FINANCIAL AUDIT
INCLUDING THE PROVISIONS OF THE SINGLE AUDIT ACT
OF THE

DEPARTMENT OF EDUCATION

October 1, 2001 through September 30, 2003

31-100-04

"...The auditor general shall conduct post audits of financial transactions and accounts of the state and of all branches, departments, offices, boards, commissions, agencies, authorities and institutions of the state established by this constitution or by law, and performance post audits thereof."

– Article IV, Section 53 of the Michigan Constitution

Audit report information may be accessed at:
http://audgen.michigan.gov

Michigan

Office of the Auditor General

REPORT SUMMARY

Financial Audit

Including the Provisions of the Single Audit Act
October 1, 2001 through September 30, 2003

Department of Education

Report Number:
31-100-04

Released:
June 2004

A Single Audit is designed to meet the needs of all financial report users, including an entity's federal grantor agencies. The audit determines if the financial schedules and/or financial statements are fairly presented; considers internal control over financial reporting and internal control over federal program compliance; determines compliance with State compliance requirements material to the financial schedules and/or financial statements; and assesses compliance with direct and material requirements of the major federal programs.

Financial Schedules and Financial Statements:

Auditor's Reports Issued

We issued unqualified opinions on the Department's financial schedules and on the School Aid Fund's financial statements.

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Internal Control Over Financial Reporting

We did not report any findings related to internal control over financial reporting.

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Noncompliance Material to the Financial Schedules or Financial Statements

We did not identify any instances of noncompliance applicable to the financial schedules or financial statements that are required to be reported under *Government Auditing Standards*.

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Federal Awards:

Auditor's Reports Issued on Compliance

We audited 16 programs as major programs and issued 5 qualified and 11 unqualified opinions. The opinions issued by major program are identified on the back of this summary.

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Internal Control Over Major Programs

We identified reportable conditions related to internal control over major programs (Findings 2 through 13). We consider Findings 2 through 6 to contain material weaknesses.

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Required Reporting of Noncompliance

We identified instances of noncompliance that are required to be reported in accordance with U.S. Office of Management and Budget (OMB) Circular A-133 (Findings 2 through 13).

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Systems of Accounting and Internal Control:
We determined that the Department was not in substantial compliance with Sections 18.1483 - 18.1487 of the *Michigan Compiled Laws* (Finding 1).

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We audited the following programs as major programs:

CFDA Number	***Program Title***	***Compliance Opinion***
10.550	Food Donation	Qualified
10.553, 10.555, 10.556	Child Nutrition Cluster	Unqualified
84.027, 84.173	Special Education Cluster	Qualified
84.181	Special Education - Grants for Infants and Families with Disabilities	Unqualified
84.186	Safe and Drug-Free Schools and Communities - State Grants	Unqualified
84.281	Eisenhower Professional Development State Grants	Qualified
84.282	Charter Schools	Qualified
84.298	Innovative Education Program Strategies	Unqualified
84.318	Education Technology State Grants (Technology Literacy Challenge Fund Grants)	Unqualified
84.340	Class Size Reduction	Qualified
84.348	Title I Accountability Grants	Unqualified
84.352	School Renovation Grants	Unqualified
84.357	Reading First State Grants	Unqualified
84.367	Improving Teacher Quality State Grants	Unqualified
84.369	Grants for State Assessments and Related Activities	Unqualified
93.575	Child Care and Development Block Grant	Unqualified

A copy of the full report can be obtained by calling 517.334.8050 or by visiting our Web site at: http://audgen.michigan.gov

Michigan Office of the Auditor General
201 N. Washington Square
Lansing, Michigan 48913

Thomas H. McTavish, C.P.A.
Auditor General

Scott M. Strong, C.P.A., C.I.A.
Deputy Auditor General

STATE OF MICHIGAN
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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

June 30, 2004

Mr. Thomas D. Watkins Jr., Chairperson
State Board of Education
Hannah Building
Lansing, Michigan

Dear Mr. Watkins:

This is our report on the financial audit, including the provisions of the Single Audit Act, of the Department of Education for the period October 1, 2001 through September 30, 2003.

This report contains our report summary; our independent auditor's reports on the financial schedules and financial statements; and the Department's financial schedules, School Aid Fund financial statements, notes to the financial schedules and financial statements, and schedule of expenditures of federal awards. This report also contains our independent auditor's reports on compliance and on internal control over financial reporting and on compliance with requirements applicable to each major program and on internal control over compliance in accordance with U.S. Office of Management and Budget Circular A-133 and our schedule of findings and questioned costs. In addition, this report contains the Department's summary schedule of prior audit findings, its corrective action plan, and a glossary of acronyms and terms.

Our findings and recommendations are contained in Section II and Section III of the schedule of findings and questioned costs. The agency preliminary responses are contained in the corrective action plan. The *Michigan Compiled Laws* and administrative procedures require that the audited agency develop a formal response within 60 days after release of the audit report.

We appreciate the courtesy and cooperation extended to us during this audit.

Sincerely,

Thomas H. McTavish, C.P.A.
Auditor General

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INDEPENDENT AUDITOR'S REPORTS, FINANCIAL SCHEDULES, AND FINANCIAL STATEMENTS

STATE OF MICHIGAN
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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

Independent Auditor's Report on
the Financial Schedules

April 2, 2004

Mr. Thomas D. Watkins Jr., Chairperson
State Board of Education
Hannah Building
Lansing, Michigan

Dear Mr. Watkins:

We have audited the financial schedules of the Department of Education for the fiscal years ended September 30, 2003 and September 30, 2002, as identified in the table of contents. These financial schedules are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial schedules based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial schedules are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial schedules. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 1b, the financial schedules present only the revenues and transfers and the sources and disposition of authorizations for the Department of Education's General Fund accounts, presented using the current financial resources measurement focus and the modified accrual basis of accounting. Accordingly, these financial schedules do not purport to, and do not, constitute a complete financial presentation of either the Department or the State's General Fund in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial schedules referred to in the first paragraph present fairly, in all material respects, the revenues and transfers and the sources and disposition of authorizations of the Department of Education for the fiscal years ended September 30, 2003 and September 30, 2002, on the basis of accounting described in Note 1b.

In accordance with *Government Auditing Standards*, we have also issued a report dated April 2, 2004 on our tests of the Department's compliance with certain provisions of laws, regulations, contracts, and grants and on our consideration of its internal control over financial reporting. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The schedule of expenditures of federal awards, required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, is presented for purposes of additional analysis and is not a required part of the Department's financial schedules referred to in the first paragraph. Such information has been subjected to the auditing procedures applied in the audit of the financial schedules and, in our opinion, is fairly stated, in all material respects, in relation to the financial schedules taken as a whole.

Sincerely,

Thomas H. McTavish, C.P.A.
Auditor General

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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

Independent Auditor's Report on the Financial Statements

April 2, 2004

Mr. Thomas D. Watkins Jr., Chairperson
State Board of Education
Hannah Building
Lansing, Michigan

Dear Mr. Watkins:

We have audited the financial statements of the School Aid Fund, Department of Education, as of and for the fiscal years ended September 30, 2003 and September 30, 2002, as identified in the table of contents. These financial statements are the responsibility of the School Aid Fund's management and the Department's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 1b, these financial statements present only the School Aid Fund and do not purport to, and do not, present fairly the financial position of the State of Michigan or its special revenue funds as of September 30, 2003 and September 30, 2002 and the changes in financial position thereof for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the School Aid Fund as of September 30, 2003 and September 30, 2002 and the changes in financial position for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued a report dated April 2, 2004 on our tests of the Department's compliance with certain provisions of laws, regulations, contracts, and grants and on our consideration of its internal control over financial reporting. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The schedule of expenditures of federal awards, required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, is presented for purposes of additional analysis and is not a required part of the financial statements referred to in the first paragraph. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

Sincerely,

Thomas H. McTavish, C.P.A.
Auditor General

DEPARTMENT OF EDUCATION
Schedule of General Fund Revenues and Transfers
Fiscal Years Ended September 30

	2003	2002
REVENUES		
From federal agencies (Note 1)	$ 89,797,406	$ 863,744,868
From local agencies		11,300
From licenses and permits	12,652,046	9,770,814
Miscellaneous	10,330,476	1,988,209
Total Revenues	$ 112,779,928	$ 875,515,191
TRANSFERS		
From School Aid Fund	$ 3,017,534	$ 2,824,555
From Gifts, Bequests, and Deposits Investment Fund	84,026	79,983
Total Transfers	$ 3,101,560	$ 2,904,538
Total Revenues and Transfers	$ 115,881,488	$ 878,419,729

The accompanying notes are an integral part of the financial schedules.

DEPARTMENT OF EDUCATION
Schedule of Sources and Disposition of General Fund Authorizations
Fiscal Years Ended September 30

	2003	2002
SOURCES OF AUTHORIZATIONS (Note 2)		
General purpose appropriations	$ 409,074,532	$ 232,310,200
Balances carried forward	3,861,072	5,822,101
Restricted financing sources (net of intrafund expenditure reimbursements):		
Federal revenue	97,801,911	863,429,367
Other	16,655,175	13,733,926
Total	$ 527,392,690	$ 1,115,295,594
DISPOSITION OF AUTHORIZATIONS (Note 2)		
Expenditures and transfers (net of intrafund expenditure reimbursements)	$ 522,576,547	$ 1,110,234,619
Balances carried forward:		
Encumbrances	$ 7,114	$ 349,966
Restricted revenues - not authorized	4,312,382	3,511,106
Total balances carried forward	$ 4,319,496	$ 3,861,072
Balances lapsed	$ 496,647	$ 1,199,903
Total	$ 527,392,690	$ 1,115,295,594

The accompanying notes are an integral part of the financial schedules.

Notes to the Financial Schedules

Note 1 Significant Accounting Policies

a. Reporting Entity

The accompanying financial schedules report the results of the governmental operations of the Department of Education for the fiscal years ended September 30, 2003 and September 30, 2002. The governmental operations of the Department are accounted for principally in the State's General Fund and are reported on in the *State of Michigan Comprehensive Annual Financial Report (SOMCAFR)*. Department operations also include the School Aid Fund, a special revenue fund that is audited separately and reported on separately in this report.

Beginning in fiscal year 2002-03, the majority of the Department's federal grants were appropriated in and received and expended through the School Aid Fund rather than through the General Fund.

The notes accompanying these financial schedules relate directly to the Department. The *SOMCAFR* provides more extensive general disclosures regarding the State's Summary of Significant Accounting Policies; Budgeting, Budgetary Control, and Legal Compliance; and Pension Benefits and Other Postemployment Benefits.

b. Measurement Focus, Basis of Accounting, and Presentation

The financial schedules contained in this report are presented using the current financial resources measurement focus and the modified accrual basis of accounting, as provided by generally accepted accounting principles applicable to governments. Under the modified accrual basis of accounting, revenues are recognized as they become susceptible to accrual, generally when they are both measurable and available. Revenues are considered to be available when they are collected within the current period or soon enough thereafter to pay liabilities of the current period. Expenditures generally are recorded when a liability is incurred; however, certain expenditures related to long-term obligations are recorded only when payment is due and payable.

The accompanying financial schedules present only the revenues and transfers and the sources and disposition of authorizations for the Department of Education's General Fund accounts. Accordingly, these financial schedules do not purport to, and do not, constitute a complete financial presentation of either the Department or the State's General Fund in conformity with generally accepted accounting principles.

c. Amounts Due From Federal Agencies

For most federally funded programs, revenue is accrued in the same period as related obligations are recorded. In certain programs, financed entirely by the federal government, expenditures and related revenues are recognized only to the extent of billings received by fiscal year-end. This treatment understates assets and liabilities and expenditures and revenues; however, there is no impact on the fund balance of the State's General Fund.

Note 2 Schedule of Sources and Disposition of General Fund Authorizations

The various elements of the schedule of sources and disposition of General Fund authorizations are defined as follows:

a. General purpose appropriations: Original appropriations and any supplemental appropriations that are financed by General Fund/general purpose revenues.

b. Balances carried forward: Authorizations for multi-year projects, encumbrances, restricted revenues - authorized, and restricted revenues - not authorized that were not spent as of the end of the prior fiscal year. These authorizations are available for expenditure in the current fiscal year for the purpose of the carry-forward without additional legislative authorization, except for the restricted revenues - not authorized.

c. Restricted financing sources: Collections of restricted revenues, restricted transfers, and restricted intrafund expenditure reimbursements to finance programs as detailed in the appropriations act. These financing sources are authorized for expenditure up to the amount appropriated. Depending upon program statute, any amounts received in excess of the appropriation are, at year-end, either converted to general purpose financing sources and made available for general appropriation in the next

fiscal year or carried forward to the next fiscal year as either restricted revenues - authorized or restricted revenues - not authorized.

d. Encumbrances: Authorizations carried forward to finance payments for goods or services ordered in the old fiscal year but not received by fiscal year-end. These authorizations are generally limited to obligations funded by general purpose appropriations.

e. Restricted revenues - not authorized: Revenues that, by statute, are restricted for use to a particular program or activity. However, the expenditure of the restricted revenues is subject to annual legislative approval. A significant carry-forward of this type was for certification fees of $2,549,642 in fiscal year 2002-03.

f. Balances lapsed: Authorizations that were unexpended and unobligated at the end of the fiscal year. These amounts are available for legislative appropriation in the subsequent fiscal year.

SCHOOL AID FUND
Department of Education
Balance Sheet
As of September 30
(In Thousands)

	2003	2002
ASSETS		
Current Assets:		
Cash	$ 1	$
Taxes receivable	1,538,203	1,179,202
Amounts due from other funds	155,690	23,530
Amounts due from federal agencies	39,730	1,606
Amounts due from local units	48,488	60,703
Other current assets	405	341
Total Current Assets	$ 1,782,518	$ 1,265,382
Noncurrent Assets:		
Taxes receivable	46,317	49,972
Amounts due from local units	1,163	652
Total Assets	$ 1,829,998	$ 1,316,007
LIABILITIES AND FUND BALANCE		
Current Liabilities:		
Warrants outstanding	$ 1,308	$ 11
Accounts payable and other liabilities	132,111	90,887
Amounts due to other funds (Note 7)	1,243,298	614,577
Deferred revenue	291,822	318,625
Total Current Liabilities	$ 1,668,539	$ 1,024,100
Long-Term Liabilities:		
Deferred revenue	46,317	49,972
Total Liabilities	$ 1,714,857	$ 1,074,072
Fund Balance:		
Reserved fund balance	$ 1,473	$ 4,924
Unreserved fund balance	113,668	237,010
Total Fund Balance	$ 115,141	$ 241,934
Total Liabilities and Fund Balance	$ 1,829,998	$ 1,316,007

The accompanying notes are an integral part of the financial statements.

SCHOOL AID FUND
Department of Education
Statement of Revenues, Expenditures, and Changes in Fund Balance
Fiscal Years Ended September 30
(In Thousands)

	2003	2002
REVENUES		
Taxes (Note 2):		
Sales	$ 4,681,370	$ 4,695,253
Personal income	1,847,755	1,860,362
Property	2,127,513	1,583,660
Use	410,201	435,722
Cigarette	489,095	403,571
Industrial facilities	161,155	152,312
Liquor	30,605	29,141
Commercial facilities		10
Casino gaming wagering	90,945	91,915
Real estate transfer	275,513	253,075
Other	14,570	15,314
Total Taxes	$ 10,128,721	$ 9,520,335
From federal agencies	1,069,511	183,019
Miscellaneous	18,757	14,709
Total Revenues	$ 11,216,989	$ 9,718,063
EXPENDITURES		
Proposal A (Note 2)	$ 6,918,356	$ 6,991,698
Discretionary payment	2,804,586	2,383,655
Special Education	802,265	766,997
At Risk Students	301,830	311,062
Intermediate school districts	91,435	92,154
Adult Education	93,711	95,000
Michigan School Readiness Program	71,942	74,793
Vocational Education	39,342	40,826
Career Preparation	21,361	22,034
Small Class Size		26,596
Student Performance		15,000
School Lunch	18,274	17,585
Mathematics and Science Centers	9,845	10,232
Court-Placed Children	8,563	11,300
Gifted and Talented	4,801	5,000
Bilingual Education	4,053	4,212
Renaissance Zone	12,236	7,276
All Students Achieve Program	529	89,832
Non-Durant district settlements (Note 4)	31,687	70,831
Golden Apple	1,270	
Michigan Virtual High School	8,618	1,500
Equity payment		128,708
Teen Health Center	3,601	
Federal non-special education	838,334	
Federal special education	227,370	183,019
Other	20,433	21,723
Total Expenditures	$ 12,334,442	$ 11,371,034

This statement continued on next page.

