STATE OF MICHIGAN
DEPARTMENT OF TREASURY
LANSING

JENNIFER M. GRANHOLM
GOVERNOR

ROBERT J. KLEINE
STATE TREASURER

DATE: November 6, 2008

TO: Governor Granholm
Michael P. Flanagan, Superintendent of Public Instruction[1]

FROM: Detroit Public School District Financial Review Team:
Robert J. Kleine, Chairman
Michael P. Flanagan
Lisa Webb Sharpe
Timotheus Weeks
Oscar W. King, III

SUBJECT: Report of the Detroit Public School District Financial Review Team

On October 7, October 15, October 17, October 20, October 22, October 24, October 29, October 30, November 3, and November 6, 2008, Detroit Public School District Financial Review Team members met and reviewed information relevant to the financial condition of the School District. Based upon those reviews, the Review Team concludes, in accordance with Section 34(3)(b) of Public Act 72 of 1990, the Local Government Fiscal Responsibility Act, that the School District does have a serious financial problem, but that a consent agreement containing a plan to resolve that serious financial problem has been adopted pursuant to Section 34(2)(c) of the Act.

I. Background

A. Preliminary Review

On August 27, 2008, the Superintendent of Public Instruction submitted to the Michigan Senate a

[1] Section 34(3) of Public Act 72 of 1990, the Local Government Fiscal Responsibility Act, provides, in part, that "t[he review team shall report its findings to the governor and the *state board* within 30 days after its appointment, or earlier if required by the governor." Emphasis supplied. However, Executive Reorganization Order 1996-12 transferred from the State Board of Education to the Superintendent of Public Instruction "[a]ll of the administrative statutory powers, duties, functions, and responsibilities of the State Board of Education set forth in the following provisions of the Michigan Compiled Laws:

> a. 141.1201 et seq. regarding procedures for the state take-over of a district in financial distress; ****

Therefore, consistent with Executive Reorganization Order 1996-12, this report is submitted to the Superintendent of Public Instruction in lieu of the State Board of Education.

review of the finances of the Detroit Public School District to determine whether or not a serious financial problem existed. Section 33(1) of the Act provides that the Superintendent of Public Instruction may determine that a school district has a serious financial problem if one or more of the conditions enumerated therein exist. The preliminary review of the Detroit Public School District resulted from the conditions enumerated in subdivisions (a), (f), and (h) of Section 33(1) having occurred within the School District.[2]

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[2] Subsection (a) provides that "[t]he school district ended the most recently completed school fiscal year with a deficit in 1 or more of its funds and the superintendent of public instruction has not approved a deficit elimination plan within 3 months after the district's deadline for submission of its annual financial statement." Subsection (f) provides that "[t]he superintendent of public instruction receives a resolution from either the senate or the house of representatives requesting a review under this section of the financial condition of the school district."

Senate Resolution 209, which was adopted by the Michigan Senate on July 28, 2008, reads as follows:

> A resolution to request the Superintendent of Public Instruction to conduct a review of the financial conditions of the Detroit Public Schools pursuant to the provisions of 1990 PA 72 and to report the findings to the legislature by August 27, 2008.
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> Whereas, The Local Government Fiscal Responsibility Act, 1990 PA 72, provides for the review, management, and planning of local units of government, including public school districts, that are facing financial emergency situations. This act sets forth specific steps to be taken to identify conditions that require emergency attention and outlines the process to be followed to ameliorate the situation; and
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> Whereas, Section 33 of this act, being MCL §141.1233, provides that either house of the legislature may request the state's Superintendent of Public Instruction to review the financial conditions of a school district. This sets in motion a series of actions ultimately aimed at rectifying problems that may subsequently be identified; and
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> Whereas, It has become clear that the state's largest school district, the Detroit Public Schools, is facing grave financial conditions. Reports indicate the possibility of the accumulation of a deficit over the past several years that is in the range of hundreds of millions of dollars. The severity of this financial crisis imperils the district's ability to educate students; and
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> Whereas, The legislature is deeply concerned about the welfare of the children of Detroit. It is critical to provide the necessary fiscal oversight that is currently lacking in the district. The legislature cannot stand by and let mismanagement fail the children in the state's largest school district. It is imperative that we ensure that state aid money from the taxpayers of Michigan is spent on the education of students and is not being diverted to areas where it may be wasted or spent inappropriately and therefore not put to its best use; now, therefore, be it
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> Resolved by the Senate, That, pursuant to the provisions of section 33 of 1990 PA 72, the Local Government Fiscal Responsibility Act, MCL § 141.1233, we request the Superintendent of Public Instruction to conduct a review of the financial conditions of the Detroit Public Schools. We also urge the Superintendent to forward to the legislature any and all relevant documentation that is currently on hand and any and all documentation that becomes available as part of the review process and to report the findings to the legislature by August 27, 2008; and be it further
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> Resolved, That copies of this resolution be transmitted to the Superintendent of Public Instruction.

