LIMITED PROCEDURES ENGAGEMENT

Lower Merion School District

Montgomery County, Pennsylvania

October 2017

Commonwealth of Pennsylvania
Department of the Auditor General

Eugene A. DePasquale • Auditor General

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EUGENE A. DEPASQUALE
AUDITOR GENERAL

Mr. Robert L. Copeland, Superintendent
Lower Merion School District
301 East Montgomery Avenue
Ardmore, Pennsylvania 19003

Dr. Robin Vann Lynch, Board President
Lower Merion School District
301 East Montgomery Avenue
Ardmore, Pennsylvania 19003

Dear Mr. Copeland and Dr. Vann Lynch:

We conducted a Limited Procedures Engagement (LPE) of the Lower Merion School District (District) to determine its compliance with certain relevant state laws, regulations, policies, and administrative procedures (relevant requirements). The LPE covers the period July 1, 2012, through June 30, 2015, except for any areas of compliance that may have required an alternative to this period. The engagement was conducted pursuant to authority derived from Article VIII, Section 10 of the Constitution of the Commonwealth of Pennsylvania and The Fiscal Code (72 P.S. §§ 402 and 403), but was not conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States.

As we conducted our LPE procedures, we sought to determine answers to the following questions, which serve as our LPE objectives:

- Did the District have documented board policies and administrative procedures related to the following?
  - Internal controls
  - Budgeting practices
  - The Right-to-Know Law
  - The Sunshine Act
- Were the policies and procedures adequate and appropriate, and have they been properly implemented?
- Did the District comply with the relevant requirements in the Right-to-Know Law and the Sunshine Act?

- Additionally, we reviewed the District's financial position and budgeting practices during the 2012-13 through 2015-16 fiscal years. Our engagement included a review of the District's annual financial reports, independent auditor's reports, and General Fund budgets for these fiscal years. We used these financial reports to calculate each fiscal year's budget to actual trends and to assess the District's budgeted unassigned General Fund balance to budgeted total expenditures. Further, we also reviewed the accuracy of the District's budgets for each fiscal year by comparing them to actual revenue and expenditures and the effect on the District's General Fund balance during this time period. Finally, we reviewed the District's Certification of Utilization of Referendum Exceptions, otherwise known as Act 1 exceptions, that were completed by the District and submitted to the Pennsylvania Department of Education (PDE) during this time period.

Our engagement found that the District properly implemented policies and procedures for the areas mentioned above and complied, in all significant respects, with relevant requirements, except as detailed in the observation in this report.

The observation and our related recommendations have been discussed with the District's Board and management, and their response is included in the Appendix section of this letter. We appreciate the District's cooperation during the conduct of the engagement.

Sincerely,

Eugene A. DePasquale
Auditor General

October 23, 2017

cc: **LOWER MERION SCHOOL DISTRICT** Board of School Directors

Background Information

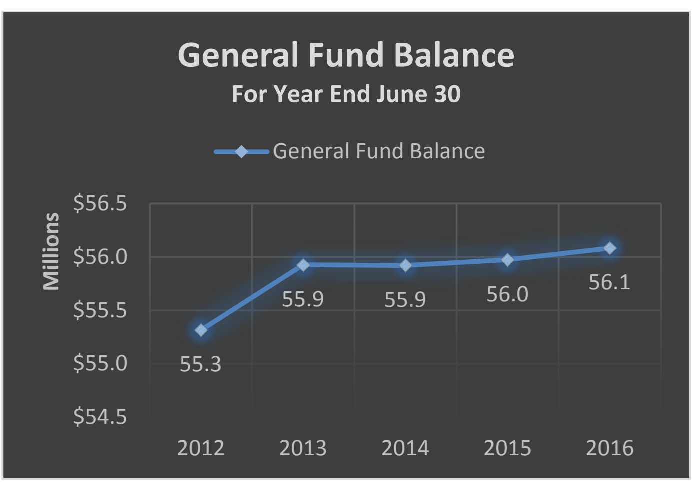
School Characteristics 2015-16 School Year[A]	
County	Montgomery
Total Square Miles	24.14
Resident Population[B]	62,107
Number of School Buildings	10
Total Teachers	683
Total Full or Part-Time Support Staff	685
Total Administrators	74
Total Enrollment for Most Recent School Year	8,341
Intermediate Unit Number	23
District Vo-Tech School	Central Montco Technical High School

A - Source: Information provided by the District administration and is unaudited.
B - Source: United States Census http://www.census.gov/2010census.

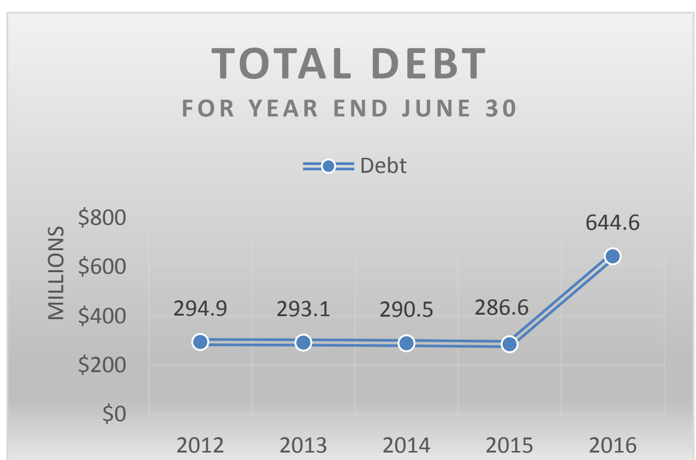
Mission Statement[A]
Committed to excellent and continuous improvement, the Lower Merion School District strives to ensure that all students achieve their highest level of critical thinking and creativity, that they value themselves and the diversity of others, and that they are knowledgeable, contributing citizens capable of excelling in a rapidly changing world. This is accomplished by individuals engaging in innovative, active experiences tailored to the myriad ways of learning and in partnership with our community.

Financial Information

The following pages contain financial information about the District obtained from annual financial data reported to the PDE and available on PDE's public website. This information was not audited and is presented for **informational purposes only**.

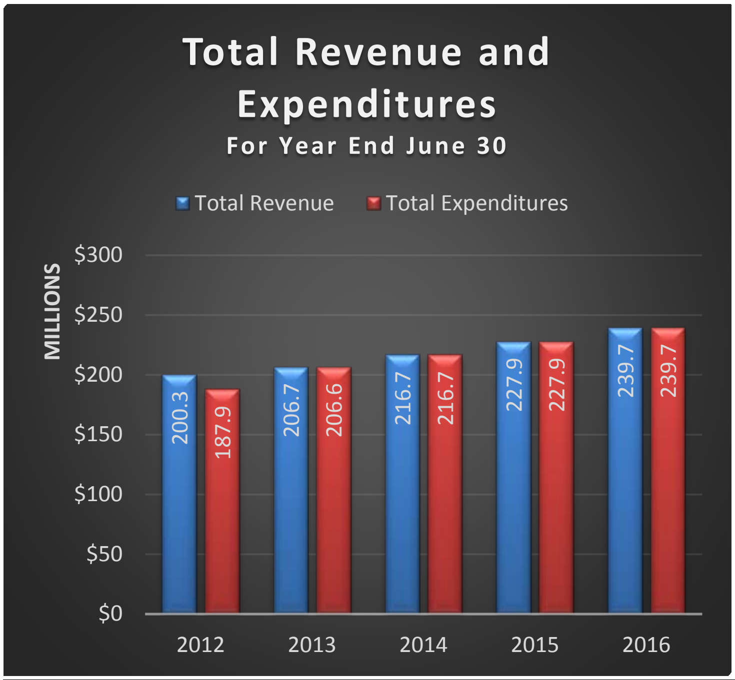


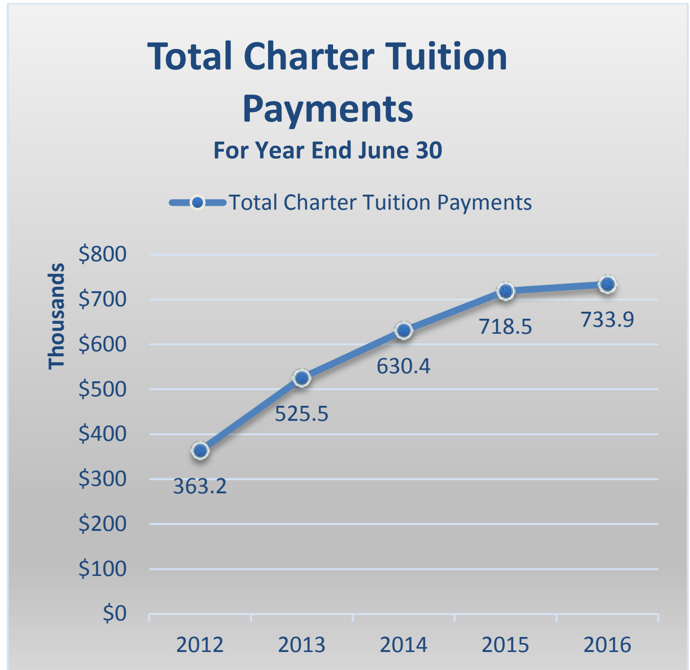
Note: General Fund Balance is comprised of the District's Committed, Assigned and Unassigned Fund Balances.

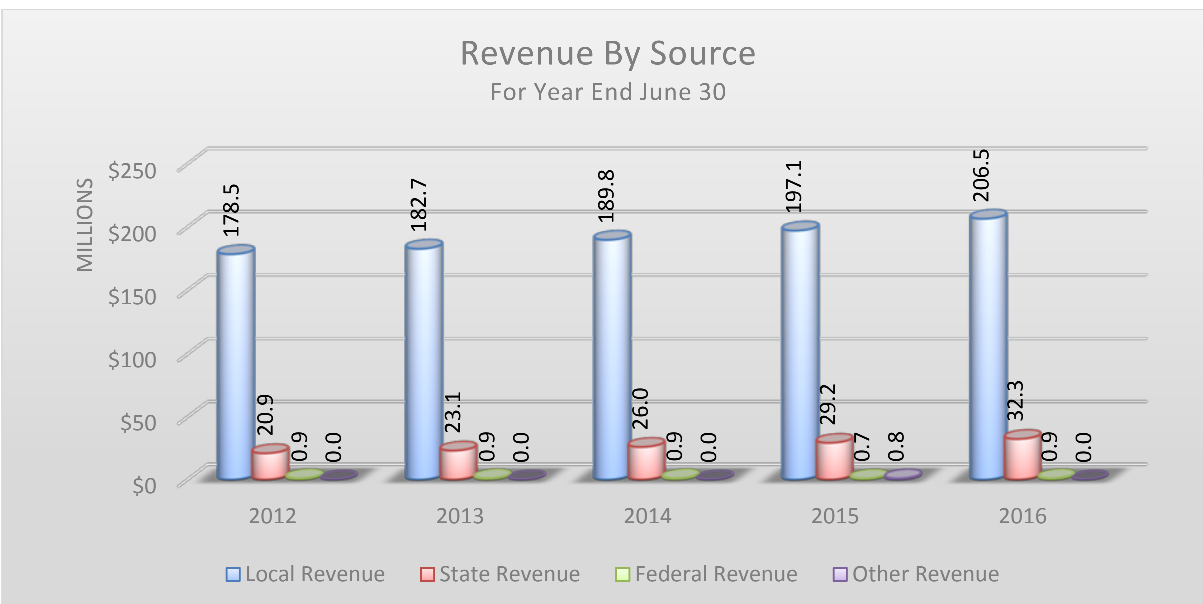


Note: Total Debt is comprised of Short-Term Borrowing, General Obligation Bonds, Authority Building Obligations, Other Long-Term Debt, Other Post-Employment Benefits and Compensated Absences.

Financial Information Continued







Academic Information

The graphs on the following pages present School Performance Profile (SPP) scores, Pennsylvania System of School Assessment (PSSA), Keystone Exam results, and 4-Year Cohort Graduation Rates for the District obtained from PDE's data files for the 2014-15 and 2015-16 school years.[1] These scores are provided in the District's report for **informational purposes only**, and they were not audited by our Department. Please note that if one of the District's schools did not receive a score in a particular category and year presented below, the school will not be listed in the corresponding chart.[2] Finally, benchmarks noted in the following graphs represent the statewide average of all public school buildings in the Commonwealth that received a score in the category and year noted.[3]

What is a SPP score?

A SPP score serves as a benchmark for schools to reflect on successes, achievements, and yearly growth. PDE issues a SPP score using a 0-100 scale for all school buildings in the Commonwealth annually, which is calculated based on standardized testing (i.e. PSSA and Keystone exams), student improvement, advance course offerings, and attendance and graduation rates. Generally speaking, a SPP score of 70 or above is considered to be a passing rate.

PDE started issuing a SPP score for all public school buildings beginning with the 2012-13 school year. For the 2014-15 school year, PDE only issued SPP scores for high schools taking the Keystone Exams as scores for elementary and middle scores were put on hold due to changes with PSSA testing.[4] PDE resumed issuing a SPP score for all schools for the 2015-16 school year.

What is the PSSA?

The PSSA is an annual, standardized test given across the Commonwealth to students in grades 3 through 8 in core subject areas, including English and Math. The PSSAs help Pennsylvania meet federal and state requirements and inform instructional practices, as well as provide educators, stakeholders, and policymakers with important information about the state's students and schools.

[1] PDE is the sole source of academic data presented in this report. All academic data was obtained from PDE's publically available website.
[2] PDE's data does not provide any further information regarding the reason a score was not published for a specific school. However, readers can refer to PDE's website for general information regarding the issuance of academic scores.
[3] Statewide averages were calculated by our Department based on individual school building scores for all public schools in the Commonwealth, including district schools, charters schools, and cyber charter schools.
[4] According to PDE, SPP scores for elementary and middle schools were put on hold for the 2014-15 school year due to the state's major overhaul of PSSA exams to align with state Common Core standards and an unprecedented drop in public schools' PSSA scores that year. Since PSSA scores are an important factor in the SPP calculation, the state decided not to use PSSA scores to calculate a SPP score for elementary and middle schools for the 2014-15 school year. Only high schools using the Keystone Exam as the standardized testing component received a SPP score.

