STATE OF MICHIGAN
DEPARTMENT OF EDUCATION
LANSING

JENNIFER M. GRANHOLM
GOVERNOR

MICHIGAN Department of Education

MICHAEL P. FLANAGAN
SUPERINTENDENT OF
PUBLIC INSTRUCTION

December 23, 2008

Dr. Carla Scott, President
& Board of Education Members
Detroit Public Schools Board of Education
7322 Second Avenue, Suite 485
Detroit, MI 48202-2711

Dear Dr. Scott and Detroit Board of Education Members:

The purpose of this letter is to inform you that I have confirmed my December 8, 2008, determination that a financial emergency exists in the Detroit Public Schools District (the District).

On December 8, 2008, I notified you that I had determined that a financial emergency existed in the Detroit Public Schools District (the District). (Exhibit 18). At your December 9, 2008, board meeting, the Detroit Public Schools Board (the Board) adopted a resolution to request a hearing concerning my determination that a financial emergency exists in the District. On December 12, 2008, I sent a Notice of Hearing informing the Board that despite the fact that the Board had waived its right to a hearing and appeal in its Consent Agreement, I decided to provide the Board with an opportunity for a hearing. The Notice of Hearing informed the Board that the hearing would be held the week of December 15, 2008, but no sooner than December 18, 2008. (Exhibit 23). In a letter signed by a majority of the Board dated December 15, 2008, the District requested a hearing and requested notice of the date of the hearing and the procedures to be used in the process.[1]

On December 16, 2008, I sent a second Notice of Hearing notifying the Board that the hearing would be held at 10:00 a.m. on Thursday, December 18, 2008, at the Michigan Gaming Control Board Hearing Room in Detroit, Michigan. (Exhibit 24). The December 16, 2008, Notice of Hearing also informed the Board of the procedure that would be followed at the hearing. This notice was transmitted to each Board member by e-mail, via facsimile, and by overnight mail on December 16, 2008.

[1] Although the letter was dated December 15, 2008 it was not transmitted to Deputy Superintendent Carol Wolenberg until December 18, 2008.

The hearing was conducted on December 18, 2008. Although the Board's representative, David Olmstead, protested the hearing, this protest appears insincere due to the Board's December 9, 2008, resolution and December 15, 2008, letter requesting a hearing.

At the hearing, representatives from the State of Michigan submitted 24 exhibits for the record and were given 30 minutes to present any information relative to my determination that there is a financial emergency in the District. Frederick Headen, Director of the Bureau of Local Government Services, Michigan Department of Treasury, gave a statement summarizing the activities and findings of the Financial Review Team and the key provisions of the Consent Agreement entered into by the Financial Review Team and the District. Carol Wolenberg, Deputy Superintendent and Chief Financial Officer of the Michigan Department of Education (MDE), presented the details that led to the initial determination that the District had a serious financial problem, the District's violation of the Consent Agreement, and significant events since December 8, 2008.

Representatives from the District were given 40 minutes to present information relative to my determination that the District has a financial emergency. Three people presented information on behalf of the District: attorney David Olmstead, attorney Floyd Allen, and the District's internal auditor William Aldrich. In addition, the District submitted three sets of documents that were labeled Exhibits A, B, and C. Mr. Olmstead's statement related entirely to legal arguments protesting the hearing. Mr. Allen's presentation concerned the District's history and its contention that it had complied with the terms of the Consent Agreement. Mr. Aldrich briefly testified to identify the exhibits alleged to show compliance with the Consent Agreement.

Findings of Fact of the Continuing or Newly Developed Conditions or Events that Provide the Basis for the Confirmation of the December 8, 2008 Determination and Statement of Facts Supporting these Findings.

The following information will outline the findings of fact of the continuing or newly developed conditions or events that provide the basis for the confirmation of my determination and a statement of the facts supporting these findings. All referenced Exhibits were admitted during the hearing on December 18, 2008.