SCHOOL AID FUND
Department of Education
Statement of Revenues, Expenditures, and Changes in Fund Balance
Fiscal Years Ended September 30
(In Thousands)
Continued

	2003	2002
Excess of Revenues Over (Under) Expenditures	$ (1,117,453)	$ (1,652,971)
OTHER FINANCING SOURCES (USES)		
Transfers from other funds	1,001,766	1,193,621
Transfers to other funds	(11,106)	(2,829)
Total Other Financing Sources (Uses)	$ 990,660	$ 1,190,792
Excess of Revenues and Other Sources Over (Under) Expenditures and Other Uses	$ (126,793)	$ (462,179)
Fund Balance - Beginning of fiscal year	241,934	704,113
Fund Balance - End of fiscal year	$ 115,141	$ 241,934

The accompanying notes are an integral part of the financial statements.

SCHOOL AID FUND
Department of Education
Statement of Revenues, Expenditures, and Changes in Fund Balance - Budget and Actual
Fiscal Years Ended September 30
(In Thousands)

	2003			
	Original Budget	Final Budget	Actual	Variance With Final Budget
Beginning Budgetary Fund Balance	$ 241,282	$ 241,282	$ 241,282	$ 0
REVENUES AND OTHER SOURCES				
Taxes	$ 10,547,061	$ 10,128,721	$ 10,128,721	$ 0
From federal agencies	1,219,825	1,069,511	1,069,511	0
Miscellaneous	700	18,757	18,757	0
Transfers in	825,414	1,001,766	1,001,766	0
Total Revenues and Other Sources	$ 12,593,000	$ 12,218,755	$ 12,218,755	$ 0
EXPENDITURES AND ENCUMBRANCES (Note 3)				
Education	$ 12,713,595	$ 12,394,743	$ 12,345,858	$ 48,884
Total Expenditures and Encumbrances	$ 12,713,595	$ 12,394,743	$ 12,345,858	$ 48,884
Reconciling Items (Note 3)				
Encumbrances at September 30	$	$ 310	$ 310	$ 0
Change in noncurrent assets		(511)	(511)	0
Net Reconciling Items	$ 0	$ (201)	$ (201)	$ 0
Ending Budgetary Fund Balance	$ 120,687	$ 65,094	$ 113,978	$ 48,884

The accompanying notes are an integral part of the financial statements.

2002			
Original Budget	Final Budget	Actual	Variance With Final Budget
$ 702,861	$ 702,861	$ 702,861	$ 0
$ 9,595,187	$ 9,520,335	$ 9,520,335	$ 0
203,000	183,019	183,019	0
	14,709	14,709	0
831,614	1,193,621	1,193,621	0
$ 10,629,800	$ 10,911,684	$ 10,911,684	$ 0
$ 11,458,647	$ 11,418,511	$ 11,373,939	$ 44,572
$ 11,458,647	$ 11,418,511	$ 11,373,939	$ 44,572
$	$ 76	$ 76	$ 0
	600	600	0
$ 0	$ 677	$ 677	$ 0
$ (125,986)	$ 196,710	$ 241,282	$ 44,572

Notes to the Financial Statements

Note 1 Significant Accounting Policies

a. Reporting Entity

The accompanying financial statements report the financial position and results of operations of the School Aid Fund, Department of Education, as of and for the fiscal years ended September 30, 2003, and September 30, 2002. The School Aid Fund is a part of the State of Michigan's reporting entity and is reported as a special revenue fund in the *State of Michigan Comprehensive Annual Financial Report* (*SOMCAFR*).

The notes accompanying these financial statements relate directly to the School Aid Fund. The *SOMCAFR* provides more extensive general disclosures regarding the State's Summary of Significant Accounting Policies; Budgeting, Budgetary Control, and Legal Compliance; and Treasurer's Common Cash.

b. Measurement Focus, Basis of Accounting, and Presentation

The financial statements contained in this report are presented using the current financial resources measurement focus and the modified accrual basis of accounting as provided by generally accepted accounting principles applicable to governments. Under the modified accrual basis of accounting, revenues are recognized as they become susceptible to accrual, generally when they are both measurable and available. Revenues are considered to be available when they are collected within the current period or soon enough thereafter to pay liabilities of the current period. Expenditures generally are recorded when a liability is incurred; however, certain expenditures related to long-term obligations are recorded only when payment is due and payable.

The accompanying financial statements present only the School Aid Fund. Accordingly, they do not purport to, and do not, present fairly the financial position and changes in financial position of the State of Michigan or its special revenue funds in conformity with generally accepted accounting principles.

c. Amounts Due From Federal Agencies

For most federally funded programs, revenue is accrued in the same period as related obligations are recorded. In certain programs, financed entirely by the federal government, expenditures and related revenues are recognized only to the extent of billings received by fiscal year-end. This treatment understates assets and liabilities and expenditures and revenues; however, there is no impact on the fund balance of the School Aid Fund.

Note 2 Description of Fund

The School Aid Fund was created in 1955 by an amendment to the 1908 State Constitution, and its continued existence was provided for by the 1963 State Constitution. The School Aid Fund's purpose is to furnish aid to school districts of the State. Payments to school districts are based on statutory formulas.

The School Aid Fund receives State revenues restricted to school programs, including the constitutional dedication of 60% of the collections of sales tax imposed at a rate of 4% and all of the collections of sales tax imposed at the additional rate of 2%; State Lottery earnings; approximately 33% of total State use tax revenue; and portions of the personal income, cigarette, liquor, industrial and commercial facilities, and casino gaming wagering taxes. In addition, in fiscal year 2002-03, the majority of federal grants were received and expended through the School Aid Fund.

A constitutional amendment (known as "Proposal A") approved by voters in 1994 made significant structural changes in the method of financing school districts. This amendment authorized the levy of a Statewide education property tax and a real estate transfer tax, all of which is deposited in the School Aid Fund. Annual appropriated transfers also are made from the State's General Fund.

School aid appropriations are set annually by the Legislature from the School Aid Fund and the General Fund. If total appropriations are less than the payments to be made based on the State School Aid Act of 1979 as amended, then total payments are to be prorated so that they equal the appropriated funding available. Proration was necessary in fiscal year 2002-03 and resulted in a reduction of approximately $127 million.

Note 3 Budgeting and Budgetary Control

For budgetary reporting purposes, encumbrances are included with expenditures in the "Actual" columns because they are considered uses of spending authority in the year the State incurs an obligation. The "Original Budget" and "Final Budget" columns include encumbrance authorization balances carried over from the prior year because they provided spending authority in the current year. In financial statements prepared in accordance with generally accepted accounting principles (GAAP), encumbrances are not included as expenditures. The effect of this difference is reflected as a reconciling item on the statement of revenues, expenditures, and changes in fund balance - budget and actual. The encumbrance of spending authority is recorded as a reservation of fund balance under both the statutory/budgetary basis and the GAAP basis of accounting.

Note 4 Contingencies

Durant et al. v *State of Michigan, et al.*: On November 15, 2000, more than 365 Michigan school districts and individuals filed two suits in the Michigan Court of Appeals. The first suit, *Durant et al.* v *State of Michigan et al*. (Durant III), asserted that the current State School Aid Act of 1979 (Act 297, P.A. 2000) violated Article IX, Sections 25 - 34 of the State Constitution (the Headlee Amendment) because it allegedly transfers per pupil revenue guaranteed to school districts under Article IX, Section 11, for unrestricted school operating purposes, in order to satisfy the State's independent funding obligation to those school districts under Article IX, Section 29. The plaintiffs in Durant III requested a monetary remedy, including approximately $1.7 billion for the 1999-2000 through 2002-03 school years for the State's alleged underfunding of special education programs and services, including special education transportation services. The Durant III plaintiffs also requested a declaratory judgment that the State, through Act 297, P.A. 2000, is violating Article IX, Section 11 and Article IX, Section 29 of the State Constitution. The Durant III plaintiffs further sought orders declaring that the State failed, through Act 297, P.A. 2000, to meet its constitutional duty to fund services and activities provided by the plaintiff school districts during the 1999-2000 through 2002-03 school years in the same proportion by which they were funded when the Headlee Amendment became effective, and that the State reduced the State-financed proportion of necessary costs incurred by the plaintiff school districts for special education services for the 1999-2000 through 2002-03 school years below that provided by the State when the Headlee Amendment became

effective. The Durant III plaintiffs also sought an injunction permanently enjoining the State from making any future reductions below the levels of funding provided when the Headlee Amendment became effective to pay for the cost of the activities and services required of them by State law. They also requested attorney fees and costs of litigation.

On May 10, 2002, the Court of Appeals issued a decision in Durant III holding that Act 297 does not violate the State Constitution. On May 31, 2002, the Durant III plaintiffs filed a motion for reconsideration in the Court of Appeals, which was denied on July 17, 2002. On August 14, 2002, the Durant III plaintiffs filed a delayed application for leave to appeal and a motion for immediate consideration of the delayed application for leave to appeal with the Michigan Supreme Court. On November 19, 2002, the Michigan Supreme Court issued an order denying the plaintiffs' application for leave to appeal. On February 28, 2003, the Michigan Supreme Court denied the plaintiffs' motion for reconsideration of that order. The Durant III case is closed.

The second suit, *Adair et al*. v *State of Michigan et al*. (Adair), asserts that the State, by operation of law, has increased the level of various specified activities and services beyond that which was required by State law as of December 23, 1978 and, after December 23, 1978, added various specified new activities or services by State law, including mandatory increases in student instruction time, without providing funding for these new activities and services, all in violation of the Headlee Amendment.

The Adair plaintiffs are seeking a declaratory judgment that the State has failed to meet its funding responsibility under the Headlee Amendment to provide the plaintiff school districts with revenues sufficient to pay for the necessary increased costs of activities and services first required by State law after December 23, 1978, and to pay for increases in the level of required activities and services beyond that which was required by State law as of December 23, 1978.

On April 23, 2002, the Court of Appeals dismissed the plaintiffs' complaint in Adair in its entirety and with prejudice. The Court held that all of the Adair plaintiffs were barred from prosecuting all but one of their claims by either the doctrine of res judicata or the principle of release. With regard to the remaining recordkeeping claim, the Court held that this is not a new activity or an

increase in the level of a State-mandated activity within the meaning of the Headlee Amendment. The Adair plaintiffs filed an application for leave to appeal and a motion for immediate consideration of the application for leave to appeal in the Michigan Supreme Court on May 14, 2002. The Michigan Supreme Court granted the Adair plaintiffs' application for leave to appeal. Oral argument in the Supreme Court was held on October 14, 2003. The ultimate disposition of the Adair litigation is not presently determinable.

State Education Tax - Personal Property Assessments: The Michigan Department of Treasury estimated that, as of September 30, 2003, there were potential tax tribunal decisions that could have resulted in additional school aid payments for prior years in the amount of $208.5 million. These decisions relate to the personal property tax table depreciation schedule. Because this is still a pending liability and was not due and payable at September 30, 2003, it was not recorded within the School Aid Fund under the modified accrual basis of accounting; however, it was recorded in the government-wide statements, presented in the *SOMCAFR*, in accordance with GAAP as applicable to governments. These balances are also reflected in the financial table in Note 14 of the *SOMCAFR*.

Note 5 Commitments

Donald Durant, et al. v *State of Michigan, et al.*: In an order dated June 10, 1997 and a decision rendered July 31, 1997, the Michigan Supreme Court decided, in the consolidated cases of *Durant* v *State of Michigan* and *Schmidt* v *State of Michigan*, that the special education, special education transportation, bilingual education, driver training, and school lunch programs provided by local school districts are State-mandated programs within the meaning of Article IX, Section 29 of the State Constitution (part of the Headlee Amendment); therefore, the State is obligated to fund these programs at the levels established by the Headlee Amendment. In fashioning a remedy in this case of first impression under the Headlee Amendment, the Court concluded that, in future cases, the correct remedy will typically be limited to a declaratory judgment. However, because of the protracted nature of the *Durant* and *Schmidt* litigation, the Court ruled that the 84 plaintiff school districts should be compensated for the full amount of the underfunding without interest for the State-mandated programs during the 1991-92, 1992-93, and 1993-94 school years.

On November 19, 1997, the Governor signed legislation providing $212 million to the 84 plaintiff school districts to cover the underfunding for those three years. Most of the $212 million was paid to the plaintiff school districts on April 15, 1998, through the State School Aid Act of 1979, using funds transferred from the State's Counter-Cyclical Budget and Economic Stabilization Fund to the School Aid Fund. The board of education of each plaintiff school district determined the appropriate distribution of the award between taxpayer relief and/or use by the district for other public purposes. The Court affirmed the award to the plaintiffs of their costs, including attorney fees. Over 400 other school districts asserted claims similar to those asserted by the Durant plaintiffs.

In companion legislation signed by the Governor on November 19, 1997, the State will pay each "non-Durant" school district for its underfunded State-mandated program costs for those same three years if the district agreed by March 2, 1998 to waive any claim against the State of the same nature made by the 84 Durant plaintiffs through September 30, 1997. All of the non-Durant school districts signed waivers on or before March 2, 1998. The payments have been and will continue to be paid through the State School Aid Act of 1979, using funds transferred to the School Aid Fund from the Counter-Cyclical Budget and Economic Stabilization Fund and the General Fund. The payments are paid half in annual payments over 10 years and half in annual payments over 15 years. Eligible non-Durant school districts were allowed to borrow and issue bonds for the amount they were to receive over 15 years. Although the School Aid Fund has no legal liability to pay the debt service costs for school districts issuing bonds, the School Aid Fund has paid and will continue to pay an additional amount for the related debt service costs as long as sufficient funds are appropriated. As a result of a refinancing of these bonds, there will be no debt service payment for fiscal years 2002-03, 2003-04, and 2004-05. The estimated aggregate payments to the non-Durant school districts will total approximately $754.2 million. As of September 30, 2003, the remaining expected amount to be paid to the non-Durant school districts totals approximately $437.4 million.

Note 6 Judgments

In a series of orders from 1967 through 1983, the U.S. District Court for the Western District of Michigan and the U.S. Court of Appeals for the Sixth District ordered the State to pay certain amounts of the cost of various comprehensive

programs for the Benton Harbor Area School District. Payments of approximately $3.0 million in fiscal year 2002-03 and $2.1 million in fiscal year 2001-02 were made from the School Aid Fund.

Note 7 Treasurer's Common Cash

The State Treasurer manages the State's common cash pool, which is used by most State funds. The pooling of cash allows the State Treasurer to invest money not needed to pay immediate obligations so that investment earnings on available cash are maximized. Investments of the pool are not segregated by fund. Each contributing fund's balance is treated as equity in the pool, which is recorded in separate accounts within the General Fund. Many funds, including retirement funds, use their equity in the pool as a short-term investment vehicle. In the *SOMCAFR,* the pooled cash is not reported as a separate fund. Each fund's balance in the pool is reported on the line "Equity in common cash." All negative balances in the pool are reclassified at year-end as interfund liabilities, with the appropriate fund recording the receivable. This reclassification resulted in a liability of approximately $1.2 billion for fiscal year 2002-03 and $614.6 million for fiscal year 2001-02 in the School Aid Fund.