The 2014-15 school year marked the first year that PSSA testing was aligned to the more rigorous PA Core Standards.[5] The state uses a grading system with scoring ranges that place an individual student's performance into one of four performance levels: Below Basic, Basic, Proficient, and Advanced. The state's goal is for students to score Proficient or Advanced on the exam in each subject area.

What is the Keystone Exam?

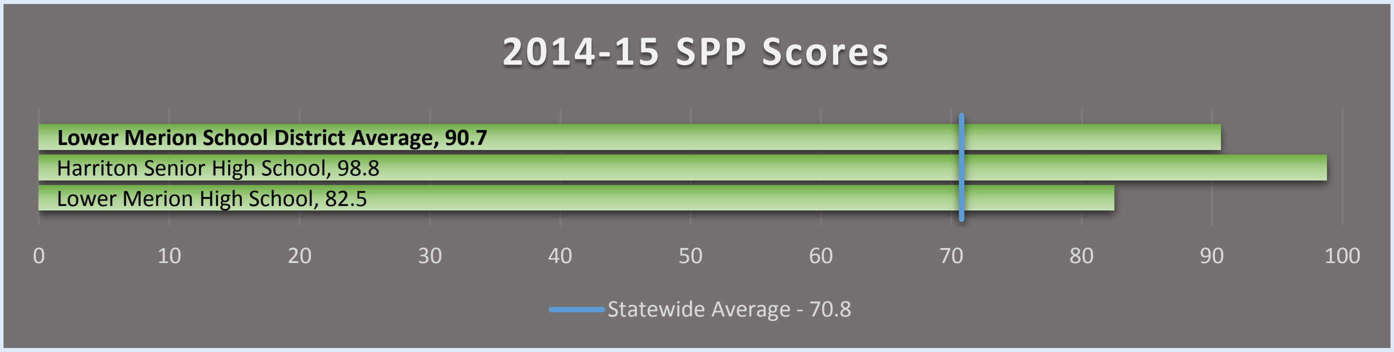
The Keystone Exam measures student proficiency at the end of specific courses, such as Algebra I, Literature, and Biology. The Keystone Exam was intended to be a graduation requirement starting with the class of 2017, but that requirement has been put on hold until at least 2020. In the meantime, the exam is still given as a standardized assessment and results are included in the calculation of SPP scores. The Keystone Exam is scored using the same four performance levels as the PSSAs, and the goal is to score Proficient or Advanced for each course requiring the test.

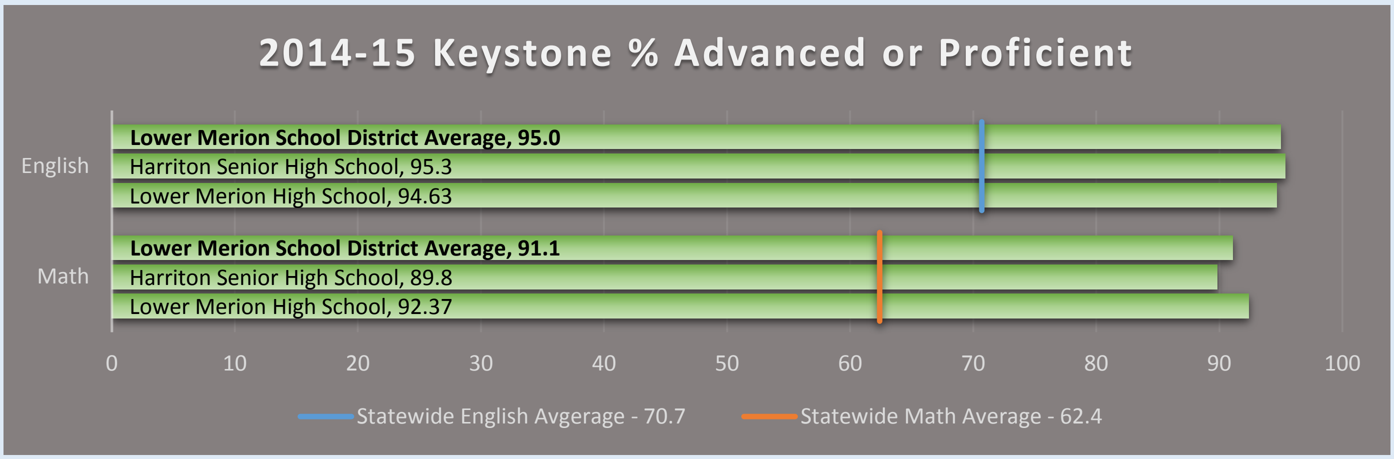
What is a 4-Year Cohort Graduation Rate?

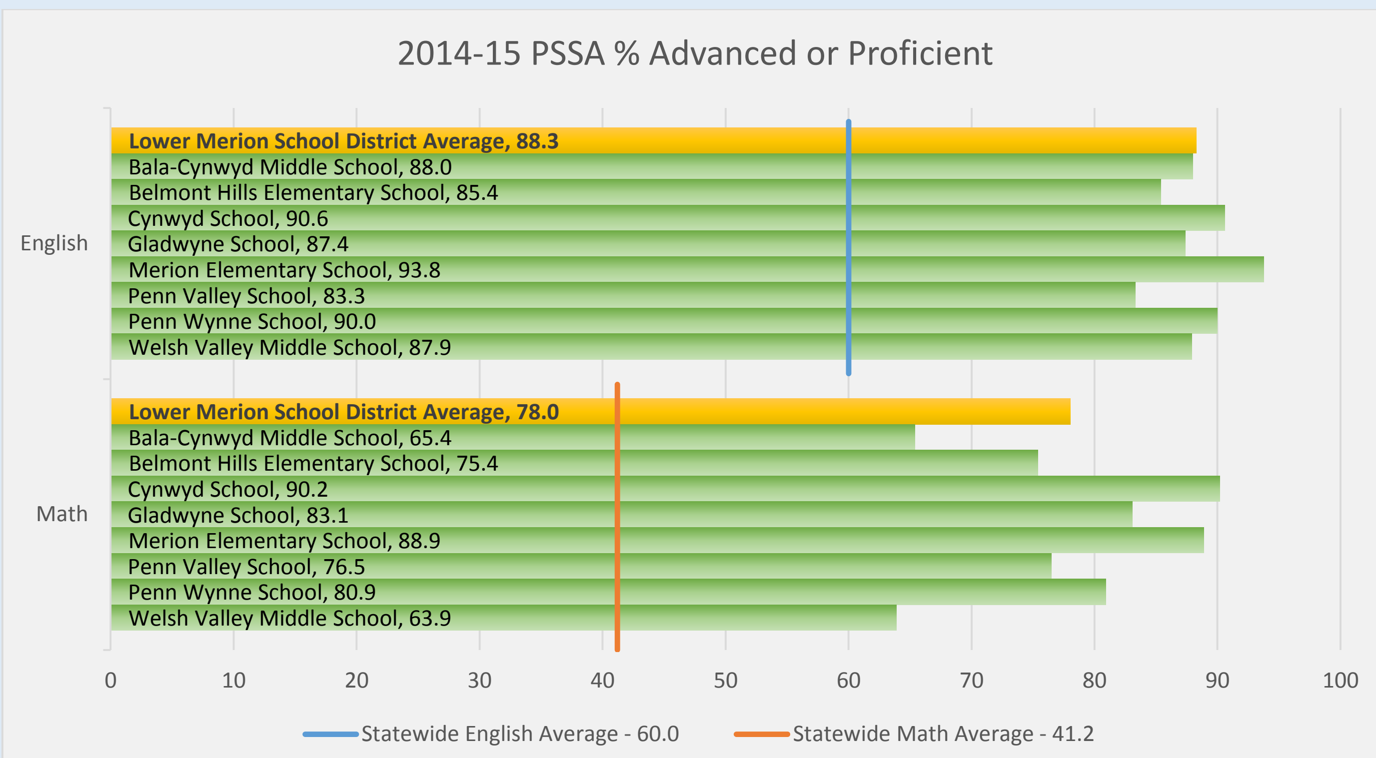
PDE collects enrollment and graduate data for all Pennsylvania public schools, which is used to calculate graduation rates. Cohort graduation rates are a calculation of the percentage of students who have graduated with a regular high school diploma within a designated number of years since the student first entered high school. The rate is determined for a cohort of students who have all entered high school for the first time during the same school year. Data specific to the 4-year cohort graduation rate is presented in the graph.[6]

[5] PDE has determined that PSSA scores issued beginning with the 2014-15 school year and after are not comparable to prior years due to restructuring of the exam. (Also, see footnote 4).
[6] PDE also calculates 5-year and 6-year cohort graduation rates. Please visit PDE's website for additional information: http://www.education.pa.gov/Data-and-Statistics/Pages/Cohort-Graduation-Rate-.aspx.

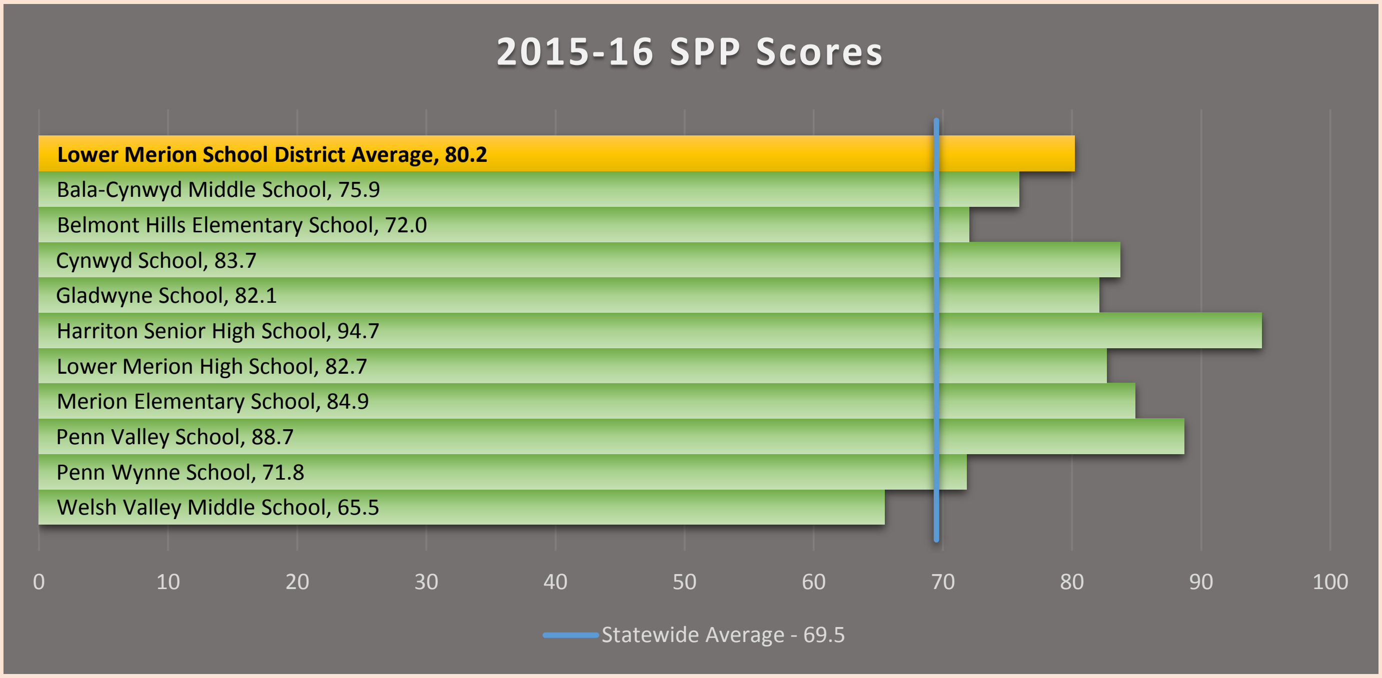
2014-15 Academic Data
School Scores Compared to Statewide Averages

