

Friendship Central School District

Fund Balance and Reserves

JULY 2022



OFFICE OF THE NEW YORK STATE COMPTROLLER
Thomas P. DiNapoli, State Comptroller

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Report Highlights

Friendship Central School District

Audit Objective

Determine whether the Friendship Central School District (District) Board of Education (Board) and District officials properly managed fund balance and reserves.

Key Findings

The Board and District officials did not properly manage fund balance and reserves. As a result, real property taxes were higher than necessary.

The Board and District officials:

- Overestimated appropriations by a total of \$2.3 million (8 percent) in the three fiscal years audited. This made it appear the District needed to use fund balance and reserves to close projected budget gaps. However, they were not used to fund operations.
- Improperly restricted \$246,000 in a debt reserve fund. The funds should be returned to the general fund.
- Did not develop and adopt a comprehensive written multiyear financial plan.

As a result, as of June 30, 2021, the recalculated surplus fund balance totaled \$2.5 million, exceeding the statutory limit by 20 percentage points. The Board and District officials also overfunded one general fund reserve by \$111,000.

Key Recommendations

- Adopt budgets that include reasonable estimates for appropriations, appropriated fund balance and reserve funds that will be used to fund operations.
- Reduce surplus fund balance to comply with the statutory limit.
- Return improperly restricted funds to general fund surplus fund balance in compliance with applicable statutes.

District officials generally agreed with our recommendations and indicated they plan to initiate corrective action.

Background

The District serves the Towns of Belfast, Cuba, Friendship and Wirt in Allegany County.

The five-member Board is responsible for managing and controlling 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 District contracts with the Cattaraugus-Allegany Board of Cooperative Educational Services (BOCES) for certain business office functions. The Business Manager, a BOCES employee, oversees the District's business office and maintains the District's financial records.

The Board, Superintendent and Business Manager are responsible for developing the budget.

Quick Facts

General Fund

Expenditures	\$9.8 million
Balance	\$3.6 million

Audit Period

July 1, 2018 – March 4, 2022

Fund Balance and Reserves

How Should Fund Balance and Reserves Be Properly Managed?

To properly manage fund balance, a school board (board) should adopt reasonably estimated and structurally balanced budgets based on historical data or known trends in which recurring revenues finance recurring expenditures. In preparing the budget, a board must estimate how much the school district will spend and receive, the amount of fund balance available for use at fiscal year-end and the expected real property tax levy. Accurate estimates help ensure the tax levy is not greater than necessary.

Fund balance represents the cumulative residual resources from prior fiscal years. A board is permitted to retain both a specified amount of surplus fund balance for cash flow needs or unexpected expenditures and reserves for other identified or planned needs. New York State Real Property Tax Law Section 1318 currently limits the amount of surplus fund balance that a school district can retain to no more than 4 percent of the next year's budgeted appropriations. A board must use any surplus balance over this percentage to reduce the upcoming fiscal year's real property levy or to fund needed reserves. When fund balance is appropriated in the budget to finance operations, a school district is budgeting for a planned operating deficit (expenditures exceeding revenues) equal to the amount of fund balance appropriated.

The Board and District Officials Overestimated Appropriations and Surplus Fund Balance Exceeded the Statutory Limit

We compared general fund budgeted appropriations and estimated revenues with actual operating results for 2018-19 through 2020-21. We determined that estimated revenues were generally reasonable, but the Board adopted budgets with overestimated appropriations totaling almost \$2.3 million, or about 8 percent each year over the three-year period (Figure 1).

Figure 1: General Fund Budget-to-Actual Comparison (Rounded to Nearest Thousand)

	2018-19	2019-20	2020-21	Totals
Appropriations^a	\$10,463,000	\$10,581,000	\$10,628,000	\$31,672,000
Less Adjusted Expenditures^b	9,652,000	9,944,000	9,805,000	29,401,000
Overestimated Appropriations	\$811,000	\$637,000	\$823,000	\$2,271,000
Percentage Overestimated	8%	6%	8%	8%