Note 8 Taxes

Revenues of the School Aid Fund consist primarily of sales, personal income, property, use, cigarette, liquor, industrial and commercial facilities, and casino gaming wagering taxes. Collections of these taxes are the responsibility of other State departments. In general, taxes receivable represent amounts due to the State at September 30 that were received by the State within approximately 60 days after that date. Sales and use taxes are accrued to the extent that the related sales occurred prior to October 1 and the State receives tax payments prior to December 1. Annual tax payments (those paid with an annual return, such as personal income taxes) have not been accrued because they are neither reasonably estimable nor available.

Delinquent taxes are recognized to the extent that they will be collected within 12 months. The following taxes were due to the School Aid Fund:

Schedule of Current Taxes Receivable
As of September 30
(In Thousands)

	2003	2002
Total taxes receivable	$1,923,357	$1,499,510
Less allowance for uncollectible receivables	(338,837)	(270,336)
Less taxes to be received more than 12 months after fiscal year-end	(46,317)	(49,972)
Current taxes receivable	$1,538,203	$ 1,179,202

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SUPPLEMENTAL
FINANCIAL SCHEDULE

DEPARTMENT OF EDUCATION
Schedule of Expenditures of Federal Awards (Note 1)
For the Period October 1, 2001 through September 30, 2003

Federal Agency/Program or Cluster	*CFDA** Number	Pass-Through Identification Number	For the Fiscal Year Ended September 30, 2002 Directly Expended	Distributed to Subrecipients	Total Expended and Distributed
Financial Assistance					
U.S. Department of Agriculture					
Child Nutrition Cluster:					
Direct Programs:					
School Breakfast Program	10.553		$	$ 42,421,619	$ 42,421,619
National School Lunch Program	10.555			164,236,989	164,236,989
Special Milk Program for Children	10.556			909,240	909,240
Total Child Nutrition Cluster			$ 0	$ 207,567,848	$ 207,567,848
Emergency Food Assistance Cluster:					
Direct Program:					
Emergency Food Assistance Program (Administrative Costs)	10.568		$ 438,132	$ 872,244	$ 1,310,376
Total Emergency Food Assistance Cluster (Note 2)			$ 438,132	$ 872,244	$ 1,310,376
Direct Programs:					
Child and Adult Care Food Program	10.558		$ 17,349	$ 46,299,958	$ 46,317,307
State Administrative Expenses for Child Nutrition	10.560		3,631,887		3,631,887
Commodity Supplemental Food Program	10.565		66,617	4,249,214	4,315,831
Team Nutrition Grants	10.574			360,596	360,596
Total Direct Programs			$ 3,715,853	$ 50,909,768	$ 54,625,621
Total U.S. Department of Agriculture			**$ 4,153,985**	**$ 259,349,860**	**$ 263,503,845**
U.S. Department of Defense					
Direct Program					
Contract for Defense Activity for Non-Traditional Education Support	12.N3569701MD**		$ 37,904	$	$ 37,904
Total U.S. Department of Defense			**$ 37,904**	**$ 0**	**$ 37,904**
U.S. Department of Education					
Special Education Cluster:					
Direct Programs:					
Special Education - Grants to States	84.027		$ 9,640,476	$ 200,738,179	$ 210,378,655
Special Education - Preschool Grants	84.173		192,228	12,207,322	12,399,550
Total Special Education Cluster			$ 9,832,704	$ 212,945,501	$ 222,778,205
Direct Programs:					
Title I Grants to Local Educational Agencies	84.010		$ 3,147,713	$ 350,423,547	$ 353,571,260
Migrant Education - State Grant Program	84.011		308,911	9,221,707	9,530,618
Title I Program for Neglected and Delinquent Children	84.013			245,965	245,965
Media and Captioning Services for Individuals with Disabilities	84.026		16,986		16,986
Immigrant Education	84.162		9,632	1,499,663	1,509,295
Special Education - Grants for Infants and Families with Disabilities	84.181		442,318	12,151,644	12,593,962
Safe and Drug-Free Schools and Communities - State Grants	84.186		178,744	13,003,571	13,182,315
Bilingual Education Support Services	84.194		99,126		99,126
Education for Homeless Children and Youth	84.196		217,138	1,152,077	1,369,215
Even Start - State Educational Agencies	84.213		321,916	6,002,027	6,323,943
Fund for the Improvement of Education	84.215		52,859	208,352	261,211
Capital Expenses	84.216			53,287	53,287
Foreign Language Assistance	84.249			(412)	(412)
Goals 2000 - State and Local Education Systemic Improvement Grants	84.276		1,250,844	13,709,114	14,959,958
Eisenhower Professional Development State Grants	84.281		895,292	15,590,475	16,485,767
Charter Schools	84.282		152,679	7,449,921	7,602,600
Twenty-First Century Community Learning Centers	84.287		36,888		36,888
Foreign Language Assistance	84.293		60,817		60,817
Innovative Education Program Strategies	84.298		1,707,346	11,544,737	13,252,083
Even Start - Statewide Family Literacy Program	84.314		218,108		218,108
Education Technology State Grants	84.318		553,724	17,000,028	17,553,752

This schedule continued on next page.

For the Fiscal Year Ended September 30, 2003			Total Expended and Distributed for the Two-Year Period
Directly Expended	Distributed to Subrecipients	Total Expended and Distributed	
$	$ 41,416,746	$ 41,416,746	$ 83,838,365
	165,995,549	165,995,549	330,232,538
	802,901	802,901	1,712,141
$ 0	$ 208,215,196	$ 208,215,196	$ 415,783,044
$ 261,961	$ 1,846,571	$ 2,108,532	$ 3,418,908
$ 261,961	$ 1,846,571	$ 2,108,532	$ 3,418,908
$ 357,038	$ 47,588,939	$ 47,945,977	$ 94,263,284
3,816,596		3,816,596	7,448,483
127,418	4,258,345	4,385,763	8,701,594
	195,129	195,129	555,725
$ 4,301,052	$ 52,042,413	$ 56,343,465	$ 110,969,086
$ 4,563,013	**$ 262,104,180**	**$ 266,667,193**	**$ 530,171,038**
$ 75,024	$	$ 75,024	$ 112,928
$ 75,024	**$ 0**	**$ 75,024**	**$ 112,928**
$ 12,530,509	$ 244,555,559	$ 257,086,068	$ 467,464,723
201,565	12,845,516	13,047,081	25,446,631
$ 12,732,074	$ 257,401,075	$ 270,133,149	$ 492,911,354
$ 3,966,546	$ 367,712,145	$ 371,678,691	$ 725,249,951
275,301	8,842,514	9,117,815	18,648,433
	548,106	548,106	794,071
952		952	17,938
	313,467	313,467	1,822,762
392,089	13,411,121	13,803,210	26,397,172
269,336	11,535,846	11,805,182	24,987,497
76		76	99,202
114,465	1,450,186	1,564,651	2,933,866
363,658	8,686,891	9,050,549	15,374,492
79,482	195,608	275,090	536,301
	15,220	15,220	68,507
		0	(412)
31,444	807,797	839,241	15,799,199
679,698	6,686,885	7,366,583	23,852,350
191,316	3,920,091	4,111,407	11,714,007
365,037	2,188,863	2,553,900	2,590,788
(6)		(6)	60,811
1,510,987	12,365,788	13,876,775	27,128,858
198,888		198,888	416,996
747,877	9,930,252	10,678,129	28,231,881

DEPARTMENT OF EDUCATION
Schedule of Expenditure of Federal Awards (Note 1)
For the Period October 1, 2001 through September 30, 2003
Continued

Federal Agency/Program or Cluster	*CFDA** Number	Pass-Through Identification Number	For the Fiscal Year Ended September 30, 2002 Directly Expended	Distributed to Subrecipients	Total Expended and Distributed
Special Education - State Program Improvement Grants for Children with Disabilities	84.323		$	$ 733,237	$ 733,237
Advance Placement Program	84.330		836,846		836,846
Comprehensive School Reform Demonstration	84.332		324,980	7,004,335	7,329,315
Class Size Reduction	84.340			78,008,890	78,008,890
Title I Accountability Grants	84.348			2,202,120	2,202,120
School Renovation Grants	84.352		70,980	866,571	937,551
Reading First State Grants	84.357		83,725		83,725
Rural Education	84.358				0
English Language Acquisition Grants	84.365				0
Improving Teacher Quality State Grants	84.367				0
Grants for State Assessments and Related Activities	84.369				0
Contract with National Center for Education Statistics	84.RN94136023**		22,779		22,779
Total Direct Programs			$ 11,010,351	$ 548,070,856	$ 559,081,207
Total U.S. Department of Education			**$ 20,843,055**	**$ 761,016,357**	**$ 781,859,412**
U.S. Department of Health and Human Services					
Direct Programs:					
Refugee and Entrant Assistance - Discretionary Grants	93.576		$ 28,942	$ 1,509,386	$ 1,538,328
Cooperative Agreements to Support Comprehensive School Health Programs to Prevent the Spread of HIV and Other Important Health Problems	93.938		600,708	326,621	927,329
Total Direct Programs			$ 629,650	$ 1,836,007	$ 2,465,657
Pass-Through Program:					
Michigan Family Independence Agency					
Child Care and Development Block Grant	93.575	93.575	$ 48,538	$ 1,569,545	$ 1,618,083
Total U.S. Department of Health and Human Services			**$ 678,188**	**$ 3,405,552**	**$ 4,083,740**
Corporation for National and Community Service					
Direct Program:					
Learn and Serve America - School and Community Based Programs	94.004		$ 170,026	$ 513,168	$ 683,194
Total Corporation for National and Community Service			**$ 170,026**	**$ 513,168**	**$ 683,194**
Total Financial Assistance			$ 25,883,158	$ 1,024,284,937	$ 1,050,168,095
Nonfinancial Assistance					
U.S. Department of Agriculture					
Emergency Food Assistance Cluster:					
Direct Program:					
Emergency Food Assistance Program (Food Commodities)	10.569		$	$ 12,596,258	$ 12,596,258
Total Emergency Food Assistance Cluster (Note 2)			$ 0	$ 12,596,258	$ 12,596,258
Direct Programs:					
Food Donation	10.550		$	$ 24,215,302	$ 24,215,302
Commodity Supplemental Food Program	10.565			18,050,089	18,050,089
Total Direct Programs			$ 0	$ 42,265,391	$ 42,265,391
Total U.S. Department of Agriculture			**$ 0**	**$ 54,861,649**	**$ 54,861,649**
Total Nonfinancial Assistance			$ 0	$ 54,861,649	$ 54,861,649
Total Expenditures of Federal Awards			$ 25,883,158	$ 1,079,146,586	$ 1,105,029,744

* *CFDA* is defined as *Catalog of Federal Domestic Assistance*.

** *CFDA* number not available. Number derived from federal agency number and contract number.

The accompanying notes are an integral part of this supplemental financial schedule.

For the Fiscal Year Ended September 30, 2003			Total Expended and Distributed for the Two-Year Period
Directly Expended	Distributed to Subrecipients	Total Expended and Distributed	
$	$ 639,810	$ 639,810	$ 1,373,047
471,484		471,484	1,308,330
416,562	9,267,080	9,683,642	17,012,957
	9,878,321	9,878,321	87,887,211
	4,254,616	4,254,616	6,456,736
144,017	41,800,919	41,944,936	42,882,487
2,063,666	8,174,875	10,238,541	10,322,266
65,770	1,370,273	1,436,043	1,436,043
139,672	1,279,912	1,419,584	1,419,584
1,037,483	84,321,114	85,358,597	85,358,597
113,622	5,850,708	5,964,330	5,964,330
5,136		5,136	27,915
$ 13,644,558	$ 615,448,408	$ 629,092,966	$ 1,188,174,173
$ 26,376,632	**$ 872,849,483**	**$ 899,226,115**	**$ 1,681,085,527**
$ 24,092	$ 765,399	$ 789,491	$ 2,327,819
642,633	377,455	1,020,088	1,947,417
$ 666,725	$ 1,142,854	$ 1,809,579	$ 4,275,236
$	$	$ 0	$ 1,618,083
$ 666,725	**$ 1,142,854**	**$ 1,809,579**	**$ 5,893,319**
$ 165,122	$ 620,773	$ 785,895	$ 1,469,089
$ 165,122	**$ 620,773**	**$ 785,895**	**$ 1,469,089**
$ 31,846,516	$ 1,136,717,290	$ 1,168,563,806	$ 2,218,731,901
$	$ 13,050,207	$ 13,050,207	$ 25,646,465
$ 0	$ 13,050,207	$ 13,050,207	$ 25,646,465
$	$ 26,136,294	$ 26,136,294	$ 50,351,596
	16,546,809	16,546,809	34,596,898
$ 0	$ 42,683,103	$ 42,683,103	$ 84,948,494
$ 0	**$ 55,733,310**	**$ 55,733,310**	**$ 110,594,959**
$ 0	$ 55,733,310	$ 55,733,310	$ 110,594,959
$ 31,846,516	$ 1,192,450,600	$ 1,224,297,116	$ 2,329,326,860

Notes to the Schedule of Expenditures of Federal Awards

Note 1 Basis of Presentation

This schedule includes the federal grant activity of the Department of Education and is presented on the modified accrual basis of accounting. The information in this schedule is presented in accordance with the requirements of U.S. Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. In certain programs, financed entirely by the federal government, expenditures and related revenues are recognized only to the extent of billings received by fiscal year-end. This treatment understates assets and liabilities and expenditures and revenues; however, there is no impact on the fund balance of the State's General Fund or the School Aid Fund.

Note 2 Emergency Food Assistance Cluster

The Emergency Food Assistance Cluster is made up of financial assistance (*CFDA* 10.568) totaling $1.3 million and $2.1 million and nonfinancial assistance (*CFDA* 10.569) valued at $12.6 million and $13.1 million as of September 30, 2002 and September 30, 2003, respectively.

Note 3 Reporting Entity

During fiscal year 2001-02, all federal expenditures and related awards, with the exception of the U.S. Department of Education's Special Education - Grants to States, were reported in the State's General Fund. The Special Education - Grants to States were reported in the School Aid Fund, a special revenue fund.

In fiscal year 2002-03, the majority of federal grants were reported in the School Aid Fund. Administrative federal expenses were reported in the State's General Fund and the U.S. Department of Education's Class Size Reduction; Goals 2000 - State and Local Education System Improvement; Eisenhower Professional Development; and School Renovation Grants were reported in the State's General Fund.

INDEPENDENT AUDITOR'S REPORTS ON COMPLIANCE AND INTERNAL CONTROL

STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

Independent Auditor's Report on Compliance and on Internal Control Over Financial Reporting

April 2, 2004

Mr. Thomas D. Watkins Jr., Chairperson
State Board of Education
Hannah Building
Lansing, Michigan

Dear Mr. Watkins:

We have audited the financial schedules and financial statements of the Department of Education for the fiscal years ended September 30, 2003 and September 30, 2002, as identified in the table of contents, and have issued our reports thereon dated April 2, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Department's financial schedules and financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial schedule and financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Department's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial schedules and financial statements and not to provide assurance on internal control over financial reporting. Our consideration of internal control over financial reporting would not necessarily disclose all matters in internal control over financial reporting that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that

misstatements caused by error or fraud in amounts that would be material in relation to the financial schedules and financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the State Board of Education, the State's management, the Legislature, federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

Sincerely,

Thomas H. McTavish, C.P.A.
Auditor General

STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

Independent Auditor's Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133

April 2, 2004

Mr. Thomas D. Watkins Jr., Chairperson
State Board of Education
Hannah Building
Lansing, Michigan

Dear Mr. Watkins:

Compliance

We have audited the compliance of the Department of Education with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement that are applicable to each major federal program for the two-year period ended September 30, 2003. The Department's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each major federal program is the responsibility of the Department's management. Our responsibility is to express an opinion on the Department's compliance based on our audit.