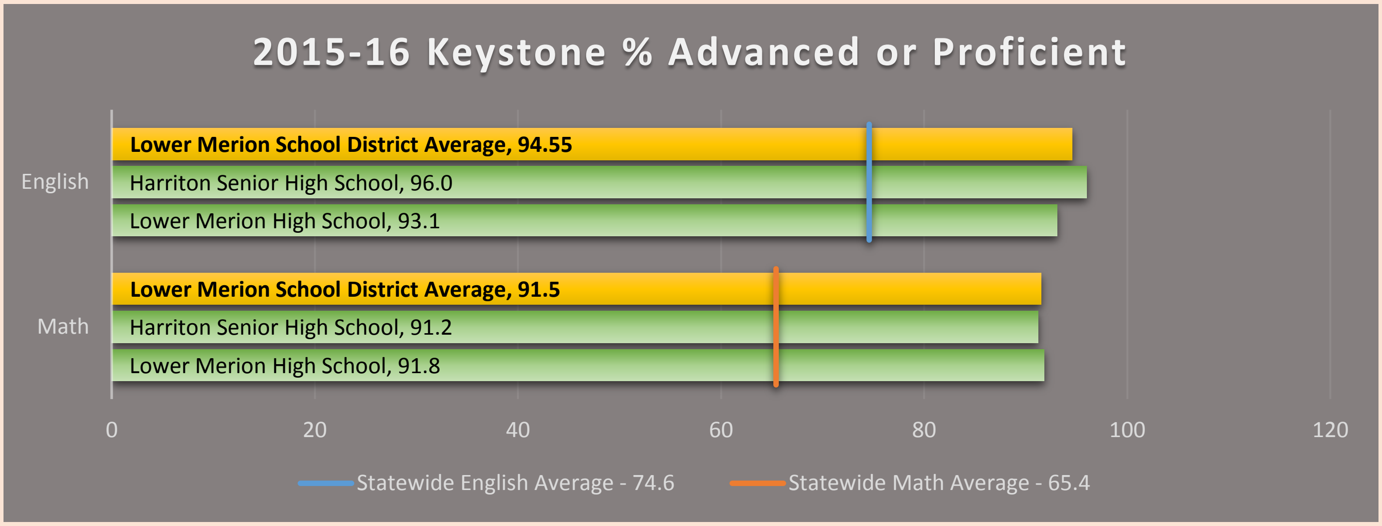




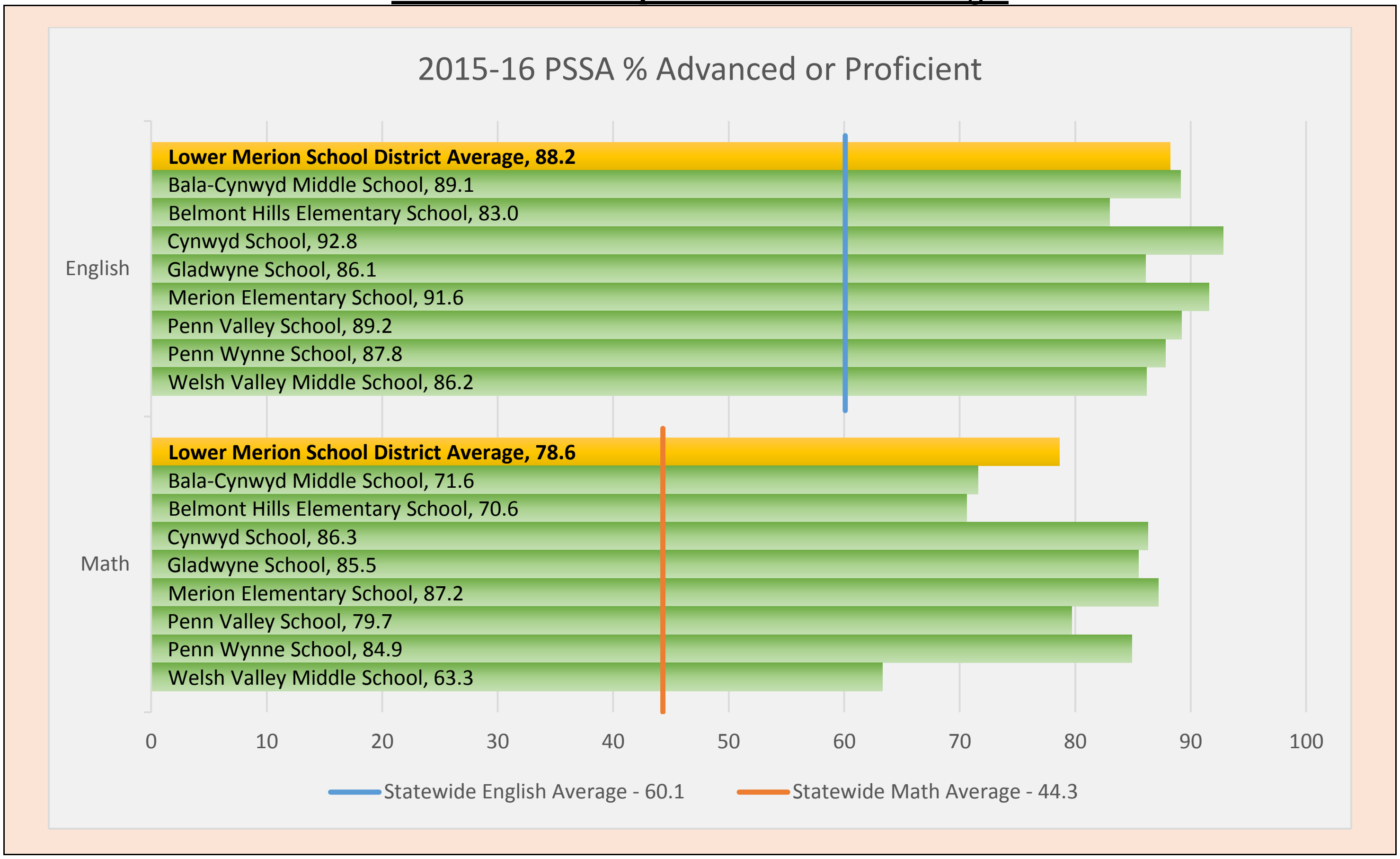


2015-16 Academic Data
School Scores Compared to Statewide Averages

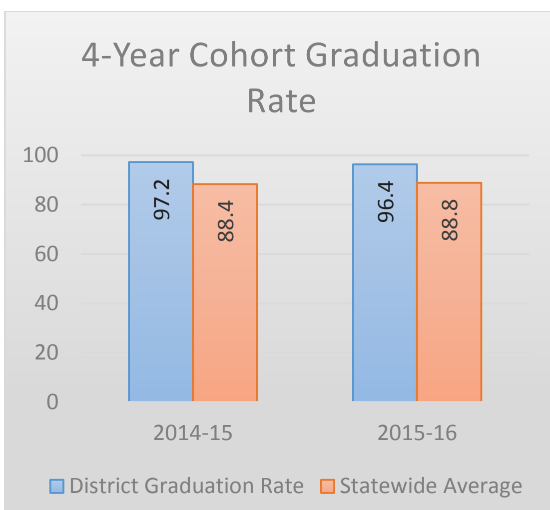




2015-16 Academic Data
School Scores Compared to Statewide Averages



4-Year Cohort Graduation Rates



Observation

The District Persistently Projected Annual Deficits Despite Realizing Annual Surpluses and Maintaining a Steady $56 Million General Fund Balance

Criteria relevant to the observation:

Section 688(a) of the Public School Code (PSC) states, in part:

> "... no school district shall approve an increase in real property taxes unless it has adopted a budget that includes an estimated ending unreserved, undesignated fund balance less than the percentages [as] set forth." *See* 24 P.S. 6-688(a).

For school districts with total budgeted expenditures greater than or equal to $19 million, the estimated ending unreserved, undesignated fund balance must be below 8 percent for it to be allowed to raise taxes under the aforementioned section of the PSC.

Section 688(b) of the PSC, states, in part:

> "... each school district that approves an increase in real property taxes shall provide the Department of Education with information certifying compliance with this section. Such information shall be provided in a form and manner prescribed by the Department of Education and shall include information on the school district's estimated ending unreserved, undesignated fund balance expressed as a dollar amount and as a percentage of the school district's total budgeted expenditures for that school year." See 24 P.S. 6-688(b).

For the five fiscal years ending June 30, 2016, the District's annual budgets projected operating deficits even though, year after year, the District actually generated surpluses. The District's budgets consistently overestimated operating costs and, as a result, underestimated ending fund balances. Contrary to its pessimistic forecasts, the District maintained a steady, substantial General Fund balance during the audit period while also transferring more than $18 million in the last four fiscal years to a Capital Reserve Fund.[7]

Inaccurate Forecasts of Operations & Fund Balances

The District consistently developed General Fund budgets that projected and anticipated operating deficits, despite actually realizing annual surpluses. As Figure 1 below demonstrates, in every single year of the five-year period ending June 30, 2016, the operating variance was significant.[8]

Figure 1

Lower Merion School District
Budgeted Deficits Despite Actual Surpluses

Fiscal Year	Budgeted Operating Surplus/(Deficit)	Actual Operating Surplus/(Deficit)	Net Variance
2012	($5,101,371)	$15,537,492	$20,638,863
2013	($8,820,452)	$5,168,620	$13,989,072
2014	($7,522,634)	$6,105,931	$13,628,565
2015	($7,517,643)	$4,117,736	$11,635,379
2016	($8,513,255)	$3,205,194	$11,718,449
Total	($37,475,355)	$34,134,973	$71,610,328

[7] The Capital Reserve Fund was one of two capital reserve funds maintained by the District during the audit period. The other fund is called the Capital Projects Fund.

[8] Source: *The Required Supplementary Information, Budgetary Comparison Schedule, General Fund,* included as part of the District's independently audited financial statements for each respective year. The budgeted amounts included here are the original budgets, rather than amended budgets, since the original budgets were used by the District in its applications for Act 1 (*known as Taxpayer Relief Act*) exceptions to PDE. The only year in the five-year period that had an amended budget was fiscal year 2016.

Criteria relevant to the observation (continued):

PDE's *Certification of Estimated Ending Fund Balance for the General Fund Budget*, accompanies a school district's Fund Budget (PDE Form 2028). The certification form is signed by the Superintendent and submitted to PDE along with the budget. The form itself refers, as follows, to the restrictions provided for in Section 688(b) of the PSC:

> "No school district shall approve an increase in real property taxes unless it has adopted a budget that includes an estimated ending unreserved, undesignated fund balance (unassigned) less than or equal to the specified percentage of its total budgeted expenditures."

Furthermore, the signature by the Superintendent states that he/she certifies that the information regarding total budgeted expenditures and ending unassigned fund balance is accurate and complete.

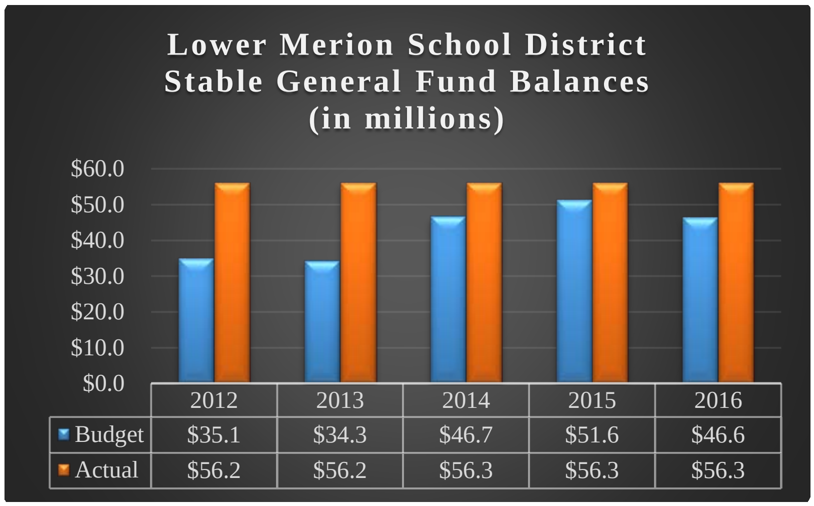
The *Government Finance Officers Association* (GFOA) has developed budgeting best practices for school districts in its *Recommended Budget Practices*. Listed among the best practices are the following:

1. *General Fund Reserve*. School districts should establish a formal process on the level of the unrestricted fund balance that should be maintained in the general fund as a reserve to hedge against risk.

2. *Year-end Savings*. A district should have a policy to define what happens to year end funds that are not used by a department. The GFOA recommends that districts develop policies that encourage a more strategic use of these funds.

Due to continually projecting budgetary deficits for the five fiscal years, the District's General Fund was also consistently projected to decrease; however, actual fund balances remained stable and strong at $56 million, as shown in the chart below.[9] As of June 30, 2016, Lower Merion's General Fund balance was the third largest in the Commonwealth. Only the Pittsburgh and Philadelphia City school districts had General Fund balances greater than the Lower Merion School District.

Figure 2



The following section addresses the main reason for the District's over-budgeting of operating costs and under-budgeting of General Fund balances.

Consistent Over-Budgeting of Expenditures

During the five fiscal years between July 1, 2011, and June 30, 2016, the District annually budgeted total expenditures an average of $12 million more than what the District actually spent. Even as recently as fiscal year 2015-16, the District budgeted expenditures nearly $10 million more than actual expenditures.

[9] Ibid.

Criteria relevant to the observation (continued):

Act 1 of 2006 known as the *Taxpayer Relief Act*, states, in part:

> "Providing for taxation by school districts, for the State funds formula, for tax relief in first class cities, for school district choice and voter participation, for other school district options and for a task force on school cost reduction; making an appropriation; prohibiting prior authorized taxation; providing for installment payment of taxes; restricting the power of certain school districts to levy, assess and collect taxes; and making related repeals."

The *Taxpayer Relief Act* has a provision for the imposition of a tax under the PSC and defines the calculation of the index limiting tax increases.
See 53 P.S. § 6926.101 *et seq.*

Section 304(b) of Act states: "A school district which imposes a tax under this chapter is subject to section 688 [related to Limit of indebtedness] of the Public School Code."
See 53 P.S. § 6926.304(b).

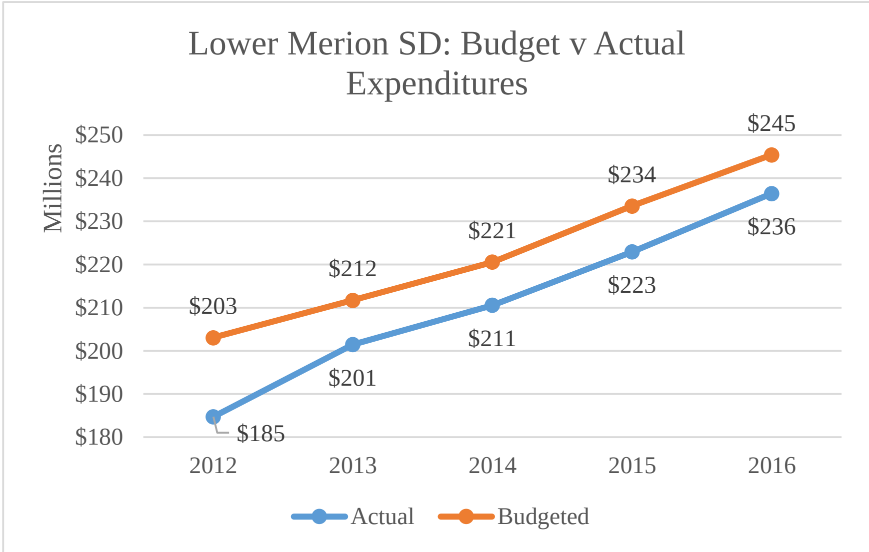
Section 333 of the Act, provides for the public referendum requirements for increasing certain taxes, and subsections (f) and (n) provides for referendum exceptions, as follows, in pertinent part:

"(f) Referendum exceptions.--A school district may, without seeking voter approval under subsection (c), increase the rate of a tax levied for the support of the public schools by more than the index if all of the following apply:

(1) The revenue raised by the allowable increase under the index is insufficient to balance the proposed budget due to one or more of the expenditures listed in paragraph (2).

