Hillsdale Preparatory School

Hillsdale, Michigan

Audited Financial Statements

June 30, 2006

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INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
of Hillsdale Preparatory School

We have audited the accompanying financial statements of the governmental activities, each major fund, and the aggregate remaining fund information of Hillsdale Preparatory School, as of and for the year ended June 30, 2006, which collectively comprise the Academy's basic financial statements listed in the table of contents. These financial statements are the responsibility of Hillsdale Preparatory School's management. Our responsibility is to express opinions 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 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.

In our opinion, the financial statements referred to above present fairly in all material respects, the respective financial position of the governmental activities, each major fund and the aggregate remaining fund information of Hillsdale Preparatory School as of June 30, 2006, and the respective changes in financial position, for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis and budgetary comparison information on pages iii through ix and 16 are not a required part of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management, regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

The accompanying financial statements have been prepared assuming that Hillsdale Preparatory Academy will continue as a going concern over the fiscal year ending June 30, 2007. The condition that leads to this going concern uncertainty includes declining enrollment directly affecting funding levels and as a result its ability to meet school building debt obligations. These conditions raise substantial doubt about its ability to continue as a going concern. Management's plans regarding those matters are described Note 11 to the financial statements. The financial statements do not include any adjustments that might result from this uncertainty.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise Hillsdale Preparatory School's basic financial statements. The introductory section, combining and individual non major fund financial statements, and statistical tables are presented for purposes of additional analysis and are not a required part of the basic financial statements. The combining and individual non major fund financial statements have been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

In accordance with *Government Auditing Standards,* we have also issued our report dated August 24, 2006 on our consideration of Hillsdale Preparatory School's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. 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.

Croskey, Lanni & Company, P.C.

August 24, 2006
Rochester, Michigan

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MANAGEMENT'S DISCUSSION AND ANALYSIS

This section of Hillsdale Preparatory School's, "HPS", annual financial report presents our discussion and analysis of the school's financial performance during the fiscal year that ended on June 30, 2006. Please read it in conjunction with the school's financial statements, which immediately follow this section.