Except as discussed in the following paragraph, we conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations.* Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to in the previous paragraph that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Department's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does

not provide a legal determination of the Department's compliance with those requirements.

As described in Finding 3 in the accompanying schedule of findings and questioned costs, we were unable to obtain sufficient documentation to satisfy ourselves as to the Department's compliance with the Special Education Cluster's reporting requirement, nor were we able to satisfy ourselves as to the Department's compliance with those requirements by other auditing procedures.

As described in Findings 2 through 6 in the accompanying schedule of findings and questioned costs, the Department did not comply with requirements regarding reporting that are applicable to its Food Donation Program and with requirements regarding subrecipient monitoring that are applicable to its Special Education Cluster, Eisenhower Professional Development State Grants, Charter Schools, and Class Size Reduction Programs. Compliance with such requirements is necessary, in our opinion, for the Department to comply with the requirements applicable to those programs.

In our opinion, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding the Department's compliance with the requirements of the Special Education Cluster's reporting requirements and except for the noncompliance described in the previous paragraph, the Department of Education complied, in all material respects, with the requirements referred to in the fourth previous paragraph that are applicable to each major federal program for the two-year period ended September 30, 2003. The results of our auditing procedures also disclosed other instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs in Findings 7 through 13.

Internal Control Over Compliance

The management of the Department is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the Department's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control over compliance that, in our judgment, could adversely affect the Department's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. The reportable

conditions are described in the accompanying schedule of findings and questioned costs in Findings 2 through 13.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of internal control over compliance would not necessarily disclose all matters in internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions identified in the previous paragraph, we consider Findings 2 through 6 to contain material weaknesses.

This report is intended solely for the information and use of the State Board of Education, the State's management, the Legislature, federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

Sincerely,

Thomas H. McTavish, C.P.A.
Auditor General

SCHEDULE OF FINDINGS
AND QUESTIONED COSTS

Section I: Summary of Auditor's Results

Financial Schedules

Type of auditor's report issued:	Unqualified*
Internal control* over financial reporting:	
Material weaknesses* identified?	No
Reportable conditions* identified that are not considered to be material weaknesses?	None reported
Noncompliance material to the financial schedules?	No

Financial Statements

Type of auditor's report issued:	Unqualified
Internal control over financial reporting:	
Material weaknesses identified?	No
Reportable conditions identified that are not considered to be material weaknesses?	None reported
Noncompliance material to the financial statements?	No

Federal Awards

Internal control over major programs:	
Material weaknesses identified?	Yes
Reportable conditions identified that are not considered to be material weaknesses?	Yes

Type of auditor's report issued on compliance for major programs:

Unqualified for all major programs except for Food Donation, Special Education Cluster, Eisenhower Professional Development State Grants, Charter Schools, and Class Size Reduction, which are qualified*.

* *See glossary at end of report for definition.*

Any audit findings disclosed that are required to be reported in accordance with U.S. Office of Management and Budget (OMB) Circular A-133, Section 510(a)? Yes

Identification of major programs:

CFDA Number	Name of Federal Program or Cluster
10.550	Food Donation
10.553, 10.555, and 10.556	Child Nutrition Cluster
84.027 and 84.173	Special Education Cluster
84.181	Special Education - Grants for Infants and Families with Disabilities
84.186	Safe and Drug-Free Schools and Communities - State Grants
84.281	Eisenhower Professional Development State Grants
84.282	Charter Schools
84.298	Innovative Education Program Strategies
84.318	Education Technology State Grants (Technology Literacy Challenge Fund Grants)
84.340	Class Size Reduction
84.348	Title I Accountability Grants
84.352	School Renovation Grants
84.357	Reading First State Grants

84.367	Improving Teacher Quality State Grants
84.369	Grants for State Assessments and Related Activities
93.575	Child Care and Development Block Grant

Dollar threshold used to distinguish between type A and type B programs: $6,987,981

Auditee qualified as a low-risk auditee*? No

Section II: Findings Related to the Financial Schedules and Financial Statements

FINDING (310401)

1. Act 272 Compliance

The Department's internal auditor did not perform all of the duties and functions required by Section 18.1486(4) of the *Michigan Compiled Laws* (a section of Act 272, P.A. 1986). As a result, the Department's programs may be subject to increased risk of noncompliance, fraud, and/or abuse.

Section 18.1486(4) of the *Michigan Compiled Laws* requires the internal auditor to conduct audits of the Department's financial activities, review the Department's programs and operations for efficiency, recommend policies for the Department's operations to prevent and detect fraud and abuse, and review and recommend activities designed to ensure compliance with directives of the Office of Financial Management, Department of Management and Budget.

Our review disclosed that the internal auditor had conducted only one limited financial audit related to the Department's year-end closing process for the fiscal year ended September 30, 2001. Our review also disclosed that the internal auditor had not reviewed the Department's programs and operations for efficiency or formally reviewed or recommended activities designed to ensure compliance with directives of the Office of Financial Management.

* *See glossary at end of report for definition.*

The Department's internal auditor had other assigned duties, including pupil membership audits and subrecipient* monitoring of certified public accountant audits.

RECOMMENDATION

We recommend that the Department's internal auditor perform all of the duties and functions required by Section 18.1486(4) of the *Michigan Compiled Laws* (a section of Act 272, P.A. 1986).

Section III: Findings and Questioned Costs* Related to Federal Awards

FINDING 310402

2. Food Donation, *CFDA* 10.550

U.S. Department of Agriculture	*CFDA* 10.550: Food Donation
Award Number: Not Applicable	Award Period: Not Applicable
	Questioned Costs: $0

The Department's internal control did not ensure that the Food Donation Program complied with federal laws and regulations regarding reporting. Our review disclosed material weaknesses in internal control and material noncompliance with federal laws and regulations regarding reporting.

Noncompliance with federal laws and regulations could result in sanctions, disallowances, and/or future reductions of Food Donation awards.

The U.S. Department of Agriculture (USDA) donated commodities worth approximately $50.4 million to the Department for the two-year period ended September 30, 2003. We reviewed the four semiannual reports (FNS-155 reports) and the supporting warehouse inventory records for the period December 2001 through June 2003.

* *See glossary at end of report for definition.*

Our exception, by compliance area, is as follows:

Reporting

The Department's internal control was not effective in ensuring compliance with federal reporting. Title 7, Part 250, section 17(a) of the *Code of Federal Regulations (CFR)* requires the Department to complete and submit a semiannual FNS-155 report regarding excessive inventories of donated food. Federal regulation 7 *CFR* 250.14(f) specifies that inventory levels of donated foods in storage should not exceed a six-month supply unless sufficient justification has been submitted to and approved by the USDA. The USDA uses excess inventory data to identify potential overordering or mishandling of USDA donated commodities and to evaluate the ordering procedures. Failure to include all the required information in the report could result in the USDA's inability to identify potential inventory problems.

The warehouse inventory records for the periods ended December 2001 and December 2002 identified 28 and 13 commodities with excess inventories, respectively. However, the Department's semiannual FNS-155 reports for the same periods reported only 4 and 1 of the commodities with excess inventories, respectively.

RECOMMENDATION

We recommend that the Department improve its internal control to ensure that the Food Donation Program complies with federal laws and regulations regarding reporting.

FINDING 310403

3. Special Education Cluster, *CFDA* 84.027 and 84.173

U.S. Department of Education	*CFDA* 84.027 and 84.173: Special Education Cluster
Award Number: H027A010110, H173A010117	Award Period: 07/01/2001- 09/30/2002
	Questioned Costs: $3,359,069

The Department's internal control did not ensure that the Special Education Cluster complied with federal laws and regulations regarding reporting and subrecipient

monitoring. Our review disclosed material weaknesses in internal control resulting in an audit scope limitation for reporting.

Noncompliance with federal laws and regulations could result in sanctions, disallowances, and/or future reductions of Special Education Cluster awards.

Special Education Cluster expenditures totaled approximately $492.9 million for the two-year period ended September 30, 2003. Subrecipients of federal awards included local educational agencies (LEAs), other State departments, nonprofit organizations, and private companies. We reviewed the Department's subrecipient monitoring activities for all subrecipients for the two-year period. In addition, we reviewed the special education student and personnel count data reports required to be submitted during our audit period.

Our exceptions, by compliance area, are as follows:

a. Reporting

The Department's internal control was not effective in ensuring compliance over federal reporting for the Special Education Cluster. As a result, we could not obtain sufficient documentation to verify the accuracy of the special education student and personnel count data reported to the U.S. Department of Education (USDOE).

Federal regulations 34 *CFR* 300.750 - 300.751 require each state to complete a count of students ages 3 through 21 residing in the state who are receiving special education and related services as of December 1 of each year. The count data is due to the USDOE's Office of Special Education Programs (OSEP) by February 1 of each year. OSEP uses the data to prepare an annual report to the U.S. Congress regarding the effectiveness of state and local efforts to provide a free and appropriate public education to children with disabilities and to provide early intervention services to infants and toddlers with disabilities who would be at risk of having substantial developmental delays if early intervention services were not provided to them. In addition, the Department allocates certain special education funds to LEAs based on these student counts.

During our audit period, the Department used the Michigan Compliance Information System (MiCIS) database, developed by an outside vendor, to collect student and personnel record counts from the LEAs.

Our review disclosed:

(1) The Department did not ensure that the student and personnel count data contained in MiCIS was accurate and complete. As a result, the Department may have reported inaccurate student and personnel counts to the USDOE and may have miscalculated grant allocations to individual school districts. We noted:

(a) The vendor that developed the MiCIS database had unrestricted access to the student and personnel count data in MiCIS, thus compromising the integrity of the data. The Department obtained the count data directly from the vendor; however, the Department could not verify that the data reconciled with what the school districts had originally entered into MiCIS.

(b) The Department changed federal handicap codes, educational setting codes, exit reason codes, and ethnicity codes during the process of preparing the USDOE reports. This coding manipulation increases the risk that data reporting errors could occur. The Department allowed LEAs to report count data in a format inconsistent with the federal reporting requirements, thereby making the coding changes necessary.

(c) The Department did not reconcile the number of special education students reported in MiCIS with special education student data reported in the Single Record Student Database (SRSD) maintained by the Center for Educational Performance and Information. As a result, district grant allocations may have been incorrectly calculated. We compared special education student record counts in MiCIS as of February 20, 2003 to special education student records in SRSD as of February 15, 2003. We identified a difference of 5,474 records between the two databases.

(2) The Department did not submit special education data to the USDOE by the required deadline. The Department is required to report the number of children who are receiving special education and related services to the USDOE by February 1 of each year. During fiscal years 2002-03 and 2001-02, the USDOE allowed the Department to submit a portion of the report by February 1 and the remainder of the report by the following November 1. We noted that the Department's February 1, 2003 and November 1, 2003 reports were submitted 54 and 95 days late, respectively. Further, we were not able to determine when the Department submitted the report that was due February 1, 2002.

b. Subrecipient Monitoring

The Department did not obtain reasonable assurance that federal awards distributed to subrecipients of the Special Education Cluster were used for authorized purposes in compliance with laws, regulations, and provisions of contracts or grant agreements, as required by OMB Circular A-133, Section 400(d)(3). As a result, we questioned costs in the amount of $3,359,069.

Our review disclosed:

(1) The Department did not reduce the allocations of districts that had not complied with the federal maintenance of effort requirement. Our review disclosed that the Department identified 13 LEAs that did not meet their maintenance of effort requirement by a total of $3,359,069 during fiscal year 2001-02. Federal regulation 34 *CFR* 300.231 requires LEAs to expend local funds for the education of children with disabilities greater than or equal to the level of those expenditures provided for the preceding fiscal year. Federal regulation 34 *CFR* 300.197 requires the state educational agency (SEA) to reduce or not provide any further payments to any LEA in noncompliance with this requirement until the SEA is satisfied that the LEA is complying with the requirement.

(2) The Department did not ensure that subrecipients submitted final narrative progress reports for each grant and did not document that program staff reviewed the progress reports to ensure that project goals were met. The two-year subrecipient grant application states that a final narrative report is due at the end of the two-year grant period for Part B

flow-through grants and at the end of the 12-month grant period for mandated activities projects.

We reviewed progress reports for 10 of the 57 LEAs that received Part B flow-through funding during the two-year period ended September 30, 2003. We noted that 2 (20%) of the 10 LEAs did not submit the final narrative report for the grant period ended September 30, 2003.

We also reviewed progress reports for 7 of the 14 mandated activities projects for the two-year period ended September 30, 2003. The 7 mandated activities projects involved 9 subrecipients in 2002-03 and 13 subrecipients in 2001-02. We noted that 3 (33%) of the 9 and 5 (38%) of the 13 subrecipients did not submit the final narrative report in fiscal years 2002-03 and 2001-02, respectively.

(3) The Department did not adequately document program fiscal reviews. We reviewed the supporting documentation for 10 (53%) of the 19 program fiscal reviews performed during fiscal year 2001-02. We could not determine that the Department reviewed all program fiscal review objectives during these reviews. The Special Education Grants Manual explains what a program fiscal review is and identifies specific objectives that should be evaluated during each review.

RECOMMENDATION

We recommend that the Department improve its internal control to ensure that the Special Education Cluster complies with federal laws and regulations regarding reporting and subrecipient monitoring.

FINDING 310404

4. Eisenhower Professional Development State Grants, *CFDA* 84.281

U.S. Department of Education	*CFDA* 84.281: Eisenhower Professional Development State Grants
Award Number: S281A010022, S281B010022	Award Period: 07/01/2001 - 09/30/2002
	Questioned Costs: $100,533

The Department's internal control did not ensure that the Eisenhower Professional Development State Grants (Eisenhower Professional Development) Program complied with federal laws and regulations regarding subrecipient monitoring. Our review disclosed material weaknesses in internal control and material noncompliance with federal laws and regulations regarding subrecipient monitoring.

Noncompliance with federal laws and regulations could result in sanctions or disallowances of Eisenhower Professional Development awards.

The Department distributed approximately $15.6 million of the $16.5 million total program expenditures to Eisenhower Professional Development subrecipients in fiscal year 2001-02. Subrecipients of the Program included LEAs, which received approximately $13.5 million, and institutions of higher education (IHEs), which received approximately $1.0 million. We reviewed final expenditure reports for 16 of the 384 LEAs that received fiscal year 2001-02 grant funds to determine if the LEAs had met the 33% matching requirement. Additionally, we reviewed the Department's subrecipient monitoring activities for all subrecipients in fiscal year 2001-02.

Our exceptions, by compliance area, are as follows:

Subrecipient Monitoring

The Department's internal control was not effective in ensuring compliance regarding subrecipient monitoring. As a result, we questioned costs in the amount of $100,533. OMB Circular A-133, Section 400(d)(3), requires the Department to monitor the activities of subrecipients to ensure that federal awards are used for authorized purposes in compliance with laws, regulations, and provisions of contracts or grant agreements. Also, OMB Circular A-133, Section 400(d)(7), requires the Department to require each subrecipient to permit the pass-through entity and auditors to have access to the records and financial statements as necessary.

Our review disclosed:

(1) The Department did not ensure that the subrecipients of the Eisenhower Professional Development Program complied with the Program's matching requirement in fiscal year 2001-02. Section 2209 of the

Elementary and Secondary Education Act (Title 20, Section 6649 of the *Code of Laws of the United States (USC)*) requires LEAs to provide not less than 33% of the cost of the program, excluding the cost of services provided to private school teachers.

The Department reviewed the LEAs' applications to ensure that the LEAs intended to provide sufficient local funds to meet the matching requirement. However, the Department did not review the LEAs' final expenditure reports to determine that the LEAs had actually expended at least 33% in local matching funds. Our review of final expenditure reports for 16 LEAs that had received Eisenhower Professional Development Program funds in fiscal year 2001-02 noted that 10 (63%) of the LEAs had not met the 33% matching requirement. The total amount paid to these 10 LEAs was $100,533.