In a letter to Governor Jennifer M. Granholm on September 17, 2008, I declared that the Detroit Public Schools District had a serious financial problem, pursuant to Article 3 of the Local Government Fiscal Responsibility Act (the Act), MCL 141.1231- MCL 141.1244. (Exhibit 9) This determination was made due to the fact that the State Senate had passed a resolution requesting a review and report of the financial condition of the District. (Exhibit 3). My report to the Senate identified multiple areas of financial weakness, three of which were considered critical: 120 findings from the 2006-2007 Single Audit; the District was placed in High Risk status for all federal education programs; and the District's submission of a Deficit Elimination Plan that was unacceptable to the MDE. (Exhibit 8).

The District was given an opportunity to address its deficit in August by submitting a Deficit Elimination Plan (the Plan) to the MDE to resolve a projected shortfall of $112.8 million. (Exhibit 6). In an attempt to reach out to the District and gain a better understanding of the details and viability of the Plan the District submitted, I initiated a September meeting with the District Board president, appropriate committee chairs from the District Board, and the District administration. During the course of our meeting and after further review, it was clear that the Plan submitted was unacceptable due to lack of data integrity and the fact that little action had been taken to implement any of the budget reduction measures outlined in the Plan. This was just one in a series of previous instances in which District officials, both the administration and the Board, failed to take necessary action to address the District's fiscal problems.

Following my September 17, 2008 declaration that the District had a serious financial problem, and pursuant to the Act, Governor Granholm appointed a Financial Review Team (the Team) to review the District's financial situation and issue a report and recommendation based on the Team's findings. (Exhibit 10). The Team's report confirmed that the District has a serious financial problem and found, among other things, that District officials failed to implement provisions of prior agreements to address budgetary concerns; operated in a deficit condition numerous times over multiple years; and contributed to a pattern of deficit spending facilitated through a series of short-term notes and refinancing short-term debt into long-term debt. (Exhibit 13). The Team cited several other factors that worked to compound the financial situation, including: "declining student enrollments, coupled with the inability or unwillingness of School District officials to make in a timely manner the budgetary adjustments necessitated by those declines in enrollment; a demonstrated inability of the administration and Board of Education of the School District to work cooperatively in a consistent manner over time; and administrative inconstancy due, in part, to a succession of general superintendents in the School District."

The Team's report highlighted the reality and seriousness of the District's financial problem. It also confirmed that District officials have not demonstrated the ability to resolve their budget problems and appropriately manage their finances. However, in an attempt to avoid a determination that the District had a financial emergency, the Team offered the District an opportunity to address the situation through a Consent Agreement. The Consent Agreement was intended to resolve the District's serious financial problem by mandating that District officials perform specific actions within specific timeframes. In the absence of a Consent Agreement, the Team would have determined that a financial emergency exists in the District. (Exhibit 12).

On October 31, 2008, the Team sent the proposed Consent Agreement to the District. (Exhibit 11). The transmittal letter noted that the Team's Report must be filed by November 5, 2008 and therefore, the signed Consent Agreement approved by the Board of Education must be received by noon on November 5, 2008. The transmittal letter also stated that the Team was "willing to meet with representatives of the Board of Education on Monday, November 3, 2008, to further explain the Contents of the Consent Agreement." (Exhibit 11). There is no indication that the District ever requested a meeting with the Team.

On November 5, 2008, the District's Board of Education adopted a resolution for execution of the Consent Agreement and the District's general superintendent signed the Consent Agreement. (Exhibit 12).

On November 6, 2008, the Team sent its report to the Governor and me. (Exhibit 13). The Report confirmed the findings in my report to the Senate and found that the District does have a serious financial problem, but that a Consent Agreement had been adopted pursuant to section 34(2)(c) of the Act.

In my letter to Governor Granholm dated December 1, 2008, I determined that the District has a serious financial problem, but a Consent Agreement containing a plan to resolve the problem had been adopted. (Exhibit 16).