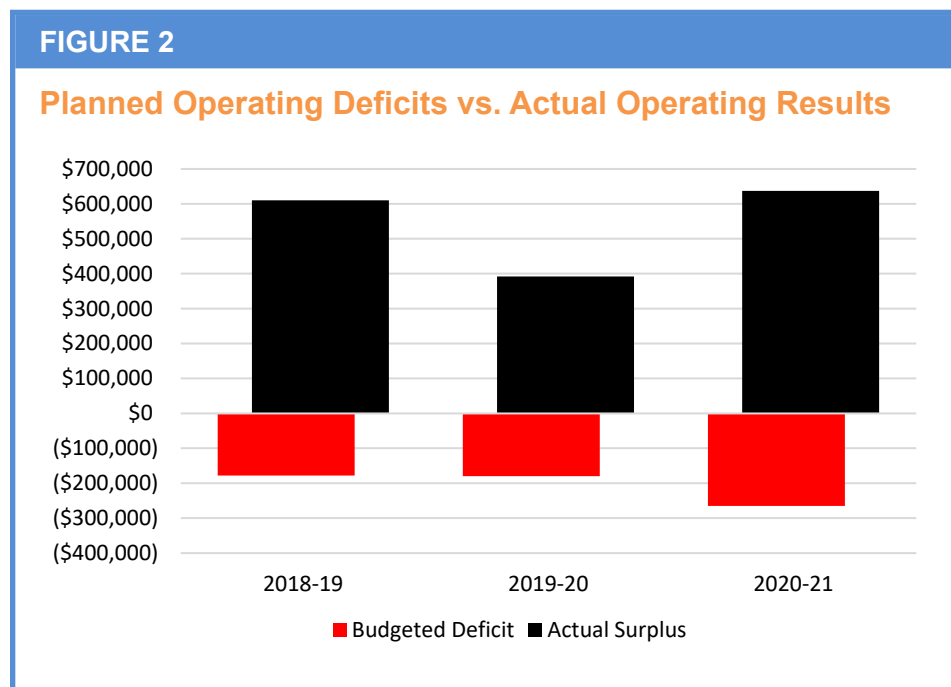
a) Includes encumbrances (prior fiscal year funds scheduled to be paid or disbursed in the current fiscal year and recorded with the current fiscal year's expenditures).

b) Includes budgeted portion of transfers to other funds and encumbrances of \$130,000, \$50,000, \$6,000 for fiscal years ended 2019 through 2021, respectively.

The most significant overestimated appropriations were for special education and employee benefits; these appropriations were overestimated by a total of \$1.5 million from 2018-19 through 2020-21, or an annual average of 16 percent.

Two Board members and the Superintendent said the District annually overestimated certain appropriations to provide flexibility in the budget in the event certain expenditures were higher than anticipated. For example, the Superintendent told us that special education costs are overestimated to accommodate potential additional special needs students and that health insurance costs are overestimated to accommodate employees potentially switching from single to family insurance plans. During the audit period, total special education related expenditures averaged 15 percent less than appropriations and health insurance expenditures averaged 25 percent less than appropriations. While it is necessary to consider potential expenditure increases during budget preparation, the Board and District officials should consider previous years' results of operations and surplus fund balance – which exceeded \$1.9 million at the end of 2020-21 – available to accommodate such expenditures. Surplus fund balance is intended to cover unplanned expenses.

In addition, the Board and District officials appropriated \$505,000 of fund balance and \$118,000 in reserves to finance operations in the adopted budgets that was not needed or used (Figure 2). The District should incur a planned operating deficit equal to the fund balance and reserves appropriated in a budget developed with reasonable revenue and expenditure estimates. This allows a school district to use reserves and reduce excess fund balance accumulated in prior years.

