



Andover Central School District

Internal Controls Over Reserve Funds

Report of Examination

Period Covered:

July 1, 2007 — April 30, 2013

2013M-162



Thomas P. DiNapoli

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State of New York Office of the State Comptroller

Division of Local Government and School Accountability

September 2013

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 Andover Central School District, entitled Internal Controls Over 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 Andover Central School District (District) is located in the Towns of Alfred, Andover, Independence, Ward, and Wellsville in Allegany County and the Town of Greenwood in Steuben County. The District is governed by the Board of Education (Board) composed of five elected members. The Board is responsible for the general management and control of the District's financial and educational affairs. The Superintendent of Schools (Superintendent) is the chief executive officer of the District and is responsible, along with the Business Administrator, for the day-to-day management of the District under the direction of the Board.

There is one school in operation within the District, with approximately 340 students and 80 employees. The District's budgeted expenditures for the 2012-13 fiscal year were \$8.2 million, which were funded primarily with State aid and real property taxes.

Objective

The objective of our audit was to review internal controls over reserve funds and addressed the following related question:

- Are internal controls over reserve funds appropriately designed and operating effectively?

Scope and Methodology

We examined internal controls over reserve funds of the District for the period July 1, 2007, through April 30, 2013. For the debt service reserve, we extended our review back to July 1, 1999.

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

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 this plan available for public review in the District Clerk's office.

Reserves

The Board is responsible for appropriately managing the financial affairs of the District. Reserves may be established by the Board in accordance with applicable laws. Money set aside in reserves must be used in compliance with statutory provisions which determine how reserves are established and how they may be funded, expended, and discontinued. Generally, school districts are not limited as to how much money can be held in reserves. However, reserve balances must be reasonable. Funding reserves at greater than reasonable levels contributes to real property tax levies that are higher than necessary because the excessive reserve balances are not being used to fund operations. The Board is responsible for developing a formal plan for the use of its reserves, including anticipated use and need of reserve funds and how and when disbursements should be made.

Internal controls over reserve funds are not appropriately designed or operating effectively. District policy¹ provides that an annual report of District reserves must be prepared and submitted to the Board for review that includes a summary statement of projected use and need of the reserve funds. However, the annual report prepared by the Business Administrator does not include a summary statement. As a result, the Board's ability to monitor the projected use and need of reserve funds could be limited. Currently, the District has more than \$1 million in a debt service reserve that District officials could not associate with any outstanding debt and more than \$1.1 million in general fund reserves that exceeded reasonable needs of the District. By maintaining excessive and/or unnecessary reserves, the Board and District officials may have missed opportunities to lower the property tax burden and withheld significant funds from being used to meet District needs.

Debt Service Reserve

A debt service reserve must be established if a capital improvement financed with debt remains outstanding or is sold or if State or Federal aid is received for a capital improvement for which there is outstanding debt. Money in this reserve should be accounted for in the debt service fund and used for debt service on that debt or, in certain cases, other outstanding debt. In addition, if a district has residual bond proceeds and/or interest earned on bond proceeds, those moneys must be used only to pay for debt service on the related

¹ Per District Policy #5511, "an annual report of District reserves must be prepared and submitted to the Board for review that includes: the type and description of reserve funds, interest earned on each reserve, any capital gains or losses, total increase or decrease of each reserve, the year ending balance, and a summary statement of projected use and need of the reserve funds."

obligations or for capital expenditures associated with the project for which the debt was issued and accounted for in the debt service fund. There is no other authority for a school district to establish or fund a reserve to pay for debt service.

The District reported a balance in the debt service reserve of \$1,428,408 as of June 30, 2012. The majority² of funding in this reserve resulted from an \$850,000 transfer from the general fund during the 2001-02 fiscal year. According to the Superintendent, this 2001-02 transfer included approximately \$360,000 in debt proceeds and interest earnings from a building project,³ \$186,000 from building aid, and \$300,000 from the general fund surplus balance. While District officials annually⁴ appropriated approximately \$256,000 from this reserve to pay debt service costs, transfers for these appropriations were not made to the general fund because sufficient resources were available in the general fund to pay debt service costs without the transfers. When asked, District officials could not associate specific debt issues with more than \$1 million of the total reported in the reserve as of June 30, 2012. Unless District officials can identify the source of the money remaining in the debt service fund and determine that it must be used to pay debt service on outstanding debt, the balance must be transferred to the unassigned fund balance of the general fund.