The Consent Agreement gives me the responsibility and authority to hold the District accountable for failure to abide by the Agreement. As it clearly states, "the failure of the School District to comply **in any respect** with this Consent Agreement may be considered by the Superintendent of Public Instruction sufficient cause for recommending the immediate appointment of an emergency financial manager pursuant to Section 38(1) of the Act, **the provisions of Sections 35 through 37 of the Act to the contrary notwithstanding.**" (Emphasis added)(Exhibit 12). The District argues substantial compliance is sufficient. But, the plain language of the Consent Agreement provides that the District's failure to comply with the Consent Agreement "in any respect" is considered sufficient cause for recommending "the immediate appointment" of an emergency financial manager.

Section II of the Consent Agreement requires that the District, within 28 days of the Consent Agreement's execution, submit to the MDE a Deficit Elimination Plan (the Plan) that contains to the satisfaction of the MDE specific and realistic expenditure reductions that will sufficiently address any current operating deficit in any fund maintained by the School District by not later than June 30, 2010, as evidenced by a budget adopted for the fiscal year commencing July 1, 2009. The Consent Agreement also required a resolution adopted by the District's Board which authorized the District general superintendent to take any and all action necessary to implement the Plan without further, or subsequent, approval by the District's Board. (Exhibit 12).

On December 3, 2008, the due date for the Deficit Elimination Plan, the District submitted two documents to the MDE intended to meet the requirements described above: a Board resolution entitled, "Detroit Board of Education Resolution Regarding Adoption of 2008-2011 Deficit Elimination Plan and Consent Agreement," and a draft copy of a document entitled, "Revised Budget Reduction Strategy Update" dated December 1, 2008. (Exhibit 17).

Furthermore, on the afternoon of December 4, 2008, District officials submitted additional documentation to the MDE intended to constitute a revised Deficit Elimination Plan. (Exhibit 18). After thorough review, the documents do not meet the requirements of the Consent Agreement and are unsatisfactory to the MDE for several reasons.

First, the District did not submit a Board-adopted Deficit Elimination Plan or budget as required by the Consent Agreement, the Uniform Budgeting and Accounting Act, MCL 141.1421 *et seq*, the State School Aid Act, MCL 388.1702, and the Michigan Public School Accounting Manual.

Second, the District did not submit a resolution adopted by the Board that resolved to authorize the District's general superintendent to take any and all action necessary to implement the Plan without further, or subsequent, approval by the District's Board. This is clearly at odds with the unambiguous language of the Consent Agreement and violates the Consent Agreement's requirements. At the hearing, Mr. Allen claimed that the Board had complied with this requirement. However, when asked to identify the resolution, he was unable to do so. The resolution submitted by the Board, Exhibit 17, does not contain the required authorization and Mr. Allen's statements regarding compliance were misleading, at best.

Third, though the MDE repeatedly provided the District with a prescribed Deficit Elimination Plan format, the District submitted the draft "Revised Budget Reduction Strategy Update" dated December 1, 2008, which neither follows this format nor contains the information required by this format including a Standard Deficit Elimination Spreadsheet. (Exhibit 17). Therefore, the District's documents were not submitted to the satisfaction of the MDE as required by the Consent Agreement.

Fourth, the draft "Revised Budget Reduction Strategy Update" dated December 1, 2008, lacks the specific information and detail required by the Consent Agreement for the MDE to determine whether or not it would sufficiently address the District's deficit. Necessary financial data such as a revised budget, trend data, administrative procedures, and even a deficit figure upon which a Deficit Elimination Plan could be based, are absent from the draft "Revised Budget Reduction Strategy Update" dated December 1, 2008. The draft "Revised Budget Reduction Strategy Update" dated December 1, 2008, also contains inconsistent data throughout. For example, it indicates monetary savings figures for employee reductions varying between $28 million and $36.7 million, giving the MDE no consistent savings figure.