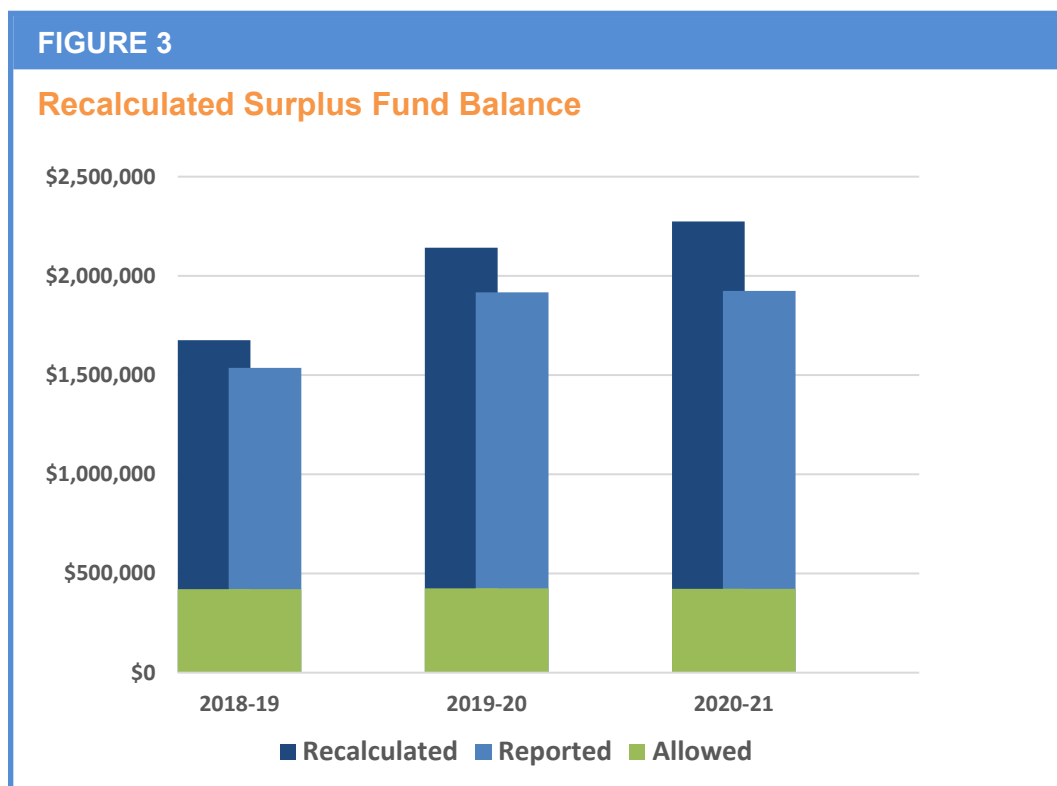


Because the Board and District officials overestimated appropriations, it appeared the District needed to use appropriated fund balance and reserves to close

projected budget gaps. Actual results showed the District's revenues were sufficient to cover annual expenditures. As a result, the District had operating surpluses totaling \$1.6 million over the past three fiscal years instead of the \$623,000 budgeted operating deficits, or an operational swing of approximately \$2.3 million. The consistent annual operating surpluses from overestimated appropriations resulted in surplus fund balance exceeding the 4 percent statutory limit.

The District's surplus fund balance increased from \$716,000 as of July 1, 2018 to \$1.9 million as of June 30, 2021, or 18 percent of the 2021-22 budgeted appropriations. This exceeded the statutory limit by \$1.5 million, or 14 percentage points. Fund balance increased because the Board and District officials did not prepare annual budgets that reasonably estimated spending, and appropriated fund balance and reserves that were not needed.

The District's practice of appropriating unneeded fund balance is, in effect, a reservation of fund balance that is not provided for by statute, circumvents the statutory limit on surplus fund balance and conceals the actual amount of surplus fund balance. For perspective, when unused appropriated fund balance was included in surplus fund balance, the recalculated surplus fund balance exceeded the 4 percent statutory limit by as much as 18 percentage points, or \$1.9 million (Figure 3).



We evaluated the District's 2021-22 budget and inquired with the Business Manager regarding her financial projections for the end of the 2021-22 fiscal year. District officials indicated the District will likely experience an operating surplus of \$91,000 and will not use the \$350,000 of fund balance or the \$40,000 in reserve funds appropriated in the budget.

Although fund balance exceeded the statutory limit and increased over the last three fiscal years, officials continued to raise real property taxes. The Board increased the real property tax levy by \$192,000 over the last three years despite having excess surplus fund balance. The Superintendent and Board President told us the increase in the real property tax levy was based on the Board's preference to keep the tax levy consistent to diminish the burden of a large one-time increase to taxpayers. However, the District's practice of overestimating appropriations and appropriating unneeded fund balance resulted in surplus fund balance that exceeded the statutory limit.

By maintaining surplus fund balance in excess of the statutory limit, real property taxes were higher than necessary. Had the Board and District officials adopted more reasonable budgets, they could have considered using excess funds toward one-time expenditures and/or needed reserves, paying off debt or reducing the tax levy.