Subsection (h) provides that "[t]he school district is in violation of the requirements of sections 17 to 20 of the uniform budgeting and accounting act, 1968 PA 2, MCL 141.437 to 141.440." Section 17 prohibits deviations from an

The preliminary review submitted on August 27, 2008, found, or confirmed, the following:

- On August 26, 2008, the Michigan Department of Education designated the School District as "high risk" resulting from "the ongoing and serious nature of the financial conditions and audit findings surrounding the Detroit Public Schools Title I, Part A, program. Such a designation imposes additional reporting requirements upon the designee and requires the Michigan Department of Education to work in close partnership with the Risk Management Services Division of the U.S. Department of Education to ensure that federal requirements are met by the designee."[3]

- The School District's 2007 single audit included 120 findings, 46 of which related to the financial statements and 74 of which related to compliance with federal program provisions.

- School District officials had transferred excessive funds from the School District's food service fund to its general fund.

- School District officials had not finalized a corrective action plan in respect to the School District's 2007 financial audit.

- The Schedule of Expenditures of Federal Awards prepared by School District officials was missing a Title I grant, overstated cash receipts for another grant, and did not properly total.

  On August 14, 2008, the Board of the School District adopted and submitted to the Michigan Department of Education a deficit elimination plan which the Department did not accept due to a lack of specificity and a lack of integrity of the data. At the time, School District officials were projecting a deficit of $112.8 million for the fiscal year ending June 30, 2008.

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adopted budget without a budgetary amendment and requires the chief administrative officer or fiscal officer to present amendments to the legislative body when necessary to prevent expenditures from exceeding revenues. Section 18 prohibits a member of the legislative body, chief administrative officer, administrative officer, or an employee of a unit of local government from creating or incurring a debt or other financial obligation on behalf of the unit of local government unless the debt or obligation is permitted by law. Finally, Section 19 prohibits a member of the legislative body, the chief administrative officer, an administrative officer, or an employee of a unit of local government from authorizing or participating in the expenditure of funds except as authorized in the budget. These requirements, taken collectively, are intended to forestall deficit spending by ensuring that expenditures in a unit of local government in a given year do not exceed the revenues that are identified and appropriated as part of the annual budgetary process.

[3] Pursuant to federal law, a school district may be considered "high risk" if it is determined that the district: (1) has a history of unsatisfactory performance; or (2) is not financially stable; or (3) has a management system which does not meet the management standards set forth in Title I, Part A; or (4) has not conformed to terms and conditions of previous awards; or (5) is otherwise not responsible.

- The School District continued to experience significant cash flow shortages, necessitating advances on State school aid payments for the months of July and August, 2008. Specifically, on June 24, 2008, School District officials requested the advance release of $103 million "[t]o assure [the District's] ability to continue to pay employees and vendors." In the absence of the requested school aid advances, School District officials estimated shortfalls in the ability to meet payroll obligations of $56 million to $66 million for July and August 2008.

- As further evidence of its ongoing cash flow shortages, the School District continued to borrow on a short-term and long-term basis. For example, the School District borrowed $139 million during 2007 from the Michigan Municipal Bond Authority's State Aid Note pool which amount matured on August 20, 2008. School District officials anticipated borrowing (and subsequently did borrow) approximately $143 million during 2008 from the Bond Authority's State Aid Note pool.

B. Review Team Findings

On October 7, 2008, the Governor appointed a five-member Financial Review Team. The Review Team convened on October 7, October 15, October 17, October 20, October 22, October 24, October 29, October 30, November 3, and November 6, 2008, to consider information relevant to the financial condition of the Detroit Public School District.

1. Conditions Indicative of a Serious Financial Problem

The Review Team found, or confirmed, the existence of the following conditions based upon information provided by School District officials, annual financial audit reports of the School District, or both:

- School District officials have demonstrated an ongoing inability to implement provisions of prior agreements, such as deficit elimination plans, that School District officials had assured State officials would address budgetary concerns through, among other things, the closure of underutilized school facilities, reductions in workforce, and other reductions in expenditures.

