FINANCIAL AUDIT
OF THE

SCHOOL AID FUND

DEPARTMENT OF EDUCATION

October 1, 1994 through September 30, 1997

31-122-97

EXECUTIVE DIGEST

SCHOOL AID FUND

INTRODUCTION	This report contains the results of our financial audit* of the School Aid Fund, Department of Education, for the period October 1, 1994 through September 30, 1997.
AUDIT PURPOSE	This financial audit was conducted as part of the constitutional responsibility of the Office of the Auditor General. Financial audits are conducted at various intervals to permit the Auditor General to express an opinion on the State's financial statements. Also, this audit complements the departmentwide financial audit.
BACKGROUND	The School Aid Fund is provided for by the State Constitution to furnish aid to school districts. Principal financing sources are various tax revenues and annual transfers from the State's General Fund and the State Lottery Fund. Payments to school districts are based on statutory formulas (the State School Aid Act*, being Sections 388.1601 - 388.1772 of the *Michigan Compiled Laws).* Annual expenditures of the School Aid Fund were approximately $8.6 billion, $8.3 billion, and $8.0 billion for fiscal years 1996-97, 1995-96, and 1994-95, respectively.

* *See glossary on page 37 for definition.*

The Department provides administrative support for the School Aid Fund, but administrative costs are not appropriated for in the Fund.

The State Aid Unit* (SAU), Office of Administrative Services, is primarily responsible for administering provisions of the State School Aid Act. SAU receives and reviews membership and taxable valuation data from school districts and from county treasurers. In addition, SAU, in conjunction with the Office of Data and Technology Services, maintains the State Aid Data System* (SADS). As of September 30, 1997, SAU had four full-time employees.

AUDIT OBJECTIVES AND CONCLUSIONS

Audit Objective: To assess the adequacy of the Department's internal control structure.

Conclusion: Our assessment of the Department's internal control structure did not disclose any material weaknesses*. However, our assessment did disclose some reportable conditions* that could have resulted in errors or irregularities that would not have been detected and corrected in the normal course of the Department's operations. These reportable conditions related to establishing SAU processing controls, improving the access controls over SADS, and improving the application controls* pertaining to SADS (Findings 1 through 3).

Audit Objective: To assess the Department's compliance with applicable statutes, the *Michigan Administrative Code*, State procedures, and Department policies and procedures that could have a material effect on the Fund's financial statements.

* *See glossary on page 37 for definition.*

Conclusion: Our assessment of the Department's compliance with laws and regulations did not disclose any instances of noncompliance that could have a material effect on the financial statements. However, the reportable conditions included under our first audit objective (Findings 1 through 3) may result in payments that are not in compliance with the State School Aid Act.

Audit Objective: To audit the Fund's financial statements as of and for the fiscal years ended September 30, 1997, September 30, 1996, and September 30, 1995.

Conclusion: We expressed an unqualified opinion on the financial statements.

AUDIT SCOPE

Our audit scope was to examine the financial and other records of the School Aid Fund for the period October 1, 1994 through September 30, 1997. Our audit was conducted in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

AGENCY RESPONSES AND PRIOR AUDIT FOLLOW-UP

Our report includes 3 findings and 5 recommendations. The Department's preliminary response indicated that it agreed with all 5 of the recommendations. In addition, the Department indicated that it had implemented corrective actions to comply with 2 of the recommendations.

The Department had complied or substantially complied with 5 of the 9 prior audit recommendations. The other 4 recommendations are repeated in this report.

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Mr. Arthur E. Ellis, Chairman
State Board of Education
Hannah Building
Lansing, Michigan

Dear Mr. Ellis:

This is our report on the financial audit of the School Aid Fund, Department of Education, for the period October 1, 1994 through September 30, 1997.

This report contains our executive digest; description of agency; audit objectives, audit scope, and agency responses and prior audit follow-up; comments, findings, recommendations, and agency preliminary responses; and independent auditor's reports on the internal control structure, on compliance with laws and regulations, and on the financial statements. This report also contains the School Aid Fund's financial statements and notes to financial statements and a glossary of acronyms and terms.

Our comments, findings, and recommendations are organized by audit objective. The agency preliminary responses were taken from the agency's responses subsequent to our audit fieldwork. 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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DEPARTMENT OF EDUCATION

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Description of Agency

The Department of Education was established under the Executive Organization Act of 1965. The Department is headed by the eight-member State Board of Education established by the 1963 State Constitution. The principal executive officer is the Superintendent of Public Instruction, who is appointed by the Board.

