Public Schools of the City of Ann Arbor, Michigan

Report to the Board of Education

June 30, 2012

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To the Board of Education
Public Schools of the City of
Ann Arbor, Michigan

We have recently completed our audit of the basic financial statements of Public Schools of the City of Ann Arbor, Michigan (the "School District") for the year ended June 30, 2012. In addition to our audit report, we are providing the following required audit communication, summary of unrecorded possible adjustments, recommendations, and informational comments which impact the School District:

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We are grateful for the opportunity to be of service to the Public Schools of the City of Ann Arbor, Michigan. Should you have any questions regarding the comments in this report, please do not hesitate to call.

Plante & Moran, PLLC

October 30, 2012

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Results of the Audit

October 30, 2012

To the Board of Education
Public Schools of the City of
Ann Arbor, Michigan

We have audited the financial statements of Public Schools of the City of Ann Arbor, Michigan (the "School District") for the year ended June 30, 2012 and have issued our report thereon dated October 30, 2012. Professional standards require that we provide you with the following information related to our audit.

Our Responsibility under U.S. Generally Accepted Auditing Standards

As stated in our engagement letter dated May 21, 2012 our responsibility, as described by professional standards, is to express an opinion about whether the financial statements prepared by management with your oversight are fairly presented, in all material respects, in conformity with U.S. generally accepted accounting principles. We are responsible for planning and performing the audit to obtain reasonable, but not absolute, assurance that the financial statements are free of material misstatement. As part of our audit, we considered the internal control of the School District. Our consideration of internal control was solely for the purpose of determining our audit procedures and not to provide any assurance concerning such internal control.

We are responsible for communicating significant matters related to the audit that are, in our professional judgment, relevant to your responsibilities in overseeing the financial reporting process. However, we are not required to design procedures specifically to identify such matters and our audit of the financial statements does not relieve you or management of your responsibilities.

Our audit of the School District's financial statements has also been conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. Under those *Government Auditing Standards*, we have made some assessments of the School District's compliance with certain provisions of laws, regulations, contracts and grant agreements. While those assessments are not sufficient to identify all noncompliance with applicable laws, regulations, and contract provisions, we are required to communicate all noncompliance conditions that come to our attention. We have communicated those conditions in a separate letter dated October 30, 2012 regarding our consideration of the School District's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements.

We are also obligated to communicate certain matters related to our audit to those responsible for the governance of the School District, including certain instances of error or fraud and significant deficiencies in internal control that we identify during our audit. In certain situations, *Government Auditing Standards* requires disclosure of illegal acts to applicable government agencies. If such illegal acts were detected during our audit, we would be required to make disclosures regarding these acts to applicable government agencies. No such disclosures were required.

Planned Scope and Timing of the Audit

We performed the audit according to the planned scope and timing previously communicated to you in our meeting about planning matters on October 8, 2012.

Significant Audit Findings

Qualitative Aspects of Accounting Practices

Management is responsible for the selection and use of appropriate accounting policies. In accordance with the terms of our engagement letter, we will advise management about the appropriateness of accounting policies and their application. The significant accounting policies used by the School District are described in Note 1 to the financial statements. No new accounting policies were adopted and the application of existing policies was not changed during 2012.

We noted no transactions entered into by the School District during the year for which there is a lack of authoritative guidance or consensus.

There are no significant transactions that have been recognized in the financial statements in a different period than when the transaction occurred.

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimate affecting the financial statements was compensated absences. We evaluated the key factors and assumptions used to develop compensated absences in determining that it is reasonable in relation to the financial statements taken as a whole.

The disclosures in the financial statements are neutral, consistent, and clear.

Difficulties Encountered in Performing the Audit

We encountered no significant difficulties in dealing with management in performing and completing our audit.

Corrected and Uncorrected Misstatements

Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. The attached schedule summarizes uncorrected misstatements of the financial statements. Management has determined that the effects are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

Disagreements with Management

For the purpose of this letter, professional standards define a disagreement with management as a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit.

Management Representations

We have requested certain representations from management that are included in the management representation letter dated October 30, 2012.