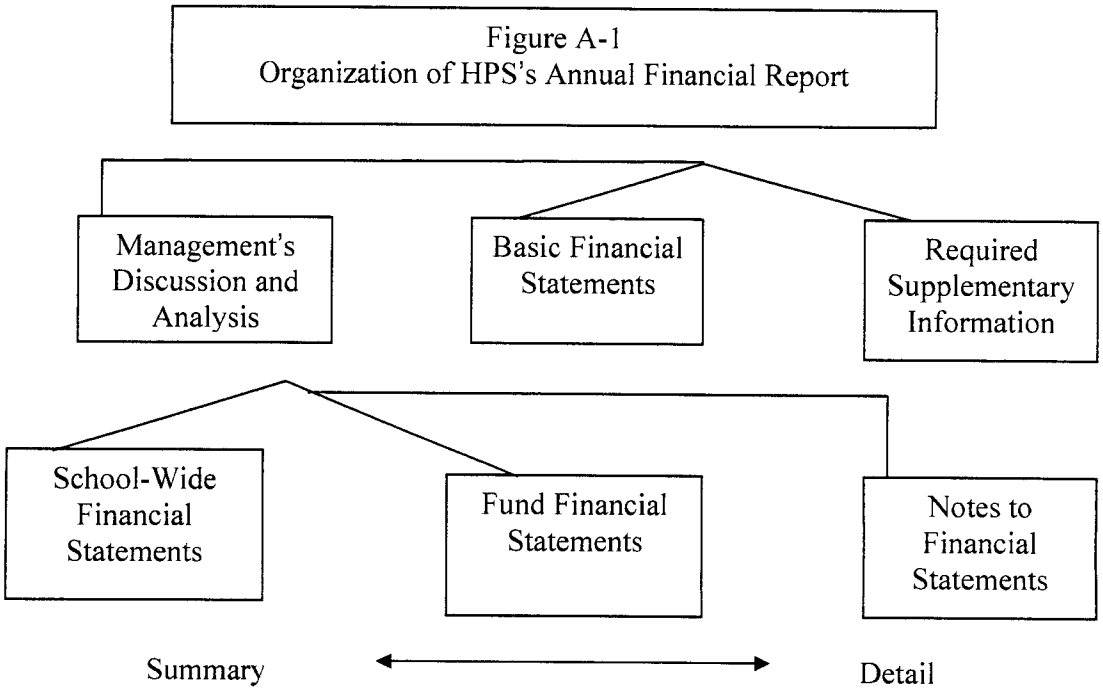
FINANCIAL HIGHLIGHTS

- General fund revenues were at $475,784, while expenses were $483,301; the school board chose to use a portion of its fund balance to cover the difference.
    - Instructional expenditures were $156,849.
- Enrollment was 39 students; the state's foundation allowance was paid based on a blended count of 53 students.
- The state increased by $175 per student resulting in a per pupil allowance of $6,875.
- As of 6/30/2006 the school has a positive fund balance in the General Fund of $13,811.

OVERVIEW OF THE FINANCIAL STATEMENTS

This annual report consists of three parts – management's discussion and analysis (this section), the basic financial statements which include two kinds of statements that present different views of the school:

- The first two statements are school wide financial statements that provide both short-term and long-term information about the school's overall financial status.
- The remaining statements are fund financial statements that focus on individual parts of the school, reporting the schools operations in more detail.
- The governmental fund statements tell how basic services like regular and special education were financed.
- Fiduciary funds statements provide information about the financial relationships in which the school acts solely as a trustee or agent for the benefit of others. These consist of student activity funds held by the school on behalf of the student group.



The financial statements also include notes that explain some of the information in the statements and provide more detailed data. The statements are followed by a section of required supplementary information that further explains and supports the financial statements with a comparison of the school's budget for the year. Figure A-1 shows how the various parts of this annual report are arranged and related to one another.

Figure A-2
Major Features of School-Wide and Fund Financial

		Fund Financial Statements	
	School-Wide Statements	Government Funds	Fiduciary Funds
Scope	Entire school (except fiduciary funds)	The activities of the school that are not proprietary or fiduciary, such as special education and building maintenance.	Instances in which the school administers resources on behalf of someone else, such as scholarship programs and student activities monies
Required Financial Statements	*Statement of net assets *Statement of activities	*Balance sheet *Statement of revenues, expenditures and changes in fund balances	*Statement of fiduciary net assets *Statement of changes in fiduciary net assets
Accounting basis and measurement focus	Accrual accounting and economic resources focus	Modified accrual accounting and current financial resources	Accrual accounting and economic resources focus
Type of asset/liability information	All assets and liabilities both financial and capital, short-term and long-term	Generally assets expected to be used up and liabilities that come due during the year or soon thereafter, no capital assets or long-term liabilities included	All assets and liabilities, both short-term and long-term
Type of inflow/outflow information	All revenues and expenses during year, regardless of when cash is received or paid	Revenues for which cash is received during or soon after the end of the year, expenditures when goods or services have been received and the related liability is due and payable	All additions and deductions during the year, regardless of when cash is received or paid

Figure A-2 summarizes the major features of the school's financial statements, including the portion of the schools activities they cover and the types of information they contain. The remainder of this overview section of management's discussion and analysis highlights the structure and contents of each of the statements.

SCHOOL-WIDE STATEMENTS

The school-wide statements report information about the school as a whole using accounting methods similar to those used by private-sector companies. The statement of net assets includes all of the school's assets and liabilities. All of the current year's revenues and expenses are accounted for in the statement of activities regardless of when cash is received or paid.

The two school wide statements report the school's net assets and how they have changed. Net assets – the difference between the school's assets and liabilities – are one way to measure the school's financial health or position.

- Over time, increases or decreases in the school's assets are an indicator of whether its financial position is improving or deteriorating, respectively.

- To assess the overall health of the school, you need to consider additional non-financial factors such as changes in the school's enrollment and the condition of school buildings and other facilities.

FUND FINANCIAL STATEMENTS

The fund financial statements provide more detailed information about the school's funds, focusing on it's most significant or "major" funds – not the school as a whole. Funds are accounting devices the school uses to keep track of specific sources of funding and spending on particular programs:

- *Governmental activities* – Most of the school's basic services are included in the general fund, such as regular and special education and administration. State foundation aid finances most of these activities.