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 Fund's purpose is to furnish aid to school districts of the State. The 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 the sales taxes 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, and industrial and commercial facilities taxes.

Act 145, P.A. 1993, eliminated the local property tax as a source of operating revenue for public schools. A constitutional amendment, 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 are also made from the State's General Fund.

Payments to school districts are based on statutory formulas (the State School Aid Act, being Sections 388.1601 - 388.1772 of the *Michigan Compiled Laws*). The payments include a foundation allowance* for each membership reported by school districts and also funding for categorical programs* .

Beginning with fiscal year 1994-95, the Legislature annually establishes the maximum funding for State school aid payments to be provided to school districts along with corresponding appropriations from the School Aid Fund and the General Fund. If

* *See glossary on page 37 for definition.*

total appropriations are less than the payments to be made based on the State School Aid Act, then payments are to be prorated so that they equal the appropriated funding available.

Annual expenditures of the School Aid Fund were approximately $8.6 billion, $8.3 billion, and $8.0 billion for fiscal years 1996-97, 1995-96, and 1994-95, respectively. The Department provides administrative support for the School Aid Fund, but administrative costs are not appropriated for in the Fund.

The State Aid Unit (SAU), Office of Administrative Services, is primarily responsible for administering provisions of the State School Aid Act. SAU receives and reviews membership and taxable valuation data from school districts and from county treasurers. In addition, SAU, in conjunction with the Office of Data and Technology Services, maintains the State Aid Data System. As of September 30, 1997, SAU had four full-time employees.

Audit Objectives, Audit Scope, and Agency Responses and Prior Audit Follow-Up

Audit Objectives

Our financial audit of the School Aid Fund, Department of Education, had the following objectives:

1. To assess the adequacy of the Department's internal control structure.

2. To assess the Department's compliance with applicable statutes, the *Michigan Administrative Code*, State procedures, and Department policies and procedures that could have a material effect on the Fund's financial statements.

3. To audit the Fund's financial statements as of and for the fiscal years ended September 30, 1997, September 30, 1996, and September 30, 1995.

Audit Scope

Our audit scope was to examine the financial and other records of the School Aid Fund for the period October 1, 1994 through September 30, 1997. Our audit was conducted in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

Agency Responses and Prior Audit Follow-Up

Our report includes 3 findings and 5 recommendations. The Department's preliminary response indicated that it agreed with all 5 of the recommendations. In addition, the Department indicated that it had implemented corrective actions to comply with 2 of the recommendations.

The agency preliminary response which follows each recommendation in our report was taken from the agency's written comments and oral discussion subsequent to our audit fieldwork. Section 18.1462 of the *Michigan Compiled Laws* and Department of

Management and Budget Administrative Guide procedure 1280.02 require the Department of Education to develop a formal response to our audit findings and recommendations within 60 days after the release of the audit report.

The Department had complied or substantially complied with 5 of the 9 prior audit recommendations. The other 4 recommendations are repeated in this report.

COMMENTS, FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES

INTERNAL CONTROL STRUCTURE

COMMENT

Audit Objective: To assess the adequacy of the Department of Education's internal control structure.

Conclusion: Our assessment of the Department's internal control structure did not disclose any material weaknesses. However, our assessment did disclose some reportable conditions that could have resulted in errors or irregularities that would not have been detected and corrected in the normal course of the Department's operations. These reportable conditions related to establishing State Aid Unit (SAU) processing controls, improving the access controls over the State Aid Data System (SADS), and improving the application controls pertaining to SADS.

FINDING

1. Processing Controls Within SAU

The Department's internal control structure did not provide for sufficient policies and procedures to reasonably ensure that State school aid payments were processed in accordance with the State School Aid Act.

During fiscal years 1996-97, 1995-96, and 1994-95, SAU processed State school aid payments of approximately $8.7 billion, $8.2 billion, and $7.9 billion, respectively, through SADS. We reviewed the Department's internal control structure and noted the following weaknesses:

a. The Department had not developed comprehensive written procedures for all of its processing functions.