Retirement Contribution Reserve

General Municipal Law (GML) authorizes the establishment of a reserve for the payment of retirement contributions to the New York State and Local Retirement System (NYSLRS). The moneys in this reserve cannot be used for contributions to the New York State Teachers' Retirement System. The District's reserve, created during the 2008-09 fiscal year, has a reported balance of \$368,769 as of June 30, 2012. For fiscal years 2009-10 through 2011-12, the District paid a total of \$323,000⁵ in NYSLRS contributions. For those fiscal years, District officials appropriated \$190,000 from this reserve for that purpose. However, the District only used \$75,000, all in the 2010-11 fiscal year. Given the infrequent use of this reserve and the lack of a formalized plan detailing the need and expected use of these funds, we question the need for this reserve at its present level of funding.

² The District's external CPA reported assets in this reserve totaling approximately \$620,000 prior to the transfer.

³ According to the Business Administrator, approximately \$3 million in debt is still outstanding for this project.

⁴ For fiscal years 2007-08, 2008-09, 2010-11, and 2011-12 the District appropriated \$256,000. For fiscal year 2009-10, District officials appropriated \$334,933.

⁵ NYSLRS contributions were \$77,000 in 2009-10, \$97,000 in 2010-11, and \$149,000 in 2011-12.

Insurance Reserve

An insurance reserve may be established to fund certain uninsured losses, claims, actions, or judgments for which the District is authorized or required to purchase insurance coverage. The insurance reserve reported a balance of \$319,526 as of June 30, 2012. Since the establishment of this reserve in September 2011, the District has not used any of these moneys to pay for any losses, claims, actions, or judgments. According to District officials, this reserve was established when the District was considering becoming self-insured for certain coverage. Currently the District is not self-insured and has no formal plans to become self-insured. In addition, current insurance coverage appears adequate to cover losses. Given the absence of a formalized plan detailing the need and expected use of these funds, we question the need for this reserve.

Unemployment Insurance Reserve

GML authorizes the establishment of a reserve to reimburse the New York State Unemployment Insurance Fund for payments made to claimants. This reserve had a reported balance of \$228,281 as of June 30, 2012. The District incurred unemployment costs totaling \$52,000 for fiscal years 2007-08 through 2011-12. Even though \$118,000 was appropriated from this reserve in total over this five-year period, actual expenditures charged to this reserve totaled only \$30,000. If unemployment costs continue to average about \$10,000 per year,⁶ this reserve at its currently funded level would last for nearly 23 years. We question the reasonableness of reserving this level of funding for this purpose.

Property Loss Reserve

Education Law authorizes school districts to establish and maintain reserves, not to exceed three percent of the annual budget, to cover property loss and liability claims. As of June 30, 2012, the amount in this reserve was below three percent and totaled \$215,320. Officials indicated this reserve was established “in case” the District needed it for unanticipated losses. Given the fact that this reserve was not used during our audit period (since July 1, 2007),⁷ and the absence of a formalized plan detailing the need and expected use of these reserved funds, we question the need for this reserve.

The District has consistently generated operating surpluses in the general fund over the five-year period examined. This resulted in little need to use the general fund reserves previously discussed for expenditures that may have been chargeable to them because sufficient appropriations were available in the general fund budget to cover those expenditures. By maintaining excessive and/or unnecessary reserves, the Board and District officials may have missed opportunities to lower the property tax burden for District residents and withheld significant funds from being used to meet District needs.

⁶ Unemployment costs totaled \$18,109 for 2012-13.

⁷ Per the Annual Reserve Report, this reserve was established in fiscal year 1999-00.

Recommendations

1. The Board should ensure that the Business Administrator includes a summary statement of the projected use and need of reserve funds in the annual report on reserves to the Board.
2. District officials should attempt to identify the source of the money remaining in the debt service fund. If it is attributable to outstanding debt, it must be used to pay debt service on that outstanding debt. If it is not attributable to outstanding debt, it must be returned to the general fund.
3. The Board and District officials should review reserves and determine if the amounts reserved are necessary and reasonable. Those amounts determined to be excessive must be transferred out of the reserves in compliance with statutory requirements.

APPENDIX A

RESPONSE FROM DISTRICT OFFICIALS

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

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WILLIAM C. BERG

Superintendent

August 28, 2013

Mr. Robert E. Meller
Chief Examiner of Local Government
And School Accountability
295 Main Street, Suite 1032
Buffalo, NY 14203-2530

Dear Mr. Meller:

Please accept this letter as the official response from the Andover Central School District regarding the Draft Audit Report for the period covering July 1, 2007 through April 30, 2013. We appreciate the opportunity to review our financial management practices and are pleased that the areas under review found no evidence of fraud or professional misconduct.