Management Consultations with Other Independent Accountants

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the organization's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

Other Audit Findings or Issues

In the normal course of our professional association with the School District we generally discuss a variety of matters, including the application of accounting principles and auditing standards, business conditions affecting the School District, and business plans and strategies that may affect the risks of material misstatement. None of the matters discussed resulted in a condition of our retention as the School District's auditors.

As required by OMB Circular A-133, we have also completed an audit of the federal programs administered by the School District. The results of that audit are provided to the Board of Education in our report on compliance with requirements applicable to each major program and on internal control over compliance in accordance with OMB Circular A-133 dated October 30, 2012.

To the Board of Education
Public Schools of the City of
Ann Arbor, Michigan

October 30, 2012

Other Information in Documents Containing Audited Financial Statements

Our responsibility for other information in documents containing the School District's financial statements and report does not extend beyond the financial statements. We do not have an obligation to determine whether or not such other information is properly stated. However, we read the Management Discussion and Analysis and the General Fund Budgetary Comparison Schedule and nothing came to our attention that caused us to believe that such information, or its manner of presentation, is materially inconsistent with the information or manner of its presentation appearing in the financial statements.

This information is intended solely for the use of the Board of Education and management of the Public Schools of the City of Ann Arbor, Michigan and is not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,

Plante & Moran, PLLC

Eric V. Formberg

To the Board of Education
Public Schools of the City of
Ann Arbor, Michigan

October 30, 2012

Client: **Ann Arbor Public Schools**
Opinion Unit: **Governmental Activities**
Y/E: **6/30/2012**

SUMMARY OF UNRECORDED POSSIBLE ADJUSTMENTS

The effect of misstatements and classification errors identified would be to increase (decrease) the reported amounts in the financial statement categories identified below:

Ref. #	Description of Misstatement	Current Assets	Long-Term Assets	Current Liabilities	Long-Term Liabilities	Net Assets	Revenue	Expenses
KNOWN MISSTATEMENTS:								
A1	To reduce gross up of AR & reserve reflected in the liablity section of the statements.	$ (339,144)		$ (339,144)				
ESTIMATE ADJUSTMENTS:								
B1	Estimated July and August claims for 26 pay employees			1,462,406		$ (1,481,804)		$ (19,398)
IMPLIED ADJUSTMENTS								
C1	None							
		-	$ -	-	$ -	-	$ -	-
	Total	$ (339,144)	$ -	$ 1,123,262	$ -	$ (1,481,804)	$ -	$ (19,398)
PASSED DISCLOSURES								
D1	None							

Client: **Ann Arbor Public Schools**
Opinion Unit: **General Fund (Major Governmental Fund)**
Y/E: **6/30/2012**

SUMMARY OF UNRECORDED POSSIBLE ADJUSTMENTS

The effect of misstatements and classification errors identified would be to increase (decrease) the reported amounts in the financial statement categories identified below:

Ref. #	Description of Misstatement	Current Assets	Long-Term Assets	Current Liabilities	Long-Term Liabilities	Fund Balance	Revenue	Expenses
KNOWN MISSTATEMENTS:								
A1	To reduce gross up of AR & reserve reflected in the liablity section of the statements.	$ (339,144)		$ (339,144)				
ESTIMATE ADJUSTMENTS:								
B1	Estimated July and August claims for 26 pay employees			1,462,406		$ (1,481,804)		$ (19,398)
IMPLIED ADJUSTMENTS								
C1	None							
		-	$ -	-	$ -	-	$ -	-
	Total	$ (339,144)	$ -	$ 1,123,262	$ -	$ (1,481,804)	$ -	$ (19,398)
PASSED DISCLOSURES								
D1	None							

Informational Items

Redefining State Aid and the Foundation Allowance - The fiscal year ended June 30, 2012 was the first year under a redefined funding approach for Michigan Schools. While the foundation allowance concept remains, three key changes had a significant impact on your district's funding level in 2011/2012 and, while modified, those changes are carried forward into 2012/2013. The three changes are a permanent $470/per pupil reduction of the School District's foundation allowance, the creation of the incentive payment concept (best practice) and an additional categorical to aid in paying for the increased cost of the retirement system (MPSERS).