The District maintains that it followed the guidelines for budget adoption and submission contained in Section VII of the Consent Agreement and did not interpret the language of the Consent Agreement to require that the Deficit Elimination Plan include a revised budget. (Exhibit B-B). Although Section II of the Consent Agreement refers to a budget adopted for the fiscal year commencing July 1, 2009, the MDE consistently requires every district in deficit to include an approved budget for the current year with the submission of a deficit elimination plan. This requirement is consistent with the Uniform Budgeting and Accounting Act (MCL 141.437) which requires the Board to adopt budget amendments for changes in projected revenues or expenditures as they become necessary throughout a given year.

The Districts Exhibit B-C claims that the District provided the Standard Deficit Elimination Spreadsheet, missing from its December 3, 2008, submission, a day late in the District's December 4, 2008, submission. This submission was made after the due date contained in the Consent Agreement. Even if I had chosen to waive the due date and accept the District's December 4 submission, all materials submitted by the District, both on December 3 and 4, were not sufficient to constitute a satisfactory deficit elimination plan as detailed in my December 8, 2008 letter.

Exhibit B-C also acknowledges that the deficit elimination plan the District submitted reflected contradictory amounts for the June 30, 2008, General Fund Balance, one of which it admits was incorrect and based on the expenditure balance from the District's August 2008 deficit elimination plan submission that was not approved. Not only did the District's submission include two contradictory deficit balances of -$130,404,302 and -$162,026,625, but on December 5, 2008, the District's auditors indicated that the deficit fund balance was -$139 million. The District should have confirmed the amount with the auditors before submitting disparate numbers to the MDE. The exhibit's contention that the District could not provide consistent numbers because its audit was incomplete at the time the deficit elimination plan was submitted is further evidence of the District's financial trouble as the audit itself was statutorily due to the MDE on November 15, 2008.

Additionally, projected revenues in the DPS Projected Revenue FY09-11 reports (Exhibit 18, page 22 of 51) total 2008-09 revenues of $1,142,621,496. This figure does not match the DPS Projected Revenue and Expenditures 2008-09 revenues reported as $1,143,697,125 (Exhibit 18, page 23 of 51). Neither of these amounts matches the Deficit Elimination Plan Worksheet (Exhibit 18, page 33 of 51) which reports 2008-09 revenues as $1,139,829,909.

The Changes in Instruction Function Worksheet (Exhibit 18, page 32 of 51) indicates that the District would reduce instructional staff (teachers and aides) during 2008-09 by 3,732 FTE (642 by attrition, 1,890 teacher layoffs, and 1,200 non teaching FTE). This is inconsistent with budget reduction strategy number two which states it will reduce instructional staff by 818 (230 layoffs, 471 funded positions and 117 deleted vacant positions) during fiscal year 2008-09. Furthermore, the 2008-09 instructional function savings ($82 Million) reported on the Changes in Instruction Function Worksheet (Exhibit 18, Page 32 of 51) does not match the instructional function savings ($76 Million) reported on the deficit elimination plan (Exhibit 18, page 33 of 51.)

There are numerous other examples of contradictory data in the District's submission. It seems reasonable to expect that all the numbers reported within financial documents submitted on the same day should contain consistent amounts for fund balances, revenues, expenditures, and staff reductions during a given year. When they are not, it is strong evidence of the District's rudimentary financial problems.

Finally, the MDE determined that the District's December 3 submission of a draft "Revised Budget Reduction Strategy Update" did not constitute an acceptable deficit elimination plan for the reasons described in my letter of December 8, 2008. Exhibit B-C contends that this document was intended to be a supplemental document "designed to address the concerns of the August 14, 2008, budget reduction strategies rejected by the MDE." As this was the document the District submitted to the MDE on the December 3, 2008 deficit elimination plan due date, and it was accompanied by a Board resolution entitled, "Detroit Board of Education Resolution Regarding Adoption of 2008-2011 Deficit Elimination Plan and Consent Agreement," it is apparent that this document was not intended to be supplemental. Instead it was intended to constitute a deficit elimination plan. As such, it was unacceptable.