- The school establishes other funds to control and manage money for particular purposes (like repaying its long-term debts) or to show that it is properly using certain revenues.

The school has two kinds of funds:

- *Governmental funds* – Most of the school's basic services are included in governmental funds, which generally focus on (1) how cash and other financial assets that can readily be converted to cash flow in and out and (2) the balances left at year-end that are available for spending. Consequently, the governmental funds statements provide a detailed short-term view that helps you determine whether there are more or fewer financial resources that can be spent in the near future to finance the school's programs. Because this information does not encompass the additional long-term focus of the school-wide statements, we provide additional information with governmental funds statements that explain the relationship (or differences) between them.

- *Fiduciary funds* – The school is responsible for ensuring that the assets reported in these funds are used only for their intended purposes and by those to whom the assets belong. We exclude these activities from the school-wide financial statements because the school cannot use these assets to finance its operations.

FINANCIAL ANALYSIS OF THE SCHOOL AS A WHOLE

The comparison of current year to prior year financial information is on the following pages. See tables A-3, A-4, and A-5.

The school's financial position is the product of many factors.

School Governmental

- A decline in enrollment over the past year has resulted in the school being unable to make its required debt payments on building. The school has entered into a forbearance agreement with US Bank and the bond holders in order to restructure the debt.

- HPS consistently curtails excessive spending

General Fund Budgetary Analysis
Over the course of the year, the school reviewed the annual operating budget several times and amended the budget three times.

Financial Outlook
The following factors are contributing to Hillsdale Preparatory School's financial forecast for the 2006-2007 school year.

- The State of Michigan anticipates a $210 increase in per pupil allowance.

- Employing a new Executive Director to further develop the schools mission, oversee classical instruction and recruit students.

- Continued efforts to curtail spending so that it aligns with revenue.

Appendix A

Table A-3
HPS's Net Assets

	2006	2005
Current and other assets	$ 344,346	$ 347,978
Capital assets	1,918,873	1,972,801
Total assets	2,263,219	2,320,779
Long-term debt outstanding	9,141	2,748,471
Other liabilities	2,675,380	-
Total liabilities	2,684,521	2,748,471
Net assets:		
Investment in capital asset, net of related debt	(582,986)	(507,199)
Restricted	253,690	-
Unrestricted	(92,006)	79,507
Total net assets	$ (421,302)	$ (427,692)

Table A-4
Changes is HPS's Net Assets

	2006	2005
Revenues:		
Program revenues:		
Charges for services	$ 8,288	$ 47,219
Federal and state operating grants	72,676	39,541
General revenues:		
State aid - unrestricted	370,081	688,760
Miscellaneous	17,242	173,805
Total revenues	468,287	949,325
Expenses:		
Instruction	156,849	280,673
Support services	223,108	357,484
Interest on long-term debt	28,012	187,465
Depreciation	53,928	53,928
Total expenses	461,897	879,550
Change in net assets	$ 6,390	$ 69,775

CAPITAL ASSET AND DEBT ADMINISTRATION

Capital Assets

By the end of 2006, the school had invested $2,149,050 in capital assets, including facilities, computers and software. This amount represents no change from last year. (More detailed information about capital assets can be found in Note 7 to the financial statements.)

Building	$ 2,050,503
Equipment	98,547
Subtotal	2,149,050
Accumulated depreciation	(230,177)
Net book value of assets	$ 1,918,873

Long-Term Debt

At year end the school had debt of $2,501,862 consisting of bond issuances and a capital lease.

- The school entered into a capital lease with MIJ Corp for the amount of $15,000, refinancing some of its current equipment.
- The school continued to pay down its debt, retiring $23,138 of the amounts due on installment loan and capital lease.
- The balance on the certificates of participation remained at $2,480,000.

FACTORS BEARING ON THE SCHOOL'S FUTURE

- Further development of the Classical Education Model.
- Increase and stabilization of student enrollment.
- Addition of a school leader.