Foundation: In the 2011/2012 fiscal year the School District's foundation allowance was reduced to $9,020. This $470 reduction effectively reduced the foundation allowance funding by 5 percent. In the 2012/2013 fiscal year, some districts will receive an increase in Foundation Allowance of up to $120/per pupil. This increase was based on the current foundation allowance level and was formula driven. Because of your current foundation allowance level, your district did not qualify for a foundation increase and your foundation allowance will continue at the 2011/2012 funding level.

Best Practices: The governor identified many educational initiatives shortly after taking office. One key initiative was the concept of encouraging best practices. This concept was built into the State Aid Act for the first time in 2011/2012 and continues into 2012/13. In 2011/2012 five best practice initiatives were identified in the State Aid Act. To qualify for the $100/per pupil incentive the district was required to implement at least four out of five of the initiatives. Your district qualified for the incentive and received the additional $100/per pupil. For 2012/2013, the concept of funding best practices continues. New initiatives have been added to the existing list in the State Aid Act. The amount has been reduced to $52 per pupil and to qualify for this incentive, the School District will now need to implement seven of eight identified best practice initiatives.

MPSERS Cost Support: The contribution rate the School District is required to pay has continued to rise. The School District has no ability to influence the rate and no choice regarding its participation in the program. Recognizing the costs are increasing under the current system, the 2011/2012 State Aid Act included funding to help pay for some of the increased cost. The categorical aid is formula driven using the School District's MPSERS payroll participation data. The School District received $2,182,045 in categorical aid to help offset the impact of the approximately 4 percentage point increase in the retirement rate. The additional funding did not provide sufficient resources to cover the full cost of the required contribution increase. The 2012/2013 State Aid Act continues the MPSERS cost support categorical, using the same formula.

State Aid Planning Considerations for 2012/2013 and Beyond

Michigan's economy continues to show signs of improvement but the rate of improvement is slow. Even with the changes in the tax structure, the State has shown an inability to generate substantial additional revenue, including in the School Aid Fund. The governor's budget theme in 2012 continued to focus on a "pay for performance" concept and the State continues to deploy school aid funds as part of that theme. In contrast to the foundation funding cuts in 2011/12 which impacted all districts, when the State had additional resources those resources were not reallocated to districts "across the board." Instead, some districts received modest foundation allowance increases with a focus toward improving equity amongst lower funded districts. The remainder of any funding increases was tied to specific objectives districts were required to meet. It appears that the initial concept of the foundation allowance, which was to provide resources to the local districts and empower them to decide how those resources were to be used, has changed noticeably. As the School District looks to the future, careful planning will continue to be a key. The use of budget modeling will increase in importance especially as it looks to assess the impact of the best practice funding approach and a continued focus of funding based on student achievement.

MPSERS Reform and Future Contribution Rates

During 2007 and again in 2010, the Michigan legislature enacted several reforms designed to curb the rising contribution rates and perpetual under-funded situation of the Michigan Public School Employee Retirement System (MPSERS). These reforms included early retirement incentives, employee funding of a portion of retiree health costs, a tiered rate and benefit structure for employees hired after July 1, 2010, and certain other provisions. These provisions were designed to avert a long-term financial crisis with the plan. The impact of investment declines during 2008 and 2009, coupled with a shrinking base of contributing active lives funding an ever larger numbers of retirees continue to result in rising costs of sustaining the MPSERS program.

The 2011-2012 State Aid Bill contained two provisions designed to defray a portion of these costs. $155 million was set aside from the School Aid Fund (SAF) for one-time allocations that districts used to offset their annual retirement contribution in 2012. Similar funding for MPSERS offsets are being provided in 2012-2013. Also in 2011-2012, $133 million was taken from the SAF to be held in a "Retirement Obligation Reform Reserve Fund" and utilized for future pension reform needs. To date, these funds remain in the Retirement Obligation Reform Reserve Fund and no decision has been made regarding their use.