The District also failed to comply with Section IV of the Consent Agreement. Section IV of the Consent Agreement required that the District submit an accounts payable listing detailing all accounts payable in the amount of $10,000 or more which are more than 30 days beyond their due date. (Exhibit 12). Though the submission deadline was met, the Consent Agreement requires that a proposed schedule for payment and information detailing accrued interest on the payables be included in the report. This information was not included, undermining the purpose of the requirement to force action in resolving overdue vendor payments. (Exhibit 14). The District's response, Exhibit B-D, acknowledges that the proposed schedule for payment required along with the District's accounts payable listing was not submitted as noted in my December 8, 2008, letter. The District claims that this was due to "PeopleSoft system logic and the District's internal Accounts Payable process." The MDE does not accept this as a reasonable excuse for not submitting information both required by the Consent Agreement and also required for the operation of a financially sound district.

The District has been in deficit for multiple years over the course of several decades. (Exhibit 13, Table 1). During that time, the MDE's interactions with the District have exposed numerous systemic issues including the failure to meet deadlines and requirements, the misappropriation and lapsing of significant amounts of federal dollars, and an inability to remedy its financial problem by taking appropriate action. In its report on the District, the Council of Great City Schools confirmed the District's lack of leadership acknowledging that the District Board has "not always been clear or unified about where it was going or why." (Exhibit 5). It calls for officials to demonstrate the "leadership necessary to improve and reform a school system that has been in deep trouble for some years." This has not occurred.

Several facts provide evidence of the lack of overall leadership, judgment, and management compounding the District's problems. For instance, the District was placed in High Risk status in August 2008 due to federal audit findings that indicated the misuse of over $53 million in federal Title I, Part A, education program dollars. (Exhibit 4). The District's Exhibit A-F maintains that the U.S. Office of Inspector General (OIG) audit covered a period that the Reform Board was in control of the District. The MDE does not dispute this; however, it is irrelevant to the District's present financial condition. The current Board is responsible for addressing the District's High Risk status regardless of when the financial conditions deteriorated and who was to blame at that time.

In addition, as part of the District's High Risk status designation, the MDE requested a copy of the District's conflict of interest policies. The District provided six different policies, some of which were in direct contradiction with others. (Exhibit 19, A-A). The District's response acknowledges that there are multiple conflicting policies that were pre-Reform Board, Reform Board, and post-Reform Board, but that it is in the process of completing a policies consolidation effort. (Exhibit A-A). Thus, the District confirms that there are multiple, contradictory policies and no single policy manual.

The District consistently uses unconventional budget practices that make it difficult to monitor actual revenues and expenditures. For example, last year the District allocated the amount awarded for various grants to a "central office" account rather than allocating the money to the appropriate account reflective of the function for which the funds would be used. These expenditures were moved to different functions on the monthly budgetary control reports submitted to the MDE. These unconventional budget practices indicate the lack of internal controls necessary to manage expenses adequately.

The District consistently lapses federal program dollars due to a lack of timely action. For example, the recent federal Reading First final expenditure report was not submitted on time. Without the MDE's willingness to make another exception for the District, this would have resulted in the loss of millions of dollars in federal funds this academic year.

The District consistently fails to pay vendors on time as evidenced by its recent accounts payable listing. The 7-page listing documented over 200 past due vendor payments totaling over $21 million. Some accounts payable have been overdue for over two years. Several vendors not included in the listing have publicly complained they are owed money. This raises the possibility that the report submitted was understated. The District's Exhibit A-B acknowledges the negative impact of untimely payments, but attempts to minimize the seriousness of the over 200 past due vendor payments by stating that the 7-page listing included only 47 active vendors, "(excluding the District's high schools)." This is not a valid excuse and also establishes that the listing submitted pursuant to the Consent Agreement is incomplete since, at a minimum, it excluded payments due to the District's high schools as well as payments due to inactive vendors.