The graph shown in Figure 3 below illustrates the District's consistent disparity between budgeted and actual expenditures.[10]

Figure 3



The District stated that it did use historical data, where appropriate, in projecting costs in addition to using guidance obtained from multiple sources, including its financial advisor, insurance broker, energy consultant, county and local planners, various local and state purchasing consortiums, and internal staff. However, the consistency with which it overestimated its expenditures year after year results in the appearance of questionable budgeting practices.

Significant Capital Reserve Fund Transfers

The District maintained two major capital funds separate from the General Fund: the Capital Projects Fund and the Capital Reserve Fund.[11] In four of the last five years reviewed, the District transferred more than $18.7 million from its General Fund to its Capital Reserve Fund.

[10] Ibid.

[11] According to the independently audited financial statements, the Capital Projects Fund "is used to account for financial resources to be used for the acquisition or construction of major capital assets other than those financed by enterprise operations." The Capital Reserve Fund "is used to account for proceeds of specific revenue sources that are legally restricted to expenditures for future capital projects."

Criteria relevant to the observation (continued):

(2) The revenue generated by increasing the rate of a tax by more than the index will be used to pay for any of the following . . . (v) costs incurred in providing **special education programs and services**. . .

(n) Treatment of certain required payments.--

(1) The provisions of subsections (f) and (j) shall apply to a school district's share of **payments to the Public School Employees' Retirement System** as required under 24 Pa.C.S. § 8327 (relating to payments by employers) if the increase in estimated payments between the current year and the upcoming year, as determined by the department under this section, is greater than the index…."

(Emphases added.) *See* 53 P.S. § 6926.333(f) and (n).

The District's Board Policy #620, *Fund Balance*, states, in part:

"The school district will strive to maintain an unassigned general fund balance of less than eight percent (8%) of the budgeted expenditures for that fiscal year. The total fund balance, consisting of any nonspendable, restricted, committed, assigned and unassigned balances, may exceed eight percent (8%). The District's policy is to first apply expenditures toward restricted fund balances followed by committed fund balances and then to assigned fund balances before using unassigned fund balances.

The District was able to transfer millions to the Capital Reserve Fund because it realized an operating surplus in each of the five years reviewed. Figure 4 shows the annual surplus and transfers to the Capital Reserve Fund.[12]

Figure 4[13]

Lower Merion SD Actual Operating Surplus and Transfers				
Fiscal Year	**Actual Revenues**	**Actual Expenditures**	**Actual Operating Surplus**	**Transferred to Capital Reserve Fund**
2012	$200,290,317	$184,752,825	$15,537,492[14]	N/A[15]
2013	$206,660,839	$201,492,219	$5,168,620	$5,000,000
2014	$216,697,343	$210,591,412	$6,105,931	$5,900,000
2015	$227,079,805	$222,962,069	$4,117,736	$4,770,000
2016	$239,703,544	$236,498,350	$3,205,194	$3,042,000
Totals	**$1,090,431,848**	**$1,056,296,875**	**$34,134,973**	**$18,712,000**

The District said that it made transfers to the Capital Reserve Fund to support its five-year plans for capital improvements, school bus replacements, and IT infrastructure improvements. But, it also maintained a significant portion of *committed* reserve funds in its General Fund for future, *capital* projects.

According to the District, in distinguishing from its Capital Reserve Fund, it stated that the separate funds in the General Fund *committed* for future capital projects "are intended to be used for future projects to address the District's rapidly increasing enrollment."

Substantial Committed Funds

Committed funds of $35.8 million per year comprised nearly 64 percent of the total General Fund balance of $56 million that was maintained in each of the five years reviewed.

[12] Source: For each respective fiscal year, the data was obtained from the *Statement of Revenues, Expenditures, and Changes in Fund Balances – Governmental Funds* of the independently audited financial statements.
[13] Ibid.
[14] According to Note 6 of the District's June 30, 2012 independently audited financial statements, the District transferred $3 million from its General Fund to its Debt Service Fund.
[15] The Capital Reserve Fund is first reported on and noted in the financial statements of fiscal year 2013. According to the June 30, 2012 independently audited financial statements, the District reported a Capital Projects Fund, but not a Capital Reserve Fund.

The following table shows the District's fund balances, by classification, for the five-year period reviewed.

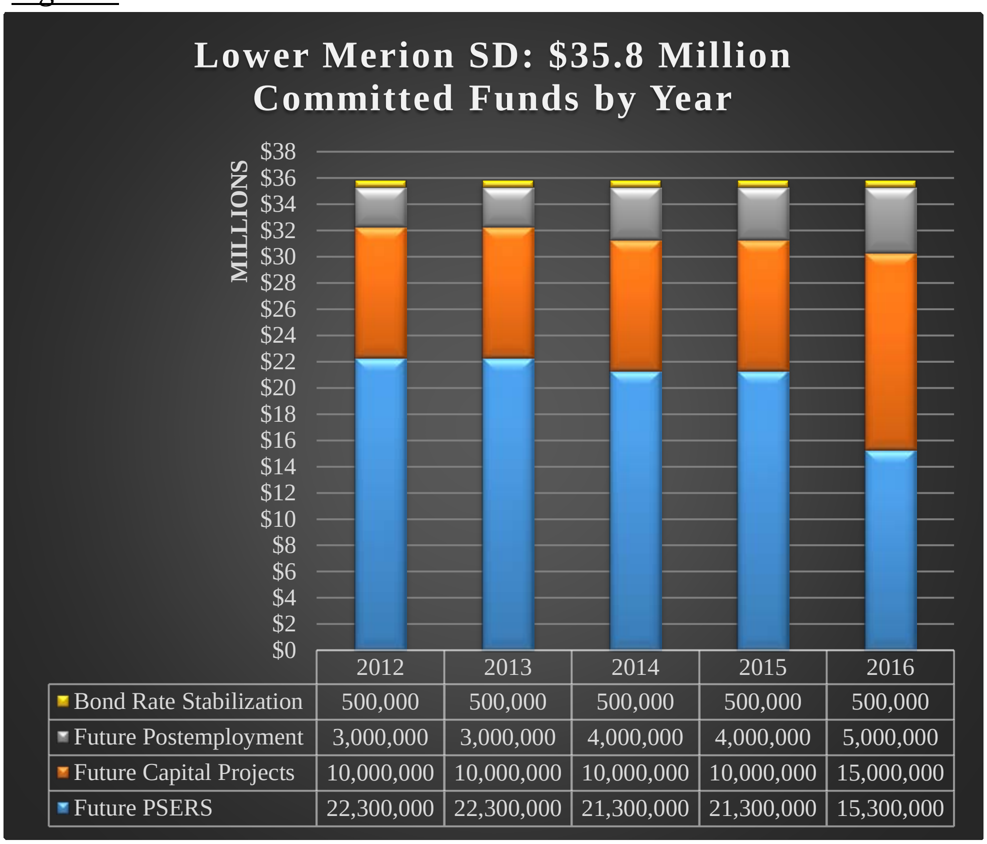
Figure 5

Lower Merion School District Analysis of General Fund Balance by Fiscal Year[16]					
Category	**2012**	**2013**	**2014**	**2015**	**2016**
Unassigned	$19,515,434	$20,125,688	$20,121,794	$20,174,232	$20,282,605
Committed	35,800,000	35,800,000	35,800,000	35,800,000	35,800,000
Non-spendable	896,100	314,433	336,199	288,103	180,286
Total Fund Balance	**$56,211,534**	**$56,240,121**	**$56,257,993**	**$56,262,335**	**$56,262,891**

According to District officials, funds were committed for future capital projects, future Public School Employees' Retirement System (PSERS) obligations, future post-employment healthcare costs, and variable rate bond stabilization.

The breakdown of the annual $35.8 million fluctuated from year to year, although it totaled the same amount every year, as shown in Figure 6 below.

Figure 6



[16] Source: For each respective fiscal year, the data was obtained from the *Balance Sheet – Governmental Funds* of the independently audited financial statements.

It is significant to note that the total amount committed for future use remained constant at $35.8 million because, according to the District, no expenses were applied against these funds in any of the five years reviewed. More importantly, the District did not spend any of the funds it committed to cover rising pension costs and instead the District applied to PDE for the retirement cost exceptions which enabled it to increase real estate taxes above the Act 1 limit[17] (more detail on this topic is provided later in the observation).

Best business practices recommend that school districts annually adopt a plan for usage of their committed funds and that they review these commitments for validity. During our review of board meeting minutes, we found that the District's Board only approved the committing of funds in two of the five fiscal years (2014 and 2016) and there was no apparent plan for usage or review for validity.

<u>The Unassigned Fund Balance Issues</u>

Section 688 of the Public School Code prohibits school districts from approving an increase in taxes if its *estimated* unassigned fund balance exceeds a certain threshold.[18] For the District, that threshold is 8 percent of expenditures.[19]

In each of the last five fiscal years ending June 30, 2016, the District's budgets *forecasted* unassigned fund balances below 8 percent every year. Thus, the District technically complied with the PSC when it approved tax increases. However, over the five-year period, the *actual* unassigned fund balance as a percentage of total expenditures averaged more than 9.5 percent, which is above the PSC threshold of 8 percent.

If the District had estimated its unassigned balances more closely to what its actual unassigned fund balances were, it would not have been able to raise taxes because its unassigned fund balance as a percentage of expenditures would have been above the 8 percent threshold.

[17] 53 P.S. § 6926.333(f)(2)(v), (n).
[18] 24 P.S. § 6-688.
[19] Pursuant to Section 688(a) of the PSC, an 8 percent limit applies to districts with estimated total expenditures equal to or exceeding $19 million. In all five years reviewed in this observation, the District's total expenditures significantly exceeded that threshold.

In addition, the District's Board Policy #620, *Fund Balance,* instructs the District to "first apply expenditures toward restricted fund balances followed by committed fund balances and then to assigned fund balances before using unassigned fund balances."

We reviewed the District's budgets and found that the District did not plan to use committed funds, as directed by its own board policy. It never defined when or how far into the future it actually planned to use the committed funds. The District asserts that it has complied with its board policy and used its unassigned fund balance to fill budgetary holes.

<u>The Impact of Budgeting Inaccuracies on Taxes</u>

As stated earlier, the Lower Merion School District can only raise taxes if its estimated unassigned fund balance falls below 8 percent. Any time the District's estimated unassigned fund balance as a percentage of expenditures fell below 8 percent, it could approve tax increases up to a limit known as the Act 1 index.

However, a school district can also raise taxes beyond the Act 1 index, but it must seek approval through a public referendum or else obtain approval for exceptions from PDE. PDE has allowed for certain exceptions to the Act 1 limit, e.g., for estimated increases in special education costs and retirement costs.

The District not only raised taxes every year in the five-year period, it raised them beyond the Act 1 limit. However, it did so not through public referendum, but by obtaining approval for exceptions from PDE for special education and retirement costs.

The exceptions used by the District in each year are shown in Figure 7 below.[20]

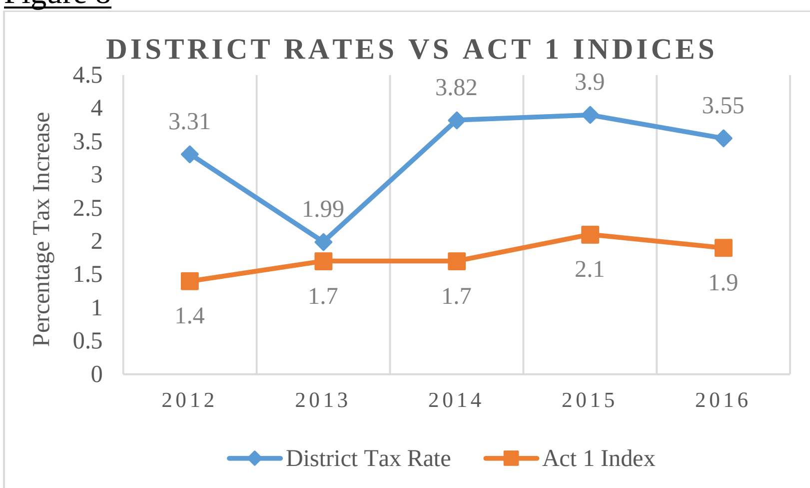
Figure 7

Lower Merion School District Use of Exceptions			
Fiscal Year	**Special Education**	**Retirement**	**Total**
2012	$1,543,574	$1,621,343	$3,164,917
2013	$486,768	-	$ 486,768
2014	$2,478,906	$1,233,830	$3,712,736
2015	$1,592,463	$1,714,965	$3,307,428
2016	$1,610,194	$1,536,794	$3,146,988
Total	**$7,711,905**	**$6,106,932**	**$13,818,837**

Consistent over-budgeting of expenditures and the District's maintenance of steady, substantial committed funds rendered the *estimated* unassigned fund balance low enough for the District to justify raising taxes in each of the five fiscal years. Figure 8 below illustrates the difference between the annual Act 1 index for the District and its actual tax rates.