Public Act 300, signed by the governor in September 2012, was designed to cap the employer contribution rate at 24.46 percent, increased employee contributions, provided for future employees to receive defined contribution instead of the current defined benefit for health care, and began prefunding health care benefits from a pay-as-you-go method to a combination of employee contributions, employer contributions, and state funding. The rate cap, originally set at 24.46 percent; will mean that the SAF will be responsible to fund any unmet required contributions determined by the actuaries. A concern is that the State funding needed to keep the rate down may limit the ability for the SAF to provide any increases in the foundation allowance and other categoricals. This will be a key factor to watch over the next few years. In late September, districts were notified that due to the legal challenges submitted related to the 3 percent contribution from employees, the retirement rate would not be able to be capped, as had been planned. The rate, effective October 1, 2012, increased to 25.36 percent of covered payroll. This .9 percentage point increase represents an actual increase of 3.7 percent. Until the Supreme Court rules on the constitutionality of the 3 percent contribution from employees, the rate is expected to remain at this higher number.

For your district, the new rate of 25.36 percent rate for 2012-13 will represent approximately $28,500,000 in total pension costs and retirement health care costs. We will continue to keep you informed as the changes to the retirement system unfold.

Federal Program Related Items

Fiscal Monitoring - The Michigan Department of Education (MDE) has instituted a grants fiscal monitoring process. The MDE has performed grants performance reviews in the past and will continue to do so. In addition, they are now also looking at the School District's accountability process. This process will focus on the financial aspects of grants management with an emphasis on control procedures assessments in the key compliance areas of the grant. These actions are the result of an increased federal emphasis for pass-through entities (the State of Michigan) to improve their monitoring efforts. To assist school districts in their compliance efforts, the State has issued a self-evaluation checklist which will allow school districts to identify areas which may require addition attention. We highly recommend the School District obtain the checklist (located on the MDE website) and self-assess its processes against the types of items the MDE is focused upon.

Written Procedures for Grants - The Michigan Department of Education continues to emphasize the importance of maintaining adequate written procedures for grants. Additionally, the department has added example procedures to the office of audits website for reference. These requirements are described in 34 CFR Part 80, 2 CFR Part 215, and OMB Circular A-133 Compliance Supplement Part 6. We encourage the School District to further update written procedures for grants using the guidance provided by the Department of Education, which can be found on the office of audits website for the Michigan Department of Education.

Special Education Excess Cost - The concept of "excess cost" has been a compliance matter within the special education cluster federal program; however, due to lack of guidance from the State of Michigan, school districts were not required to comply with the excess cost in the past. "Excess costs" are those costs incurred for the education of an elementary school or secondary school student with a disability that are in excess of the average annual per-student expenditure in a school district during the preceding school year. School districts will be required to compute the minimum average amount of per-pupil expenditure separately for children with disabilities in its elementary schools and for children with disabilities in its secondary schools, and not on a combination of the enrollments in both. The Michigan Department of Education is currently working on a tool which would assist school districts in computing the minimum average amount. Once this tool is finalized, the MDE will provide additional guidance and the School District will be required to show compliance. It is important the School District be aware of this requirement and be prepared to demonstrate compliance for fiscal year 2012-2013.

Special Education Maintenance of Effort - For fiscal year 2010-2011, the State of Michigan piloted an approach which analyzed maintenance of effort on an aggregate basis by ISD. Therefore, if an ISD passed, the local School District was deemed to have passed as well. ISDs that did not pass upon initial review by the State are responsible for working with the State to determine if an exception had been met and/or if there were further issues to resolve. Because the approach for the 2010-2011 fiscal year was a pilot, local school districts should continue to track maintenance of effort individually and coordinate the plan within the ISD to ensure the effort is being maintained. There is no indication currently that the county-wide testing approach will be suspended.

Special Education Proportionate Share - One of the requirements of the IDEA federal grant is that the School District expend a proportionate share of its allocation on services related to parentally placed private school children with disabilities enrolled in private elementary and secondary schools. Recently, the Michigan Department of Education issued guidance on the computation for determining the percentage. The School District should be aware of this requirement and should retain documentation supporting the percentage computed as well as evidence of expenditures related to these required services.

