



Mattituck-Cutchogue Union Free School District Financial Condition

Report of Examination

Period Covered:

July 1, 2012 — July 31, 2013

2013M-322



Thomas P. DiNapoli

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State of New York Office of the State Comptroller

Division of Local Government and School Accountability

January 2014

Dear 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 Mattituck-Catchogue Union Free School District, entitled Financial Condition. 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 Mattituck-Cutchogue Union Free School District (District) is located in the Town of Southold in Suffolk County. The District is governed by the Board of Education (Board) comprising seven 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 other administrative staff, for the day-to-day management of the District under the direction of the Board.

The District operates two schools and has approximately 1,400 students and 240 employees. The District's budgeted expenditures for the 2012-13 fiscal year were approximately \$38 million, funded primarily with real property taxes.

The Superintendent and Business Manager are responsible for preparing the annual budget for review and adoption by the Board. The Business Manager also plays a key role in monitoring the District's reserve funds and budget.

Objective

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

- Did the Board and District officials ensure that budget estimates were reasonable and appropriately maintain reserve funds?

Scope and Methodology

We evaluated the Board's management of the District's financial condition and budgeting practices for the period July 1, 2012 through July 31, 2013. We extended our scope back to July 1, 2010 to evaluate the District's financial condition and to provide additional information for perspective and background. Our audit found areas in need of improvement concerning information technology controls. Because of the sensitivity of this information, certain vulnerabilities are not addressed in this report but have been communicated confidentially to District officials so they could take corrective action.

We conducted our audit in accordance with generally accepted government auditing standards (GAGAS). More information on such standards and the methodology used in performing this audit is included in Appendix B of this report.

**Comments of
District Officials and
Corrective Action**

The results of our audit and recommendations have been discussed with District officials, and their comments, which appear in Appendix A, have been considered in preparing this report. District officials generally agreed with our findings and recommendations and indicated they planned to take corrective action.

The Board has the responsibility to initiate corrective action. Pursuant to Section 35 of the General Municipal Law, Section 2116-a (3) (c) of the Education Law, and Section 170.12 of the Regulations of the Commissioner of Education, a written corrective action plan (CAP) that addresses the findings and recommendations in this report must be prepared and provided to our office within 90 days, with a copy forwarded to the Commissioner of Education. To the extent practicable, implementation of the CAP must begin by the end of the next fiscal year. For more information on preparing and filing your CAP, please refer to our brochure, *Responding to an OSC Audit Report*, which you received with the draft audit report. The Board should make the CAP available for public review in the District Clerk's office

Financial Condition

The responsibility for accurate and effective financial planning rests with the Board, the Superintendent and the Business Manager. District officials must ensure that budgets are prepared, adopted and modified in a prudent manner, accurately depicting the District's financial activity while also using available resources effectively. Sound fiscal management also includes maintaining sufficient balances in reserves to address long-term obligations or planned expenditures. District officials should adopt a policy governing the use of reserve funds and ensure that residents are fully informed of all reserve funding and activity.

Over the last three fiscal years, the District's conservative budgeting practices generated more than \$5 million in budget surpluses. To reduce fund balance and stay within the year-end statutory limit for unrestricted funds, District officials transferred moneys to the District's reserves and repeatedly appropriated fund balance to reduce the tax levy. However, because of the District's surpluses, the combined \$3.2 million in fund balance appropriations over the three years went unused. These practices gave the appearance that the District's unrestricted fund balance was essentially within the legal limit, whereas in fact it exceeded that limit each year. We also found that the amounts retained in three of the District's four reserves, totaling approximately \$5 million, were excessive and were not used; rather, the District made related payments out of the general fund totaling over \$1.2 million. These ongoing budgeting practices resulted in taxpayers paying more than necessary to sustain District operations. Further, in the 2011-12 fiscal year, over \$48,000 in excess funds was improperly transferred from the employee benefits accrued liability reserve to the retirement contribution reserve without the State Comptroller's certification as required by State legislation. Therefore, the District was not in compliance with the law in making this transfer.

Budgeting and Use of Fund Balance

The Board is responsible for preparing and presenting the District budget for voter approval. In preparing the budget, the Board must estimate revenues (e.g., State aid), expenditures and the amount of unrestricted funds that will be available at fiscal year-end (some or all of which may be used to fund the ensuing year's appropriations and to balance the budget). After taking these factors into account, the Board should determine the expected tax levy necessary to fund operations. Accurate estimates help ensure that the levy of real property taxes is not greater than necessary.