How Should the Board Manage Reserve Funds?

School districts are allowed by law to establish reserves and accumulate funds for certain future purposes (e.g., unemployment or retirement expenditures). While school districts are generally not limited as to the amount of funds that can be held in reserves, the balances should be reasonable. A board should balance the intent for accumulating funds for identified future needs with the obligation to ensure real property taxes are not higher than necessary.

Certain funds are required to be set aside and used to pay related debt. New York State Local Finance Law Section 165 and New York State General Municipal Law Section 6-l require a debt reserve to be established if unexpended bond proceeds remain on a capital improvement or when a capital improvement has outstanding debt remaining at the time of sale. These funds must be restricted and used for related debt principal and interest payments.

To help ensure that reserve balances do not exceed the amount necessary to address long-term obligations or planned expenditures, a board should adopt a comprehensive written policy that states its rationale for establishing reserve funds and the objectives for each reserve, maximum targeted funding levels, conditions under which reserves will be used or replenished, and a periodic review of reserve balances to assess reasonableness.

...[T]he District's practice of overestimating appropriations and appropriating unneeded fund balance resulted in surplus fund balance that exceeded the statutory limit.

The Board and District Officials Improperly Restricted or Overfunded Reserves

As of June 30, 2021, the District reported seven reserves in the general fund totaling \$1.3 million and one reserve in the debt service fund totaling \$246,000. We found that reserves were generally properly established; however, funds were improperly restricted in the debt service fund and one general fund reserve was overfunded and not being used as intended. The remaining six reserves were reasonably funded and properly used.

Debt Reserve – The District accounts for and reports a debt reserve in the debt service fund, which is separate from the general fund. A debt service fund is used to account for the accumulation of resources designated for paying principal and interest on long-term debt. As of June 30, 2021, this reserve had a reported balance totaling \$246,000. The Superintendent, Business Manager and Board President were unable to identify the source of these funds or provide documentation to substantiate that the funds were required to be restricted and used to pay related debt.

District money should not be restricted in a debt reserve unless required by statute (e.g., unexpended bond proceeds associated with outstanding obligations). As a result, these funds should be returned to the general fund surplus fund balance. If these funds were returned to the general fund, recalculated surplus fund balance (including unused appropriated fund balance) for June 30, 2021 would be \$2.5 million, or 24 percent of the next year's appropriations.

Employee Benefits Accrued Liability Reserve (EBALR) – The Board established this reserve to pay accrued leave time benefits due to employees upon termination of employment. As of June 30, 2021, this reserve had a balance of \$450,000 and a corresponding liability of \$339,000, resulting in the reserve being overfunded by \$111,000 (33 percent). During the audit period, the District incurred \$45,000 in expenditures that could have been budgeted for and paid from the reserve, but were paid from the general fund. The Superintendent and Business Manager could not provide an explanation why the reserve was not used.

Although the Board adopted a written reserve fund policy, it did not address optimal funding levels, conditions necessary for when the funds would be used, how and when reserve funds would be replenished and periodic reviews of reserve fund balances for reasonableness. The policy requires an annual report be provided to the Board that includes:

- A description of the reserves,
- Dates of establishment,
- Interest earned,

If these funds were returned to the general fund, recalculated surplus fund balance for June 30, 2021 would be \$2.5 million, or 24 percent of the next year's appropriations.

-
- Withdrawal details,
 - Ending balances,
 - An analysis of projected needs in the upcoming fiscal year, and
 - Recommendations regarding funding those needs.

However, the policy does not address circumstances under which reserves would be used or replenished. Such information is necessary for officials when determining how and when to use reserve funds.

Two Board members, the Superintendent and the Business Manager told us they discussed reserve funds at Board meetings, including suggestions for planned usage and funding, but did not prepare an annual written report including reserve fund details. Without such details, we question how the Board could make informed decisions regarding the funding and use of reserves, and the Board's transparency with District taxpayers.

While it is a prudent practice for officials to save for future expenditures, the District is inappropriately retaining and overfunding reserves without a specific plan. Maintaining unnecessary reserve funds results in real property taxes that are higher than necessary to fund operations.

Why Is Multiyear Financial Planning Important?