As stated earlier, the Act 1 index would have been the allowable limit on tax increases for each year if the District had not obtained approval for exceptions from PDE.[21]

Figure 8



[20] Source: PDE forms for each year, entitled, *The Certification of Utilization of Referendum Exceptions.* The District noted that it could have increased taxes even more than it did in certain years because it had obtained approval from PDE for exceptions in amounts greater than what it actually used. For instance, in fiscal year 2013, the District applied for special education and retirement amounts totaling $3.7 million, but only used $486,000, as shown in Figure 7.

[21] Source: For each respective fiscal year, the PDE 2028 – Final General Fund Budget.

According to our review, the total amount of the exceptions used for special education and retirement costs over the five-year period was $13.8 million which was significantly less than the $18.7 million the District transferred to the Capital Reserve funds due to the annual operating surpluses (See Figure 4 and 5). The District clearly had unassigned funds to cover these costs.

In addition, and of greater concern, despite having already committed funds—as much as $22.3 million in 2012—for the express purpose of covering increasing retirement obligations, the District continued to request further tax increases, citing increasing retirement obligations, as opposed to using funds previously committed for this purpose. As stated previously, the District never spent any of the funds it set aside for retirement costs nor did it develop a timeline for when it intended to spend those funds.

Residents' Lawsuit[22]

Annual tax increases coupled with the District's widely reported substantial General Fund balance led residents to file a lawsuit against the District. On March 11, 2016,[23] an amended "noncertified" class action complaint[24] was filed in the Montgomery County Court of Common Pleas on behalf of present and past residents of the District in an attempt to end the District's *alleged* practice of projecting budget deficits and to prevent the District from exceeding its Act 1 index for 2016-17.[25]

The District filed preliminary objections to the amended complaint, and District management argues that "there is significant community opposition to the suit." Meanwhile, with the preliminary objections pending before another judge, the residents filed the petition for injunctive relief, requesting that the District be enjoined from enacting any tax increase for the 2016–17 fiscal year. On August 29, 2016, the trial court issued an injunction ordering the District to revoke "that portion of the tax

[22] This section is provided for informational purposes **only**.
[23] The initial complaint was filed on February 1, 2016.
[24] While the court dockets appear to indicate that the lawsuit has been proceeding as a "class action", District management has noted that the matter was never officially certified as a class action suit. Therefore, we are referring to the matter as a "noncertified" class action.
[25] *Wolk et al. v. Lower Merion Sch. District*, No. 2016-01839, Montgomery County Court of Common Pleas, August 29, 2016 (regarding to Injunctive relief).

increase that had been authorized by the Department [of Education] pursuant to Section 333 of Act 1[26] . . . to compensate for the increased costs of pension and special education obligations. The trial court further enjoined the District from collecting a tax increase for fiscal year 2016-17 of over 2.4 percent more than what was in effect for the prior fiscal year."[27] As confirmed by the District, the lawsuit is still pending at the lower court level, and the District's preliminary objections have not yet been ruled upon.[28]

Conclusion

We reviewed the District's financial data and found that in each of the past five fiscal years, the District:

- Repeatedly budgeted for operating deficits despite actually realizing operating surpluses.
- Consistently over-estimated expenditures.
- Transferred an average of $3.7 million to its Capital Reserve Fund each year (in four of the last five years).
- Maintained a steady $35.8 million in committed reserves.
- Maintained a $56 million General Fund balance consisting of more than $20 million in unassigned reserves, which exceeded 8 percent of total expenditures.
- Annually applied for and received exceptions from PDE so that it could raise taxes above the Act 1 index in lieu of using the committed funds specifically set aside for rising retirement costs.

The District's conservative budgeting practices allowed it to raise taxes for each fiscal year from fiscal years 2012-16. Additionally, the District was able to obtain exceptions from PDE to increase taxes every year beyond the Act 1 index. These strategies were insufficiently transparent to

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[26] 53 P.S. § 6926.333.

[27] The procedural history cited here is, in part, from the unreported opinion of the Pennsylvania Commonwealth Court issued April 20, 2017 (reargument denied June 19, 2017) regarding the District's appeal of the lower court's August 29, 2016, injunction order. *See Wolk et al. v. Lower Merion Sch. District*, 2017 WL 1418445, page 1 (2017). In its unreported opinion, the Commonwealth Court dismissed the District's appeal for failure to preserve issues on appeal by failing to file post-trial motions. The District has requested an allowance of appeal, filed July 19, 2017, to the Pennsylvania Supreme Court (481 MAL 2017) on the lower court's August 29, 2016, order.

[28] As of October 18, 2017, *Wolk et al. v. Lower Merion Sch. District*, No. 2016-01839, is still pending at the lower court level.

the public because they painted a financial picture that did not reflect the District's actual financial condition.

Recommendations

The Board and District officials should:

1. Consider modification of the board policy governing the General Fund to include an annual review of the validity of its committed reserves and a requirement of the Board to approve a plan for using those committed funds.

2. As part of its annual budgeting process, determine whether its General Fund commitments and reserves should be maintained, increased, or used for their respective designated, authorized purposes.

3. Evaluate the need for taking the Act 1 exception for retirement costs while it still retains significant funds committed for this express purpose.

Management Response:

The District disagreed with our observation and provided a lengthy response which can be found in its entirety in the appendix.

Auditor Conclusion

The following is our conclusion to those management comments that we deemed relevant to the facts of this observation. Our response is presented by topic area for clarity.

Summary

It is important to note that our audit period for the prior report was January 28, 2011, through November 26, 2013. Our review period for the financial objective in this engagement was July 1, 2012, through June 30, 2016. The information contained in our observation in this report resulted from District decisions and actions that occurred during our current review period.

Audit periods are integral since information changes over time and the District's statement that this information was previously reviewed by our office is inaccurate as evidenced by the distinct audit periods. It is also unfounded for the District to presume that previous audit reports without findings and/or observations are going to lead to future reports without findings or observations. Each audit engagement we conduct is an independent engagement that is not influenced by previous audits.

We disagree with the District's statement that the issues discussed in our observation are not worthy of being a reportable condition. During our review of the District's financial data for the 2012-13 through 2015-16 fiscal years, we identified continual and repeated operational surpluses, despite the District repeatedly budgeting for operational deficits. This was primarily due to the District consistently over-estimating expenditures. As a result, the District transferred an average of $3.7 million to its Capital Reserve Fund while maintaining a $56 million General Fund balance and $35.8 million in committed fund balances.

During the time period reviewed, and despite healthy fund balances, the District raised taxes above the Act 1 index. The District stated these tax increases were necessary for future expenditures despite already committing funds for this purpose.

Key Considerations

We agree that each district has unique circumstances which create challenges for annually budgeting expenditures. However, our review of the District's budget showed the District annually budgeted total expenditures an average of $12 million more than what the District actually spent during the period reviewed.

If budgeted expenditures were more accurate and more in line with actual expenditures, the District would have been limited in its ability to raise taxes over the Act 1 index.

Fund Balance

The District responded that the Office of the Auditor General [*sic*] took special note of the health of the District's fund balance in its last audit report, and offered no findings or observations of concern. The District went on to say that is the same fund that the Auditor General is now viewing as "too high." The District is correct that there were no findings in the prior audit report, however, there was not a special note regarding the health of the District's fund balance in the prior audit report. Furthermore, the District's assertion that we view the District's fund balance as too high is inaccurate.

During our period of review, we observed that the District's actual expenditures consistently were less than the budgeted amount. The overly pessimistic budgets allowed the District to raise taxes over the Act 1 index.

The District questioned why other school districts with similar fund balances did not have a similar observation. The District states that the General Fund balance percentages of other districts in the Commonwealth is misleading. As stated earlier, this observation is not solely based on the District's General Fund balance. While other districts in the Commonwealth have a greater General Fund balance, in percentage terms, than the Lower Merion School District, the situations are not similar. The other districts cited in the District's response did not consistently outperform budgets and raise taxes above the Act 1 index.

Variance

The District questioned our rationale for using the independent auditor's report for the budgeted and actual amounts used in Figures 1, 3, and 4 of the observation, instead of using the final revised budget document that was submitted to PDE. The District's chart in this section also included transfers out as an expenditure. Our rationale for using the original budgeted versus actual revenue and expenditure figures and not to include transfers out was to show the consistent variance from presentation of the original budget to what actually transpired at year end. This is important to show the need for a transparent budgetary process.

Furthermore, the original budgeted expenditures were used to apply for Act 1 exceptions, not the amended figures. The Business Manager and Superintendent confirmed on October 13, 2017, that our figures used in Figures 1, 3, and 4 were accurate and did not contain errors. The District had a difference of opinion on which figures we should have presented to highlight the significant budgeting variances that occurred during our period of review. Our presentation of data will stand as presented in Figures 1, 3, and 4. It should also be noted that the figures used throughout the observation in this report were obtained from the independent auditor's report to ensure consistency and ensure the numbers we presented were audited as part of the District's annual independent financial audit.

The District noted budgeting variances due to circumstances beyond the District's control for specific account functions. While we acknowledge that this can occur, the pattern of outperforming budgetary amounts over our review period is concerning since Act 1 exceptions were based on the budgetary numbers. We continue to believe that using historical data for certain expenditures would have helped the District to budget more accurately.

Substantial Committed Funds

The District stated that our comment that "the District never spent any of the funds it set aside for retirement costs, nor did it develop a timeline for when it intended to spend those funds" was misleading. While the District did set aside funds for future increases in PSERS costs, there is no certainty that the District will expend these funds by 2020. In fact, our review of the District's committed funds over the review period showed that the District continued to set aside funds for retirement costs without expending funds for this purpose. Instead, the District continued to apply for and receive Act 1 exceptions.

We believe that the District should have considered using a portion of its committed fund balances for PSERS obligations prior to applying for and exercising the use of the Act 1 exception for retirement costs. Furthermore, the District's fund balance policy #620 noted committed funds should be used before unassigned fund balances. Review of the District's budgets noted unassigned fund balances were budgeted to be used before the committed funds for retirement obligations.

Referendum Exceptions/Act 1

The District applied for and received PDE's approval for Act 1 exceptions. As stated multiple times, request and approval for Act 1 exceptions was based on District prepared budgetary projections that were consistently pessimistic.

Our intent was to show that the District applied for exceptions each year while maintaining a large General Fund balance. We are recommending the District evaluate the need for taking the Act 1 exception for retirement costs while it still retains significant funds committed for this express purpose.

Pending Residents' Lawsuit

We wish to note that our discussion regarding the residents' lawsuit in the observation was presented for informational purposes ***only*** (see related footnote). Further, we denoted that the District's alleged practice of projecting budget deficits and exceeding its Act 1 index for 2016-17 remains an *allegation* until the final lower court's decision is issued at least within this venue.[29]

Conclusion

We have noted and responded to management's disagreement to our determinations, but our conclusions remain unchanged. As such, this observation stands as presented.

[29] Pending *Wolk et al. v. Lower Merion Sch. District*, No. 2016-01839, Montgomery County Court of Common Pleas (pending status of case was confirmed as of October 18, 2017).

Status of Prior Audit Findings and Observations

Our prior audit of the District resulted in no findings or observations.

Appendix

LOWER MERION SCHOOL DISTRICT MANAGEMENT COMMENTS

Summary

The Administration of Lower Merion School District appreciates the opportunity to respond to the draft Performance Audit received September 5, 2017. Our management comments are provided with the hope of addressing many of the assertions made throughout the report and to show the Auditor General the ways in which the principles that are in the draft report have been part and parcel of our already adopted standard and expanded operational methodology. Specifically, this document was prepared for two reasons:

1. The District believes that its financial practices and financial standing are sound and it has achieved **consistent budget approval by the Pennsylvania Department of Education, a history of strong audit reports from the office of the Auditor General and continued clean annual audit reports from independent auditors.** Much of the data identified in the draft audit has been previously reviewed and approved by the Auditor General's office.

2. The District believes that based on the methodology adopted by the Auditor General's office, the draft audit report does not rise to the level of a "finding" or an "observation."[1] A finding would indicate non-compliance with a "statute, regulation, policy, contract, grant requirement or administrative procedure." **The report in fact indicates that the District was in compliance with the Public School Code in enacting its tax increases. Further, the District's accounting and budgeting practices have been generally affirmed in every audit report for at least the past 20 years.** Moreover, the recommendation that budgeting be based on historical amounts is not in keeping with mandated accounting policies for matters such as self-insurance (for which the District seeks actuarial analysis annually), PSERS, and special education expenditures (as to which the District cannot cap current expenditures at prior expenditure levels).

As a threshold matter, the District expresses its concern that the Auditor General appears to have been influenced by material presented by Arthur Wolk and Keith Knauss at an injunction hearing held in 2016. The District has been involved in litigation with Mr. Wolk, and that litigation is ongoing. The District believes that Mr. Wolk is wrong as to the merits of the case, but also disagrees with the public policy position that animates his litigation. Mr. Wolk believes that it is wrong to try to provide public education at a level commensurate with the best secondary schools in the region. His philosophy is readily apparent from his amended complaint, in which he states: "Public education is not courses, programs, activities, free laptop computers, and curriculums [*sic*] that are neither mandated nor normally part of a public education standard, and are normally provided only by private institutions at larger expense to individual patrons who

[1] According to the methodology outlined by the Auditor General, "Findings describe noncompliance with a statute, regulation, policy, contract, grant requirement, or administrative procedure. Observations are reported when we believe corrective action should be taken to remedy a potential problem not arising to the level of noncompliance with specific criteria."

prefer to afford their children education and opportunities that are neither required, nor offered, nor appropriate for public education paid for by taxpayers." In the amended complaint, he also condemns teacher salaries as too high, and calls the "higher or continuing education" program for teachers "nothing but a theft of the Plaintiffs' tax money and a scam." The District believes that Mr. Wolk's positions are at odds with those of most residents of the District; indeed, over 3,500 residents of the Lower Merion School District have signed a petition opposing Mr. Wolk and his lawsuit and supporting the District's budgeting practices.