Procedure manuals had been developed in some cases but were incomplete. For example, the Department's Office of Data and Technology Services developed procedure manuals for membership data input. However, these

manuals did not instruct users on data verification processes. Comprehensive written procedures help ensure that daily and nonroutine activities are performed consistently and in accordance with the State School Aid Act. Written procedures are also useful for training new staff.

In response to a similar finding in our prior two audits, the Department agreed with our recommendation but stated that limited resources precluded its full implementation.

b. SAU did not maintain a separation of staff duties when processing certain State school aid data.

SAU staff prepared data relating to property taxable values for entry into SADS, including performing required calculations, and entered this data into SADS without proper supervisory review and approval. In addition, SAU staff entered data adjustments relating to pupil memberships into SADS without proper supervisory review and approval.

Establishing and enforcing proper separation of duties helps detect and prevent payment errors on a timely basis. In response to a similar finding in our prior three audits, the Department agreed with our recommendation but stated that limited resources precluded its implementation.

c. SAU procedures did not require supervisory staff to document their review and approval of data entered into SADS and used for generating payments.

SAU procedures require that, on a test basis, supervisory staff review school district preliminary status reports prior to authorizing the monthly payments. However, we could not determine that the required test reviews were being made. Maintaining and initialing reports used to verify the propriety of the transactions would improve SAU's processing controls.

In response to a similar finding in our prior two audits, the Department agreed with our recommendation but stated that limited resources precluded its implementation.

Because of these internal control structure weaknesses, we increased our audit testing procedures to help ensure that the School Aid Fund's financial statements were not materially misstated. Although material errors were not noted, the purpose of an internal control structure is to help ensure that material errors would be detected and corrected in the regular course of SAU operations.

RECOMMENDATIONS

To improve the internal control structure for processing data critical to computing State school aid payments, WE AGAIN RECOMMEND THAT:

(a) THE DEPARTMENT DEVELOP COMPREHENSIVE WRITTEN PROCEDURES FOR ALL OF ITS PROCESSING FUNCTIONS.

(b) SAU PROPERLY SEPARATE STAFF DUTIES TO HELP ENSURE THAT EMPLOYEES ARE NOT RESPONSIBLE FOR INCOMPATIBLE DUTIES WHEN PROCESSING STATE SCHOOL AID DATA.

(c) SAU SUPERVISORY STAFF DOCUMENT THEIR REVIEW AND APPROVAL OF THE DATA ELEMENTS AND CALCULATIONS PRIOR TO PROCESSING STATE SCHOOL AID PAYMENTS.

AGENCY PRELIMINARY RESPONSE

The Department agreed with the recommendations. The Department indicated that limited resources have had an impact on its ability to comply with Recommendation 1(a) but stated that a new staff member had been recently added to SAU, which should help address these needs in the very near future. The Department also indicated that it had implemented corrective actions to comply with Recommendations 1(b) and 1(c).

FINDING

2. SADS - Access Controls

The Department's internal control structure did not provide proper security restrictions to safeguard SADS from unauthorized access.

SADS is a computerized system developed by the Department to calculate the State school aid payments due school districts based on the funding requirements as specified in the State School Aid Act. The Department utilizes a local area network* (LAN) to provide access to SADS. The LAN was developed to allow system users access through personal computers.

Department of Management and Budget Administrative Guide procedure 1310.02 requires departments to develop policies and procedures to address general security, physical security, software and data security, and network installation. Development of policies and procedures to safeguard the Department's LAN would help ensure that unauthorized access does not occur.

We reviewed access security over the LAN file servers* and SADS information systems and noted the following internal control structure weaknesses:

a. The Department did not limit user access to production programs, data files, application software files, and documentation files related to SADS.

   Limiting access to these files to only those individuals responsible for working with the files is essential for ensuring file integrity.

b. The Department did not limit the assignment of the LAN administrator usercode* or administrator access rights* to appropriate users.

   The administrator usercodes and administrator access rights allow an individual unlimited access to system files and also allow the individual to create new system users. These capabilities should be restricted to the LAN system administrators.

   We noted that the Department assigned the LAN administrator usercode to a temporary employee and also assigned LAN administrator access rights to an employee whose job responsibilities did not require those rights. Misuse of

** See glossary on page 37 for definition.*

the administrator usercode or the administrator access rights could result in unauthorized access and use of the LAN.

c. The Department did not ensure that LAN system users had appropriate access rights.

