

FINANCIAL AUDIT
OF THE
SCHOOL AID FUND

DEPARTMENT OF EDUCATION

October 1, 1997 through September 30, 2000

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, 1997 through September 30, 2000.

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 provide for enhanced financial reporting of significant State programs and/or activities and to complement the annual audit of 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 of 1979*, being Sections 388.1601 - 388.1772 of the *Michigan Compiled Laws*). Annual expenditures of the School Aid Fund were approximately \$10.1 billion, \$9.6 billion, and \$9.4 billion for

* See glossary at end of report for definition.

fiscal years 1999-2000, 1998-99, and 1997-98, respectively. The Department provides administrative support for the School Aid Fund, but administrative costs are not appropriated for in the School Aid Fund.

The State Aid Unit* (SAU), Office of State Aid and School Finance, is primarily responsible for administering provisions of the State School Aid Act of 1979. 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 Management System* (SAMS). As of September 30, 2000, SAU had 5 full-time employees.

**AUDIT OBJECTIVES
AND CONCLUSIONS**

Audit Objective: To assess and report on the School Aid Fund's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the financial statements, and on its internal control* over financial reporting, based on our audit of the financial statements.

Conclusion: Our assessment of compliance did not disclose any instances of noncompliance that could have a direct and material effect on the financial statements. Also, our assessment of internal control over financial reporting did not disclose any material weaknesses*.

Audit Objective: To audit the School Aid Fund's financial statements as of and for the fiscal years ended September 30, 2000, September 30, 1999, and September 30, 1998.

* See glossary at end of report for definition.

Conclusion: We expressed an unqualified opinion* on the School Aid Fund's 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, 1997 through September 30, 2000. Our audit was conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in <i>Government Auditing Standards</i> 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.
PRIOR AUDIT FOLLOW-UP	The Department complied with the one prior audit recommendation included within the scope of this audit.

* See glossary at end of report for definition.

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November 8, 2001

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 of the School Aid Fund, Department of Education, for the period October 1, 1997 through September 30, 2000.

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

Our comments are organized by audit objective.

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

AUDITOR GENERAL

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TABLE OF CONTENTS

SCHOOL AID FUND DEPARTMENT OF EDUCATION

INTRODUCTION

	<u>Page</u>
Executive Digest	1
Report Letter	5
Description of Agency	8
Audit Objectives, Audit Scope, and Prior Audit Follow-Up	10

COMMENTS

Compliance and Internal Control Over Financial Reporting	11
Financial Accounting and Reporting	11

INDEPENDENT AUDITOR'S REPORTS AND FINANCIAL STATEMENTS

Independent Auditor's Report on Compliance and on Internal Control Over Financial Reporting	12
Independent Auditor's Report on the Financial Statements	14
School Aid Fund Financial Statements	
Balance Sheet	17
Statement of Revenues, Expenditures, and Changes in Fund Balance	18
Statement of Revenues, Expenditures, and Changes in Fund Balance - Budget and Actual	20
Notes to the Financial Statements	22

GLOSSARY

Glossary of Acronyms and Terms	30
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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 elected 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 School Aid Fund's purpose is to furnish aid to school districts of the State. 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 the 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 wagering 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 also are made from the State's General Fund.

Payments to school districts are based on statutory formulas (the State School Aid Act of 1979, 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*.

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 total appropriations are less than the payments to be made based on the State School Aid Act of 1979, then payments under certain sections of the Act are to be prorated so that they equal the appropriated funding available.

* See glossary at end of report for definition.

Annual expenditures of the School Aid Fund were approximately \$10.1 billion, \$9.6 billion, and \$9.4 billion for fiscal years 1999-2000, 1998-99, and 1997-98, respectively. The Department provides administrative support for the School Aid Fund, but administrative costs are not appropriated for in the School Aid Fund.

The State Aid Unit (SAU), Office of State Aid and School Finance, is primarily responsible for administering provisions of the State School Aid Act of 1979. 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 Management System. As of September 30, 2000, SAU had 5 full-time employees.

Audit Objectives, Audit Scope, 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 and report on the School Aid Fund's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the financial statements, and on its internal control over financial reporting, based on our audit of the financial statements.
2. To audit the School Aid Fund's financial statements as of and for the fiscal years ended September 30, 2000, September 30, 1999, and September 30, 1998.

