

Middletown Enlarged City School District

Financial Condition

FEBRUARY 2018



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

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Report Highlights

Middletown Enlarged City School District

Audit Objective

Determine whether the Board and District officials effectively managed the District's financial condition.

Key Findings

- The Board appropriated \$27 million of fund balance in the District budgets for the last five years; however, only \$1.4 million was used.
- The District's unrestricted fund balance has exceeded statutory limits in each of the past five years.
- The Board has not adopted a fund balance policy.
- Reserves were overfunded by \$8 million.

Key Recommendations

- Discontinue the practice of adopting budgets that appropriate fund balance that is not needed to fund operations.
- Ensure that the amount of unrestricted fund balance complies with the statutory limit.
- Adopt a fund balance policy that outlines the level of fund balance to be maintained. Surplus funds should be used to fund one-time expenditures, pay off debt or reduce property taxes.
- Review reserve funds to ensure the amounts are justified, necessary and reasonable.

District officials generally agreed with our recommendations and indicated they planned to take corrective action. Appendix B includes our comment on the issue raised in the District's response letter.

Background

The Middletown Enlarged City School District (District) is located in the City of Middletown and Towns of Goshen, Walkill and Wawayanda in Orange County.

The Board of Education (Board) is composed of nine members and is responsible for managing District operations. The Superintendent of Schools (Superintendent) is responsible, along with other administrative staff, for managing the District's day-to-day operations and developing and administering the budget.

Quick Facts

Employees	1,293
Enrollment	7,159
2016-17 General Fund Appropriations	\$173,481,266
2016-17 Year-End Fund Balance	\$58,868,105.60

Audit Period

July 1, 2016 - June 30, 2017

We extended our scope period back to July 1, 2012 to review fund balance trends.

Financial Condition Management

What Is Effective Financial Condition Management?

The Board, Superintendent and Assistant Superintendent of Administration (Assistant Superintendent) are responsible for making sound financial decisions in the best interest of the District, the students they serve and the residents who fund the District's programs and operations. The Board should adopt realistic and structurally balanced budgets based on historical or other known factors, in which recurring revenues finance recurring expenditures.¹ The Board may appropriate a portion of fund balance² to help finance the next year's budget. The Board should adopt a fund balance policy and comply with the New York State Real Property Tax Law that limits the amount of unrestricted fund balance to no more than 4 percent of the next fiscal year's budget. When District officials establish reserve funds for specific purposes (e.g., capital projects or retirement expenditures), it is important that they develop a plan for funding the reserves and determine how much should be accumulated, how and when the funds will be used and to review the reserves to ensure that reserve amounts are reasonable. In addition, the Board should receive and review periodic Treasurer's cash reports and budget versus actual reports.

Budgeted Appropriations Were Overestimated

We compared budgeted appropriations to actual expenditures for 2012-13 through 2016-17 and found that District officials overestimated appropriations by over \$43 million. As a result, the District routinely expended significantly less than budgeted.

Figure 1: Overestimated Appropriations

	2012-13	2013-14	2014-15	2015-16	2016-17	Total
Appropriations	\$140,570,095	\$146,082,585	\$154,014,126	\$161,693,691	\$173,481,266	\$775,841,763
Actual Expenditures	\$133,152,261	\$141,988,517	\$150,458,903	\$150,223,842	\$156,732,332	\$732,555,855
Overestimated Appropriations	\$7,417,834	\$4,094,068	\$3,555,223	\$11,469,849	\$16,748,934	\$43,285,908
Percentage Overestimated	5.28%	2.80%	2.31%	7.09%	9.65%	5.58%

For example, personal services were overestimated by a total of \$15,272,845 or 4.5 percent and employee benefits were overestimated by \$22,169,246 or 13.19 percent over the last five years. Also, employee retirement costs were overestimated by \$6,796,527 or 12.7 percent over the last five years while

1 District officials must estimate what the District will spend and receive (e.g., State aid) and how much fund balance will be available at year-end to help balance the budget.