Fund balance represents resources remaining from prior fiscal years. A district may retain a portion of fund balance at year end for purposes of cash flow or unexpected expenses. However, Real Property Tax Law requires that unrestricted fund balance cannot exceed 4 percent of the ensuing year's appropriations. Districts may establish reserve funds to restrict a portion of fund balance for a specific purpose, in a reasonable amount and in compliance with statutory directives. However, District officials should not appropriate fund balance or establish reserves simply to circumvent the 4 percent statutory limit.

The District reported year-end unrestricted funds at levels that essentially complied with the 4 percent limit for fiscal years 2010-11 through 2012-13. This was accomplished, in part, by appropriating fund balance and setting aside reserves. District officials' appropriation of fund balance aggregated to more than \$3 million over the past three years, which should have resulted in planned operating deficits. However, because the District significantly overestimated expenditures in its adopted budgets, it experienced large operating surpluses in each of those three years and did not need the appropriated fund balance included in each year's budget. For that period, total actual revenues exceeded expenditures by more than \$5 million and none of the nearly \$3.2 million of appropriated fund balance was used to finance operations. Instead, the District used surplus funds to finance reserves without including those transfers in the budget process.

Table 1: Unrestricted Funds at Fiscal Year End			
	2010-11	2011-12	2012-13
Beginning Fund Balance	\$1,456,369	\$1,493,245	\$1,593,106
Plus: Operating Surplus	\$1,865,876	\$1,571,526	\$1,614,189
Unrestricted Funds – Subtotal	\$3,322,245	\$3,064,771	\$3,207,295
Less: Appropriated Fund Balance	\$1,242,000	\$1,140,000	\$775,000
Less: Transfers to Reserves	\$587,000	\$331,665	\$950,936
Total Unrestricted Funds at Year End	\$1,493,245	\$1,593,106	\$1,481,359
Ensuing Year's Budget	\$37,363,239	\$38,004,156	\$38,857,295
Reported Unrestricted Funds as a Percentage of Ensuing Year's Budget	4.00%	4.19%	3.81%
Actual Unrestricted Funds Resulting From Unused Appropriated Fund Balance	\$2,735,245	\$2,733,106	\$2,256,359
Actual Unrestricted Funds as Percentage of Ensuing Year's Budget	7.32%	7.19%	5.81%

The District's practice of consistently appropriating fund balance that was not needed to finance operations and transferring surplus funds to reserves in effect circumvented the statutory limitation of unrestricted fund balance to no more than 4 percent of the ensuing year's appropriations. Had District officials used more realistic

budget estimates, they could have avoided the accumulation of excess fund balance and possibly reduced the tax levy.

Reserve Funds

Reserve funds may be established by Board action, pursuant to various laws, to provide financing for specific purposes, such as unemployment insurance and workers' compensation payments. The statutes under which the reserves are established determine how the reserves may be funded, expended or discontinued. Generally, school districts are not limited as to how much money can be held in reserves, but should maintain reserve balances that are reasonable. Over-funding reserves can result in real property tax levies that are higher than necessary because the reserve funds are not being used to finance operations.

The Board should have a formal plan for the use of its reserves, to include how and when disbursements should be made, optimal targeted funding levels and procedures for maintaining appropriate documentation to account for and monitor reserve activity and balances. The Board should include amounts to be placed in reserve funds in the annual budget to inform voters of the Board's plan for funding reserves and should not routinely fund reserves with excess fund balance at year-end.

Over the past three years, District officials complied with the 4 percent unassigned fund balance limit by assigning a portion of annual operating surpluses to fund various reserves. As of June 30, 2013, the District had four reserves in the general fund with reported balances totaling approximately \$5.6 million, which had increased by more than \$1.8 million since June 30, 2011.

However, the Board has not adopted a policy or plan for accumulating and using reserves funds to ensure that the amounts are necessary, reasonable and in compliance with statutory requirements. In addition, District officials did not provide any calculations or justifications for the funding levels of the various reserves and used reserve fund money for purposes not allowed by applicable statutes. Furthermore, they incorrectly recorded and reported the reserve funds' cash balances as "unrestricted" rather than "restricted" in the District's financial statements. As a result, the unrestricted cash balance is overstated and the District is at risk of using legally restricted funds for ineligible purposes.

We analyzed these reserves for reasonableness and adherence to statutory requirements and found the funding of the workers' compensation reserve to be reasonable. However, the amounts retained in the reserves for retirement contributions, employee benefit accrued liability and unemployment, totaling approximately \$5 million, appear to be excessive.