Audit Scope

Our audit scope was to examine the financial and other records of the School Aid Fund for the period October 1, 1997 through September 30, 2000. Our audit was conducted 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 and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

Prior Audit Follow-Up

The Department complied with the one prior audit recommendation included within the scope of this audit.

COMMENTS

COMPLIANCE AND INTERNAL CONTROL OVER FINANCIAL REPORTING

COMMENT

Audit Objective: To assess and report on the School Aid Fund's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the financial statements, and on its internal control over financial reporting, based on our audit of the financial statements.

Conclusion: Our assessment of compliance did not disclose any instances of noncompliance that could have a direct and material effect on the financial statements. Also, our assessment of internal control over financial reporting did not disclose any material weaknesses.

FINANCIAL ACCOUNTING AND REPORTING

COMMENT

Audit Objective: To audit the School Aid Fund's financial statements as of and for the fiscal years ended September 30, 2000, September 30, 1999, and September 30, 1998.

Conclusion: We expressed an unqualified opinion on the School Aid Fund's financial statements.

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

June 12, 2001

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, 2000, September 30, 1999, and September 30, 1998 and have issued our report thereon dated June 12, 2001. 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 School Aid Fund's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of 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 School Aid Fund's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the 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 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 the 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 Department of Education, and the Legislature 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.

AUDITOR GENERAL

Independent Auditor's Report on
the Financial Statements

June 12, 2001

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

Dear Mr. Watkins:

We have audited the accompanying balance sheet of the School Aid Fund, Department of Education, as of September 30, 2000, September 30, 1999, and September 30, 1998 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 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, the accompanying financial statements present only the School Aid Fund and are not intended to present fairly the financial position and 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, 2000, September 30, 1999, and September 30, 1998 and the results of its operations

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 June 12, 2001 on our tests of the School Aid Fund's compliance with certain provisions of laws and regulations 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.

AUDITOR GENERAL

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SCHOOL AID FUND
Department of Education
Balance Sheet
As of September 30
(in thousands)

	<u>2000</u>	<u>1999</u>	<u>1998</u>
ASSETS			
Current Assets:			
Cash	\$ 302,168	\$	\$
Taxes receivable (at net) (Note 7)	843,896	749,256	717,489
Amounts due from federal agencies	358	7	650
Amounts due from local units	21,883	29,459	8,291
Other current assets	<u>697</u>	<u>297</u>	<u>139</u>
Total Current Assets	\$ 1,169,001	\$ 779,018	\$ 726,569
Noncurrent Assets:			
Taxes receivable (at net) (Note 7)	11,896	11,464	11,024
Amounts due from local units	1,732	2,288	624
Total Assets	<u>\$ 1,182,629</u>	<u>\$ 792,770</u>	<u>\$ 738,217</u>
LIABILITIES AND FUND BALANCE			
Current Liabilities:			
Warrants outstanding	\$ 26	\$ 2,305	\$ 290
Accounts payable and other liabilities	185,075	134,545	89,567
Amounts due to other funds (Note 6)	<u></u>	<u>68,421</u>	<u>363,050</u>
Total Current Liabilities	\$ 185,102	\$ 205,270	\$ 452,906
Long-Term Liabilities:			
Deferred revenue	11,896	11,464	11,024
Total Liabilities	<u>\$ 196,997</u>	<u>\$ 216,734</u>	<u>\$ 463,930</u>
Fund Balance:			
Reserves for:			
Budgetary Carry-Forwards:			
Encumbrances (Note 3)	\$ 980	\$	\$
Multi-year projects (Note 8)	119,600		
Restricted revenues (Note 2)	9,899	899	899
Noncurrent assets	<u>1,732</u>	<u>2,288</u>	<u>624</u>
Total Reserved	\$ 132,211	\$ 3,187	\$ 1,522
Unreserved Fund Balance	853,420	572,849	272,764
Total Fund Balance	<u>\$ 985,632</u>	<u>\$ 576,036</u>	<u>\$ 274,287</u>
Total Liabilities and Fund Balance	<u>\$ 1,182,629</u>	<u>\$ 792,770</u>	<u>\$ 738,217</u>

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)