Although fiscal year 2001-02 was the last award year for the Eisenhower Professional Development Program, the essence of the Program was combined into the Improving Teacher Quality Program that began in fiscal year 2002-03.

(2) The Department did not obtain reasonable assurance that federal awards passed through to subrecipients were used for authorized purposes in compliance with laws, regulations, and provisions of contracts or grant agreements.

The Department reviewed subrecipient program budgets for allowable activities and costs for both LEAs and IHEs, and the Department performed on-site monitoring of the LEAs. The Department did not perform on-site monitoring of the IHEs; did not reconcile LEAs' or IHEs' final expenditure reports with the approved budgets; did not monitor the subrecipients' draws to ensure that they were for reimbursement and 30-day cash needs only, in compliance with cash management requirements; and did not notify the IHEs of their responsibility to retain and provide access to records and financial statements to the Department and other auditors. In addition, the Department placed reliance on the subrecipients' Single Audits to monitor the use of federal funds. However, our review of the Federal Clearinghouse database noted that only 23% of the Eisenhower Professional Development Program's total

payments to subrecipients for fiscal years 2002-03 and 2001-02 were audited as major program expenditures in the subrecipients' Single Audits.

RECOMMENDATIONS

We recommend that the Department improve its internal control to ensure that the Eisenhower Professional Development State Grants Program complies with federal laws and regulations regarding subrecipient monitoring.

We also recommend that the Department require the LEAs that did not meet their matching requirement to return the $100,533 to the Department.

FINDING 310405

5. Charter Schools, *CFDA* 84.282

U.S. Department of Education	*CFDA* 84.282: Charter Schools
Award Number: S282A010007 S282A010007-02	Award Period: 08/01/2001 - 07/31/2002 10/01/2002 - 09/30/2003
	Questioned Costs: $98,818

The Department's internal control did not ensure that the Charter Schools Program complied with federal laws and regulations regarding activities allowed or unallowed and subrecipient monitoring. Our review disclosed material weaknesses in internal control and material noncompliance with federal laws and regulations regarding subrecipient monitoring.

Noncompliance with federal laws and regulations could result in sanctions, disallowances, and/or future reductions of Charter Schools awards.

Expenditures for the Charter Schools Program totaled approximately $11.7 million for the two-year period ended September 30, 2003. For 20 Charter Schools grantees, we tested 42 expenditures totaling approximately $3.4 million for activities allowed or unallowed. Additionally, we reviewed the subrecipient monitoring activities for all grantees in fiscal years 2002-03 and 2001-02.

Our exceptions, by compliance area, are as follows:

a. Activities Allowed or Unallowed

The Department's internal control was not effective in ensuring compliance regarding activities allowed or unallowed for the Charter Schools Program. As a result, we questioned costs in the amount of $98,818:

(1) The Department approved budgets and expenditures for implementation grants that included $10,068 of unallowable costs for field trips. Part B, Subpart 1, Section 5204(f)(3)(B) of the No Child Left Behind Act of 2001 states that Charter Schools Program implementation grants are to be used for initial implementation of the charter school, which may include (i) informing the community about the school; (ii) acquiring necessary equipment and educational materials and supplies; (iii) acquiring or developing curriculum materials; and (iv) other initial operational costs that cannot be met from State or local sources. Field trip costs were specifically included in a U.S. Department of Education list of unallowable costs for implementation grants.

(2) The Department approved budgets and expenditures for dissemination grants that included $88,750 of unallowable costs for curriculum mapping, assessment software, conference attendance, and curriculum development. Part B, Subpart 1, Section 5204(f)(6)(B) of the No Child Left Behind Act of 2001 states that Charter Schools Program dissemination grants are to be used by the grantee to assist other schools in adapting the charter school's program (or certain aspects of the charter school's program) or to disseminate information about the charter school.

b. Subrecipient Monitoring

The Department's internal control was not effective in ensuring compliance with OMB Circular A-133 for the Charter Schools Program. OMB Circular A-133, Section 400(d)(3), requires the Department to monitor the activities of subrecipients to ensure that federal awards are used for authorized purposes in compliance with laws, regulations, and provisions of contracts or grant agreements. Our review of the Department's subrecipient monitoring activities noted that the Department did not ensure that federal awards passed through to subrecipients were used for authorized purposes in compliance with laws, regulations, and provisions of contracts or grant agreements.

The Department had not performed any on-site reviews of its Charter Schools subrecipients. It had relied solely on the subrecipients' Single Audits to monitor the use of federal funds. The Department distributed approximately $11.3 million to 59 Charter Schools subrecipients in fiscal years 2002-03 and 2001-02. We determined that 40 of the 59 Charter Schools subrecipients expended less than $300,000 of federal funds and, therefore, were not required to obtain a Single Audit. These 40 subrecipients received Charter Schools grant funds of nearly $6.0 million in fiscal years 2002-03 and 2001-02. Also, our review of the Federal Clearinghouse database noted that only 30% of the Charter Schools Program's total payments to subrecipients for fiscal years 2002-03 and 2001-02 were audited as major program expenditures in the subrecipients' Single Audits.

RECOMMENDATION

We recommend that the Department improve its internal control to ensure that the Charter Schools Program complies with federal laws and regulations regarding activities allowed or unallowed and subrecipient monitoring.

FINDING 310406

6. Class Size Reduction, *CFDA* 84.340

U.S. Department of Education	*CFDA* 84.340: Class Size Reduction
Award Number: S340A010023, S340A010023A	Award Period: 07/01/2001 - 09/30/2002
	Questioned Costs: $0

The Department's internal control did not ensure that the Class Size Reduction Program complied with federal laws and regulations regarding subrecipient monitoring. Our review disclosed material weaknesses in internal control and material noncompliance with federal laws and regulations regarding subrecipient monitoring.

Noncompliance with federal laws and regulations could result in sanctions or disallowances of Class Size Reduction awards.

The Department distributed 100% of its $87.9 million of total program expenditures to Class Size Reduction subrecipients in fiscal years 2001-02 and 2002-03.

Subrecipients of the Program were LEAs. We reviewed the Department's subrecipient monitoring activities for all subrecipients in fiscal year 2001-02.

Our exception, by compliance area, is as follows:

Subrecipient Monitoring

The Department's internal control was not effective in ensuring compliance regarding subrecipient monitoring. OMB Circular A-133, Section 400(d)(3), requires the Department to monitor the activities of subrecipients to ensure that federal awards are used for authorized purposes in compliance with laws, regulations, and provisions of contracts or grant agreements.

The Department reviewed subrecipient program budgets for allowable activities and costs. However, the Department did not reconcile final expenditure reports to the approved budget; did not monitor the subrecipients' draws to ensure that they were for reimbursement and 30-day cash needs only, in compliance with cash management requirements; and did not perform on-site reviews of the subrecipients to ensure that federal awards were used for allowable activities and costs. In addition, the Department placed reliance on the subrecipients' Single Audits to monitor the use of federal funds. However, our review of the Federal Clearinghouse database noted that only 10% of the Class Size Reduction Program's total payments to subrecipients for fiscal years 2002-03 and 2001-02 were audited as major program expenditures in the subrecipients' Single Audits.

Although fiscal year 2001-02 was the last award year for the Class Size Reduction Program, the essence of the Program was combined into the Improving Teacher Quality Program that began in fiscal year 2002-03.

RECOMMENDATION

We recommend that the Department improve its internal control to ensure that the Class Size Reduction Program complies with federal laws and regulations regarding subrecipient monitoring.

FINDING 310407

7. Cash Management

U.S. Department of Education	*CFDA* 84.181: Special Education - Grants for Infants and Families with Disabilities
Award Number: H181A010012 H181A020012	Award Period: 07/01/2001 - 09/30/2002 07/01/2002 - 09/30/2003
	Questioned Costs: $0

U.S. Department of Education	*CFDA* 84.281: Eisenhower Professional Development State Grants
Award Number: S281A010022, S281B010022	Award Period: 07/01/2001 - 09/30/2002
	Questioned Costs: $0

U.S. Department of Education	*CFDA* 84.318: Education Technology State Grants
Award Number: S318X010022 S318X020022A	Award Period: 10/01/2000 - 09/30/2001 10/01/2001 - 09/30/2003
	Questioned Costs: $0

U.S. Department of Education	*CFDA* 84.340: Class Size Reduction
Award Number: S340A10023A	Award Period: 07/01/2001 - 09/30/2002
	Questioned Costs: $0

U.S. Department of Education	*CFDA* 84.348: Title I Accountability Grants
Award Number: S348A000022 S348A010022	Award Period: 07/01/2000 - 09/30/2001 07/01/2001 - 09/30/2002
	Questioned Costs: $0

U.S. Department of Education	*CFDA* 84.352: School Renovation Grants
Award Number: S352A010023	Award Period: 07/01/2001 - 09/30/2004
	Questioned Costs: $0

U.S. Department of Education	*CFDA* 84.367: Improving Teacher Quality State Grants
Award Number: S367A020021A, S367B020019	Award Period: 07/01/2001 - 09/30/2003
	Questioned Costs: $0

The Department's internal control did not ensure compliance with federal cash management requirements. Section 8.6.2 of the Cash Management Improvement Act agreement and federal regulation 31 *CFR* 205.15 indicate that the Department could be at risk of incurring interest liability for funds received that do not comply with federal cash management requirements.

Federal regulation 31 *CFR* 205.11 requires the Department to minimize the time elapsing between the transfer of funds from the U.S. Department of Treasury and the Department's payout of funds for federal assistance program purposes. The federal regulation also requires the Department to limit the amount of funds transferred to the minimum required to meet its actual and immediate cash needs. In addition, the Departments' grant request instructions for its subrecipients indicate that grant award requests are to be for reimbursement of expenditures and 30-day cash needs only. Further, federal regulation 34 *CFR* 80.20(b)(7) indicates that the pass-through entity must monitor cash drawdowns by its subrecipients to ensure that the subrecipients conform to the same standards of timing and amount as apply to the pass-through entity itself.

The Department did not evaluate the timeliness of the subrecipients' draws. The Department's subrecipients request reimbursement through the Grants Cash Management System. We determined that subrecipients can request and receive reimbursement of their total grant award amount in one request. Also, we were informed by most of the program staff they do not monitor the subrecipients' draws or do not document their monitoring of the subrecipients' draws. Without knowing whether subrecipients minimize the time elapsing between their payment and reimbursement of program expenditures, the Department cannot ensure that its own requests for reimbursements are within the cash management requirements.

RECOMMENDATION

We recommend that the Department improve its internal control to ensure compliance with federal cash management requirements.

FINDING 310408

8. Child Nutrition Cluster, *CFDA* 10.553, 10.555, and 10.556

U.S. Department of Agriculture	*CFDA* 10.553, 10.555, and 10.556: Child Nutrition Cluster
Award Number: Not Applicable	Award Period: Not Applicable
	Questioned Costs: $0

The Department's internal control did not ensure that the Child Nutrition Cluster complied with federal laws and regulations regarding subrecipient monitoring.

Noncompliance with federal laws and regulations could result in sanctions, disallowances, and/or future reductions of Child Nutrition Cluster awards.

Federal expenditures of the Child Nutrition Cluster totaled approximately $415.8 million for the two-year period ended September 30, 2003. We reviewed the Department's subrecipient monitoring activities for all grantees for the two-year period.

Our exception, by compliance area, is as follows:

Subrecipient Monitoring

The Department's process for tracking and scheduling review dates for subrecipients of the Child Nutrition Cluster did not ensure that all school food authorities (SFAs) received the required coordinated reviews. Failure to properly monitor SFAs through the required coordinated reviews could potentially result in federal funds being provided for children who are not eligible, for meals that are not actually served, or for meals that do not meet required nutritional standards. OMB Circular A-133, Section 400(d)(3), requires the Department to monitor the activities of subrecipients to ensure that federal awards are used for authorized purposes in compliance with laws, regulations, and provisions of contracts or grant agreements. Additionally, federal regulation 7 *CFR* 210.18(c)(1) requires the Department to conduct an on-site coordinated review of every SFA at least once every 6 years.

The Department contracts with SFAs to assist in providing low cost, nutritious meals to children. SFAs consist of public and private schools and residential child care facilities. As of November 2003, the Department had contracts with

922 SFAs throughout Michigan. The Department distributed approximately $178.6 million and $170.4 million in federal funds to these SFAs in fiscal years 2002-03 and 2001-02, respectively.

Our review noted that 10 of the 922 SFAs were not included in the database used to track and schedule coordinated reviews. We examined the review histories for the 10 SFAs and found that 2 SFAs had not received a coordinated review in the last 6 years, and there was no evidence that coordinated reviews had ever been conducted for 3 other SFAs. A total of $134,874 and $106,320 in federal funds were distributed to the 5 SFAs in fiscal years 2002-03 and 2001-02, respectively.

The Department relied on Single Audits of the subrecipients to help meet its subrecipient monitoring requirement. However, our review of the Federal Clearinghouse database noted that only 41% of the Child Nutrition Cluster's total payments to subrecipients for fiscal years 2002-03 and 2001-02 were audited as major program expenditures in the subrecipients' Single Audits.

RECOMMENDATION

We recommend that the Department improve its internal control to ensure that the Child Nutrition Cluster complies with federal laws and regulations regarding subrecipient monitoring.

FINDING 310409

9. Special Education - Grants for Infants and Families with Disabilities, *CFDA* 84.181

U.S. Department of Education	*CFDA* 84.181: Special Education - Grants for Infants and Families with Disabilities
Award Number: H181A010012 H181A020012	Award Period: 07/01/2001 - 09/30/2002 07/01/2002 - 09/30/2003
	Questioned Costs: $0

The Department's internal control did not ensure that the Special Education - Grants for Infants and Families with Disabilities (Early-On) Program complied with federal laws and regulations regarding reporting and subrecipient monitoring.

Noncompliance with federal laws and regulations could result in sanctions, disallowances, and/or future reductions of Early-On awards.

Expenditures for the Early-On Program totaled $26.4 million for the two-year period ended September 30, 2003. We reviewed the Department's subrecipient monitoring activities for all subrecipients for the two-year period.

Our exceptions, by compliance area, are as follows:

a. Reporting

The Department did not submit special education student and personnel count data to the USDOE's Office of Special Education Programs (OSEP) by the required deadlines. OSEP requires the Department to report Part C child count data by February 1 each year and to report non-child count data by the following November 1. OSEP uses the data to prepare an annual report to the U.S. Congress regarding the effectiveness of state and local efforts to provide a free and appropriate public education to children with disabilities and to provide early intervention services to infants and toddlers with disabilities who would be at risk of having substantial developmental delays if early intervention services were not provided to them. We noted that 2 (50%) of the 4 required reports for fiscal years 2002-03 and 2001-02 were submitted 26 and 3 days late, respectively.

b. Subrecipient Monitoring

The Department did not obtain reasonable assurance that federal awards passed through to subrecipients of the Early-On Program were used for authorized purposes in compliance with laws, regulations, and provisions of contracts or grant agreements. OMB Circular A-133, Section 400(d)(3), requires the Department to monitor the activities of subrecipients to ensure that federal awards are used for authorized purposes in compliance with laws, regulations, and provisions of contracts or grant agreements. Our review disclosed:

(1) The Department did not document that subrecipients' final expenditure reports reconciled with the final approved grant budgets. Our review disclosed that the Department did not document its review of 12 (100%) of 12 and 13 (100%) of 13 final expenditure reports to the final approved grant budgets for fiscal years 2002-03 and 2001-02, respectively. A

comparison of the final expenditures to the final approved grant budgets would help ensure that federal awards are used for authorized purposes.

(2) The Department did not monitor subrecipients' cash draws to ensure that they were for reimbursement and 30-day cash needs only, in compliance with cash management requirements. The Department had reviewed the cash draw reports for other purposes; however, it had discarded the reports after one week, leaving no audit trail. The Department should utilize available cash management reports to help ensure that subrecipients minimize the time elapsing between the transfer of federal funds from the recipient and the payout of funds for program purposes. The Department also should maintain documentation to show that the cash management reports were reviewed.