- The School District consistently has operated in a deficit condition for a number of years. As illustrated in Table 1, at the end of this report, general fund expenditures of the School District exceeded general fund revenues during seven of the eight fiscal years examined. The operating deficits ranged from a low of $10,631,337 in 2000 to a high of $122,167,428 in 2003; the estimated operating deficit for the 2008 fiscal year is $112.8 million. In many of the years during this period, general fund expenditures were not reduced or were not reduced commensurately in proportion to the decrease in general fund revenues. For example, general fund revenues decreased by $17,222,085 in 2001, compared to the prior year, but general fund expenditures increased by $10,193,257. Similarly, for the 2003 fiscal year, general fund revenues decreased by $19,006,122, compared to the prior year, while general fund expenditures increased by $43,837,180. [4]

- The pattern of deficit spending by the School District was facilitated by a succession of short-term notes. However, during the 2005 fiscal year, School District officials refinanced outstanding cash flow notes by issuing $210 million in bonds payable over a 15-year period. The effect of this refinancing was to convert what had been short-term debt into long-term debt.

2. Review Team Meetings

On October 17, 2008, Review Team members Lisa Webb Sharpe, Timotheus Weeks, and Oscar King, III, conducted a series of meetings in Detroit with the following School District officials: Connie Calloway, General Superintendent; Carla Scott, Board of Education President; Steven Wasko, Executive Director, Public Relations; Joan McCray, Chief Financial Officer; Delores Brown, Executive Director, Accounting; Walter Esaw, Executive Director, Budget and Interim Board Treasurer; Douglas Smith, Executive Director, Payroll; Clarence Tucker, Chief Contracting Officer, Contracting and Procurement; Srujan Bodepudi, Program Supervisor, Financial Training and Technical Services; Naga Nagaran, Executive Director, Financial Service Systems and Networks; Christopher Nelson, Chief Information Officer; Nathaniel Taylor, Chief of Facilities; Ines DeJesus, Associate Superintendent for Human Resources; Gwendolyn DeJonge, Chief Labor Negotiator; Virginia Cantrell and Patrick Falcuson, Detroit Federation of Teachers; Ruby Newbold, President, Detroit Association of Educational Office Employees; and Marvis Cofield, Otis Mathis, Terry Catchings, Marie Thornton, Ida Short, Annie Carter, and Jimmie Womack, Board of Education members.

The Review Team members present at the October 17 meetings were suitably impressed by the dedication, earnestness, and candor exhibited by the foregoing officials. It should be noted that, with one exception that was more definitional than substantive, none of the officials interviewed took issue with the underlying conclusion of the State Superintendent's preliminary review that a serious financial problem presently exists within the School District. However, the general consensus was that the present serious financial condition resulted not from a single catastrophic event, but from several factors which aggregated over time.

Among these factors were the following: 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; the

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[4] The eight-year period here examined includes the five-year period (1999 to 2004) during which the School District was governed by a seven-member reform board, appointed by the Mayor of the City of Detroit, pursuant to State legislation adopted in 1999. It is evident that the pattern of deficit spending was not ameliorated during the period of State intervention. However, it should be noted that the eight-year period is but an exemplar of a longstanding pattern of deficit spending by the School District spanning decades, a pattern which has continued under the current elected Board of Education.

admission by some members of the Board of Education of the School District of the reluctance to make necessary but politically difficult decisions; and administrative inconstancy due, in part, to a succession of general superintendents in the School District. [5]

Among the foregoing also should be noted the perception of some members of the Board of Education of the School District officials that the previous State intervention contributed to the School District's current financial problems.

3. Other Considerations

During the course of our meetings, a diversity of opinions were expressed regarding the appropriateness of, or the necessity for, State intervention. Several individuals expressed the view that should the Review Team reach the conclusion that a financial emergency exists and that an emergency financial manager should be appointed, such a conclusion would be perceived as "another State takeover." The adjective "another" was in reference to Public Act 10 of 1999 (about which more will be said in a moment) pursuant to which the authority of the Board of Education of the School District was suspended.

Given the foregoing perception, the Review Team thinks it necessary and proper to note that the consequences of the statutory conclusion reached in this report, if accepted, will differ in several significant respects from actions taken under former Public Act 10 of 1999.