	<u>2000</u>	<u>1999</u>	<u>1998</u>
REVENUES			
Taxes (Note 2):			
Sales	\$ 4,577,161	\$ 4,301,458	\$ 4,094,188
Personal income	1,968,377	1,848,121	1,699,374
Property	1,638,513	1,535,155	1,484,725
Use	452,871	427,506	386,419
Cigarette	387,652	394,374	362,974
Industrial facilities	152,434	135,929	112,337
Liquor	27,233	25,434	23,917
Commercial facilities	65	522	3,004
Other	<u>66,515</u>	<u>20,216</u>	<u>13,385</u>
Total Taxes	\$ 9,270,822	\$ 8,688,714	\$ 8,180,324
From federal agencies	121,550	106,823	84,675
Miscellaneous	16,338	39,703	17,121
 Total Revenues	 <u>\$ 9,408,710</u>	 <u>\$ 8,835,240</u>	 <u>\$ 8,282,120</u>
 EXPENDITURES			
Foundation allowance (Note 2)	\$ 8,443,404	\$ 8,032,531	\$ 7,825,776
Special education	892,610	829,552	804,272
At risk students	270,920	259,806	249,978
Intermediate school districts	83,691	80,198	79,836
Adult education	79,291	75,265	70,845
School readiness grants	61,765	56,838	54,050
Vocational education	40,844	40,566	38,407
Career preparation	23,742	23,935	1,210
Small class size	19,750	20,000	100
Student performance	15,000		
School lunch	8,715	12,002	
Mathematics and science centers	8,305	7,693	7,693
Court-placed children	7,900	7,000	6,977
Reading improvement	4,999		
Gifted and talented	4,990	5,000	5,000
Bilingual education	4,212	4,212	4,212
Renaissance Zone	3,989	3,063	2,163
One time per pupil grants		96,582	
Other educational programs	6,400	2,915	2,478
Durant court order settlement			211,101
Non-Durant district settlements (Note 4)	70,856	72,557	
Other	5,198	14,797	34,788
 Total Expenditures	 <u>\$ 10,056,580</u>	 <u>\$ 9,644,511</u>	 <u>\$ 9,398,887</u>

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

	<u>2000</u>	<u>1999</u>	<u>1998</u>
Excess of Revenues Over (Under) Expenditures	<u>\$ (647,870)</u>	<u>\$ (809,272)</u>	<u>\$ (1,116,766)</u>
OTHER FINANCING SOURCES (USES)			
Operating transfers in:			
From State Lottery Fund	\$ 618,514	\$ 621,131	\$ 616,110
From State General Fund	<u>452,114</u>	<u>493,297</u>	<u>587,968</u>
Total operating transfers from other funds	\$ 1,070,627	\$ 1,114,429	\$ 1,204,078
Operating transfers to other funds	(12,999)	(3,408)	(6,950)
Operating transfers to component units	(163)		
Total Other Financing Sources (Uses)	<u>\$ 1,057,466</u>	<u>\$ 1,111,021</u>	<u>\$ 1,197,128</u>
Excess of Revenues and Other Sources Over (Under) Expenditures and Other Uses	\$ 409,595	\$ 301,749	\$ 80,362
Fund Balance - Beginning of Fiscal Year	576,036	274,287	193,925
Fund Balance - End of Fiscal Year	<u>\$ 985,632</u>	<u>\$ 576,036</u>	<u>\$ 274,287</u>

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)

<u>(Statutory/Budgetary Basis)</u>	2000		Variance Favorable (Unfavorable)
	Budget	Actual	
REVENUES AND OTHER SOURCES			
Taxes	\$ 9,270,822	\$ 9,270,822	\$
From federal agencies	121,550	121,550	
Miscellaneous	16,338	16,338	
Operating transfers in	1,070,627	1,070,627	
Total Revenues and Other Sources	\$ 10,479,337	\$ 10,479,337	\$ 0
EXPENDITURES AND ENCUMBRANCES (Note 3)			
Education and General Government	\$ 10,071,850	\$ 10,070,722	\$ 1,127
Total Expenditures and Encumbrances	\$ 10,071,850	\$ 10,070,722	\$ 1,127
Revenues and Other Sources			
Over (Under) Expenditures and Encumbrances (Statutory/Budgetary Basis)	\$ 407,488	\$ 408,615	\$ 1,127
Reconciling Items (Note 3):			
Encumbrances at September 30		\$ 980	
Net Reconciling Items		\$ 980	
Excess of Revenues and Other Sources Over (Under) Expenditures and Other Uses (GAAP Basis)			
		\$ 409,595	
FUND BALANCE (GAAP BASIS) (Note 3)			
Beginning Balance		576,036	
Ending Balance (GAAP Basis)		\$ 985,632	