We determined that at least 18 users had excessive access rights to LAN directories used to maintain membership data. Limiting access would help reduce the risk of unauthorized changes being made to membership data. Therefore, it is important that access to this data be restricted. Periodic monitoring of user access rights would allow management to determine if the level of access granted to users is appropriate.

d. The Department did not install a secure menu system for dial-in users.

We determined that the users could bypass the current menu system which was installed to limit user access on the network. A secure menu system allows management to limit user access on the network to individuals authorized to have access to SADS.

e. The Department did not restrict access to the file server consoles that operated the LAN software.

The file server consoles are located in a secured computer room. However, all staff with computer room access have access to this console and can make unauthorized changes to the LAN or disable the system using the consoles. The ability to make changes to the LAN should be limited to authorized network administrators.

f. The Department did not require the use of an automated security system to disable computer terminals connected to the LAN after a reasonable period of inactivity. This could result in unauthorized system access when computer terminals connected to the LAN are left unattended.

The use of computer software that automatically disconnects computer terminals or provides password-protected screen savers would help ensure

that computer terminals that are left unattended are not vulnerable to misuse by unauthorized individuals.

g. The Department did not establish or use usercodes and passwords effectively.

We determined that some system users were required to share common usercodes and passwords for connecting to the LAN. We also determined that SAU staff shared a common usercode and password when connecting to the SADS application.

The use of unique usercodes allows management to identify the originators of transactions on information systems. The use of uncompromised passwords helps to ensure that unauthorized personnel do not have access to information systems.

In response to our prior audit regarding parts a., c., d., and g., the Department agreed with our recommendations and indicated that it would implement procedures to improve controls as resources are available. In response to our prior audit regarding part e., the Department disagreed with our recommendation, stating that the file server consoles were located in a secured room and that access to the room is restricted to authorized personnel via a combination door lock mechanism.

RECOMMENDATION

WE AGAIN RECOMMEND THAT THE DEPARTMENT IMPROVE ITS INTERNAL CONTROL STRUCTURE TO PROVIDE PROPER SECURITY RESTRICTIONS TO SAFEGUARD SADS FROM UNAUTHORIZED ACCESS.

AGENCY PRELIMINARY RESPONSE

The Department generally agreed with the recommendation and indicated that it would implement procedures to improve controls over SADS in accordance with Findings 2.a., 2.b., 2.c., 2.d., 2.f., and 2.g. The Department disagreed with Finding 2.e., stating that the file server consoles are located in a secured room and that access to the room is restricted to authorized personnel via a combination door lock mechanism.

EPILOGUE

Department staff who have authorized access to the computer room include individuals who should not have access to the file server consoles that operate the LAN software.

FINDING

3. SADS - Application Controls

The Department's internal control structure did not provide effective application controls over SADS.

Application controls include input, processing, and output controls over an automated information system. These controls provide the necessary safeguards to help ensure that an automated information system functions as designed.

We reviewed the application controls for SADS and noted the following internal control structure weaknesses:

a. The Department had not established controls to ensure the accuracy and completeness of data entered into SADS:

(1) The Department had not programmed effective data validation edits in the data entry process that would help detect and prevent the entry of erroneous membership data. For example, SADS did not compare current and prior year data for reasonableness and then alert users of large fluctuations. Also, SADS did not prevent users from entering data on the system even though automated control total comparisons revealed out-of-balance conditions.

Because of the lack of appropriate system controls, SAU staff performed inefficient manual data validation procedures to help ensure the accuracy of the data contained on the system.

(2) SADS did not provide a complete audit trail to assist users in the reconstruction of files should data be destroyed or to enable Department management to identify the originator of transactions entered on the system.

Although a history file was maintained for transactions affecting system data, Department staff informed us that the history file would only provide information related to the most recent change entered on the system. A complete audit trail would allow management to identify the user who originally entered a transaction, the date and time the data was entered, as well as all subsequent modifications of the data.

b. The Department had not established effective controls to ensure that SADS programs were run in the correct sequence.

SAU relied on inefficient manual procedures to help ensure that the programs necessary for calculating monthly State aid payments were run in the proper sequence. In addition, system control logs did not capture the data necessary to verify that programs were run in the proper sequence.