Key Considerations

Among the universal school district budgeting laws observed by LMSD that we wish to emphasize in this response is the requirement by the Pennsylvania Department of Education that districts budget on a line item basis. **This is and always has been our practice.** It is important to note, moreover, that while there are universal laws and standards for districts, no school district is the same and each must approach budgeting based on local circumstances and realities.

The Auditor General made multiple requests over the course of the past year for information, and some of that information is reattached, because it was not referenced in the Performance Audit draft that was provided to us.[2] The District notes as well that in questioning the acknowledged and undisputed consistency of the District's accounting practices on the grounds that they have resulted in the appearance of questionable budgeting practices, the Auditor General seems to have departed from his own previous position that conservative accounting practices that are designed to maintain healthy fund balances and a good credit rating are laudable rather than blameworthy. As set forth in greater detail below, the Auditor General's positions on adequate fund balances, community awareness of the purpose and timetable for using these balances, and the extent of permissible variances are not only at odds with best accounting practices but are actually inaccurate in some respects.

Enrollment Growth

No school district in Pennsylvania has been impacted more by enrollment growth in recent years than Lower Merion School District. **Since 2008, LMSD has had the largest growth in the Commonwealth by total number of students (nearly 1,500 additional students) and the second-fastest enrollment growth rate (more than 21%) according to the Pennsylvania Department of Education.** As the 2016-17 school year opened, enrollment in the District was nearly 8,400 students for the first time since the early 1970's. The last time LMSD enrolled this many students, the District operated 15 schools (ten K-6 elementary schools, three 7-9 junior high schools and two 10-12 senior high schools). Today the District has just ten schools and has been making every effort to maximize limited space in an era of unprecedented growth.

LMSD's growth is in direct contrast to that of most districts in the state. Of the 500 school districts in the Commonwealth, more than 400 are showing declining enrollment. Only 15 districts are showing growth in excess of 10% in the last eight years. It should be noted that

[2] This includes a 13-page response to supplemental questions from the Auditor General on 9/27/16 detailing our use of historical analysis in developing the budget, as well as a detailed written response to questions regarding committed fund balance and capital reserve transfers, sent 5/19/17.

enrollment growth is projected to continue in LMSD for the foreseeable future. Two recent independent enrollment studies (conducted by the Montgomery County Planning Commission and Sundance Associates) point to steady increases in enrollment through 2021 and beyond. Here are some statistics worth noting from these studies:

- Enrollment is projected to increase by approximately 1,000 students over the next six years.
- Middle schools will increase by more than 350 students.
- Growth will impact the high schools the most with the addition of 700 more students.
- The current second grade class of 687 started as a kindergarten class of 454 and will graduate as a 12th grade class of 908 students.

Enrollment growth continues to have a significant impact on the District's budget planning. An increasing number of students has resulted in the need for additional staff and expanded facilities and a reserve for future growth. Additionally, enrollment growth has required/is projected to require additional expenses with regard to transportation and other services to maintain existing programs. Staffing is the single biggest driver of the budget; more students result in the need for more staffing and thus, greater costs. During the 2005-06 school year, for example, there were 670 teachers in the LMSD; today, there are 779.

The District has a long history of proactively addressing enrollment growth despite challenges posed by limited space, lack of available land and the high cost of purchasing property in Lower Merion Township and Narberth Borough. The District has sought to make the best of its existing property and has expanded classroom capacity as needed following careful study and public planning. In recent years, the District has increased capacity at a cost of more than $30M, completing additions at two elementary schools, two middle schools and re-purposing space in the District Administration Building for high school classroom use. Our demographic studies indicate that in the next few years we will need to – at minimum – add capacity at one middle school, one elementary school and one high school. The middle school project is currently underway with the installation of temporary modular classrooms this summer. We are holding $15M dollars in committed fund balance in anticipation of needing those funds to expand classroom capacity in response to growing enrollment.

The District has also invested another $3M in safety accommodations and security infrastructure following the tragedy at Sandy Hook Elementary School **– a reminder that even the most accurate demographic projections and budget forecasts may not account for certain unforeseen and necessary expenditures.**

While expanding classroom capacity is one strategy to address enrollment growth, the Board of School Directors continues to be sensitive to the potential costs of temporary classrooms and new construction. Thus, the Board has implemented fiscally-responsible short-term strategies that have provided more time to review enrollment projections and plan for the future.

In an effort to maintain favorable class sizes, preserve programs, maximize existing resources and provide planning flexibility at the elementary level, for example, the District now utilizes a "partner school" plan. The plan caps certain sections of grade levels in elementary schools that have reached class size targets. When those sections are capped, students who register thereafter will be enrolled at a “partner school” – a Lower Merion elementary school that can accommodate further enrollment in that class section. This strategy has helped minimize the need to open additional sections in the short term, maximizing existing classroom capacity and staff resources. This program along with other strategies allowed us to hold tax increases below the state index for the 2017-18 school year.

While the District must consider enrollment growth in its budget planning, it is impossible – even with detailed studies and projection data – to forecast the precise impacts and costs. Ten years ago, for example, it would have been difficult to fully predict trends like: significant growth in the number of students enrolling in public schools vs. private schools in our community (a swing of between 600-700 students); a greater draw rate (almost double in eight years) of public school students from multifamily homes and rental apartments; and the development of new housing in Lower Merion (464 new units in the last two years and almost 1800 expected over the next six years). One thing is certain, families are continuing to choose Lower Merion School District for the quality of its schools. The demographic studies have indicated that growth is most closely associated with “the overall quality, reputation, and appeal of the [District].”

As LMSD balances its commitment to fiscal responsibility with the needs of its students, the Board of School Directors has made clear their commitment to maintaining the quality of the educational experience. The commitment is manifested in the long-term strategic plans, developed with extensive input from the entire community, including specific stakeholders. The funding required to support annual strategic plan needs is a part of public budget discussions. **Funding decisions have been developed and endorsed by the community, as evidenced by the cross-party support for the current School Board and the involvement of a broad cross-section of the population in our strategic planning and budgeting processes.**

Fund Balance

Lower Merion School District carries approximately $56M in total fund balance, which represents roughly 22.9% of 2016 budgeted expenditures. Most of this amount represents a “committed” fund balance, which means it serves a financially-prudent purpose as permitted by law. In fact, the Office of the Auditor General took special note of the health of the District’s fund balance in its last audit report, and offered no findings or observations of concern. Yet, that is the same fund balance that the Auditor General is now viewing as “too high.” The balance includes $15.3M for PSERS (state pension system).[3] While the District's PSERS obligation for this year is currently about $20M, the state projects that within five years this amount will increase to over $23M, a point at which reserves will be needed to offset the increases, something that the District has anticipated and prepared for several years – well before the prior audit, which raised no concerns with this analysis. An additional $15M is committed for future capital projects and will be used for ongoing facilities needs, decreasing the District's reliance on borrowing, and carrying into effect the community-developed strategic plan. A total of $5M is

[3] PSERS is managed by the Commonwealth, and school districts are mandated by law to contribute based on a rate annually determined by the PSERS Board. Local districts have no control over current and future contribution rates. Per 2017 data from PSERS, the current unfunded liability for the pension system is over $42B. It is no surprise that district contribution rates continue to rise almost every year. (See chart on p. 13)

committed for post-retirement benefits as determined by actuaries and an additional $0.5M is assigned for rate stabilization on variable rate bonds (should interest rates rise, the District will be covered). The reliance on actuaries for projected uncertainty is a good accounting practice. The remaining $20.3M in “unassigned” fund balance consitutes [*sic*] approximately 7.6% of the District’s budget and is **therefore well below the allowable 8% limit set by the PA School Code**. The District used $6.3M to close its budget deficit and maintained $13.9M in reserve. The $13.9M represents 5.2% of the budget.

The Auditor General‘s public pronouncements have affirmed the principles behind Lower Merion School District’s and certain other districts’ budgeting practices. In a December 2015 Performance Audit report of the Pittsburgh Public Schools (which were carrying the state’s largest fund balance as of December 31, 2014 of just over $129.2M) the Auditor General explained, “It is important to note that **a generous fund balance is a necessary component of a fiscally healthy school district.** Fund balances are important to districts the same way a savings account is important to individuals. Just as individuals should maintain a savings account to deal with emergencies or other unforeseen events, districts should also have funds in reserve to pay for emergency repairs or interruptions to revenues...School districts must walk a fine line between being prepared for emergencies, increasing fixed costs, or interruptions to revenue and being responsible to their students and taxpayers.”

The Auditor General cited Pittsburgh as one of the state’s most “successful financially run districts” due in large part to its healthy reserves. According to Pittsburgh’s most recent audit, the district’s fund balance ratio to total budget was 24%, which is actually higher than Lower Merion‘s.

Although the Auditor General has recently referred to “20%” as a possible threshold for appropriate fund balance percentages, we reviewed school district audits released by the Auditor General’s Office between January 1, 2017 and July 27, 2017 but found **no observations or findings regarding fund balance in any of the 67 school district audits. This list included 29 districts with fund balances above 20% and at least 23 districts that had higher fund balance percentages than LMSD in 2015-16**. For example, of the six school district audits released via the Auditor General website on February 2, 2017 four districts had fund balances greater than LMSD and one had a fund balance of more than 40%.[4]

At the same time, the Auditor General has continued to recognize that school districts that run low fund balances risk the fiscal health of the district. As part of a public release regarding a recent audit of Blackhawk School District, he noted the following[5]:

- “Just as individuals and families should maintain a savings account to deal with unforeseen events, school districts should also have funds in reserve.”

[4] Windber 40.6%, Midd West 34.2%, Carmichaels 25.6%, and Wyomissing 23%. Information based on press releases and audits at http://www.paauditor.gov/

[5] Auditor General DePasquale Says Poor Budget Planning Led to Blackhawk School District’s Nearly Depleted Fund Balance http://www.paauditor.gov/press-releases/auditor-general-depasquale-says-poor-budget-planning-led-toblackhawk-school-district%E2%80%99s-nearly-depleted-general-fund-balance

- “Unbudgeted expenditures necessitated that the district use the general fund balance to cover these expenditures...This is an unsustainable practice that nearly depleted the district’s general fund and led to the district’s perilous financial condition.”

In an audit of Eastern York School District, he shared similar concerns about the District’s declining fund balance:

“Maintaining a healthy general fund for a school district is not unlike individuals and families stashing cash in a savings account to save for an emergency,” DePasquale said. He cautioned that a decreasing fund balance reduces a district's ability to pay for unexpected repairs or cover unexpected interruptions in revenue — like the recent nine-month budget impasse — and could impact the district's credit rating.[6]

According to a study by the Commonwealth Foundation, 167 districts (one-third of all districts in Pennsylvania) had a higher percentage of total fund balance to actual expenditures than Lower Merion School District in 2014-15.[7] By 2015-16, this number had increased to 181 districts (more than 36% of PA districts), according to a report by Temple University.[8] Additionally, more than 50 districts are operating with a total fund balance of less than 6%, including 17 districts completely in the red and operating in a deficit. The Temple report also found that 33% of Pennsylvania school districts (165 total) had an actual unassigned fund balance as a percentage of actual expenditures greater or equal to Lower Merion’s.

This statewide snapshot underscores our District's fiscal vitality and illustrates that there is great variance in total fund balance percentages across the state and no guidelines, mandates, or even general consensus as to what an appropriate percentage should be. The Temple study confirmed the varied distribution of fund balances across the Commonwealth and noted that “fund balance is a point-in-time measure; they change from year to year. **The amount of fund balance is not necessarily an indicator that school districts are collectively, or even individually, irresponsibly hoarding a pot of gold that could or should be used to avoid tough budget decisions.”**

Districts with adequate and healthy fund balances can address short-term and long-term needs, demonstrate financial stability and preserve or enhance bond ratings, thereby lowering debt issuance costs. The ratings agency Moody's affirmed LMSD's Aaa credit rating last year, enabling the refinancing of general obligation bonds that will save taxpayers $9.8M. Among Pennsylvania's 500 school districts, LMSD is one of only five that carries the Moody's Aaa credit rating. Moody's specifically cited the District's "strong and stable reserve levels" in its most recent report. In the best and worst of times, a strong credit profile serves a district well. **The facts clearly show that Lower Merion School District has observed both responsible**

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[6] Eastern York’s Emergency Fund Too Law, Audit Warns
http://www.ydr.com/story/news/education/2016/07/21/audit-flags-eastern-york-fund-balance-drop/87399304/

[7] School Districts Amass Record Reserve Funds
https://www.commonwealthfoundation.org/policyblog/detail/school-districts-amass-record-reserve-funds. Lower Merion’s percentage was 24.56% for 2014-15, which was based upon $55,974,232 of fund balance to $237,893,842 actual expenditures.

[8] Explaining School Fund Balances/Temple University Center for Regional Policy
http://www.cla.temple.edu/corp/files/2017/07/Fund-Balance-Update-2017.pdf

budgeting practices and the letter of the law with regard to maintaining an appropriate fund balance.

We find it puzzling that the Auditor General is suggesting that the District ought to spend down its fund balance, particularly in light of his recent public comments regarding the Pennsylvania budget crisis. In a June letter co-signed by State Treasurer Joseph Torsella, the Auditor General noted the dangers of the Commonwealth's declining fund balance and the implications with regard to the state's credit rating, ability to pay obligations, and chronic need for borrowing:

> *"The continued drop in the average annual General Fund balance is indicative of a structural imbalance between revenues and expenditures. Without a correction to this imbalance, we anticipate the trend of lower General Fund average balances to continue to worsen in the coming years."*[9]

This month, Standard & Poor's Global Rating lowered its general obligation rating on the Commonwealth from "A+" to "AA-", citing the need for "additional liquidity and...the likely need for external borrowing." **The result is that the state -- and taxpayers -- will pay more to borrow money.**

The same principle holds here, only with the opposite result. The taxpayers of the Lower Merion School District have benefited from a strong credit rating and lower borrowing costs (which is particularly important given unprecedented enrollment growth and the need to expand capacity at our schools). A deliberate plan to reduce the District's fund balance would likely lead to a lower bond rating and an increased cost of borrowing. The District believes this is bad policy for the same reason that the Auditor General has advanced in other contexts.