(3) The Department did not always monitor annual progress reports for each subrecipient. Our review disclosed that the Department did not receive 12 (92%) of 13 and 1 (8%) of 13 progress reports for fiscal years 2002-03 and 2001-02, respectively. In addition, we noted that the Department did not document its review of the progress reports that were received. By requiring submission and review of the annual progress reports, the Department can determine whether subrecipients fulfilled project goals.

(4) The Department did not adequately document program fiscal reviews. We reviewed the supporting documentation for 7 (37%) of the 19 program fiscal reviews performed during fiscal year 2001-02. We could not determine that the Department reviewed all program fiscal reviews objectives during these reviews. The Special Education Grants Manual explains what a program fiscal review is and identifies specific objectives that should be evaluated during each review.

The Department relied on Single Audits of the subrecipients to help meet its subrecipient monitoring requirement. However, our review of the Federal Clearinghouse database noted that only 27% of the Early-On Program's total payments to subrecipients for fiscal years 2002-03 and 2001-02 were audited as major program expenditures in the subrecipients' Single Audits.

RECOMMENDATION

We recommend that the Department improve its internal control to ensure that the Special Education - Grants for Infants and Families with Disabilities (Early-On) Program complies with federal laws and regulations regarding reporting and subrecipient monitoring.

FINDING 310410

10. Education Technology State Grants, *CFDA* 84.318

U.S. Department of Education	*CFDA* 84.318: Education Technology State Grants
Award Number: S318X010022 S318X020022A	Award Period: 10/01/2000 - 09/30/2001 10/01/2001 - 09/30/2003
	Questioned Costs: $0

The Department's internal control did not ensure that the Education Technology State Grants Program (formerly named Technology Literacy Challenge Fund) complied with federal laws and regulations regarding subrecipient monitoring.

Noncompliance with federal laws and regulations could result in sanctions, disallowances, and/or future reductions of Enhancing Education Through Technology awards.

Expenditures for the Education Technology State Grants Program totaled $28.2 million for the two-year period ended September 30, 2003. We reviewed the Department's subrecipient monitoring activities for all subrecipients for the two-year period.

Our exception, by compliance area, is as follows:

Subrecipient Monitoring

The Department did not obtain reasonable assurance that federal awards passed through to subrecipients of the Education Technology State Grants Program were used for authorized purposes in compliance with laws, regulations, and provisions of contracts or grant agreements. OMB Circular A-133, Section 400(d)(3), requires the Department to monitor the activities of subrecipients to ensure that federal awards are used for authorized purposes

in compliance with laws, regulations, and provisions of contracts or grant agreements. The Department distributed approximately $9.9 million and $17.0 million of the total program expenditures to subrecipients in fiscal years 2002-03 and 2001-02, respectively.

The Department reviewed grantees' applications to ensure that budgets included only costs for activities allowed. However, the Department either did not review or did not document its review of subrecipients' final expenditure reports to ensure that expenditures reconcile to the approved budgets. Our review also noted that the Department did not monitor the weekly draws by subrecipients to ensure that draws were for reimbursement and 30-day cash needs only, in compliance with cash management requirements. In addition, the Department relied on Single Audits of the subrecipients to help meet its subrecipient monitoring requirement. However, our review of the Federal Clearinghouse database noted that only 27% of the Education Technology State Grants Program's total payments to subrecipients for fiscal years 2002-03 and 2001-02 were audited as major program expenditures in the subrecipients' Single Audits.

RECOMMENDATION

We recommend the Department improve its internal control to ensure that the Education Technology State Grants Program complies with federal laws and regulations regarding subrecipient monitoring.

FINDING 310411

11. Title I Accountability Grants, *CFDA* 84.348

U.S. Department of Education	*CFDA* 84.348: Title I Accountability Grants
Award Numbers: S348A000022 S348A010022	Award Period: 07/01/2000 - 09/30/2001 07/01/2001 - 09/30/2002
	Questioned Costs: $0

The Department's internal control did not ensure that the Title I Accountability Grants Program complied with federal laws and regulations regarding subrecipient monitoring.

Noncompliance with federal laws and regulations could result in sanctions, disallowances, and/or future reductions of Title I Accountability awards.

Expenditures for the Title I Accountability Grants Program totaled $6.5 million for the two-year period ended September 30, 2003. We reviewed the Department's subrecipient monitoring activities for all subrecipients for the two-year period.

Our exception, by compliance area, is as follows:

Subrecipient Monitoring

The Department did not obtain reasonable assurance that federal awards passed through to subrecipients of the Title I Accountability Grants Program were used for authorized purposes in compliance with laws, regulations, and provisions of contracts or grant agreements. OMB Circular A-133, Section 400(d)(3), requires the Department to monitor the activities of subrecipients to ensure that federal awards are used for authorized purposes in compliance with laws, regulations, and provisions of contracts or grant agreements. In addition, OMB Circular A-133, Section 400(d)(1), requires the Department to identify federal awards made by informing each subrecipient of the *CFDA* title and number, award name and number, award year, and name of the federal agency.

The Department distributed approximately $4.3 million and $2.2 million to Title I Accountability Grants Program subrecipients in fiscal years 2002-03 and 2001-02, respectively. Our review determined that the Department reviewed subrecipient program budgets for allowable activities and costs and performed on-site reviews. However, the Department did not reconcile subrecipients' final expenditure reports to their approved budgets and did not monitor the subrecipients' draws to ensure that they were for reimbursement and 30-day cash needs only, in compliance with cash management requirements. Also, the Department relied on Single Audits of the subrecipients to help meet its subrecipient monitoring requirement. However, our review of the Federal Clearinghouse database noted that only 11% of the Title I Accountability Grants Program's total payments to subrecipients for fiscal years 2002-03 and 2001-02 were audited as major program expenditures in the subrecipients' Single Audits.

RECOMMENDATION

We recommend that the Department improve its internal control to ensure that the Title I Accountability Grants Program complies with federal laws and regulations regarding subrecipient monitoring.

FINDING 310412

12. School Renovation Grants, *CFDA* 84.352

U.S. Department of Education	*CFDA* 84.352: School Renovation Grants
Award Number: S352A010023	Award Period: 07/02/2001 - 09/30/2004
	Questioned Costs: $0

The Department's internal control did not ensure that the School Renovation Grants Program complied with federal laws and regulations regarding subrecipient monitoring.

Noncompliance with federal laws and regulations could result in sanctions, disallowances, and/or future reductions of School Renovation awards.

Expenditures for the School Renovation Grants Program totaled $42.9 million for the two-year period ended September 30, 2003. We reviewed the Department's subrecipient monitoring activities for all subrecipients for the two-year period.

Our exception, by compliance area, is as follows:

Subrecipient Monitoring

The Department did not obtain reasonable assurance that federal awards passed through to subrecipients of the School Renovation program were used for authorized purposes in compliance with laws, regulations, and provisions of contracts or grant agreements. OMB Circular A-133, Section 400(d)(3), requires the Department to monitor the activities of subrecipients to ensure that federal awards are used for authorized purposes in compliance with laws, regulations, and provisions of contracts or grant agreements. Also, OMB Circular A-133, Section 400(d)(7), requires the Department to require each subrecipient to permit the pass-through entity and auditors to have access to the records and financial statements as necessary.

The Department distributed approximately $41.8 million and $0.9 million to School Renovation subrecipients in fiscal years 2002-03 and 2001-02, respectively.

Our review determined that the Department reviewed subrecipient program budgets for allowable activities and costs, performed on-site monitoring of subrecipients, and conducted program training. However, the Department did not reconcile final expenditure reports to approved budgets; did not monitor subrecipients' cash draws to ensure that they were for reimbursement and 30-day cash needs only, in compliance with cash management requirements; and did not inform the subrecipients of their responsibility to permit the Department and other auditors to have access to records and financial statements as necessary.

Also, the Department relied on Single Audits of the subrecipients to help meet its subrecipient monitoring requirement. However, our review of the Federal Clearinghouse database noted that only 49% of the School Renovation Grants Program's total payments to subrecipients for fiscal years 2002-03 and 2001-02 were audited as major program expenditures in the subrecipients' Single Audits.

RECOMMENDATION

We recommend that the Department improve its internal control to ensure that the School Renovation Grants Program complies with federal laws and regulations regarding subrecipient monitoring.

FINDING 310413

13. Improving Teacher Quality State Grants, *CFDA* 84.367

U.S. Department of Education	*CFDA* 84.367: Improving Teacher Quality State Grants
Award Number: S367A020021A, S367B020019	Award Period: 07/01/2002 - 09/30/2003
	Questioned Costs: $7,794

The Department's internal control did not ensure that the Improving Teacher Quality State Grants (Improving Teacher Quality) Program complied with federal laws and regulations regarding subrecipient monitoring.

Noncompliance with federal laws and regulations could result in sanctions, disallowances, and/or future reductions of Improving Teacher Quality awards to the Department.

The Department distributed approximately $84.3 million of the $85.4 million total program expenditures to Improving Teacher Quality subrecipients in fiscal year 2001-02. Subrecipients of the Program included LEAs, which received approximately $83.5 million, and IHEs, which received approximately $0.5 million. We reviewed the 10 LEAs that the Department had determined had failed to meet the maintenance of effort requirement. Additionally, we reviewed the Department's subrecipient monitoring activities for all grantees in fiscal year 2002-03.

Our exceptions, by compliance area, are as follows:

Subrecipient Monitoring

The Department needs to improve internal control over subrecipient monitoring for the Improving Teacher Quality Program. As a result, we questioned costs in the amount of $7,794:

(1) The Department did not reduce allocations for LEAs that failed to meet the maintenance of effort requirement.

Federal law 20 *USC* 7901(b) requires the SEA to reduce the amount of the allocation of funds in any fiscal year in the exact proportion by which the LEA failed to meet the maintenance of effort requirements. Federal law 20 *USC* 7901(a) requires that LEAs may receive funds only if the SEA finds that either the combined fiscal effort per student or the aggregate expenditures of the LEA from state and local funds for free public education by such agency for the preceding fiscal year was not less than 90% of the combined fiscal effort or aggregate expenditures for the second preceding fiscal year.

Due to the timing of financial data submitted by the LEAs, allocation reductions made by the Department for fiscal year 2002-03 are based on fiscal year 2000-01 maintenance of effort calculations. The Department identified 10 LEAs that had been allocated Improving Teacher Quality grants in fiscal year 2002-03 that had failed to meet the maintenance of effort requirement in fiscal year 2000-01. However, the Department had

not reduced these LEAs' fiscal year 2002-03 Improving Teacher Quality allocations. In total, the Department should have reduced these allocations by $36,716. Through September 30, 2003, the Department had not distributed $28,922 of the reduced allocation amount. As a result, we questioned costs of $7,794.

(2) The Department did not obtain reasonable assurance that federal awards passed through to subrecipients of the Improving Teacher Quality Program were used for authorized purposes in compliance with laws, regulations, and provisions of contracts or grant agreements.

OMB Circular A-133, Section 400(d)(3), requires the Department to monitor the activities of subrecipients to ensure that federal awards are used for authorized purposes in compliance with laws, regulations, and provisions of contracts or grant agreements. Also, OMB Circular A-133, Section 400(d)(7), requires the Department to require each subrecipient to permit the pass-through entity and auditors to have access to the records and financial statements as necessary for the pass-through entity's own records.

The Department performed on-site monitoring of the LEAs and plans to perform on-site monitoring of the IHEs beginning in spring 2004. In addition, the Department reviewed subrecipient program budgets for allowable activities and costs. The Department did not reconcile final expenditure reports to the approved budget and did not monitor the weekly draws by the subrecipients to ensure that draws were for reimbursement and 30-day cash needs only, in compliance with cash management requirements. In addition, the IHEs were not notified of their responsibility to retain and provide access to records and financial statements to Department and other auditors.

The Department relied on Single Audits of the LEAs to help meet its subrecipient monitoring requirement. However, our review of the Federal Clearinghouse database noted that only 51% of the Improving Teacher Quality Program's total payments to subrecipients for fiscal years 2002-03 and 2001-02 were audited as major program expenditures in the subrecipients' Single Audits.

RECOMMENDATIONS

We recommend that the Department improve its internal control to ensure that the Improving Teacher Quality State Grants Program complies with federal laws and regulations regarding subrecipient monitoring.

We also recommend that the Department reduce the fiscal year 2002-03 Improving Teacher Quality State Grants Program allocations for the 10 LEAs that the Department had determined had failed to meet the maintenance of effort requirement in fiscal year 2000-01.

We further recommend that the Department recover the $7,794 from the LEAs that had been overpaid.

OTHER SCHEDULES

DEPARTMENT OF EDUCATION
Summary Schedule of Prior Audit Findings
As of September 30, 2003

PRIOR AUDIT FINDINGS RELATED TO THE FINANCIAL SCHEDULES

There were no findings related to the financial schedules in the prior Single Audit.

PRIOR AUDIT FINDINGS RELATED TO FEDERAL AWARDS

Audit Findings That Have Been Fully Corrected:

Audit Period: October 1, 1999 through September 30, 2001
Finding Number: 310201
Finding Title: Cash Management

Finding: The Department of Education's internal control did not ensure that interest amounts due to the federal government for repayments received from subrecipients were calculated in accordance with the State/federal Cash Management Improvement Act (CMIA) agreement and did not report exceptions to the Michigan Department of Treasury.

Comments: Even prior to the audit citation, cash management practices had been improved significantly. Additional control measures were put into place in May 2002. In addition, information relating to the refunds from which the schedule of questioned costs was based was submitted to the Cash and Debt Management Unit of the Michigan Department of Treasury for inclusion in the 2002 Cash Management Improvement Act settlement/negotiation.

Audit Period: October 1, 1999 through September 30, 2001
Finding Number: 310203
Finding Title: Child Care and Development Block Grant Eligibility

Finding: The Department's internal control did not ensure that School Age Child Care Program and Low Income, Three-Year-Old Child at Risk of School Failure Program grant applicants and recipients complied with appropriate child care licensing regulations.

Comments: The Office of School Excellence has recovered funds from grantees that were unable to complete the child care licensing process as required by the grant funding source.

Audit Period: October 1, 1999 through September 30, 2001
Finding Number: 310204
Finding Title: Title I Overallocation

Finding: The Department did not recover Title I funds that were overallocated to a local educational agency.

Comments: This finding resulted from maintenance of effort reduction to a local educational agency's Title I allocation that was not adjusted in the Department's grant system. The Office of Field Services has implemented a new step to verify that these adjustments are made.

Audit Period: October 1, 1999 through September 30, 2001
Finding Number: 310205
Finding Title: Migrant Education Students Served

Finding: The Department did not amend its annual Migrant Education Program performance report to report actual students served for school years 1997-98 and 1998-99.

Comments: The Department implemented new procedures to report actual student counts beginning in school year 1999-2000. The Department was advised by the U.S. Department of Education that amended reports for prior years would not be accepted.

Audit Findings Not Corrected or Partially Corrected:

Audit Period: October 1, 1999 through September 30, 2001
Finding Number: 310202
Finding Title: Subrecipient Monitoring

Finding: The Department's internal control did not ensure that all Class Size Reduction Program and Charter Schools Program subrecipients were monitored as required.

Comments: The Class Size Reduction Program, which was initiated and funded for three years through the annual education appropriations process, was eliminated as a separate program beginning with the 2002-03 school year. The new Title II, Part A Program, which permits the use of funds to reduce class size, is included in the Office of Field Services' on-site review process.