Department staff informed us that programs had sometimes been processed out of sequence, resulting in unnecessary system reruns. The proper sequencing of the programs that generate payments is necessary to ensure that the monthly State aid payments are correctly calculated. SADS is programmed to automatically correct most of these overpayments and underpayments in the subsequent monthly State aid payment. However, this self-correcting programming does not include certain categorical programs. Any errors made in the payments for these programs, caused by running programs out of sequence, could go uncorrected if not detected and corrected manually by SAU staff.

The development of effective application controls would help ensure the accuracy, completeness, and timeliness of data entered into and processed by SADS.

RECOMMENDATION

We recommend that the Department improve its internal control structure to provide effective application controls over SADS.

AGENCY PRELIMINARY RESPONSE

The Department agreed with the recommendation and indicated that it had implemented procedures to improve application controls over SADS in accordance with Findings 3.a.(1) and 3.a.(2). The Department also indicated that a new staff member had been added recently to SAU to assist in the development of controls to adjust procedures related to the payment process as indicated in Finding 3.b.

COMPLIANCE WITH LAWS AND REGULATIONS

COMMENT

Audit Objective: To assess the Department's compliance with applicable statutes, the *Michigan Administrative Code*, State procedures, and Department policies and procedures that could have a material effect on the Fund's financial statements.

Conclusion: Our assessment of the Department's compliance with laws and regulations did not disclose any instances of noncompliance that could have a material effect on the financial statements. However, the reportable conditions included under our first audit objective may result in payments that are not in compliance with the State School Aid Act.

FINANCIAL ACCOUNTING AND REPORTING

COMMENT

Audit Objective: To audit the Fund's financial statements as of and for the fiscal years ended September 30, 1997, September 30, 1996, and September 30, 1995.

Conclusion: We expressed an unqualified opinion on the financial statements.

Independent Auditor's Report on the
Internal Control Structure

April 17, 1998

Mr. Arthur E. Ellis, Chairman
State Board of Education
Hannah Building
Lansing, Michigan

Dear Mr. Ellis:

We have audited the financial statements of the School Aid Fund, Department of Education, as of and for the fiscal years ended September 30, 1997, September 30, 1996, and September 30, 1995 and have issued our report thereon dated April 17, 1998.

We conducted our audit in accordance with generally accepted auditing standards and *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.

The management of the Department of Education is responsible for establishing and maintaining an internal control structure, which operates in conjunction with the Statewide internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the financial statements as of and for the fiscal years ended September 30, 1997, September 30, 1996, and September 30, 1995, we obtained an understanding of the School Aid Fund's internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the Department's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

Our audit disclosed weaknesses in the Department's internal control structure relating to processing controls within the State Aid Unit and access and application controls relating to the State Aid Data System. These reportable conditions are more fully described in Findings 1 through 3.

A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the 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.

Our consideration of the internal control structure policies and procedures would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the School Aid Fund's reportable conditions described above is a material weakness.

Sincerely,

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

Independent Auditor's Report on
Compliance With Laws and Regulations

April 17, 1998

Mr. Arthur E. Ellis, Chairman
State Board of Education
Hannah Building
Lansing, Michigan

Dear Mr. Ellis:

We have audited the financial statements of the School Aid Fund, Department of Education, as of and for the fiscal years ended September 30, 1997, September 30, 1996, and September 30, 1995 and have issued our report thereon dated April 17, 1998.

We conducted our audit in accordance with generally accepted auditing standards and *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.

Compliance with laws, regulations, contracts, and grants applicable to the School Aid Fund is the responsibility of the Department of Education's management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the Department's compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. 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.*

Sincerely,

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

Independent Auditor's Report on
the Financial Statements

April 17, 1998

Mr. Arthur E. Ellis, Chairman
State Board of Education
Hannah Building
Lansing, Michigan

Dear Mr. Ellis:

We have audited the accompanying balance sheet of the School Aid Fund, Department of Education, as of September 30, 1997, September 30, 1996, and September 30, 1995 and the related statement of revenues, expenditures, and changes in fund balance and statement of revenues, expenditures, and changes in fund balance - budget and actual for the fiscal years then ended. These financial statements are the responsibility of the Department management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and *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 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 discussed in Note 1b, the accompanying financial statements present only the School Aid Fund and are not intended to present fairly the financial position and the results of operations of the State of Michigan or its special revenue funds.

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, 1997, September 30, 1996, and September 30, 1995 and the results of its operations for the fiscal years then ended on the basis of accounting described in Note 1b.