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

1999			1998		
Budget	Actual	Variance Favorable (Unfavorable)	Budget	Actual	Variance Favorable (Unfavorable)
\$ 8,698,514	\$ 8,688,714	\$ (9,800)	\$ 8,183,924	\$ 8,180,324	\$ (3,600)
106,823	106,823		84,675	84,675	
39,703	39,703		17,121	17,121	
<u>1,114,429</u>	<u>1,114,429</u>		<u>1,204,078</u>	<u>1,204,078</u>	
<u>\$ 9,959,468</u>	<u>\$ 9,949,668</u>	<u>\$ (9,800)</u>	<u>\$ 9,489,798</u>	<u>\$ 9,486,198</u>	<u>\$ (3,600)</u>
<u>\$ 9,661,597</u>	<u>\$ 9,647,919</u>	<u>\$ 13,678</u>	<u>\$ 9,422,052</u>	<u>\$ 9,405,836</u>	<u>\$ 16,216</u>
<u>\$ 9,661,597</u>	<u>\$ 9,647,919</u>	<u>\$ 13,678</u>	<u>\$ 9,422,052</u>	<u>\$ 9,405,836</u>	<u>\$ 16,216</u>
<u>\$ 297,871</u>	<u>\$ 301,749</u>	<u>\$ 3,878</u>	<u>\$ 67,746</u>	<u>\$ 80,362</u>	<u>\$ 12,616</u>
	\$ _____			\$ _____	
	\$ 0			\$ 0	
	\$ 301,749			\$ 80,362	
	274,287			193,925	
	<u>\$ 576,036</u>			<u>\$ 274,287</u>	

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, 2000, September 30, 1999, and September 30, 1998. 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 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 and Budgetary Control, and Treasurer's Common Cash.

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 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 wagering 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 also are 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 of 1979, 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 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 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.

For the School Aid Fund, encumbrances of \$980,373 in fiscal year 1999-2000 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

a. *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 so-called 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 total agreed upon amount to be paid to the non-Durant school districts is approximately \$632.6 million. 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 liability for these payments is recorded in the State's General Long-Term Obligations Account Group. 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, the estimated aggregate payments to the non-Durant school districts will total \$733.8 million, including \$101.2 million of debt service costs. As of September 30, 2000, the remaining expected amount to be paid to the non-Durant school districts totals \$590.4 million, including \$80.7 million for debt service costs.

b. *Durant v State of Michigan (Durant II)*

In a decision rendered October 19, 1999, the Court of Appeals held that the State School Aid Act of 1979 complied with the State's obligations under Article IX, Section 29 of the State Constitution to fund the State-mandated portions of the special education, special education transportation, and school lunch programs at the levels required by the Headlee Amendment.

The Court of Appeals further held that certain sections of the State School Aid Act of 1979 violated Article IX, Section 11 of the State Constitution. Article IX, Section 11 of the State Constitution provides, in part, that beginning in the State's fiscal year 1995-96, and each fiscal year thereafter, the State shall guarantee that the total State and local per pupil revenue for school operating purposes for each local school district shall not be less than the 1994-95 total State and local per pupil revenues for school operating purposes. The Court held that under Article IX,

Section 11, the Legislature must appropriate the State portion of the per pupil revenue for school operating purposes to local school districts as unrestricted school aid. Thus, the Court held that to the extent the Legislature appropriated restricted funds to pay for special education and special education transportation from funds that were guaranteed to local school districts as unrestricted aid, the amendments to the State School Aid Act of 1979 violated Article IX, Section 11.