The District has consistently demonstrated poor cash management practices. Over the past several months, the District made requests for last-minute wire transfers, particularly to cover payroll. The District's response to these poor cash management practices, Exhibit A-D, supports my determination that there is a financial emergency and the need for appointment of an emergency financial manager. The exhibit acknowledges that the District has a financial problem and notes that "the District's cash issue is the availability of cash to make payments." In response to the unavailability of cash, the exhibit states that "strategies are developed" and provides as an example that the District requests expedited payments from the City of Detroit. The District should not be dependent on expedited payments from the city or any other source in order to meet normal operating expenses.

The District consistently fails to follow Generally Accepted Accounting Practices (GAAP).

The District Board has established separate legal and auditing functions and separate offices and staff from the administrative functions. This duplication of services increases District expenses and contributes to the lack of systemic controls. The District's Exhibit A-C argues that the internal audit function should report to the Board. This is not in dispute. But, the Board consistently works autonomously from the administration. Moreover, the Board did not address the duplication of legal services between the District administration and the Board.

The District Board did not approve a contract with an auditor to complete the 2008 financial audit due by statute on November 15 of every year until September 2008. Much of the preliminary audit field work should have been completed by the end of June when the District budget is required to be adopted by the Board. The District's response in Exhibit A-E argues that they have now taken steps to assure this does not happen in the future. The exhibit indicates that the District has corrected this issue by assigning the annual financial audit responsibility to the internal audit department and by entering into an audit contract with a two-year renewal option. Although this may eliminate a lengthy request for proposal process if the District finds the contractor's work to be satisfactory, it does not provide for a timely audit. Section 18 of the State School Aid Act establishes the audit timeframes. The audit is due to Wayne RESA 120 days after the end of the fiscal year (October 28), and is due to the MDE on November 15. The contract entered into with Rehmann Robson on September 9, 2008, establishes an audit deadline of December 15, 2008. The District cannot ensure that future audits are timely if it does not modify this contract.

Additionally, since my December 8, 2008, determination that the District has a financial emergency, on December 10, 2008, the MDE received the required single and financial audits and financial information data for the fiscal year ending June 30, 2008, from the District. (Exhibits 20 & 22) The auditors reviewed eight major federal programs and clusters issuing an unqualified opinion for one cluster and qualified opinions on the remaining seven programs and cluster. This reflects material weaknesses and significant deficiencies in the District's compliance with federal requirements. The audit includes 84 findings. Fifty of the findings relate to issues with the District's financial statements. The remaining 34 findings reflect compliance deviations. The audit also identifies findings from the OIG audit that have not been corrected relating to fringe benefits and federal timekeeping requirements. Finally, the Schedule of Expenditures of Federal Awards is out of balance with the MDE's records for 18 grants.

Conclusion:

As the Superintendent of Public Instruction, I am responsible for monitoring the financial condition of all school districts to ensure compliance with state laws as well as their financial stability. Representatives for the Board claimed during the December 18, 2008, hearing that the Board fully intended to comply with the terms of the Consent Agreement. Whether or not this is true, the subjective nature of the Board's intent cannot be the basis on which I determine the financial condition of the District. The actions of the Board and administration and their effect on the fiscal stability of the District are the only criteria from which I can make my determination.

Therefore, based on the findings outlined in my December 8, 2008, letter and the findings of fact of the continuing or newly developed conditions or events and the statement of the facts supporting these findings outlined above, I confirm my previous determination that a financial emergency exists in the Detroit Public Schools District and that an emergency financial manager is required. As a result, I will submit to the Governor up to three names of nominees, one of which shall be appointed to serve as an emergency financial manager for the District.

Sincerely,

Michael P. Flanagan
Superintendent of Public Instruction

cc: Jennifer M. Granholm, Governor
Teresa Gueyser, Interim Superintendent
State Board of Education