In accordance with *Government Auditing Standards*, we have also issued a report dated April 17, 1998 on our consideration of the School Aid Fund's internal control structure and a report dated April 17, 1998 on its compliance with laws and regulations.

Sincerely,

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

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

	1997	1996	1995
ASSETS			
Current Assets:			
Cash	$ 3	$ 46	$
Taxes receivable (at net) (Note 7)	655,137	606,014	576,593
Amounts due from federal agencies	663	4,688	3,493
Amounts due from local units	15,359	44,175	29,585
Other current assets	141	9	
Total Current Assets	$ 671,304	$ 654,932	$ 609,671
Noncurrent Assets:			
Taxes receivable (at net) (Note 7)	10,111	7,598	5,912
Amounts due from local units	860	1,095	2,310
Total Assets	$ 682,275	$ 663,625	$ 617,893
LIABILITIES AND FUND BALANCE			
Current Liabilities:			
Warrants outstanding	$ 665	$ 274	$ 9,537
Accounts payable and other liabilities	34,404	71,290	77,257
Amounts due to other funds (Note 6)	443,170	464,213	336,834
Total Current Liabilities	$ 478,239	$ 535,777	$ 423,628
Long-Term Liabilities:			
Deferred revenue	10,111	7,598	5,912
Total Liabilities	$ 488,350	$ 543,375	$ 429,539
Fund Balance:			
Reserves for:			
Budgetary Carry-Forwards:			
Encumbrances (Note 3)	$	$	$ 28,654
Restricted revenues (Note 2)			12,663
Noncurrent assets	860	1,095	2,310
Total Reserved	$ 860	$ 1,095	$ 43,627
Unreserved Fund Balance	$ 193,065	$ 119,155	$ 144,726
Total Fund Balance	$ 193,925	$ 120,250	$ 188,353
Total Liabilities and Fund Balance	$ 682,275	$ 663,625	$ 617,893

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)

	1997	1996	1995
REVENUES			
Taxes (Note 2):			
Sales	$ 3,933,531	$ 3,778,832	$ 3,564,577
Property	1,348,832	1,272,288	1,155,601
Personal income	1,582,910	918,182	882,539
Cigarette	350,515	371,423	397,213
Use	362,026	341,585	318,890
Liquor	22,428	22,641	21,937
Industrial facilities	115,677	120,383	105,319
Commercial facilities	1,330	968	1,322
Other	14,218	18,564	7,328
Total Tax Revenues	$ 7,731,469	$ 6,844,867	$ 6,454,726
From federal agencies	70,220	69,691	63,114
From local agencies		23	537
Miscellaneous	22,679	5,176	7,502
Total Revenues	$ 7,824,369	$ 6,919,758	$ 6,525,878
EXPENDITURES			
Foundation allowance (Note 2)	$ 7,789,172	$ 7,339,456	$ 6,979,677
At risk children	229,997	230,000	230,000
Special education	327,170	324,483	293,421
Adult education	65,084	210,392	246,757
Vocational education	38,359	35,760	35,589
Intermediate school districts	80,286	82,586	34,861
Preschool readiness grants	49,668	52,395	42,441
TIFA hold harmless payments			12,000
Mathematics and science centers	7,614	7,614	6,240
Court-placed children	6,500	6,500	5,800
Professional development		8,000	9,995
Bilingual education	4,212	4,212	4,212
Large pupil growth	3,000		
Other educational programs	2,625	5,209	7,175
Court-ordered desegregation		5,420	4,961
Retirement and social security payments			65,301
Other	1,958	7	235
Total Expenditures	$ 8,605,644	$ 8,312,033	$ 7,978,667

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

	1997	1996	1995
Excess of Revenues Over (Under) Expenditures	$ (781,275)	$ (1,392,275)	$ (1,452,789)
OTHER FINANCING SOURCES (USES)			
Operating transfers in:			
From State Lottery Fund	$ 587,733	$ 548,319	$ 547,782
From State General Fund	277,948	620,969	664,915
Total operating transfers from other funds	$ 865,681	$ 1,169,288	1,212,697
Operating transfers to other funds	(10,731)	(19,616)	(40,000)
Total Other Financing Sources (Uses)	$ 854,950	$ 1,149,672	$ 1,172,697
Excess of Revenues and Other Sources Over (Under) Expenditures and Other Uses	$ 73,675	$ (242,603)	$ (280,092)
Fund Balance - Beginning of Fiscal Year	120,250	188,353	468,445
Equity transfers from other funds (Note 8)		174,500	
Fund Balance - End of Fiscal Year	$ 193,925	$ 120,250	$ 188,353