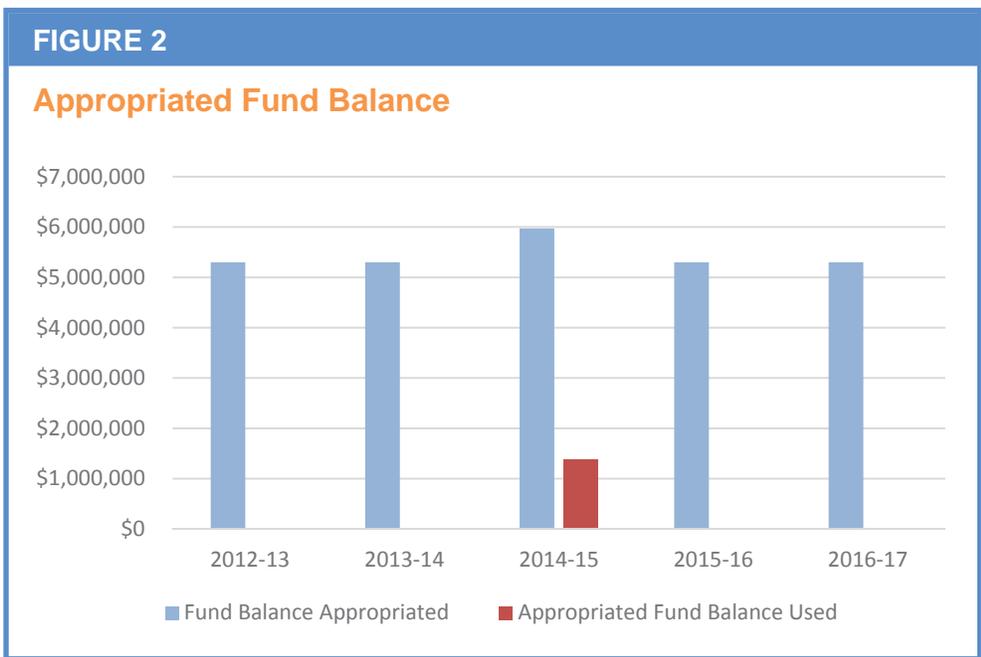
2 Fund balance is the difference between revenues and expenditures accumulated over time.

operating surpluses were used to fund a reserve for these costs. Further, a single furniture and equipment account was budgeted for \$6,939,920 over the last two years. However, only \$383,079 or 5.5 percent was spent or encumbered during that period.

The Board adopted inflated estimates for certain appropriations because District officials prepared the budgets using the current year’s budget and did not compare estimates with actual revenues and expenditures. While some expenditures are more difficult than others to accurately estimate, some of the overestimations were avoidable. For example, salaries are set by collective bargaining agreements and did not fluctuate between the time estimates were prepared and the budgets were adopted.

The Assistant Superintendent told us the District budgets conservatively because of uncertainty with some expenditures. The overestimations of expenditures are used as a buffer to protect against fluctuations. For example, the District overestimated salaries to ensure it would be able to fund salaries when the District’s Race to the Top grant expires in December 2017.

Because annual budgets contained significantly overestimated appropriations each year, it appeared that the District needed to increase its tax levy and use appropriated fund balance to close projected budget gaps. From 2012-13 through 2016-17, the Board increased the property tax levy by a total of \$7,982,396 or 12.4 percent and appropriated a total of nearly \$27.2 million of fund balance. However, only \$1,375,819 of appropriated fund balance was actually needed and was only needed in one year of the five-year period.



Fund Balance Increased Significantly

Due to the inflated estimates for certain appropriations, the District had operating surpluses in four of the last five years totaling \$23.4 million. Furthermore, the Board did not adopt a fund balance policy to outline the desired level of year-end fund balance to be maintained by the District. As a result, the total fund balance increased to \$58.9 million as of June 30, 2017. While \$22.9 million³ of the June 30, 2017 fund balance was restricted in reserve funds, the unrestricted fund balance⁴ grew from \$17.3 million as of June 30, 2013 to \$27.7 million as of June 30, 2017. As a result, the unrestricted fund balance exceeded the statutory limit by about \$11.5 million in 2012-13, \$10.6 million in 2013-14, \$6.9 million in 2014-15, \$12.1 million in 2015-16 and \$20.6 million in 2016-17.

When the appropriated fund balance not used and excessive or unnecessary reserves are included, the District's recalculated unrestricted fund balance ranged from 17.12 to 24.26 percent of the ensuing year's budget, exceeding the 4 percent statutory limit in each of the last five years.