CONTACTING THE SCHOOL'S FINANCIAL MANAGEMENT

This financial report is designed to provide our students, parents and creditors with a general overview of the school's finances and to demonstrate the school's accountability for the money it receives. If you have questions about this report or need additional information, contact the school's office at:

Hillsdale Preparatory School, 160 West Mechanic Hillsdale MI 49242

HILLSDALE PREPARATORY SCHOOL

STATEMENT OF NET ASSETS
JUNE 30, 2006

ASSETS

Current Assets	
Cash and cash equivalents	$ 257,368
Due from other governmental units	80,250
Prepaid expenses	6,728
Total current assets	344,346
Facilities, Furniture and Equipment	
At cost less accumulated depreciation of $230,177	1,918,873
Total assets	$ 2,263,219

LIABILITIES AND NET ASSETS

Current Liabilities	
Accounts payable	$ 36,470
Notes payable	15,436
Long-term debt - current portion	2,492,718
Other accrued expenses	130,756
Total current liabilities	2,675,380
Long-Term Debt - Long-Term Portion	9,141
Net Assets	
Restricted for debt service	253,690
Invested in capital assets, net of related debt	(582,986)
Unrestricted	(92,006)
Total net assets	(421,302)
Total liabilities and net assets	$ 2,263,219

See accompanying notes to financial statements

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HILLSDALE PREPARATORY SCHOOL

STATEMENT OF ACTIVITIES
FOR THE YEAR ENDED JUNE 30, 2006

Functions	Expenses	Program Revenues: Charges for Services	Program Revenues: Operating Grants	Net (Expense) Revenues and Changes in Net Assets: Government Type Activities
Elementary school	$ 156,849	$ -	$ 18,481	$ (138,368)
Student support services	6,712	-	6,712	-
Improvement of instruction	47,483	-	47,483	-
General administration	15,641	-	-	(15,641)
Executive administration	27,931	-	-	(27,931)
Building administration	63,094	-	-	(63,094)
Operations and maintenance	61,177	-	-	(61,177)
Central support services	1,070	-	-	(1,070)
Depreciation	53,928	-	-	(53,928)
Interest	28,012	8,288	-	(19,724)
Total primary government	$ 461,897	$ 8,288	$ 72,676	(380,933)
General Purpose Revenues:				
State school aid - unrestricted				370,081
Rental income				13,200
Miscellaneous				4,042
Total general purpose revenues				387,323
Excess of revenues over expenses				6,390
Net assets - July 1, 2005				(427,692)
Net assets - June 30, 2006				$ (421,302)

See accompanying notes to financial statements

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HILLSDALE PREPARATORY SCHOOL

BALANCE SHEET - GOVERNMENTAL FUNDS
JUNE 30, 2006

ASSETS

	General	Debt Service
Cash and cash equivalents	$ 3,678	$ -
Investments	-	253,690
Due from other governmental units	80,250	-
Prepaid expenses	6,728	-
Total assets	$ 90,656	$ 253,690

LIABILITIES AND FUND BALANCES

Liabilities		
Accounts payable	$ 36,470	$ -
Notes payable	15,436	-
Other accrued expenses	24,939	-
Total liabilities	76,845	-
Fund Balances		
Restricted for debt service	-	253,690
Unreserved:		
Undesignated	13,811	-
Total liabilities and fund balances	$ 90,656	$ 253,690

See accompanying notes to financial statements

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HILLSDALE PREPARATORY SCHOOL

RECONCILIATION OF TOTAL GOVERNMENTAL FUND BALANCE TO NET ASSETS
OF GOVERNMENTAL ACTIVITIES
JUNE 30, 2006

Amounts reported for governmental activities in the statement of net assets are different because:

Total Governmental Fund Balance	$ 267,501
Capital assets used in governmental activities are not financial resources and, therefore, are not reported in the funds. The cost of the assets is $2,149,050 and the accumulated depreciation is $230,177.	1,918,873
Interest is not payable until due in governmental activities and, therefore, is not recorded in the funds.	(105,817)
Long-term liabilities are not due and payable in the current period and therefore are not reported in the funds.	(2,501,859)
Net Assets of Governmental Activities	$ (421,302)

See accompanying notes to financial statements

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HILLSDALE PREPARATORY SCHOOL