First, the legislative justification for Act 10 had little to do with the financial condition of the School District. Rather, the focus was upon such factors as student performance and graduation rates.[6] By contrast, the sole purpose of the Review Team is to review and assess the *financial* condition of the School District. Act 72, under which the Review Team was appointed, is limited to financial matters and the authority of an emergency financial manager likewise would be limited in scope. Instructional matters, student performance, graduation rates, and the like will not fall within the orbit of an emergency financial manager's authority.[7]

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[5] Since 1989, the School District has had nine General Superintendents (or Chief Executive Officers while subject to Public Act 10 of 1999): John Porter, 1989-91; Deborah McGriff, 1991-93; David Snead, 1994-97; Eddie Green, 1998-99; David Adamany, (interim) 1999-00; Kenneth Burnley, 2000-05, William Coleman, 2005-07; Lamont Satchell, (interim), 2007; and Connie Calloway, 2007-present.

[6] For example, a March 31, 1999, analysis of Senate Bill 297, which became Act 10, indicated that the dropout rate during the 1996-97 school year for high school students in the Detroit School District was 26.4 percent, compared to a statewide average dropout rate of only 6.6 percent. Similarly, the four-year (grades 9 through 12) graduation rate for the Detroit School District was only 29.7 percent, compared to 76.2 percent statewide.

[7] For example, Section 41 of Act 72 provides, in part, that "[u]pon appointment under section 38, an emergency financial manager shall immediately assume control over all *fiscal* matters of, and make all *fiscal* decisions for, the school district for which he or she is appointed. Emphasis supplied.

Second, Act 10 suspended for a five-year period the authority of the School District's elected school board and established in lieu thereof a seven-member reform board, six members of which were appointed by the Mayor of the City of Detroit.[8] Furthermore, under the Act, the elected school board then in existence was relegated to no more than an advisory body. Indeed, even the period of its advisory status was limited to the unexpired terms of board members then in office. By contrast, if an emergency financial manager is appointed as recommended, that appointment will not affect the terms of office of the present school board, nor otherwise suspend its authority, except in regards to matters financial.

C. Conclusion and Recommendation

Based upon the foregoing meetings and review, the Review Team confirms the findings of the preliminary review, concludes that the School District does have a serious financial problem, but that a consent agreement containing a plan to resolve that serious financial problem has been adopted pursuant to Section 34(2)(c) of the Act. [9]

The Review Team is cognizant that its responsibilities under Act 72 are limited to an assessment of the School District's financial condition. Nevertheless, the Review Team is of the opinion that the foregoing financial condition has been exacerbated by non-financial considerations. Among these considerations have been the absence of stability in School District leadership, as evidenced by high turnover in the General Superintendent position, and related upper management positions;

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[8] Act 10 was adopted on March 26, 1999, and given immediate effect. As originally adopted, the Act provided that after five years, Detroit School District electors could select either to retain the reform board or recur to a traditional elected school board. Subsequently, Act 10 was amended by Public Act 303 of 2004. Act 303 provided that Detroit School District electors could select either a nine-member school board elected from districts and a Chief Executive Officer appointed by the Mayor or, in the alternative, an 11-member school board, seven members of which would be elected from districts, with the remaining four members being elected at large. At the November 2, 2004, general election, Detroit School District electors chose the latter option. An 11-member school board was elected on November 8, 2005, and assumed statutory responsibility for governance of the School District on January 1, 2006.

[9] The conclusion reached by the Review team concerning the School District's financial exigencies is supported by the findings of the Council of the Great City Schools, which recently submitted its report to School District officials. The Council's report noted in part, as follows:

> At the same time, the [Council review] teams found a school system whose financial standing was far more precarious than the leadership of the school systems had realized. This situation was many years in the making as well. The district has no capacity for long-term planning and its operations are largely transactional in nature. Its budget has no connection with district instructional or other priorities. Its internal financial controls are weak. It relies inordinately on short-term borrowing to cover debt in a way that both masks the extent of the financial problems and exacerbates long-term deficits. Its budget routinely assumes paying more people than it can support. Its position control system is inadequate. It has no strategy for correcting its many and repeated audit findings. Its payroll system is riddled with errors. Its risk management system is dysfunctional. Few of these problems emerged overnight.

inadequate school safety, as evidenced by the level of violence within the School District; the low level of educational performance; and a widely held belief among School District residents that the five-year intervention by the State gravely harmed the School District, leaving it financially worse off than before the intervention. Given the foregoing, any pronounced, long-term improvement in the financial condition of the School District likely will be inextricably dependent upon improvement of these non-financial considerations as well.