Retirement Contribution Reserve — General Municipal Law (GML) restricts the use of this reserve fund to payments to the New York State and Local Retirement System. Even though the District has funded this reserve with excess fund balance totaling over \$1.5 million in the last three years, the Board consistently budgeted for and paid retirement contributions each fiscal year directly from the general fund rather than using the reserves intended for that purpose. The District paid approximately \$1.2 million over the past three years from the general fund for retirement contribution payments. Although the District had planned to pay a portion of its retirement contributions from the reserve fund each year, operating surpluses resulted in there being sufficient moneys available to pay the liability without using the reserves. Therefore, the Board levied real property taxes to make these annual contributions while also increasing the reserve fund without using it.

Employee Benefits Accrued Liability Reserve (EBALR) — By law, this reserve fund can be used only for cash payments to employees for accrued leave time due to them upon separation from District employment. These cash payments are for employees' unused and unpaid sick leave, personal leave, holiday leave, vacation time, time allowances granted in lieu of overtime compensation and any other payments due to them, as authorized by law or collective bargaining agreement. School districts are not required to fund the liability for compensated absences, but they are required to calculate this liability and to report it in their financial statements.

During the 2011-12 fiscal year, the District reserved more EBALR funds than necessary to cover liabilities for compensated absences. To give school districts access to these funds, the New York State Legislature included provisions in the 2011-12 State budget that amended the law to allow school districts – during the 2011-12 school year only – to withdraw EBALR moneys for other purposes in funding their 2011-12 budgets. The legislation also required that the amount of excess reserved over the liabilities associated with compensated absences be certified by the Office of the State Comptroller.

Despite the restricted use of this reserve for payment of compensated absences, the Board and District officials funded the EBALR to an amount that exceeded the liability and, further, did not use available funds to pay for compensated absences. District officials improperly transferred, and the Board approved, excess EBALR funds totaling over \$48,000 to the retirement contribution reserve. The State Comptroller did not certify this transfer and, therefore, the District was not in compliance with the law when making this transfer. District officials paid \$50,217 for compensated absences in the 2010-11 fiscal year, \$95,900 during the 2011-12 fiscal year and \$112,774

in the 2012-13 fiscal year from the general operating fund rather than the reserve fund. Therefore, the Board levied real property taxes to pay for compensated absences while also maintaining an excessive balance in the reserve fund.

Unemployment Insurance Reserve — GML authorizes school districts to create a reserve to reimburse the State Unemployment Insurance Fund for payments made to claimants. Over the past three years, the District has transferred over \$150,000 of excess fund balance to this reserve but has made no payments from it;¹ rather, District officials budgeted for and paid these claims each fiscal year directly from the general fund. Based on the average annual expenditures of approximately \$41,000, the District has enough money in this reserve to cover over 13 years of expenditures. This balance is excessive and there is no formal Board plan explaining the need and rationale for such a funding level.

Restricted Cash — Reserve funds are mechanisms for accumulating and earmarking cash for a future specific purpose. The legal statutes under which the reserves are established determine how the reserves may be funded and expended. Therefore, the cash accumulated for these specific purposes must be reported on financial statements as restricted and made unavailable for immediate and general use. The District is not required to establish separate bank accounts for each reserve it establishes; however, money in each reserve is restricted for reserve fund purposes and must be accounted for separately from other District moneys.

District officials maintained appropriate accounting records for each of the four reserve funds; however, they incorrectly reported the reserve funds' cash balances as "unrestricted" rather than "restricted" in the District's financial statements. The District's four reserve funds had a combined balance of \$5.6 million at June 30, 2013. However, District officials reported a restricted cash balance of \$0 on its financial statements. Without earmarking and restricting cash for the four reserve funds, District officials risk using legally restricted funds for ineligible purposes.

By maintaining excessive and/or unnecessary reserves, combined with ongoing budgeting practices that generate repeated operating surpluses, the Board and District officials have withheld significant funds from productive use and levied more property taxes than necessary.

¹ The District did budget to pay a portion of the unemployment liability from the reserve fund each year; however, operating surpluses resulted in there being sufficient moneys available to pay the liability without using the reserves.

Recommendations

1. District officials should develop a plan for the use of the surplus funds identified in this report in a manner that benefits District taxpayers. Such uses could include, but are not limited to:
 - Increasing necessary reserves,
 - Paying off debt,
 - Financing one-time expenses, and
 - Reducing District property taxes.
2. The Board should review all reserves and determine if the amounts reserved are necessary, reasonable and in compliance with statutory requirements. To the extent that they are not, transfers should be made to unrestricted fund balance, where allowed by law, or other reserves established and maintained in compliance with statutory directives.
3. District officials should report reserve fund moneys separately from other general fund moneys as restricted cash.