Variance

The title of the audit report suggests that the District projects deficits and yet realizes surpluses. This is true and we believe it is the result of prudent, conservative budgeting and year-long efficiency and frugality, as well as the fact that the budgets are developed line-by-line, category-by-category, as the Department of Education requires. We do a careful analysis of each budget category every year, but that doesn't necessarily result in zero (0%) variance between budgeted expenditures and actual expenditures in each category.

Each year school districts prepare budgets that are an estimation of expenses for the following school year. In Pennsylvania, budgets are prepared almost a year in advance of implementation and must take into account numerous variables, including but not limited to:

- Enrollment changes
- Staffing needs
- State budgets (which often aren't determined until late in, or in many cases after the closing of, the budget cycle)

[9] Auditor General DePasquale, Treasurer Torsella Warn Legislators of Dangerously Low General Fund Balance Going into Next Fiscal Year http://www.paauditor.gov/press-releases/auditor-general-depasquale-treasurertorsella-warn-legislators-of-dangerously-low-general-fund-balance-going-into-next-fiscal-year

- Fluctuations in the local real estate market and transfer tax revenues
- Special education costs
- Charter school costs
- Healthcare costs
- Facilities planning and emergency needs (winter weather, repairs, etc.)

This timetable can be particularly challenging to rapidly-growing districts like Lower Merion. The District makes a best estimate as to its projected costs using historical data and guidance obtained from multiple sources, including its financial advisor, insurance broker, energy consultant, county and local planners, various local and state purchasing consortiums and internal staff.

The budgeting process in LMSD begins in early fall with outlines and expectations given to administrators. The District utilizes a modified zero-based budgeting that relies on carefully-examined historical data. (See footnote #2 and attached documents). A variety of situations and scenarios, from union contract agreements to emergency situations are considered. The administration then follows a PDE timeline in submitting and presenting for public Board deliberation a series of budget documents.

In that regard, the District notes that in footnote 2, the Auditor General attempts to justify using "original" rather than "amended" budget data in Figure 1, "since the original budgets were used by the District in its applications for Act 1 … exceptions to PDE." But the numbers that the Auditor General are not from *any* budget that was submitted on a Department of Education form to the Department of Education. *See* 24 P.S. § 6-687, 24 P.S. § 6-688. Instead, the data came from a table in the Audited Financial Statements prepared for the District, which was not intended to and did not set forth either the preliminary estimates that were submitted to the Department of Education in applying for the exceptions or the statutory measure of final expenditures. If the correct budgeted and actual numbers are used, the story looks very different.

Expenditures	2012	2013	2014	2015	2016
Budgeted	$204,571,449.00	$212,809,404.00	$221,634,342.00	$234,520,559.00	$246,266,565.00
Difference Between Actual and Budgeted	$16,660,515.00	$6,177,152.00	$4,954,871.00	$7,445,096.00	$6,563,577.00
Percentage Difference	8.14%	2.90%	2.24%	3.17%	2.67%
Revenues					
Budgeted	$197,986,495.00	$202,930,116.00	$213,062,872.00	$226,063,700.00	$236,931,310.00
Difference Between Actual and Budgeted	$2,303,822.00	$3,730,723.00	$3,634,471.00	$1,016,105.00	$2,772,234.00
Percentage Difference	1.16%	1.84%	1.71%	0.45%	1.17%

It is worth noting that the largest variance by far was in 2012, a year that was previously audited by the Auditor General, who raised no concerns raised over that variance at that time. The subsequent variances have all been much lower. The errors in Figure 1 are carried over into Figures 3 and 4. Moreover, in Figure 7, the Auditor General misreported the amount of the special education exception that was not used, suggesting that the District forewent $1,050, when in fact it forewent $51,050.

In addition, the District can have and generally does have almost no variance between projected and actual expenditures in many areas (approximately 72% of line items were within a 2% variance in 201516) but nonetheless experiences surpluses based on a small subset of line items. That line item budgeting is preserved through the course of the year. Accordingly, if not all of the monies budgeted for an item are needed – whether because the winter was warmer than projected or healthcare expenditures were lower than the actuaries anticipated – the monies are not simply moved elsewhere to be spent in other categories; they are saved. Those savings add up to produce a surplus, and it could be that one or two line items could give rise to a significant surplus.

In the audited fiscal year of 2014-15, for example, the District realized a total surplus of approximately $4M. The two main factors were a one-time bond refunding (similar to mortgage refinancing) and fewer employee healthcare claims (District is self-insured) that reduced expenses and together accounted for the surplus. **Without these non-recurring savings, the District would not have experienced a surplus for the year.** Following an accepted practice, these funds were transferred to LMSD's capital reserve account upon a public Board vote to be used as part of the District's five-year capital improvement plan, five-year technology/infrastructure plan and for the replacement of aging buses. These plans have been developed in recognition that deferring such projects indefinitely would eventually result in increased maintenance costs and the degradation of District facilities and operations. This is a snapshot of just one fiscal year, but it is telling in the context of variance and fund balance.

In 2015-16, the District realized a positive variance on a single line item of nearly $439K due to lower-than-expected costs related to students who receive educational services through schools, programs, or agencies outside of the District (Budget Code 560/Tuition to Non-Public Schools). Per Federal regulations (Individuals with Disabilities Act and Section 504 of the Rehabilitation Act of 1973), the District is responsible for providing a free and appropriate public education (FAPE) to students with disabilities. To be appropriate, education programs for students with disabilities must be designed to meet their individual needs to the same extent that the needs of nondisabled students are met at no additional expense to the parent/guardian. Sometimes students' needs, due to their disability, exceed what can be provided within their home school, and outside educational services and placements are necessary to provide FAPE.

In preparing a budget, we need to ensure that enough funds are available to support all students with disabilities without knowing in advance all the specific services that will be required for every disabled child. As students' needs change, their educational program must be adapted to meet current needs. Administration also cannot predict the enrollment of new students with disabilities. The District has had new students enroll with complex needs that require highly specialized programs costing in excess of $100,000. Furthermore**, the District does not control**

costs associated with out-of-district programs and we are not provided with exact tuition costs of programs until well after the final budget is approved. While our administration makes carefully considered recommendations based on an analysis of historical trends and current student population, it is not possible to know the exact dollar amount needed a year in advance.[10]

Likewise, there are a number of examples where actual costs exceeded historical budgeted costs, demonstrating additional challenges in relying on historical data. For several years, vo-tech expenditures were less than the budget of $350,000, however when we received our final vo-tech school tuition for 2015-16, it was more than $600,000 (See Table 1) resulting in an unfavorable variance of $258,000. The vo-tech program sets tuition rates and the District has no input in the cost figures. Historical data would not have led the school district to budget for increased costs.

Transportation is another area of fluctuation, depending upon required transportation services as a result of student placement and needs. For the 2015-16 school year, the District budgeted a little more than $12M, but spent more than $13M. The variance was due in large part to specialized transportation services to meet the requirements of students with special needs (See Table 1). Generally speaking, when districts choose to contract with an intermediate unit to provide special education transportation, the IU submits a report to PDE at the end of the year and those expenditures are recorded in the following year. LMSD realized the cost increase in specialized transportation services and determined that the most fiscally-responsible way to provide them moving forward was through other contracted services. However, the District was still paying for IU transportation services provided in the prior year, while paying for contracted services in the current year. This is another example where historical data would not have determined our actual costs. See Table 1 below for additional examples of variance between budgeted and actual expenditures in the 2015-16 LMSD Budget.

Table 1: Examples of Variance in the 2015-16 LMSD Budget

Year End	Function	Budget	Actual	Difference
6/30/2016	1300 VoTech	$350,000.00	$608,022.00	($258,022.00)
	2300 Support Srvcs-Administration	$12,980,919.00	$13,052,231.00	($71,312.00)
	2700 Transportation	$12,156,308.00	$13,203,694.00	($1,047,386.00)
	2800 Central Sprt & Tech Srvcs	$5,566,821.00	$5,897,778.00	($330,957.00)
	3300 Community Svcs	$197,500.00	$198,566.00	($1,066.00)
Total		**$31,251,548.00**	**$32,960,291.00**	**($1,708,743.00)**

A greater focus on historical budgeting would not have helped the District budget more accurately and/or reduce variance in most situations. Areas of significant variance occur not

[10] Approximately 13.5% of District students receive special education services and their individualized programs are developed and annually reviewed by each individual student's IEP (Individualized Education Plan) team, which includes relevant school personnel, parents, and the student (if 14 years of age or older).

because of a failure to understand or look at historical information, but rather due to circumstances beyond the District's control.

Finally, the fact is that LMSD's conservative budgeting practices are common to districts across the Commonwealth. As noted by school budget expert Dr. William Hartman of Penn State, the majority of Pennsylvania school districts "underestimate revenues", "overestimate expenditures" and "any resulting surplus goes to fund balance." Dr. Hartman affirms these "conservative practices" as appropriate strategies for "prudent budget management to allow for future unknowns."[11] The Auditor General has not previously taken issue with these practices.

Fund Transfers

The District appropriately, lawfully, and publicly authorized the transfer of funds to its capital reserve for each and every year under auditor review. According to the state accounting manual[12], the District's practices are consistent with code; as referenced above, surpluses from the general operating fund may be transferred to capital reserve to fund budgeted capital reserve items. During the years 2012-16, the District transferred more than $18M and spent more than $19M in support of its five-year capital improvement plan, five-year bus replacement plan and five-year technology plan. Over the next five years, the District anticipates needing nearly $22M to implement these ongoing plans.[13]

Substantial Committed Funds

The draft Performance Audit accurately notes that the District has maintained a relatively constant committed fund balance of around $35.8M for the five fiscal years 2012-16. All budgeted items in the committed fund balance have been affirmed as appropriate by local auditors and reflect a measure of fiscal prudence for a district planning for future needs – particularly given uncertainties like enrollment growth and increasing PSERS obligations. That the number has remained constant is a reflection of sound fiscal policy and strategic budgeting decisions. For example, the District planned to utilize committed fund balance to support the financing of several recent classroom expansion projects. After careful review, the District determined that it could realize savings and maintain funds for future capital projects by taking advantage of historically low interest rates and issuing bonds for these projects. The result would be greater flexibility and security in the future; if enrollment growth continued and interest rates rose, the District would be able to save taxpayers by having more funds available (and issuing less debt service) for future capital projects as designated in the community-generated strategic long-term plans.

[11] "An Analysis of the Budgeting Process in Downingtown Area School District" by Dr. William T. Hartman, Professor of Education, Emeritus, the Pennsylvania State University 10/11/16

[12] Municipal Code P.L. 145, Act of April 30, 1943, also known as Purdon's 53§1431 accounts for (1) moneys transferred during any fiscal year from appropriations made for any particular purpose which may not be needed, (2) surplus moneys in the General Fund of the treasury of the LEA at the end of any fiscal year, and (3) interest earnings of the fund itself.

[13] The five-year facilities plan is presented to the Board Facilities & Purchasing Committee and reviewed on a consistent basis.

Neighboring school districts without modernized facilities will face significant challenges in renovating/building new schools in coming years due to Act 1 constraints and the rising costs of construction. Other districts will eventually need to incur debt – likely at much greater cost – to continue to provide safe, adequate facilities. Preserving high quality facilities is a priority for the District not only related to capacity needs. LMSD's commitment to consistent maintenance and upkeep yields long-term cost savings and value to the community. **Deferring these services would lead to costly repairs, renovations and impact the curb appeal of the community's public schools – potentially diminishing property values.**

The importance – and challenge – of maintaining adequate committed funds to mitigate future employee retirement obligations is illustrated by the table below (Table 2), which shows the most recent PSERS employer contribution projections through 2021-22. Every year PSERS provides new projections to school districts estimating what future obligations will be. For the year ending June 30, 2010, the 2021-22 rate was projected to be 27.03%. The most recent projection (as of June 30, 2016) for 2021-22 is 36.40%. In the current 2017-18 year, the actual employer contribution rate is already 32.57%. With rates continually being adjusted upward, the District is being prudent in appropriately planning for the uncertainty of PSERS employer contribution rate obligation.

Table 2: Historical PSERS Employer Contribution Projections

Year Ending	**2021-22 Projection of Employer Contribution Rate ~~%~~**
6/30/2010	27.03
6/30/2011	27.58
6/30/2012	30.76
6/30/2013	32.01
6/30/2014	31.90
6/30/2015	33.51
6/30/2016	36.40

The draft Performance Audit's assessment that "the District never spent any of the funds it set aside for retirement costs, nor did it develop a timeline for when it intended to spend those funds" is misleading. As noted above, the District has been very clear as to the purpose of its committed fund balance and the importance of maintaining these funds to cover increasing PSERS obligations and when that is projected to occur. To date, the District has utilized state subsidies and annual tax revenues to cover rising PSERS costs with that timeline in mind, recognizing that **it will be impossible to keep pace with projected increases without drawing from reserves.**

The Auditor General appears to be under a mistaken impression in this regard. The reason the fund balance was established in the first place was to respond to projections of future need. Those projections have been revisited at various points in time, and the evaluation of the timeline has been communicated to the Board and the public. During the 2015-16 school year, for example, the District hosted a series of "community conversations" on the budget, including a February 22, 2016 presentation to local civic associations that described PSERS employer contribution projections and the forecasted need to draw from reserves as early as 2020.[14] If the Auditor General had asked for information of this kind in any of the multiple requests he made during the course of the year, the District would certainly have provided it.