II. Review Team Report Transmittal Requirements

Section 34(3) of Act 72 requires that a copy of this report be transmitted to the Superintendent of Public Instruction, School District boardmembers, the Senate Majority Leader, and the Speaker of the House of Representatives.

cc: Detroit Public School District Board of Education members
Connie Calloway, General Superintendent
Mike Bishop, Senate Majority Leader
Andy Dillon, Speaker of the House of Representatives

Table 1
General Fund Revenues, Expenditures,
Change in Fund Balance, and Enrollment

	1999-00	2000-01	2001-02[10]	2002-03
Revenue				
General Operations	$1,212,541,532	$1,194,787,276	--	--
Special Programs	218,468,270	255,221,129	--	--
Auxiliary Operations	37,102,162	881,474	--	--
Local	--	--	$149,442,586	$135,938,289
State	--	--	1,204,706,629	1,191,449,831
Federal	--	--	199,031,889	206,786,862
Total Revenue	**$1,468,111,964**	**$1,450,889,879**	**$1,553,181,104**	**$1,534,174,982**
Expenditures				
Instruction	$537,667,895	$698,251,247	$875,700,585	$891,894,493
Support Services	427,692,759	516,718,280	626,045,607	651,198,490
Comm. Service	--	2,988,144	5,205,218	5,790,337
Debt Service			4,066,818	3,835,141
Capital Outlay	24,971,635	--	16,562,955	17,764,439
Other	488,411,012	270,978,887		935,463
Total Expenditures	**$1,478,743,301**	**$1,488,936,558**	**$1,527,581,183**	**$1,571,418,363**
Current Surplus/ (Deficit)	**($10,631,337)**	**($38,046,679)**	**$25,599,921**	**($37,243,381)**
Other Finance Sources				
Transfers In	--	4,578,791	53,667,403	59,376,611
Transfers Out	--	(2,070,262)	(56,473,131)	(60,157,662)
Bonds	--	--	--	--
Sale of Capital Assets	--	--	--	9,071,440
Total Other Fin. Sources	--	2,508,529	(2,805,728)	8,290,389
Beginning Fund Balance	**$114,959,354**	**$104,328,017**	**$80,808,808**	**$103,603,001**
Ending Fund Balance	**$104,328,017**	**$68,789,867**	**$103,603,001**	**$74,650,009**
Enrollment	**168,213**	**162,693**	**159,694**	**157,003**

[10] The beginning fund balance of $68,789,867 was increased by $12,018,941 to $80,808,808 due to a GASB 34 adjustment.

Table 1
General Fund Revenues, Expenditures,
Change in Fund Balance, and Enrollment
(Continued)

	2003-04	2004-05	2005-06	2006-07
Revenue				
General Operations	--	--	--	--
Special Operations	--	--	--	--
Auxiliary Operations	--	--	--	--
Local	$150,653,121	$167,084,062	$174,770,593	$196,808,961
State	1,119,522,326	1,024,334,845	972,484,297	913,734,458
Federal	240,881,118	244,634,339	232,094,003	277,370,294
Total Revenue	**$1,511,056,565**	**$1,436,053,246**	**$1,379,348,893**	**$1,387,913,713**
Expenditures				
Instruction	939,338,567	$878,408,647	$773,046,823	$774,288,861
Support Services	667,027,335	652,896,930	614,815,850	597,198,103
Comm. Service	6,836,155	5,729,048	4,804,658	8,388,184
Debt Service	3,334,500	2,362,145	2,022,143	18,465,335
Capital Outlay	16,636,226	9,442,504	6,109,796	6,667,098
Other	51,210	--	--	--
Total Expenditures	**$1,633,223,993**	**$1,548,839,274**	**$1,400,799,270**	**$1,405,007,581**
Current Surplus/ (Deficit)	**($122,167,428)**	**($112,786,028)**	**($21,450,377)**	**($17,093,868)**
Other Finance Sources				
Transfers In	--	--	--	6,123,051
Transfers Out	(1,916,975)	(2,868,955)	(3,546,883)	(3,888,729)
Bonds	--	210,000,000	--	--
Sale of Capital Assets	747,045	1,133,610	228,675	--
Total Other Fin. Sources	($1,169,930)	$208,264,655	($3,318,208)	$2,234,322
Beginning Fund Balance	**$74,650,009**	**($48,687,349)**	**$46,791,278**	**$22,022,693**
Ending Fund Balance	**($48,687,349)**	**$46,791,278**	**$22,022,693**	**$7,163,147**
Enrollment	**150,415**	**141,148**	**130,718**	**119,113**