We have carefully reviewed the findings and recommendations and will continue to work with our independent financial advisors and external auditors to ensure that taxpayer funds are used appropriately and prudently to provide a sound educational program and fiscal stability.

While the District respects the comments made in the audit and by the representatives of the State Comptroller's office, the Andover Central School district and its Board of Education believe that our financial management practices provide long-term stability for our district. The Board and the administration are committed to taking appropriate action to correct, clarify and strengthen our operating procedures; however, we feel strongly that some of the comments are misleading the reader. Certain statements in the audit are conflicting in nature with the Comptroller's overall philosophy and that there are areas where guidance is subjective with no statutory basis or guidelines. We also feel that certain facts have been utilized in such a manner

that is misleading either through the use of language or tone, or through omission of other pertinent information.

The audit states that “school districts are not limited as to how much money can be held in reserves” and that “reserve balances must be reasonable”. During the exit interview we asked for guidance, in general terms, on what may be considered “reasonable” as opinions may vary widely. No definition could be provided. The audit also questions the funding levels of reserves based on “infrequent use” when the reserve had indeed been utilized within the last two years. Again, when we asked for some definition or clarification on what is considered “infrequent”, no definition could be provided. Given the fact that this terminology is not codified, the task of determining exactly what corrective action is necessary is difficult.

See
Note 1
Page 13

We feel that it is important to note that our district is fiscally stable through long-term financial planning and strategic use of available funds. Our overall approach to financial management is consistent with our legal authority and is consistent with our fiduciary responsibility to our taxpayers. Over the last 10 years the tax levy increases have remained consistently low.

The District works on an ongoing basis with its financial advisors and external auditors to make the best use of reserve and Debt Service funds. In the 2012-13 school year, money was re-allocated to provide the District with the best current and future usage of fund balance. A thorough analysis of identified current fiscal needs was completed resulting in the District’s paying off current capital project costs by utilizing Debt Service and fund balance. The reduction of future debt, a future source of revenue, and maintaining our reserves at a level we are comfortable with is the result. The District feels our reserves are reasonable and in compliance with statutory requirements.

In response to the recommendations made, the District will make every effort to provide a plan that we feel is realistic and in the best interest of the District and our taxpayers.

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We would like to thank the New York State Comptroller's Office for their high level of professionalism in working with us.

Sincerely,

William C. Berg
Superintendent

APPENDIX B

OSC COMMENT ON THE DISTRICT'S RESPONSE

Note 1

As indicated in the report and discussed at the exit meeting, the reasonableness of the reserve balances and their use is dependent on the Board's intention and plan in establishing and using the reserves. Our determination of reasonableness is in relation to the Board's plan, or lack thereof. The Board should document its needs and intentions for each reserve.

APPENDIX C

AUDIT METHODOLOGY AND STANDARDS

Our overall goal was to assess the adequacy of the internal controls put in place by officials to safeguard District assets. To accomplish this, we performed an initial assessment of the internal controls so that we could design our audit to focus on those areas most at risk. Our initial assessment included evaluations of the following areas: financial oversight (including reserve funds), cash receipts and disbursements, purchasing, payroll and personal services, and information technology. During the initial assessment, we interviewed appropriate District officials, performed limited tests of transactions and reviewed pertinent documents, such as District policies and procedures manuals, Board minutes, and financial records and reports.

After reviewing the information gathered during our initial assessment, we determined where weaknesses existed and evaluated those weaknesses for the risk of potential fraud, theft, and/or professional misconduct. We then decided upon the reported objective and scope by selecting for audit the area most at risk. We selected reserve funds for further audit testing. To accomplish our objective, we performed the following procedures:

- We interviewed District officials to obtain an understanding of the District's internal controls over financial operations, budgeting, and the use of reserve funds.
- We reviewed the last five years of financial information submitted to the Office of the State Comptroller and determined data reliability.
- We reviewed Board minutes, policies, accounting records, audited financial statements, applicable statutes, and activity within the reserves to determine if reserves were properly funded and used.
- We evaluated the methods used to fund the reserves and the level of fund balance remaining as unassigned in the general fund.
- We compared budgets with actual results for fiscal years 2007-08 through 2011-12 to assess if the budgets were realistic and supported and if the amounts appropriated from the reserves were actually needed and used.
- We reviewed reserve account bank activity for all transfers to District or non-District accounts.

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.

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Nathalie N. Carey, Assistant Comptroller

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