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)

	1997		
(Statutory/Budgetary Basis)	Budget	Actual	Variance Favorable (Unfavorable)
REVENUES AND OTHER SOURCES			
Taxes	$ 7,731,469	$ 7,731,469	$
From federal agencies	70,220	70,220	
From local agencies			
Miscellaneous		22,679	22,679
Operating transfers in	888,360	865,681	(22,679)
Total Revenues and Other Sources	$ 8,690,049	$ 8,690,049	$ 0
EXPENDITURES AND ENCUMBRANCES (Note 3)			
Education	$ 8,633,930	$ 8,616,375	$ 17,556
Total Expenditures and Encumbrances	$ 8,633,930	$ 8,616,375	$ 17,556
Excess of Revenues and Other Sources Over (Under) Expenditures and Encumbrances	$ 56,119	$ 73,675	$ 17,556
Reconciling Items (Note 3):			
Encumbrances at September 30		$ 0	
Net Reconciling Items		$ 0	
Excess of Revenues and Other Sources Over (Under) Expenditures and Other Uses (GAAP Basis)		$ 73,675	
FUND BALANCE (GAAP BASIS) (Note 3)			
Beginning Balance		120,250	
Equity transfer from other funds (Note 8)			
Ending Balance (GAAP Basis)		$ 193,925	

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

1996			1995		
Budget	Actual	Variance Favorable (Unfavorable)	Budget	Actual	Variance Favorable (Unfavorable)
$ 6,849,083	$ 6,844,867	$ (4,216)	$ 6,455,312	$ 6,454,726	$ (587)
69,691	69,691		63,114	63,114	
	23	23	8,027	537	(7,490)
	5,176	5,176		7,502	7,502
1,368,992	1,169,288	(199,704)	1,212,915	1,212,697	(218)
$ 8,287,767	$ 8,089,046	$ (198,721)	$ 7,739,368	$ 7,738,575	$ (793)
$ 8,354,022	$ 8,331,649	$ 22,373	$ 8,111,416	$ 8,047,321	$ (64,095)
$ 8,354,022	$ 8,331,649	$ 22,373	$ 8,111,416	$ 8,047,321	$ (64,095)
$ (66,255)	$ (242,603)	$ (176,348)	$ (372,049)	$ (308,746)	$ 63,302
	$ 0			$ 28,654	
	$ 0			$ 28,654	
	$ (242,603)			$ (280,092)	
	188,353			468,445	
	174,500				
	$ 120,250			$ 188,353	

Notes to 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, 1997, September 30, 1996, and September 30, 1995. This 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 footnotes 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.

b. Basis of Accounting and Presentation

The financial statements contained in this report are prepared on the modified accrual basis of accounting. The modified accrual basis of accounting, which emphasizes the measurement of current financial resource flows, is explained in more detail in the *SOMCAFR*.

The accompanying financial statements present only the School Aid Fund. Accordingly, they are not intended to present fairly the financial position and results of operations of the State of Michigan or its special revenue funds.

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 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 taxes 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, and industrial and commercial facilities taxes.

Act 145, P.A. 1993, eliminated the local property tax as a source of operating revenue for public schools. A constitutional amendment, 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 are also made from the State's General Fund.

Total payments to school districts are set annually by the Legislature, along with corresponding appropriations 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, then total payments are to be prorated so that they equal the appropriated funding available. These payments include a foundation allowance for each membership reported by the local and intermediate school districts and also funding for categorical programs.

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 "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 on the generally accepted accounting principles (GAAP) basis, 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 bases of accounting.

For the School Aid Fund, encumbrances of $28.7 million in fiscal year 1994-95 were a reconciling item from the statutory/budgetary basis to the GAAP basis on the statement of revenues, expenditures, and changes in fund balance - budget and actual.