Multiyear financial planning enables school district officials to identify revenue and expenditure trends, establish long-term priorities and goals, consider the impact of near-term budgeting decisions on future fiscal years and assess the merits of alternative approaches (such as using surplus funds or establishing and using reserves) to finance operations. A comprehensive written multiyear (long-term) financial plan should be periodically reviewed and updated to provide a reliable framework for preparing budgets and ensure that information used to guide decisions is current and accurate.

Officials Did Not Develop a Comprehensive Written Multiyear Financial Plan

District officials did not prepare or develop a comprehensive written multiyear financial plan. The lack of a multiyear plan limits the Board and District officials' ability to effectively manage finances and address future needs. Two Board members, the Superintendent and the Business Manager told us they discussed long-term planning during budget preparation and throughout the year. They were unaware that a multiyear financial plan should be prepared and used to assist with financial planning for the District. We sent officials a link to the Office of the

While it is a prudent practice for officials to save for future expenditures, the District is inappropriately retaining and overfunding reserves without a specific plan.

State Comptroller's publication Local Government Management Guide on Multi-Year Planning on February 17, 2022.¹

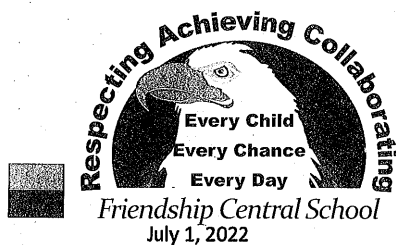
What Do We Recommend?

The Board and District officials should:

1. Develop and adopt budgets that include reasonable estimates for appropriations and the amount of fund balance and reserves that will be appropriated and used to fund operations.
2. Discontinue the practice of appropriating fund balance and reserves that are not needed or used to fund operations.
3. Develop and adopt a plan to reduce surplus fund balance to comply with the statutory limit. Surplus funds can be used for reducing the real property tax levy, funding one-time expenditures, funding needed reserves and/or paying down debt.
4. Develop and adopt a comprehensive written reserve policy that addresses the objective of each reserve, targeted funding levels, conditions under which reserves will be used and replenished, and provide a detailed annual report to the Board.
5. Transfer reserve funds improperly maintained in the debt service fund to the general fund surplus fund balance.
6. Review the EBALR and develop a plan to reduce the balance to a reasonable level in accordance with statute.
7. Develop and adopt a comprehensive written multiyear financial plan.

¹ <https://www.osc.state.ny.us/files/local-government/publications/pdf/multiyear.pdf>

Appendix A: Response From District Officials



46 West Main Street Friendship, NY 14739-9702
Phone (585) 973-3311 • Fax (585) 973-2023

Melissa Myers
Chief Examiner
Office of State Comptroller
295 Main Street, Suite 1032
Buffalo, NY 14203-2510

Dear Melissa Myers:

The Friendship Central School is in receipt of the draft audit for the period July 1, 2018 through March 4, 2022, prepared by the Office of the State Comptroller. We appreciate the opportunity to review our fund balance and reserves practices with your auditing team, and we would like to thank the Comptrollers Office for its recommendations.

The district's response to the audit findings and corresponding recommendations related to fund balance and reserves practices of the district is outlined below.

Recommendation:

Adopt budgets that include reasonable estimates for appropriations, appropriated fund balance and reserve funds that will be used to fund operations.

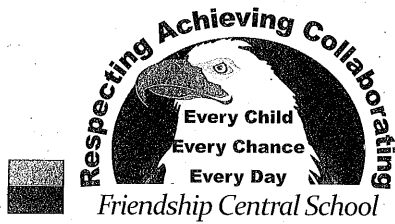
District Response:

The district budgets appropriately through the budget process and reviews historical expenditure reports to ensure the budget can meet the planned and unplanned expenditures for students' programming and maintain the levels of programming required throughout the year. We have to plan for the unforeseen expenses that may come up throughout the year through reasonably estimating appropriations. The use of appropriated fund balance and reserves helps with these unforeseen expenses that are unpredictable when completing the budgeting process. The district continually pursues cost-saving opportunities that may result in actual costs being less than budgeted for. The population of our district is transient and could result in an increase or decrease to our special education budget. The district has been able to stay below the tax cap and still maintain fiscal stability through budgeting appropriately.