Figure 3: Recalculated Fund Balance

	2012-13	2013-14	2014-15	2015-16	2016-17
Total Unrestricted Fund Balance at Year-End	\$19,390,395	\$18,982,351	\$15,285,489	\$21,239,688	\$30,615,829
Less: Encumbrances	\$2,070,072	\$2,242,494	\$1,916,619	\$2,147,308	\$2,875,907
Add: Appropriated Fund Balance not used to fund ensuing year's budget	\$5,299,227	\$5,299,227	\$4,596,106	\$5,299,227	\$5,299,227
Add: Excessive or Unnecessary Reserves	\$5,254,126	\$6,680,793	\$9,719,534	\$9,095,173	\$10,518,516
Total Recalculated Unrestricted Fund Balance	\$27,873,676	\$28,719,877	\$27,684,510	\$33,486,780	\$43,557,665
Ensuing Year's Budget	\$146,082,585	\$154,014,126	\$161,693,691	\$173,481,266	\$179,516,780
Recalculated Unrestricted Fund Balance as a percent of ensuing year's budget	19.08%	18.65%	17.12%	19.30%	24.26%

The District voters approved a capital reserve up to \$20 million in May 2017. The reserve has a current balance of approximately \$4 million. The Assistant Superintendent stated that the District has no plans to further fund the capital reserve that voters approved in May 2017. Additional funding of the capital reserve could help to reduce the unrestricted fund balance for 2016-17 to

³ See Reserves Were Overfunded

⁴ Net of encumbrances

at or near the statutory 4 percent limit. Had the Board adopted budgets with realistic estimates of appropriations and used appropriated fund balance to fund operations, it could have stayed within the statutory limit for fund balance and possibly reduced real property tax levies.

Reserves Were Overfunded

The District had eight reserves with a total balance of \$22.9 million as of June 30, 2017, including the tax certiorari, workers' compensation, retirement contribution, unemployment, reserve for liability, property loss, compensated absences and capital reserves. Six of the eight were overfunded by a total of \$5.3 million to \$10.5 million during the five-year period.

Figure 4: Excessive or Unnecessary Reserves

	2012-13	2013-14	2014-15	2015-16	2016-17
Tax Certiorari	\$2,692,264	\$4,395,936	\$5,214,588	\$5,079,879	\$4,513,643
Workers' Compensation	\$0	\$0	\$0	\$0	\$2,266,359
Retirement Contribution	\$1,500,771	\$1,000,771	\$2,503,241	\$2,009,411	\$1,514,356
Unemployment	\$808,216	\$1,030,826	\$1,033,442	\$1,036,072	\$1,068,947
Reserve for Liability	\$0	\$0	\$714,618	\$715,758	\$708,004
Property Loss	\$252,875	\$253,260	\$253,645	\$254,053	\$447,207
Totals	\$5,254,126	\$6,680,793	\$9,719,534	\$9,095,173	\$10,518,516

The tax certiorari reserve is intended to pay for judgments and claims in tax certiorari proceeding. New York State Education Law (Education Law) requires that funds placed in this reserve be used only for tax certioraris arising from the tax roll of the year in which the money is placed in the reserve. Education Law also provides that the total in this reserve shall not exceed the amount which might reasonably be deemed necessary to meet anticipated judgments and claims.

The District's potential liability for tax certiorari petitions filed is \$13.7 million. The District's tax certiorari reserve totaled \$8.9 million as of June 30, 2017. We reviewed the District's potential liability for all claims and calculated the average rate of settlement of claims paid for each of the last five years to be 32 percent. Using this average rate of settlement, we determined that the tax certiorari reserve was overfunded in the last five fiscal years ranging from \$2.7 million to \$5.2 million.

The District budgets for and levies taxes to fund the worker's' compensation and retirement contribution reserves, but pays the associated expenses from the annual operating budget. It is unclear why these reserves are necessary when District officials are not using them to pay for associated expenses. In addition, the District maintains an unemployment reserve fund that totaled \$1,068,947 as

of June 30, 2017. The average annual expenditure for the last five years was \$92,386. Therefore, the amount held in the reserve is enough to fund over 11 years of average expenditures. Also, the Reserve for Liability had no significant expenditures in the last three fiscal years and the property loss reserve has not had any activity in the last five years, making the need for both reserves questionable.

The unnecessary amounts maintained in these reserves occurred because the Board did not adopt a written reserve policy to indicate the amount of funds to be reserved, how reserves will be funded and when balances will be used. In addition, there was no policy to address any review of reserve balances to determine whether the amounts were justified, necessary and reasonable. As a result, the District has accumulated excessive or unnecessary amounts in its reserves.