The Public School Academy Program, responsible for the federal Charter Schools Program, has not monitored subrecipients as required. The plan to develop a protocol and checklist for completion of a desk audit was not implemented. The response provided subsequent to the audit assumed anticipated enhancement of staff resources and capacity. This did not occur and the Public School Academy Program has continued to lack the available resources to complete the level and intensity of monitoring required. Grant narrative reports for federal start-up and implementation grants are due 30 days following completion of the grant and are generally submitted in a timely manner. Narrative reports for the federal dissemination grant program are required in the middle of the grant year and 30 days following completion of the grant year. The proposed implementation of checklist and desk audit will be accomplished as future resources become available.

DEPARTMENT OF EDUCATION
Corrective Action Plan
As of June 23, 2004

FINDINGS RELATED TO THE FINANCIAL SCHEDULES AND FINANCIAL STATEMENTS

Finding Number: 310401
Finding Title: Act 272 Compliance

Management Views: We agree with the underlying intent of the recommendation but are unable to comply due to lack of resources. The Office of Audits has minimal State funds ($11,327 from The Emergency Food Assistance Program (TEFAP) match, 3% of its budget) at this time.

The Office of Audits has historically focused its resources to the areas of highest risk. The Office of Audits' first and second priorities are to provide adequate oversight of the $1.2 billion in federal assistance and $13 billion of State school aid. The Office of the Auditor General cites the Department of Education because oversight of federal assistance granted to subrecipients and State school aid payments are not internal audit activities.

In the past, as resources permitted, the Department increased time spent on its third priority, which is internal audit activities. Due to ongoing budget cuts, the Department cannot do internal audits at this time. If State funding should become available, the Department will resume internal audit activities.

Corrective Action: Not applicable

Anticipated Completion Date: Not applicable

Responsible Individual: Kathleen Weller

FINDINGS RELATED TO FEDERAL AWARDS

Finding Number: 310402
Finding Title: Food Donation, *CFDA* 10.550

Management Views: Food Distribution will adhere to all federal regulations pertaining to our program. We instituted the reporting procedure with our December 2003 semiannual report and will continue to ensure compliance.

Corrective Action: Staff did not list these products on the December report because the majority of these commodities were received in December and by the time the report was completed in February the commodities had been distributed. A process is now in place whereby staff will list every commodity that has a six-month inventory level for both the December and June reports.

Anticipated Completion Date: June 2004 - semiannual FNS-155 report

Responsible Individual: Marla J. Moss, Supervisor

Finding Number: 310403
Finding Title: Special Education Cluster, *CFDA* 84.027 and 84.173

Management Views: 3.a.(1) The Office of Special Education and Early Intervention Services (OSE/EIS) acknowledges the deficiencies in the 2000-01 and 2001-02 data collection systems. This audit reviewed the first two years of a multi-

year project. The 2003-04 version of the Michigan Compliance Information System (MiCIS) addresses this finding with the following:

3.a.(1)(a) The vendor had unrestricted access to the data because there was no other way to make the changes. For the December 2003 data collection, a tracking system was added to the software with the following key features:

- Each user was required to state the number of records being submitted for each batch, and the count was immediately checked by the system. If the counts did not match, an error message was generated and the batch was not accepted.

- Well-defined data edits are performed, users have the option to make changes on-line to the data they submitted, and reports are generated by each intermediate school district (ISD) showing the changes they made and the impact on the submitted count.

- Multiple reports are available for each district showing summary counts for each data field to ensure that the totals match the submitted counts.

- A process will be developed to track changes made by the vendor to the submitted data when necessary.

3.a.(1)(b) Written procedures in the revised Technical Manual specifically identify how the current Michigan categories crosswalk into the federal placement categories. This process was agreed to as a result of our Federal Data Audit in 2001.

3.a.(1)(c) The OSE/EIS recognizes that the number of special education students reported in the MiCIS does not reconcile with the special education student data reported in the Single Record Student Database (SRSD) as maintained by the Center for Educational Performance and Information. This reconciliation does not have relevance to the accuracy of our count for the following reasons:

- The accuracy of the special education student count reported in the MiCIS is verified by each submitting entity.

- The MiCIS and SRSD counts are taken on different dates resulting in student count variances.

- The two counts have different purposes. The December 1 count is strictly a one day snapshot count for federal Special Education reports. The SRSD has multiple pupil counts for calculations of State aid payments.

3.a.(2) The OSE/EIS agrees that the Department did not submit special education data to the USDOE by the required deadline. The OSE/EIS submitted with the 2002-03 Annual Performance Report to the Office of Special Education Programs (OSEP), U.S. Department of Education (USDOE), a timeline of activities that will allow us to collect and process the data to meet the deadlines.

3.b.(1) The OSE/EIS is not out of compliance in this finding. The 13 local educational agencies (LEAs) selected were from a list of LEAs that have potential federal maintenance of effort (MOE) concerns. The OSE/EIS has one 1.0 full-time equated Senior Auditor that is addressing all MOE concerns Statewide along with regular program fiscal reviews. The Senior Auditor is providing extensive technical assistance to the LEAs to attempt to resolve MOE concerns. In many cases, the potential MOE concerns identified are being resolved. The OSE/EIS is currently identifying LEAs that even with technical assistance will result in a MOE shortfall. The OSE/EIS has sought guidance from the USDOE's OSEP regarding the fund source to be used in repayment and continues to seek guidance within the

Department regarding the appropriate repayment procedure to implement. At such a time when the procedure is identified, the OSE/EIS will pursue repayment from those LEAs with a MOE shortfall.

3.b.(2) The OSE/EIS agrees that not all grantees submitted final narrative progress reports for the fiscal years cited. The OSE/EIS has implemented a new grant management process for fiscal year 2003-04 that ensures that all narrative reports are received, reviewed, and documented.

3.b.(3) The OSE/EIS agrees that while we are confident that appropriate program fiscal review objectives were performed, these activities were not adequately documented. The OSE/EIS will implement a checklist system that identifies and documents all program fiscal review objectives conducted.

Corrective Action:

3.a.(1)(a) Protocols are being developed that restrict the vendor's ability to make changes to submitted data without prior approval.

3.a.(1)(b) Completed - Written procedures in the revised Technical Manual specifically identify how the current Michigan categories crosswalk into the federal placement categories.

3.a.(1)(c) The OSE/EIS continues to communicate with the Center for Educational Performance and Information to coordinate data collection within the MiCIS and SRSD

for greater assurance of accuracy in both data collection systems.

3.a.(2) Completed - The OSE/EIS has developed a timeline of activities that will collect and process the data to meet deadlines.

3.b.(1) Completed

3.b.(2) Completed - The OSE/EIS has implemented a new Grant Management system that ensures that subrecipients submit final narrative progress reports and documents program staff review to ensure project goals are met.

3.b.(3) The OSE/EIS will implement a checklist system that identifies and documents all program fiscal review objectives conducted.

Anticipated Completion Date:

3.a.(1)(a)	November 30, 2004
3.a.(1)(b)	Completed
3.a.(1)(c)	Ongoing MiCIS and SRSD systems development
3.a.(2)	Completed
3.b.(1)	Completed
3.b.(2)	Completed
3.b.(3)	September 1, 2004

Responsible Individual: Jacquelyn Thompson

Finding Number: 310404

Finding Title: Eisenhower Professional Development State Grants, *CFDA* 84.281

Management Views: The LEAs that submitted final expenditure reports without including the required local match have revised and resubmitted their reports, indicating that the match requirement was met. It is the Department's view that this is adequate documentation and that the federal expenditures should not be questioned costs.

Corrective Action: The Eisenhower program has been replaced by the Title II, Part A program, which does not require a local match.

Anticipated Completion Date: Not applicable

Responsible Individual: Not applicable

Finding Number: 310405
Finding Title: Charter Schools, *CFDA* 84.282

Management Views: The Department concurs with Finding 5.a.(1) that $10,068 was awarded for unallowable costs for field trips under the federal Charter School Grant Program. Since that expenditure was approved, the Department has adhered to stricter guidelines and now requests greater detail from the academies before allowing grant expenditures. The Department has also received additional guidance from the USDOE regarding the approval of certain expenditures. We now know that field trips are an unallowable expenditure.

The Department agrees with the Office of the Auditor General's audit finding regarding the Department's approval of unallowable expenditures totaling $88,750 for dissemination grants. The unallowable expenditures include those for curriculum mapping, assessment software, conference attendance, and

curriculum development. The Department approved the first dissemination grants, awarded in 2001-02, before the USDOE provided clear guidance on the intent of the grant and the kinds of expenditures allowable. Since that time, a representative from the USDOE has provided additional clarification of the intent of the grants and of allowable expenditures. A USDOE official visited Michigan in December 2002 and provided technical assistance to Department staff and potential dissemination grant applicants. As a result, the Department now utilizes a more rigorous interpretation of allowable costs. The Department concurs that the $88,750 was awarded for unallowable costs under the dissemination grant. The Department now requests greater detail from subgrantees before allowing grant expenditures.

Corrective Action: In response to Finding 5.a.(1), the Department will no longer approve proposed expenditures for field trips and has already ceased this practice.

Regarding Finding 5.a.(2), the Department now has a more thorough understanding of the allowable expenditures permitted under Part B, Subpart 1, Section 5204 of the No Child Left Behind Act of 2001. Expenditures permitted must be justified based upon the grant proposal to assist other charter and traditional public schools, to disseminate the information concerning the project to other charter and traditional public schools and/or assist other schools with replication of the success of the recipient of the dissemination grant.

Anticipated Completion Date: Immediate: The Department has already altered its practices and no longer approves expenditures for field trips. Proposed expenditures for dissemination

grants are more scrupulously reviewed to ensure that expenditures comply with federal intent.

Responsible Individual: Greg Olszta, Public School Academy Liaison

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Finding Number: 310406
Finding Title: Class Size Reduction, *CFDA* 84.340

Management Views: The No Child Left Behind legislation combined the former Class Size Reduction and Eisenhower Professional Development Programs in the new Title II, Part A, Improving Teacher Quality Program. This Program has been monitored since its inception as part of the On-Site Review process conducted by the Department's Field Services staff. The Class Size Reduction Program was a short-term program that was not incorporated in this process.

See Exhibits 1, 2, and 3 for the Department's response to subrecipient monitoring issues.

Corrective Action: The Title II, Part A, Improving Teacher Quality Program was incorporated in the On-Site Review process immediately upon passage of the No Child Left Behind Act.

Anticipated Completion Date: Has been completed.

Responsible Individual: Linda Brown

Finding Number: 310407
Finding Title: Cash Management

Management Views: The Department does have a systematic process in place to require certification from subrecipients that

cash draws do not exceed reimbursement for expenditures and/or a 30-day cash need for each project. The Department understands the process is not 100% fail-safe; however, the Department contends that this level of control is cost-beneficial and offers significant barriers to cash management fraud.

In the grants cash management and reporting system, the authorized representative of the subrecipient must complete an electronic form certifying expenditures to date and anticipated needs for the project for the next 30 days. Each time cash draws are requested, the authorized representative must certify every active project in this manner. Therefore, if the representative mistakenly overreported expenses or 30-day cash needs during one request, the situation should be rectified at the next request. In addition, the grants cash management and reporting system will verify the amounts certified against the grant approval for each project. However, other than this check to total approval, there are not any edits to compare the values drawn against the timing of the project. That sort of analysis is done at the discretion of the program offices.

For those recipients subject to Single Audit, cash management practices are included in the compliance manual for auditors. Although the federal Compliance Supplement does not adequately address cash management requirements for subrecipients, in an effort to improve the quality of school district audits, the Department has addressed this issue in the Michigan School Auditing Manual. The Manual includes an overview of the Department's grant

system. The portion addressing cash management states:

> The Federal Cash Management Information Act requires that neither the state nor any subgrantee may accumulate interest earnings from drawing federal cash in advance of needs. MDE [Michigan Department of Education] is required by the Federal Cash Management Improvement Act (CMIA) to manage federal cash so that excess balances do not accumulate in public schools' accounts. The on-line cash request form requires school districts and other subrecipients to enter project-to-date expenditures on-line to meet this requirement.

Further, the Department has included supplemental audit requirements, which include cash management requirements, for several programs in the Michigan School Auditing Manual. These are designed to provide additional clarification above the federal Compliance Supplement. The Department believes that the certified public accountants are auditing cash management in the major programs, and that will suffice because the same control system is in place in the districts for all federal draws.

While the Department agrees that systemic measures to further compare grant draws against the timing of the projects and the approved amount would be an improvement, the value added would not be warranted given the additional costs and that the audit has not disclosed a problem with early draws. There is a lack of both monetary and human resources available to implement this improvement. The Department will not implement this change at this time because it is judged

not to be cost-beneficial. This concept will be kept under advisement for future enhancements.

Corrective Action: Not applicable

Anticipated Completion Date: Not applicable

Responsible Individual: Lori Schomisch

Finding Number: 310408

Finding Title: Child Nutrition Cluster, *CFDA* 10.553, 10.555, and 10.556

Management Views: The Department originally planned that the Filemaker database, used to track and schedule the required coordinated review effort (CRE) for subrecipients of the National School Lunch Program, would be populated annually from the MO1 payment system database. However, this was not implemented due to staff retirements.

See Exhibit 3 for the Department's response to the subrecipient monitoring issue.

Corrective Action: The Department will ensure the Filemaker database lists all participating school food authorities (SFAs) completely and accurately. On an annual basis, a list of all SFAs obtained from the most recent application information database from the Department's MO1 system will be compared to the listing of the SFAs on the Filemaker database. Any deviations between the Filemaker and the MO1 database will be corrected to ensure that all SFAs participating in the School Meals Programs are listed, tracked, and scheduled for the required CRE.

Anticipated Completion Date: Currently completed. Ongoing completion annually.

Responsible Individual: Barbara Campbell, Supervisor
School Meals Program

Finding Number: 310409

Finding Title: Special Education - Grants for Infants and Families with Disabilities, *CFDA* 84.181

Management Views:

9.a. The OSE/EIS agrees that for the two years audited (December 2001 and December 2002 collections), copies of Table 1 due to the USDOE's OSEP on February 1 were submitted late. These delays were due to implementing the processing of this data through the new MiCIS. For those collection years, all tables (Tables 2, 3, 4, and 5) were submitted to OSEP well ahead of the due date of November 1. In addition, all reports for the prior 8 years were turned in on time. So, the two late reports represent 2 (2%) out of 100 reports submitted in the last 10 years.

The OSE/EIS has implemented a process in which all federal reports will be submitted by the due dates. Table 1 representing the December 2003 collection was submitted to OSEP prior to the required date of February 1, 2004.

9.b.(1) See the Departmentwide response, *Reconciliation of Expenditure Reports to Approved Budgets*, for this finding.

9.b.(2) See the Departmentwide response, *Cash Management Practices*, for this finding.

9.b.(3) The OSE/EIS agrees that not all grantees submitted final narrative progress reports for the fiscal years cited. The OSE/EIS has implemented a new grant management process for fiscal year 2003-04 that ensures that all narrative reports are received, reviewed, and documented.

9.b.(4) The OSE/EIS agrees that while we are confident that appropriate program fiscal review objectives were performed, these activities were not adequately documented. The OSE/EIS will implement a checklist system that identifies and documents all program fiscal review objectives conducted.

See Exhibits 1, 2, and 3 for the Department's response to subrecipient monitoring issues b.(1), b.(2), and b.(3).

Corrective Action:

9.a. Completed - The OSE/EIS has developed a timeline of activities that will collect and process the data to meet deadlines.

9.b.(1) See Departmentwide response.

9.b.(2) See Departmentwide response.

9.b.(3) Completed - The OSE/EIS has implemented a new Grant Management system that ensures that subrecipients submit final narrative progress reports and documents program staff review to ensure project goals are met.

9.b.(4) The OSE/EIS will implement a checklist system that identifies and documents all program fiscal review objectives conducted.

Anticipated Completion Date: 9.a. Completed
9.b.(1) See Departmentwide response.
9.b.(2) See Departmentwide response.
9.b.(3) Completed
9.b.(4) September 1, 2004

Responsible Individual: Jacquelyn Thompson

Finding Number: 310410
Finding Title: Education Technology State Grants, *CFDA* 84.318

Management Views: See Exhibits 1, 2, and 3 for the Department's response to subrecipient monitoring issues.