Implementation Date: During the preparation of the 2023-2024 School Budget

Responsible Person: Board of Education, Superintendent, School District Treasurer

www.friendship.wnyric.org



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Recommendation:

Reduce surplus fund balance to comply with the statutory limit.

District Response:

The district acknowledges that the fund balance for the years audited was above the statutory limits. The district will review the fund balance and generate a multi-year plan to decrease the amount of fund balance. The plan will be fiscally responsible and bring the fund balance within the statutory limits.

Implementation Date: During the fall of the 2022-2023 school year

Responsible Person: Board of Education, Superintendent, School District Treasurer

Recommendation:

Return improperly restricted funds to general fund surplus fund balance in compliance with applicable statutes.

District Response:

The district will transfer the debt service reserve funds to the general fund surplus fund balance. We will develop a plan to maintain the reserves at the applicable statute. This plan will be a part of the multi-year plan we will develop for the school district. We will review the district reserve plans and update the policy in accordance with the appropriate levels.

Implementation Date: During the completion of the multi-year financial plan for fall of the 2022-2023 school year

Responsible Person: Board of Education, Superintendent, School District Treasurer

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The Friendship Central School District appreciates the review of our financial management with the State Comptroller's Office. The district will implement the recommendations of the State Comptroller's Office. This will strengthen the financial position of the district while providing the students of Friendship Central School a quality education.

Sincerely,

Judy May
Superintendent, Friendship Central School

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Appendix B: Audit Methodology and Standards

We conducted this audit 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. To achieve the audit objective and obtain valid audit evidence, our audit procedures included the following:

- We interviewed District officials and reviewed Board meeting minutes, resolutions, and policies to gain an understanding of the District's financial management policies, procedures and budgeting practices.
- We analyzed general and debt service fund financial records from 2018-19 through 2020-21 and evaluated any factors contributing to fluctuations in fund balance, including real property tax levy fluctuations and trends.
- We reviewed the adopted general fund budgets from 2018-19 through 2020-21 to assess whether they are reasonable and structurally balanced by comparing adopted budgets with actual results of operations and analyzing significant budget-to-actual variances.
- We reviewed the District's results of operations from 2018-19 through 2020-21 and calculated the surplus fund balance as a percentage of the next year's appropriations for compliance with the statutory limit.
- We recalculated surplus fund balance as a percentage of the next year's appropriations after adding back improperly restricted funds and appropriated fund balance not used to fund the next year's operations.
- We reviewed reserve fund balances as of June 30, 2021 to assess whether they were properly established, used and reasonably funded.
- We evaluated the District's 2021-22 budget and inquired with District officials regarding their financial projections for the end of the 2021-22 fiscal year as of March 4, 2022.
- We discussed multiyear financial plans with District officials.

We conducted this performance audit in accordance with generally accepted government auditing standards (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.

The Board has the responsibility to initiate corrective action. 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, 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. 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 CAP should be posted on the District's website for public review.

Appendix C: Resources and Services

Regional Office Directory

www.osc.state.ny.us/files/local-government/pdf/regional-directory.pdf

Cost-Saving Ideas – Resources, advice and assistance on cost-saving ideas

www.osc.state.ny.us/local-government/publications

Fiscal Stress Monitoring – Resources for local government officials experiencing fiscal problems

www.osc.state.ny.us/local-government/fiscal-monitoring

Local Government Management Guides – Series of publications that include technical information and suggested practices for local government management

www.osc.state.ny.us/local-government/publications

Planning and Budgeting Guides – Resources for developing multiyear financial, capital, strategic and other plans

www.osc.state.ny.us/local-government/resources/planning-resources

Protecting Sensitive Data and Other Local Government Assets – A non-technical cybersecurity guide for local government leaders

www.osc.state.ny.us/files/local-government/publications/pdf/cyber-security-guide.pdf

Required Reporting – Information and resources for reports and forms that are filed with the Office of the State Comptroller

www.osc.state.ny.us/local-government/required-reporting

Research Reports/Publications – Reports on major policy issues facing local governments and State policy-makers

www.osc.state.ny.us/local-government/publications

Training – Resources for local government officials on in-person and online training opportunities on a wide range of topics

www.osc.state.ny.us/local-government/academy

Contact

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www.osc.state.ny.us/local-government

Local Government and School Accountability Help Line: (866) 321-8503

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