having this reserve means lower operating costs for the district. The amount necessary in the reserve will be reviewed.

Tax Certiorari Reserve

The district does not currently have a pending certiorari action. This reserve will be reviewed by the Board and the proceeds will be re-assigned in the best interest of the district.

The Board will now prepare and initiate a Corrective Action Plan pursuant to Section 35 of General Municipal Law, Section 2116-a (3)(c) of NY State Education Law and Section 170.12 of the regulations of the Commissioner of Education within 90 days. This Corrective Action Plan will address each finding in the audit and the remediation of those findings. Most importantly this plan will be implemented as soon as possible.

Sincerely,

Dr. Ravo Root, Superintendent

APPENDIX B

OSC COMMENTS ON THE DISTRICT'S RESPONSE

Note 1

RPTL requires school districts to retain unrestricted fund balance totaling no more than 4 percent of the subsequent year's appropriations. We do not recommend that the District exceed this limit. As stated in our audit report, the District could move excess funds in existing reserves to other reserves, as permitted by law. Another option for the District is to move excess reserve funds to unrestricted fund balance. Any unrestricted fund balance above the statutory limit must be used to reduce the real property tax levy. We modified our report to provide further clarification on this issue.

Note 2

This reserve is not authorized to pay employer retirement contributions to the New York State Teachers' Retirement System.

APPENDIX C

AUDIT METHODOLOGY AND STANDARDS

To achieve our audit objective and obtain valid evidence, we performed the following procedures:

- We interviewed District officials to gain an understanding of the District's reserve fund management practices.
- We reviewed Board minutes and the District's policies regarding reserve funds.
- We reviewed the 2013-14, 2014-15 and 2015-16 annual budgets and reserve fund activity to determine if the activity was budgeted and, if so, if the reserve funds were actually used towards related expenditures.
- We extended the scope period back to 1996 to review reserve fund activity to determine if the reserve funds were used for related expenditures.
- We identified all reserves in place during the last three years and requested substantiation from District officials to determine if each reserve was established and maintained properly and if the reserve balances were reasonable.

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.

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