Financial Reports Were Not Provided to all Board Members

Most of the Board members have not been provided interim financial reports as required by law. The reports not provided include the Treasurers report which reports on the District's cash and the changes that affected the balances and the budget versus actual report which would let the Board members know where revenues and expenditures stand in relation to the budget.

This occurred because the District established an audit committee⁵ that currently receives and reviews the financial reports that should be reviewed and approved by the Board as a whole, thereby preventing five of the nine Board members from performing their duties. The five Board members who are not on the audit committee do not receive detailed interim financial reports and are only able to approve audit committee meeting minutes. The only financial information provided to these five Board members are the budget presentations each year, which do not include actual operating results. Without proper information, the Board cannot make informed decisions regarding District financial matters.

What Do We Recommend?

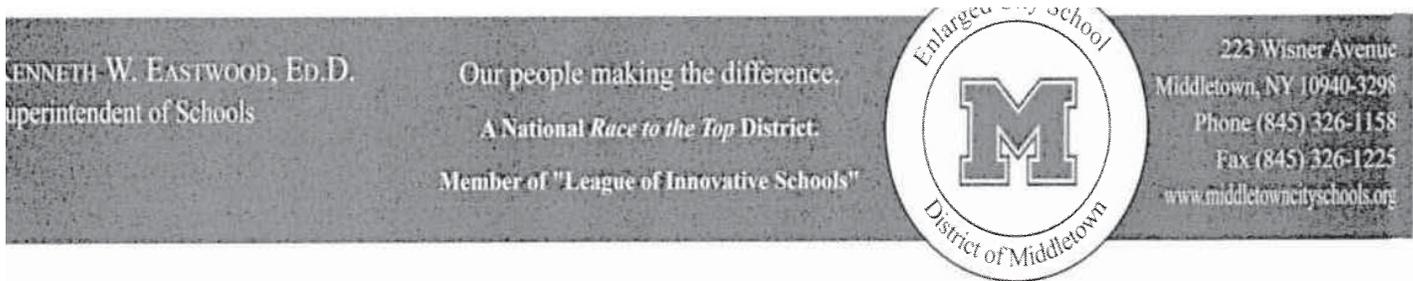
The Board should:

1. Adopt annual budgets that contain realistic estimates for appropriations based on historical or other known factors.

⁵ The committee consists of four Board members, one community member, the Assistant Superintendent, the Treasurer and the District Clerk. The responsibilities and members of the audit committee are outlined in a Board policy and relate only to external and internal audits.

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2. Discontinue the practice of adopting budgets that appropriate fund balance that will not be used to fund operations.
 3. Ensure that the amount of unrestricted fund balance complies with the statutory limit.
 4. Adopt a fund balance policy that outlines the desired level of year-end fund balance to be maintained by the District. Surplus funds should be used as a financing source for:
 - Funding one-time expenditures
 - Pay off debt
 - Reducing District property taxes.
 5. Adopt a written reserve policy that indicates the amount of funds to be reserved, how reserves will be funded and when balances will be used to finance related costs.
 6. Review all reserves at least annually to determine whether the amounts reserved are necessary and reasonable, and use excess amounts in accordance with applicable statutes in a manner that benefits taxpayers.
 7. Ensure all Board members are provided Treasurer's cash reports and budget versus actual reports for review.

Appendix A: Response From District Officials



January 30, 2018

Tenneh Blamah, Chief Examiner
Newburgh Regional Office
33 Airport Center Drive, Suite 103
New Windsor, NY 12553

Dear Mr. Blamah:

The Middletown Enlarged City School District (“the District”) is in receipt of the State Comptroller’s Office Draft Report of Examination for Financial Position for the period July 1, 2016 through June 30, 2017. The Board of Education of the District has reviewed and approved this response.

On behalf of the District, I would like to thank the staff of the Comptroller’s Office, who were found to be courteous and professional throughout the audit process. The District welcomes the feedback provided by the Comptroller’s Office and appreciates the opportunity to strengthen our practices based upon some the recommendations made in the report.