The Court of Appeals denied plaintiffs' request for mandamus, injunctive relief, and monetary damages and, as described above, granted declaratory relief only. The Court also held that plaintiffs may petition for costs and reasonable attorney fees as allowed by Article IX, Section 32 of the State Constitution. Under the court rules, the parties had until November 9, 1999 to appeal the decision to the Supreme Court or to move for rehearing in the Court of Appeals. Neither party appealed the decision nor moved for rehearing. Plaintiffs' petition for costs and attorney fees was granted by the Court of Appeals on January 14, 2000 in the amount of approximately \$400,000. On February 4, 2000, the State filed an application for leave to appeal and motion for peremptory reversal of the January 14, 2000 Court of Appeals order in the Supreme Court. On June 20, 2000, the Supreme Court denied the State's appeal and on August 22, 2000, denied the State's motion for reconsideration. Therefore, in October 2000, payments were made to plaintiff school districts reflecting their share of the \$400,000 in attorney fees. This case was dismissed on November 27, 2000.

c. *Durant et al. v State of Michigan et al. (Durant III)*

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.*, asserts that the current State School Aid Act of 1979, Act 297, P.A. 2000, violates 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* are seeking 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 are also requesting a declaratory judgment that the State, through Act 297, P.A. 2000, is violating Article IX, Section 11 and Article IX, Section 29. The Durant III plaintiffs further seek orders declaring that the State has failed, through Act 297, P.A. 2000, to meet its constitutional duty to fund services and activities provided by the plaintiff school districts during school years 1999-2000 through 2002-03 in the same proportion by which they were funded when the Headlee Amendment became effective, and that the State has 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 seek 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 seek attorneys fees and costs of litigation.

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.

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 \$1.6 million in fiscal year 1999-2000, \$1.7 million in fiscal year 1998-99, and \$2.7 million in fiscal year 1997-98 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 \$68.4 million for fiscal year 1998-99 and \$363.0 million for fiscal year 1997-98 in the School Aid Fund.

Note 7 Taxes

Revenues of the School Aid Fund consist primarily of sales, personal income, property, use, cigarette, liquor, industrial and commercial facilities, and casino 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			
<u>As of September 30</u>			
(in thousands)			
	<u>2000</u>	<u>1999</u>	<u>1998</u>
Total taxes receivable	\$1,340,893	\$1,226,646	\$1,198,790
Less allowance for uncollectible receivables	242,551	232,963	235,139
Less taxes to be received more than 12 months after fiscal year-end	<u>11,896</u>	<u>11,464</u>	<u>11,024</u>
Current taxes receivable	<u><u>\$1,086,446</u></u>	<u><u>\$ 982,220</u></u>	<u><u>\$ 952,627</u></u>

Note 8 Multi-Year Projects

These projects consist of \$110.0 million for the Teacher Technology Initiative and \$9.6 million for the Golden Apple Awards that were appropriated or transferred in late in fiscal year 1999-2000. The Department did not initiate the programs prior to the end of the fiscal year. This money was carried forward for expenditure in the subsequent fiscal year.

Glossary of Acronyms and Terms

categorical programs	The various specific programs that are designated in the State School Aid Act of 1979. Examples of categorical programs that received funding during the audit period include: special education, at-risk students, intermediate school district, adult education, school readiness, and vocational education programs.
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.
foundation allowance	The amount legislatively designated for 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 is 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 of 1979.
GAAP	generally accepted accounting principles.
internal control	A process, effected by an entity's management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (1) reliability of financial reporting, (2) effectiveness and efficiency of operations, and (3) compliance with applicable laws and regulations.
material weakness	A 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/or 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.

school districts	School districts eligible to receive funding through the State School Aid Act of 1979. School districts include local school districts, local act school districts, intermediate school districts, and, in some cases, public school academies and university schools.
SOMCAFR	<i>State of Michigan Comprehensive Annual Financial Report.</i>
State Aid Management System (SAMS)	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 of 1979.
State Aid Unit (SAU)	The unit within the Department of Education that is responsible for processing the State school aid payments that go to school districts.
State School Aid Act of 1979	Sections 388.1601 - 388.1772 of the <i>Michigan Compiled Laws</i> , which provide the basis for the amount of school aid provided by the State to school districts.
unqualified opinion	An auditor's opinion in which the auditor states, without reservation, that the financial schedules and/or financial statements are fairly presented in conformity with the disclosed basis of accounting or are fairly presented in relation to the primary financial schedules and/or statements.

These definitions apply specifically to their usage in the audit report. Certain terms are defined differently in specific statutes.