APPENDIX A

RESPONSE FROM DISTRICT OFFICIALS

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

JAMES F. MCKENNA
Superintendent of Schools

TRICIA DESIDERIO
Director of Special Education



MICHAEL ENGELHART
Business Manager

GERALDINE DOHerty
Director of Technology

MATTITUCK-CUTCHOGUE U.F.S.D.
CENTRAL ADMINISTRATIVE OFFICES

Mr. Ira McCracken, Chief Examiner
NYS Office Building, Room 3A10
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Hauppauge NY 11788-5533

JANUARY 16, 2014

RE: Written response to draft audit report
July 1, 2012-July 31, 2013
2013M-322

Dear Mr. McCracken:

The Mattituck-Cutchogue UFSD fully appreciates the audit results and recommendations to help in effectively managing operations and meeting expectations of our constituents. Operations can always be improved and the District will use your recommendations to help formulate improvements to our practices and procedures.

The district has a conservative approach in its budget development considering the uncertainty of school aid, continuing unfunded mandates, and significant increases in operational costs. As a practical matter it is difficult to anticipate all budgetary needs and revenues that may (or may not be available); this district does make sure that there are enough funds appropriated and that revenues are not overstated. Good management has resulted in underspending the budget and collecting revenues slightly above estimates.

Reserve funds were established by Board action and funded with operational surpluses. These reserves will only be used to fund what they were intended for and ultimately will reduce a property tax levy in the future.

District officials and the Board have been diligent and fiscally responsible by keeping the public fully informed with detailed budget presentations during Board meetings, publishing a detailed fund balance analysis in the local papers, and providing all budget and audit materials on the District's website.

Steps that will be taken by the Mattituck-Cutchogue UFSD in response to this audit as well as maintaining a financially health district that meets the community's high quality education needs:

-during future budget development processes, make every effort to estimate the appropriations and revenues as close as possible to the actual amounts needed. This should cut down on future surpluses and make the tax levy as accurate as possible. While this has always been the goal, we will not fund the unexpected to the degree as in the past.

-a plan will be developed for the use and management of surplus funds in reserves. It will be determined if all of the reserve balances are necessary and meet statutory requirements. The Board will determine a course of action in the plan for any reserve funds or fund balance that needs to be transferred or moved.

-The funding and use of all reserves funds will be discussed in the budget plan each year in the form of notations in the detailed budget document sent home each year and during the public budget presentations.

-Reserve fund moneys will be reported on a separate line in the annual financial reports as restricted cash.

Gerard Diffley, President
Board of Education
Mattituck-Cutchogue Union Free School District

APPENDIX B

AUDIT METHODOLOGY AND STANDARDS

We interviewed appropriate District officials to obtain an understanding of the organization and the accounting system and reviewed pertinent documents, such as District policies and procedure manuals, Board minutes, and financial records and reports. Further, we reviewed the District's internal controls and procedures over the computerized financial databases to help ensure that the information produced by such systems was reliable.

After reviewing the information gathered during our initial assessment, we evaluated the District's internal controls for the risk of potential fraud, theft and/or professional misconduct. We then decided on the reported objective and scope by selecting for audit the areas most at risk. We selected financial condition for further audit testing. To accomplish the objective of this audit and obtain valid audit evidence, our procedures included the following:

- We interviewed District officials and employees to gain an understanding of the internal controls and related procedures regarding reserve funds, including how they were funded and how they were used.
- We reviewed reserve funds to ensure that they were adequately funded and in compliance with applicable laws.
- We reviewed District policies and procedures regarding budgeting and level of fund balance to be maintained.
- We obtained an understanding of the District's internal control environment and specific controls that are significant to the District's budget process.
- We reviewed annual financial statements and the accompanying management letters prepared by the District's independent public accountant.
- We compared the amounts reported in the District's externally audited financial statements with a trial balance, Treasurer's reports and bank statements to verify their reliability.
- We analyzed revenue and expenditure trends and budget-to-actual comparisons for the operating funds for fiscal years 2010-11 through 2012-13 and calculated the percentage of unrestricted funds compared with budget appropriations.
- We reviewed and analyzed reported fund balance levels in comparison to amounts appropriated in adopted budgets.
- We reviewed the real property tax rate and levy increases.

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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

APPENDIX C

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