In that regard, we also note that in our review of a number of other school district audits this year, including those of districts that maintain a committed fund balance for PSERS, we could find no references to a timeline for drawing down PSERS reserves. We reviewed 2015-16 financial statements and budget presentations for several districts that have recently been audited (Windber and Midd-West, for example) and found no specific mention of how and when retirement funds held in reserve would be spent.[15] We also note that the Auditor General has not sought a specific timeline for a PSERS reserve drawdown in past audits, and never before criticized the long-standing fund balance.

Finally, the Board approves the audited financial statements annually, and they contain a full description of committed reserves. In addition, there is a public vote any time an item in the committed fund balance changes.

In 2017, the District augmented its practices to include a Board motion to reconfirm commitments even if designations do not change. Although not required by law or code, the Board has updated its procedures to confirm committed fund balances whether they change or not.

Referendum Exceptions/Act 1

Under Act 1, the Pennsylvania Department of Education publishes an inflationary tax index that represents the maximum real estate property tax levy increase for each school district (without PDE exception or voter approval). Districts that seek to raise taxes above the index can only do so by submitting referendum exceptions to PDE or receiving approval from the local voters by referendum. The four referendum exceptions are school construction-grandfathered debt, school construction-electoral debt, special education expenditures and retirement contributions. Requests for exceptions are unique to each district. The General Assembly requires PDE approval before such exceptions can be taken, and while PDE does not approve all amounts requested for all districts, PDE has approved Lower Merion School District's requests for exceptions in full, for each year of the draft Performance Audit. It should be noted, however, that it was rare for the District to take the full exceptions.

The draft audit seems to suggest that districts seeking exceptions to raise taxes above the Act 1 index are somehow violating the spirit of the law. We disagree. The narrow exceptions that the Lower Merion School District has applied for are **mandatory** expenditures; the District's taxpayers cannot determine that they do not want to fund pensions or special education. The District has **always** used exceptions specifically for the purposes stated in its application to PDE.

[14] 2016-17 LMSD Budget: A Community Conversation http://www.lmsd.org/uploaded/documents/Departments/Business/ISC_Budget_Pres_Apr_2016.pdf [15] If the data exists we could not find it online in audit reports, presentations, or financial reports.

Those exceptions do not cover the cost of the District's contributions; they do not even cover the *increased* cost from one year to the next.

	LMSD Contributions to PSERS*	Difference Year over Year	Taxes Realized Through PSERS Exceptions
2011-12	$4,403,139	$1,634,365	$1,621,343
2012-13	$6,537,759	$2,134,620	$0
2013-14	$9,231,888	$2,694,130	$1,233,830
2014-15	$11,305,376	$2,073,488	$1,714,965
2015-16	$14,373,465	$3,068,089	$1,536,794

*Half of the District's total contribution is paid by the Commonwealth. Accordingly, only the half actually spent by the District is set forth here.

Even with funds obtained through exceptions, the District cannot fully cover its increasing annual special education and PSERS obligations without drawing from other sources. We find it particularly telling that the PSERS Board recently scaled back the number of years it includes in its employer contribution rate projections (from 20 years to five). Forecasts have been so consistently and egregiously low that they have been almost useless for school district planning purposes.

Moreover, the Auditor General has not taken issue with or identified a single concern with the District's use of exceptions for special education. Similar to rising PSERS costs, the costs of providing appropriate special education services continue to increase while state support remains virtually unchanged. Since 2000, the District's special education budget has increased from less than $15M to nearly $48M. At the same time, state contributions for special education have remained flat at less than $3.5M/year. As a result, LMSD must rely more on local revenues to comply with federal and state mandates, such as IDEA. The learning environment in LMSD is considered by the Department of Education to be highly inclusive for students with special needs.

The fact is that none of the funds that make up the District's fund balance were obtained through exceptions. All of the monies raised through the exceptions were spent on the costs covered by the exceptions. The entirety of the fund balances have come from other sources clearly defined and discussed during our budget process and, as the Auditor General observed, the fund balances have been in place for several years – since prior to the last audit.

Wolk Litigation

The Auditor General devotes an entire section of the report to the *Wolk* litigation. The amended complaint in that case seeks relief that includes but is not limited to $55,000,000, plus interest and attorneys' fees, suspension of the Board and appointment of a Trustee over the District, requiring the District and its Directors to attend courses in arithmetic and public finance, a constructive trust, orders that certain employees be terminated, and a declaration that the method and mode of school tax assessment and collection in Pennsylvania is illegal. Whether or not the Auditor General is in sympathy with Mr. Wolk's goals, the District respectfully suggests that the public policy opinion should be outside the scope of an audit.

Community Values

During the District's most recent strategic planning process, the community affirmed its steadfast support for providing a rich, progressive curricular and co-curricular experience. Opportunity is at the heart of what defines us as a school system. LMSD offers a rigorous, comprehensive multi-disciplinary academic program, low class sizes, an array of world-class services for special needs and gifted children as well as community-based learning programs, early-intervention literacy support, an International Baccalaureate diploma program, a full menu of high school honors and AP courses, an extensive range of course offerings in music, technology and the arts. The District's world language program enables all students to receive uninterrupted foreign language instruction from first grade until the time they graduate from high school. More than 500 supervised academic, athletic, community outreach and performance-oriented co-curricular programs are available in the District, from elementary school technology clubs to high school varsity sports. In addition to serving student programs, the District's facilities are utilized by thousands of community members for enrichment programs, recreation and general use.

Opportunities yield results. Our schools rank among the highest in Pennsylvania for SAT and PSAT scores, AP participation rate, total number of National Merit Semifinalists, total number of International Baccalaureate diplomas granted and in numerous publications' "top schools" lists. For the past three years, the District has been named one of the top ten school districts in the US by Niche.com and recently our schools earned recognition as among the top STEM schools in the country. We annually are recognized as among the nation's Best Communities for Music Education by the NAMM Foundation. All ten schools have been recognized for excellence by the Commonwealth. Approximately 95% of high school graduates attend institutions of higher learning. Our students excel at the national level in co-curricular programs ranging from Science Olympiad to FIRST Robotics and our athletic teams have won numerous state championships.

In short, LMSD seeks to provide an extraordinary level of service and opportunity and a culture of student and staff excellence. This is what distinguishes our schools and serves as a point of pride for the community. The community consistently votes for school boards that share these values. They demand that the District deliver a world-class public education and they are willing to make the investments necessary as indicated by the Board members they choose to elect. And it should be noted that our schools are truly a Lower Merion community investment; more than 85% of our budget comes from local revenues. LMSD believes it serves as a model of how public schools can be successful with community support and adequate funding. We believe all districts should be able to provide the same level of opportunity and investment in their children. **The ability to do so requires sustained financial stability and budget stewardship as demonstrated (and affirmed by the voting public) over time by Lower Merion School District.**

Additional Considerations

- **Revenues**: More than 90% of the school districts in Pennsylvania levy an earned income or wage tax in addition to real estate taxes to generate revenue. Unlike these districts, Lower Merion does not have an earned income tax, so its reliance on real estate taxes is particularly pronounced. (As required by state law, Lower Merion's residents were presented the option and voted to rely on property taxes alone.) State and Federal subsidies account for just 14% of LMSD's total revenue – well below the state average. The result is that communities with different taxing authorities must take significantly different approaches to budgeting. **In Lower Merion, the heavy reliance on property taxes as a primary source of revenue forces more conservative budgeting.**

  It should also be noted that school districts are required to operate by a different set of rules than other governmental entities (municipalities, for example) when it comes to generating revenue. Other governmental entities can establish budgets and cover projected expenses (and shortfalls) through other means like municipal service fees and have no fund balance limit. School districts do not have this opportunity, nor the same degree of flexibility.

- **State accounting changes:** In recent years, the state has changed its accounting manual with regard to account reporting. This has created some challenges in using historical budgeting to accurately track longitudinal data in certain accounting locations. For example, software used to be recorded as object code 618. At the end of the 2016 school year, this code was changed to object code 650. So when looking at historical numbers for software, an item/budget code that might have previously been reported as an expense now appears as a zero in the budget. The District has worked hard to reconcile previous and current budgets, but given that the LMSD budget has more than 8000 expenditure accounts, the state changes have made it more challenging to track historical numbers as items have been reported in different locations in different years.

- **Public process:** The LMSD budget reflects public input received through a variety of forums, including regular Board meetings, public budget workshops, committee meetings and community comments. In 2016-17, the District's Finance Committee hosted a series of detailed, in-depth presentations on key areas of the budget, including curriculum and instruction, facilities, transportation, staffing and special education. The District also maintans [*sic*] online and video resources related to the budget, which can be found in the budget section of the District website.

- **Common Practices:** The District utilizes accounting and budgeting practices that are standard for school districts across the Commonwealth. **In fact, every state and independent audit of the District over the past five years (seven total) has affirmed the District's full compliance with budgeting and accounting standards. The District has consistently been lauded for strong fiscal management by credit ratings agencies.** Both the Pennsylvania School Boards Association and Pennsylvania Association of School Business Officials affirmed the District's practices during the past school year. PASBO issued a school budgeting fact sheet and the following statement[15] in response to the ongoing Wolk lawsuit (referenced in the draft Performance Audit):

> *"Despite the fact that Lower Merion adhered to all applicable laws, provided appropriate transparency regarding financial decisions, engaged in careful, long-term financial planning and budgeted conservatively in light of the myriad of fluctuating issues that are beyond their control, they are being criticized and penalized for coming in under budget and planning for future taxpayer savings."*

Conclusion

By all accounts the District's sound, lawful, and responsible financial practices have enabled the preservation of high-quality educational programs in the face of unprecedented enrollment growth, perennial state budget uncertainty and the rising costs of mandates like pensions and special education. We believe the pressing question with regard to reserves and a healthy fund balance is whether the District should spend down such surpluses or prudently set them aside for anticipated needs.

Lower Merion School District is in a fortunate position to have broad community support for high-quality public education. The community, through its elected school board, has made significant investments in program, infrastructure, staffing and has prioritized saving for the future. **Decision-making has occurred in public, with thoughtful deliberation and complete transparency.**

Ultimately, doing as the Auditor General recommends will result not just in reduced fund balances, but in a reduction of services. Because of the line item budget, and because a district cannot spend at a deficit, the inevitable shortfalls in critical areas will lead – as they did for many districts during the recent budget impasse – to borrowing money at high interest rates, requiring more tax increases to cover the interest than if the needs had been properly anticipated up front. As noted previously, due solely to fixed costs and mandates (salaries, PSERS, special education, etc.) and not accounting for the fastest enrollment growth in the region, our district (and many others) will – by drawing down its reserves – be forced to grapple with budgetary shortfalls and likely a diminished bond rating. Over the long term, this would most certainly have a negative impact on the quality of LMSD schools and real estate in Lower Merion and Narberth.

The draft Performance Audit suggests that a school district that does what the law allows (through Act 1 exceptions) is utilizing a loophole in the law. **LMSD has never exceeded the legally-approved Act I tax rate (index and approved exceptions).** The General Assembly permitted only certain narrow areas of increased expenditures, and the only two that the District has invoked are for areas in which expenditures cannot be compromised, but state and federal funding does not cover the costs of complying with the statutes that give rise to the expenditures. As those costs go up, the General Assembly wanted to ensure that districts can meet those needs. Voters cannot by referendum decide not to fund pensions or special education. LMSD has actively solicited continuous and ongoing public input on its expenditures and long-term

[15] Recent Court Decision Has Statewide Implications http://www.pasbo.org/blog_home.asp?Display=84

strategic plans, and it has always followed Board-enacted policies concerning assigning surplus to appropriate accounts. LMSD maintains an appropriate fund balance based on generally accepted accounting standards and laws governing school districts.

We understand that some might choose to make different budgeting decisions. One district might place less emphasis on maintaining capital reserve funds and instead borrow funds when interest rates are low. Other districts may fund building projects mostly with reserves and reduce public exposure to interest rate increases. Others might use a combination of several strategies. Given that our district continues to grow at a rate far faster than any other school district in the region, our practice has been to maintain a variety of fiscal strategies in an effort to grow in the most responsible manner. **Our Aaa bond rating enables our community to maintain a reliable combination of options for addressing growth while preserving our programs.**

We would refer the Auditor General to strategies employed by local municipalities as examples of responsible, realistic and appropriate approaches to budgeting. In 2015 Lower Merion Township proudly shared with taxpayers that it had realized a budget surplus instead of a planned deficit due to positive budgetary performance and expenditures that were less than what had been budgeted. The Township's fund balance policy, which it deems its "fiscal safety net", requires a minimum year-end General Fund undesignated fund balance no less than 12% of that year's total General Fund operating expenditures. Futher [*sic*], the policy has a goal to maintain a year-end General Fund undesignated fund balance within a minimum of 15% and a maximum of 18% of the General Fund expenditures. In recent years, the Township has adopted General Fund budgets with structural imbalance anticipating a drawdown of fund balance to finish the year closer to the policy goal range. Fund balance was reduced in 2014 but due to better than projected financial performance in 2015, the fund balance actually increased. At year-end 2015, the General Fund undesignated fund balance was 35%, up from 34% the previous year. In turn, the Township has been able to maintain its AAA rating from Standard & Poor's Rating Service and its Aaa rating from Moody's Investors Service. The high credit rating means the Township's general obligation bonds are considered excellent investment quality, allowing the Township to borrow at the lowest possible interest rates, which translates to tangible savings for taxpayers. Likewise, this is and has been the goal of Lower Merion School District.

The Lower Merion School District appreciates the Auditor General's consideration in reviewing this information and taking the time to understand some of the factors unique to budgeting in our District.

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This letter was initially distributed to the Superintendent of the District, the Board of School Directors, and the following stakeholders:

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