Corrective Action: See Exhibit 2

Anticipated Completion Date: Summer 2004

Responsible Individual: Mary Ann Chartrand

Finding Number: 310411
Finding Title: Title I Accountability Grant, *CFDA* 84.348

Management Views: See Exhibits 1, 2, and 3 for the Department's response to subrecipient monitoring issues.

Corrective Action: See Exhibit 2

Anticipated Completion Date: Summer 2004

Responsible Individual: Linda Brown

Finding Number: 310412
Finding Title: School Renovation Grants, *CFDA* 84.352

Management Views: The School Renovation, Individuals with Disabilities Education Act (IDEA) and Technology Grant Program was a one-time offering by the USDOE. The initial award was for 27 months. However, the Department received an additional year beyond the initial award period in which to complete the grant activities. The first awards were made in approximately September 2002. The grant award period expires September 30, 2004. Although the majority of the $41 million in grant funds was awarded by September 2002, most of the funds were not drawn by the districts until late in fiscal year 2002-03. As such, much of the oversight work of the Department is only now being completed. On-site monitoring activities are occurring now on at least a weekly basis.

12.(1) Review of final expenditure reports - We agree that there was no documentation to prove that the final expenditure reports were reconciled with the final approved budget. However, the final reports were reviewed before they were filed in the grant file. Additionally, when either the final performance report was reviewed or when an on-site visit occurred, the final expenditure report was examined for accuracy and appropriateness.

12.(2) Review of 30-day cash draw - The Department actually experiences a greater problem with having grantees not draw their funds until very late into the grant period than having grantees draw funds early.

12.(3) Access to records - The Department was not denied access to any records it required during the monitoring of subrecipients.

12.(4) Monitoring requirement not met - We disagree that the monitoring requirement for this grant program was not met. In addition to the Single Audit required for some districts, all districts were subject to the Michigan-required district audit. Further, the monitoring visits were not in full implementation until only recently in order to allow districts to complete their work. Between the regular audits, the Single Audits, and the monitoring visits, we feel that we have complied with the U.S. Office of Management and Budget (OMB) Circular A-133 subrecipient monitoring requirements.

Corrective Action:

12.(1) A process is now in place whereby staff will initial the final performance reports after reviewing them and before filing them in order to document that a review for appropriate expenditures has occurred.

12.(2) Staff do have a plan in place to review draws on a monthly basis in the early stages of the grant programs, when there are relatively few requests for reimbursement. Those districts that request a proportionally larger request for funds are contacted to ascertain that the funds were appropriately requested. Additionally, each district must ensure that it is requesting funds needed within 30 days. The on-site review will also review records for compliance with the 30-day requirement.

12.(3) Even though we disagree about this being a problem, we have agreed to insert an assurance in all of our electronic grants and paper grants to which the applicants will have to

agree that they will make all such records available to auditors and monitors.

12.(4) Response same as for all other Department areas.

See Exhibits 1 and 2 for the Department's response to subrecipient monitoring issues.

Anticipated Completion Date: All corrective actions have been implemented.

Responsible Individual: Mary Ann Chartrand, Director, Grants Coordination and School Support

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Finding Number: 310413

Finding Title: Improving Teacher Quality State Grants, *CFDA* 84.367

Management Views: The failure of Department staff to reduce the Title II, Part A allocations of local school districts and academies that had not maintained effort was the result of incorrect information received early in the implementation of the No Child Left Behind legislation. The proper procedures have now been implemented. Because this was a Department error, the Department will recover funds from the affected districts and academies only if they have unobligated funds.

See Exhibits 1, 2, and 3 for the Department's response to subrecipient monitoring issues.

Corrective Action: 13.(1) Revise procedures to reduce the allocations of Title II, Part A funds to school districts and academies that fail to maintain effort.

13.(2) Recover the excess amount of Title II, Part A funds allocated to school districts and

academies that failed to maintain effort if these agencies have unobligated funds.

Anticipated Completion Date: 13.(1) Has been completed
13.(2) August 31, 2004

Responsible Individual: Linda Brown

Exhibit 1

Cash Management Practices

The Michigan Department of Education does have a systematic process in place to require certification from subrecipients that cash draws do not exceed reimbursement for expenditures and/or a 30-day cash need for each project. The Department understands the process is not 100% fail-safe; however, the Department contends that this level of control is cost-beneficial and offers significant barriers to cash management fraud.

In the grants cash management and reporting system, the authorized representative of the subrecipient must complete an electronic form certifying expenditures to date and anticipated needs for the project for the next 30 days. Each time cash draws are requested, the authorized representative must certify <u>every</u> active project in this manner. Therefore, if the representative mistakenly overreported expenses or 30-day cash needs during one request, the situation should be rectified at the next request. In addition, the grants cash management and reporting system will verify the amounts certified against the grant approval for each project. However, other than this check to total approval, there are not any edits to compare the values drawn against the timing of the project. That sort of analysis is done at the discretion of the program offices.

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> The Federal Cash Management Information Act requires that neither the state nor any subgrantee may accumulate interest earnings from drawing federal cash in advance of needs. MDE [Michigan Department of Education] is required by the Federal Cash Management Improvement Act (CMIA) to manage federal cash so that excess balances do not accumulate in public schools' accounts. The on-line cash request form requires school districts and other subrecipients to enter project-to-date expenditures on-line to meet this requirement.

Further, the Department has included supplemental audit requirements, which include cash management requirements, for several programs in the Michigan School Auditing Manual. These are designed to provide additional clarification above the federal Compliance Supplement. The Department believes that the certified public accountants are auditing cash management in the major programs, and that will suffice because the same control system is in place in the districts for all federal draws.

While the Department agrees that systemic measures to further compare grant draws against the timing of the projects and the approved amount would be an improvement, the value added would not be warranted given the additional costs and that the audit has not disclosed a problem with early draws. There is a lack of both monetary and human resources available to implement this improvement. The Department will not implement this change at this time because it is judged not to be cost-beneficial. This concept will be kept under advisement for future enhancements.

Exhibit 2

Reconciliation of Expenditure Reports to Approved Budgets

The Michigan Education Grants System is being enhanced to automatically reconcile final expenditure reports to approved budgets. Deviation reports will be forwarded to program staff for follow-up. The development has begun and will become operational after the development has been completed, tested, and released.

Exhibit 3

Risk Analysis
Subrecipient Monitoring of Federal Funds

RISK

During fiscal year 2002-03, the Department of Education expended $1,219,214,005 in federal financial and nonfinancial assistance. The Department expended $29,068,049 (2.4%) directly. The Department transferred $9,367,925 (.8%) to other State departments. The Department transferred $1,130,127,833 (92.7%) in financial assistance and $50,650,199 (4.1%) in nonfinancial assistance to non-State agencies, including school districts, colleges, universities, and nonprofit agencies.

These funds represent 10 U.S. Department of Agriculture programs, 1 U.S. Department of Defense program, 34 U.S. Department of Education programs, 2 U.S. Department of Health and Human Services programs, and 1 Commission on National Service program.

The risk is that funds transferred to other agencies will be misspent and that the Department's subrecipient monitoring system will not prevent or detect the misspending.

INTERNAL CONTROLS CURRENTLY IN PLACE

- The Department has rigorous application reviews. Depending on the type of grant, applications may be reviewed by independent reviewers. Department staff review all applications and budgets for unallowable activities.

- Final program reports and evaluations are obtained from subrecipients. Subrecipients must certify these reports for accuracy before the Department will process them.

- The Department's grants payment system will not process payments in excess of approved grant amounts.

- Based on programmatic staff's professional judgment, some program offices manually compare final expenditure reports (DS4044s) to approved budgets.

- Based on programmatic staff's professional judgment, some program staff review financial data when doing programmatic monitoring.

- The Department obtains Single Audits from all school districts meeting the federal Single Audit criteria.

- The Department obtains financial audits from all districts not required to submit Single Audits.

- The Department 1) reviews the audits to ensure that they meet audit standards, 2) follows up on findings, questioned costs, and reportable conditions, and 3) ties applicable information into the Department's records as a test of audit accuracy.

- In order to improve the quality of programmatic monitoring, audit findings related to specific programs are forwarded to the program offices for follow-up.

- In order to improve audit quality, the Department annually provides the Michigan School Auditing Manual as a supplement to the federal Compliance Supplement.

- In order to improve audit quality, the Department annually performs training of school district auditors and school district financial officials.

- In order to improve audit quality, the R7120, Grants Section Auditors Report, is annually prepared and provided to school district staff and their auditors. This report includes all federal funds flowing through the Department so that the auditors will include the programs in the scope of the districts' audits.

- As a method of improving the quality of school district audits, the Department does 2 to 5 quality control reviews of financial audits each year. The Department refers substandard auditors to the State Board of Accountancy for disciplinary action.

- As a method of improving the quality of school district audits, the Department uses the American Institute of Certified Public Accountants (AICPA) Web site to determine auditors who have potentially not met peer review requirements.

After a reasonable due process, the Department notifies the school districts involved with the auditors that it will no longer accept audits by the substandard auditors.

PLANNED CONTROLS

- Beginning with fiscal year 2003-04, the Michigan Education Grants System (MEGS) will compare expenditure detail line items to budgets and alert staff of differences.

ACCEPTABLE RISK

- The U.S. Office of Management and Budget (OMB) has determined that all subrecipients expending $500,000 must obtain Single Audits. There is no federal audit requirement for subrecipients expending less than $500,000.

- As a supplement to the federal requirement, Michigan state law requires that all public school districts submit an annual financial audit to the Department within 4.5 months after their fiscal year-end. State aid is withheld for delinquent audits.

- OMB Circular A-133, Section .520, establishes a risk-based process for determining the major programs to be audited in each Single Audit. Section .520(d)(2)(i) exempts programs smaller than $100,000 from being included in the audit rotation. This shows that the OMB wishes to focus audit resources on the larger programs. This legitimately allows programs with small grants to be "lightly audited."

- Section M of the federal A-133 Compliance Supplement which addresses subrecipient monitoring indicates, "Larger dollar awards are of greater risk."

- OMB Circular A-133 requires 50% audit coverage in general and 25% coverage for low-risk auditees. An analysis of the Federal Audit Clearinghouse indicates that $706,903,371 (59.9%) of the $1,180,778,033 passed through to non-state agencies was audited as major programs in the fiscal year 2002-03 audits (this may be understated as the Clearinghouse may not have received all data collection forms at this time). This level of audit coverage meets and exceeds the federal expectations.

- The Office of the Auditor General uses $1 million individually or $3 million collectively as its representation letter materiality threshold when obtaining representations from the Department. All subrecipient programs of $1 million are audited in the Single Audit rotation process.

CONCLUSION

- It is clear that the federal Single Audit system adopted by the U.S. Congress requires a risk-based approach and has assigned higher risk to larger dollars. The Office of the Auditor General's records show that the larger programs are more frequently audited as major programs. This meets federal expectations.

- Internal controls must be cost-beneficial. Implementing additional controls for the smaller programs is not judged to be cost beneficial, especially in light of the lack of evidence to the contrary.

- The Department's subrecipient monitoring system meets minimum federal requirements.

GLOSSARY

Glossary of Acronyms and Terms

CFDA	*Catalog of Federal Domestic Assistance.*
CFR	*Code of Federal Regulations.*
CRE	coordinated review effort.
Early-On	Special Education - Grants for Infants and Families with Disabilities.
Eisenhower Professional Development	Eisenhower Professional Development State Grants.
financial audit	An audit that is designed to provide reasonable assurance about whether the financial schedules and/or financial statements of an audited entity are fairly presented in conformity with the disclosed basis of accounting.
GAAP	generally accepted accounting principles.
IDEA	Individuals with Disabilities Education Act.
IEP	individualized education program.
IHEs	institutions of higher education.
Improving Teacher Quality	Improving Teacher Quality State Grants.
internal control	A process, effected by management, designed to provide reasonable assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

LEAs	local educational agencies.
low-risk auditee	As provided for in OMB Circular A-133, an auditee that may qualify for reduced federal audit coverage if it receives an annual Single Audit and it meets other criteria related to prior audit results. In accordance with State statute, this Single Audit was conducted on a biennial basis; consequently, this auditee is not considered a low-risk auditee.
material noncompliance	Violations of laws and regulations that could have a direct and material effect on major federal programs or on financial schedule or financial statement amounts.
material weakness	A reportable condition related to the design or operation of internal control that does not reduce to a relatively low level the risk that either misstatements caused by error or fraud in amounts that would be material in relation to the financial schedules and/or financial statements or noncompliance with applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.
MiCIS	Michigan Compliance Information System.
MOE	maintenance of effort.
OMB	U.S. Office of Management and Budget.
OSE/EIS	Office of Special Education and Early Intervention Services.
OSEP	Office of Special Education Programs.

qualified opinion An auditor's opinion in which the auditor:

a. Identifies a scope limitation or one or more instances of misstatements that impact the fair presentation of the financial schedules and/or financial statements presenting the basic financial information of the audited agency in conformity with the disclosed basis of accounting or the financial schedules presenting supplemental financial information in relation to the basic financial schedules and/or financial statements. In issuing an "in relation to" opinion, the auditor has applied auditing procedures to the supplemental financial schedules to the extent necessary to form an opinion on the basic financial schedules and/or financial statements, but did not apply auditing procedures to the extent that would be necessary to express an opinion on the supplemental financial schedules taken by themselves; or

b. Expresses reservations about the audited agency's compliance, in all material respects, with the cited requirements that are applicable to each major federal program. In issuing an "in relation to" opinion, the auditor has applied auditing procedures to the supplemental financial schedules to the extent necessary to form an opinion on the basic financial schedules and/or financial statements, but did not apply auditing procedures to the extent that would be necessary to express an opinion on the supplemental financial schedules taken by themselves.

questioned costs A cost that is questioned by the auditor because of an audit finding: (1) which resulted from a violation or possible violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the use of federal funds, including funds used to match federal funds; (2) where the costs, at the time of the

audit, are not supported by adequate documentation; or (3) where the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances.

reportable condition A matter coming to the auditor's attention relating to a significant deficiency in the design or operation of internal control that, in the auditor's judgment, could adversely affect the entity's ability to (1) record, process, summarize, and report financial data consistent with the assertions of management in the financial schedules and/or financial statements or (2) administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants.

SEA state educational agency.

SFAs school food authorities.

Single Audit A financial audit, performed in accordance with the Single Audit Act Amendments of 1996, that is designed to meet the needs of all federal grantor agencies and other financial report users. In addition to performing the audit in accordance with the requirements of auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, a Single Audit requires the assessment of compliance with requirements that could have a direct and material effect on a major federal program and the consideration of internal control over compliance in accordance with OMB Circular A-133.

SOMCAFR *State of Michigan Comprehensive Annual Financial Report.*

SRSD Single Record Student Database.

subrecipient A nonfederal entity that expends federal awards received from another nonfederal entity to carry out a federal program.

unqualified opinion An auditor's opinion in which the auditor states that:

a. The financial schedules and/or financial statements presenting the basic financial information of the audited agency are fairly presented in conformity with the disclosed basis of accounting; or

b. The financial schedules and/or financial statements presenting supplemental financial information are fairly stated in relation to the basic financial schedules and/or financial statements. In issuing an "in relation to" opinion, the auditor has applied auditing procedures to the supplemental financial schedules to the extent necessary to form an opinion on the basic financial schedules and/or financial statements, but did not apply auditing procedures to the extent that would be necessary to express an opinion on the supplemental financial schedules taken by themselves; or

c. The audited agency complied, in all material respects, with the cited requirements that are applicable to each major federal program.

USC *Code of Laws of the United States.*

USDA U.S. Department of Agriculture.

USDOE U.S. Department of Education.