The District is pleased that the draft report does not suggest any malfeasance with respect to the District’s general business operations. To the extent that the Comptroller’s audit represents a review of District operations, practices and policies for statutory and regulatory compliance, the District generally agrees with the findings of the Comptroller’s auditors and their recommendations regarding those findings. We especially agree with the recommendation that the District develop a fund balance and reserve policy and ensuring that all Board members are provided Treasurer’s cash reports and budgeted versus actual reports for review. Also, please note that the District is committed to funding the newly approved capital reserve.

The report contains several conclusions that reflect, in our viewpoint, subjective opinion statements by the Comptroller’s auditors related to the District’s fiscal management, specifically in the areas of budgeting practices and fund balance and reserve fund management. We respectively acknowledge the Comptroller’s perspective in those areas, but the District and its elected Board of Education firmly believe that our conservative approach to fiscal management is consistent with our legal authority and our fiduciary responsibility to taxpayers.

See
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The District faces many unique challenges that we feel may have been overlooked as part of the audit process. The post-recession fiscal volatility, the creation of the State tax levy cap and the resulting low annual allowable tax levy increases, inequities in the fair distribution of state aid to

high need Districts like ours, financial problems at the State level which led to frozen foundation aid cuts that have not been made up, combined with dramatic student enrollment increases (with a large segment of the population made up of English as a New language (ENL) students and students with disabilities (SWD) and other special needs students), necessitating the District to undertake extensive capital construction projects over the past ten years and continuing into the future to keep up with the demands, all contributed to the defensive budgeting practices enacted in the District, and necessitated estimating revenues conservatively. The District also would like to note that the equipment line item mentioned in the audit report was budgeted to account for the Smart Schools Bond Funding. When guidance was received from the State Education Department indicating that the funds should be accounted for in the Capital fund, the money was not spent from the General fund. It should be noted that the revenue associated with the expenditure was also not received, resulting in no additional fund balance nor tax levy.

See
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More recently, the potential severe negative impacts of the recent federal income tax restriction on the deductibility of state and local taxes, posing a real threat to the District's ability to raise taxes or get budgets passed, could drain our reserves and fund balances in a matter of years. It is our belief that had we not budgeted conservatively, we would be doing an injustice to our taxpayers, and more importantly, our students.

Very truly yours,

Dr. Kenneth W. Eastwood, Ed.D.
Superintendent of Schools

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Appendix B: OSC Comment on the District's Response

Note 1

A conservative approach to fiscal management is consistent with the Board's legal authority and fiduciary responsibilities. However, the District's budgeting practices led to operating surpluses which were used to overfund reserves and may have resulted in a higher than necessary tax levies.

Appendix C: 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, we performed the following audit procedures:

- We interviewed District officials and reviewed the Board meeting minutes, resolutions and District policies to gain an understanding of the budget process.
- We compared budgeted appropriations and revenues to trends in actual expenditures and revenues from 2012-13 through 2016-17 and investigated significant variances.
- We reviewed reviewed the results of operations to determine annual surpluses or deficits.
- We recalculated the District's unrestricted fund balances using the appropriated fund balance not used and the excessive or unnecessary reserves from 2012-13 through 2016-17.
- We analyzed the general fund's trend in total and unrestricted fund balances from 2012-13 through 2016-17 and compared the unrestricted fund balances to the ensuing year's budgets to determine whether the fund balances were within statutory limits.
- We analyzed reserve fund records to determine whether the balances were reasonable.
- We reviewed monthly financial reports provided to the audit committee and Board for adequacy.

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.

Unless otherwise indicated in this report, samples for testing were selected based on professional judgment, as it was not the intent to project the results onto the entire population. Where applicable, information is presented concerning the value and/or size of the relevant population and the sample selected for examination.

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 2116-1(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 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. We encourage the Board to make the CAP available for public review in the Clerk's office.

Appendix D: Resources and Services

Regional Office Directory

www.osc.state.ny.us/localgov/regional_directory.pdf

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

www.osc.state.ny.us/localgov/costsavings/index.htm

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

www.osc.state.ny.us/localgov/fiscalmonitoring/index.htm

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

www.osc.state.ny.us/localgov/pubs/listacctg.htm#lmgm

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

www.osc.state.ny.us/localgov/planbudget/index.htm

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

www.osc.state.ny.us/localgov/lgli/pdf/cybersecurityguide.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/localgov/finreporting/index.htm

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

www.osc.state.ny.us/localgov/researchpubs/index.htm

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

www.osc.state.ny.us/localgov/academy/index.htm

Contact

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