GASB Proposed Changes

The Governmental Accounting Standards Board has recently proposed/implemented two major standards changes for public comment. These changes, if enacted, will create major financial reporting changes for all governmental entities in future years. Following are highlights of the two provisions:

GASB's No.63 - *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position* and No.65 - *Items Previously Reported as Assets and Liabilities*

Effective for the year ending June 30, 2013, GASB No.63 will be implemented. GASB No.63 provides guidance on financial reporting related to deferred outflows of resources and deferred inflows of resources. The pronouncement impacts the governmental fund-based, government-wide, proprietary, and fiduciary fund financial statements.

The objective of this statement is to improve financial reporting by standardizing the presentation of deferred outflows of resources and deferred inflows of resources and their effects on a government's net position. It alleviates uncertainty about reporting those financial statement elements by providing guidance where none previously existed.

"Deferred inflows" and "deferred outflows" are defined as follows:

> Deferred inflows: An acquisition of net assets by the government that is applicable to a future reporting period. The most common example for a school district would be property taxes recorded as a receivable at June 30 which are not received within 60 days following year end.
>
> Deferred outflows: A consumption of net assets by the government that is applicable to a future reporting period. The most common example for a school district would be deferred funding charges paid on bonds. These would be shown only on the government-wide statement of net position.

Once implemented, the School District's statement of net assets (the government-wide statement) will become the statement of net position. Components of the statement of net position will include assets, deferred outflows of resources, liabilities, deferred inflows of resources, and net position. Net position will continue to be reported in three categories, which will include net investment in capital assets, restricted, and unrestricted. There are two format choices for the statement of net position.

The governmental fund balance must continue to use the balance sheet presentation they have always used and will retain the terminology "fund balance" vs. "net position."

GASB was careful at the time GASB No. 63 was issued to state that nothing on the balance sheet could be classified as a deferred inflow or deferred outflow until specifically proscribed by the GASB. They made none of those decisions in GASB No. 63, opting instead to delve into the issue more specifically under a different standard.

GASB No. 65 is the final standard that was issued to close the loop on the concepts of deferred inflows and deferred outflows as a result of the issuance of GASB Statement No 63. GASB No. 65 reclassifies, as deferred outflows or deferred inflows of resources, certain items that were previously recorded as assets and liabilities. In addition, GASB also found certain items that they felt should not hit the balance sheet at all; as a result, this statement requires recognition of those items as either an outflow (expenditure/expense) or inflow (revenue) of resources.

The following are examples of items which will have changes to presentation under GASB Nos. 63 and 65:

Account Balance	**Treatment**
Debt refunding - Difference between reacquisition price and carrying value of debt (or lease)	Deferred inflow
Resources received (or receivable) before the period resources may be used (including property taxes before the period levied)	Deferred inflow
Government mandated nonexchange revenue or voluntary nonexchange resources received before eligibility requirements are met (excluding time requirements)	Liability
Awaiting just time requirements	Deferred inflow / outflow
Debt issuance costs	Expense
Prepaid insurance costs	Asset (then amortized)
Operating leases - Initial direct costs	Expense
Insurance - Acquisition costs	Expense
Governmental Funds - Revenue that is not available	Deferred inflow

One other important provision in GASB Statement No. 65 relates to the use of the term "deferred." Under this pronouncement, GASB has restricted the use of this terminology only to items reported as deferred inflows or deferred outflows. Items which had previously been termed “deferred revenue” will now be called "unavailable revenue" or "unearned revenue."

The data required to record this liability will come from the MPSERS and there will be expanded disclosure in the School District's financial statement, footnotes regarding this obligation. For your June 30, 2012 financial statements, a footnote was added to alert the reader this pronouncement will be implemented in the future. We will keep you apprised of this GASB as more information becomes available.

GASB No.68 - Pension Standards

GASB has issued their long-awaited pension standards, GASB No.68 - *Financial Reporting for Pensions*, which will be effective for the School District's June 30, 2015 financial statements. Due to the School District's participation in the Michigan Public School Employees' Retirement System (MPSERS), the School District will be required to reflect their share of the long-term pension obligation for the plan on their financial statements. This liability will be recorded only on the government-wide financial statement and will represent the School District's share of the unfunded pension liability for the entire system. Currently, the unfunded liability associated with retiree health care is not included in the computation, but may be in the future.