Note 4 Contingencies and 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 9, Section 29 of the State Constitution (part of the so-called Headlee Amendment); and 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, 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 is to determine the appropriate distribution of the award between taxpayer relief and/or use by the district for other public purposes. The Court has affirmed the award to the plaintiffs of their costs including attorney fees. Over 400 other school districts have 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. It is estimated that the aggregate payments to the non-Durant school districts will, over time, total $632 million. Those payments, commencing in fiscal year 1998-99, will be paid through the State School Aid Act, using funds transferred to the School Aid Fund from the Counter-Cyclical Budget and Economic Stabilization Fund and the General Fund, half in annual payments over 10 years and half in annual payments over 15 years.

Note 5 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 $1.2 million in fiscal year 1996-97, $1.6 million in fiscal year 1995-96, and $5.3 million in fiscal year 1994-95 were made from the School Aid Fund.

Note 6 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 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. The Treasurer annually publishes the *Annual Report of the State Treasurer* which includes audited schedules of the State Treasurer's Common Cash - assets and equities, investment portfolios of specific funds, and investment revenues. 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 $443.2 million for fiscal year 1996-97, $464.2 million for fiscal year 1995-96, and $336.8 million for fiscal year 1994-95 in the School Aid Fund.

Note 7 Taxes

Revenues of the School Aid Fund consist primarily of sales, property, personal income, cigarette, use, liquor, and industrial and commercial facilities 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. Sales taxes are accrued to the extent that the related sales occurred prior to October 1 and the State receives deposits 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)

	1997	1996	1995
Total taxes receivable	$890,613	$807,366	$748,627
Less allowance for uncollectible receivables	225,365	193,754	166,121
Less taxes to be received more than 12 months after fiscal year-end	10,111	7,598	5,912
Current taxes receivable	$655,137	$606,014	$576,593

Note 8 Equity Transfer

Act 300, P.A. 1996, authorized the School Aid Fund to refund accumulated excess health insurance contributions to school districts from the health benefit reserve of the Public School Employees' Retirement System. An equity transfer of $174.5 million was made from the Public School Employees' Retirement Fund to the School Aid Fund in fiscal year 1995-96 to finance the refunds, which were paid during fiscal year 1995-96.

Glossary of Acronyms and Terms

administrator access rights	Rights granted to enable a user access to and control over system directories, files and hardware.
administrator usercodes	A usercode assigned to a system administrator giving him/her access to all system directories, files, and hardware.
application controls	Application controls are grouped according to the various stages of an automated information system, including data origination, data input, data processing, and data output. Application controls can also apply on an individual basis and vary among information processing systems, unlike general controls, which apply only to information processing applications carried out within a data center.
categorical programs	The various special program grants that are designated in the State School Aid Act. The categorical programs that received funding during the audit period included: at-risk pupils; special education; vocation education; adult education; and intermediate school district programs.
file server	A computer containing files available to all users connected to a LAN.
financial audit	An audit that is designed to provide reasonable assurance about whether the financial statements/schedules of an audited entity are fairly presented in conformity with generally accepted accounting principles.
foundation allowance	The guaranteed minimum amount paid to each school district for each reported pupil. Foundation allowance funds are to be used for the general operating expenses of a school district. The starting point for the foundation allowance was

the eligible base revenue each school district received per pupil in the 1993-94 school year. This amount is then increased each year by an amount specified in the annual amendments to the State School Aid Act.

GAAP generally accepted accounting principles.

general controls Controls that apply to all of the processing of data within an automated information system. Although general controls are normally independent of individual computer applications, they provide the framework within which many different applications are processed.

local area network (LAN) A network established by the Department of Education to provide greater and more direct access to the State Aid Data System.

material weakness A serious reportable condition in which the design or operation of one or more of the internal control structure elements (including management controls) does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements would not be prevented or detected.

reportable conditions Matters coming to the auditor's attention that, in his/her judgment, should be communicated because it represents either an opportunity for improvement or a significant deficiency in the design or operation of the internal control structure.

SOMCAFR *State of Michigan Comprehensive Annual Financial Report.*

State Aid Data System (SADS) A computerized system developed by the Department of Education to calculate the State school aid payments due school districts based on the funding requirements as specified in the State School Aid Act.

State Aid Unit (SAU)	The unit within the Department of Education that is responsible for processing the State school aid payments that go to the local and intermediate school districts.
State School Aid Act	Sections 388.1601 - 388.1772 of the *Michigan Compiled Laws*, which provide the basis for the amount of school aid provided by the State to local and intermediate school districts.
TIFA	tax increment finance authority.