STATEMENT OF REVENUES, EXPENDITURES
AND CHANGES IN FUND BALANCE - GOVERNMENTAL FUNDS
FOR THE YEAR ENDED JUNE 30, 2006

	General	Debt Service
Revenues		
Local sources	$ 18,027	$ 7,503
State sources	382,423	-
Federal sources	60,334	-
Total governmental fund revenues	460,784	7,503
Expenditures		
Elementary school	156,849	-
Student support services	6,712	-
Improvement of instruction	47,483	-
General administration	11,113	4,528
Executive administration	27,931	-
Building administration	63,094	-
Operations and maintenance	61,177	-
Central support services	1,070	-
Debt principle and interest	28,990	22,160
Total governmental fund expenditures	404,419	26,688
Excess (deficiency) of revenues over expenditures	56,365	(19,185)
Other Financing Sources (Uses)		
Proceeds from long term debt	15,000	-
Operating transfers in	-	78,882
Operating transfers out	(78,882)	-
Total other financing sources (uses)	(63,882)	78,882
Excess of revenues and other financing sources over expenditures and other (uses)	(7,517)	59,697
Fund balance - July 1, 2005	21,328	193,993
Fund balance - June 30, 2006	$ 13,811	$ 253,690

See accompanying notes to financial statements

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HILLSDALE PREPARATORY SCHOOL

RECONCILIATION OF THE STATEMENT OF REVENUES, EXPENDITURES AND CHANGES IN FUND BALANCE OF GOVERNMENTAL FUNDS TO THE STATEMENT OF ACTIVITIES FOR THE YEAR ENDED JUNE 30, 2006

Amounts reported for governmental activities in the statement of activities are different because:

Net Change in Fund Balances - Total Governmental Funds		$ 52,180
Governmental funds report capital outlays as expenditures. However, in the statement of activities, assets are capitalized and the cost is allocated over their estimated useful lives and reported as depreciation expense. This is the amount by which capital outlays exceeded depreciation in the current period.		
Depreciation expense		(53,928)
The governmental funds report loan proceeds as an other financing source, while repayment of loan principal is reported as an expenditure. Interest is recognized as an expenditure in the governmental funds when it is due. The net effect of these differences in the treatment of general loan obligations is as follows:		
Proceeds from long-term debt	$ (15,000)	
Payments on long-term debt	23,138	8,138
Change in Net Assets of Governmental Activities		$ 6,390

See accompanying notes to financial statements

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NOTE 1 - Summary of Significant Accounting Policies

The accounting policies of Hillsdale Preparatory School (the "Academy") conform to generally accepted accounting principles applicable to public school academies. The following is a summary of the significant accounting policies:

Reporting Entity

Hillsdale Preparatory School, formerly Sauk Trail Academy, was formed as a public school academy pursuant to the Michigan School Code of 1976, as amended by Act No. 362 of the Public Acts of 1993 and Act No. 416 of the Public Acts of 1994. The Academy filed articles of incorporation as a nonprofit corporation pursuant to the provisions of the Michigan Nonprofit Corporation Act of 1982, as amended, on June 5, 1996, and began operation in June 2001.

The Academy entered into a contract with the Hillsdale Intermediate School District to charter a public school academy. The contract requires the Academy to act exclusively as a governmental agency and not undertake any action inconsistent with its status as an entity authorized to receive state school aid funds pursuant to the State constitution. The Hillsdale Intermediate School District is the fiscal agent for the Academy and is responsible for overseeing the Academy's compliance with the contract and all applicable laws. The Academy pays the Hillsdale Intermediate School District three percent of state aid as administrative fees. Total administrative fees paid for the year ended June 30, 2006 were $11,101.

In August 2005, the Academy entered into a three year agreement with CS Partners, LLC (CSP) under the terms of this agreement, CSP will provide a variety of services including oversight of administration and staff and coordinate the development of budgets and financial reports. The Academy is obligated to pay CSP five percent of state aid funds for the year. Total paid for these services amounted to $16,830 for the year ended June 30, 2006.

The accompanying financial statements have been prepared in accordance with criteria established by the Governmental Accounting Standards Board for determining the various governmental organizations to be included in the reporting entity. These criteria include significant operation of financial relationships with the public school academy. Based on application of criteria, the entity does not contain component units.

Fund Financial Statements

Fund financial statements report detailed information about the Academy. The focus of governmental fund financial statements is on major funds rather than reporting funds by type. Each major fund is presented in a separate column. Non-major funds are aggregated and presented in a single column. The Academy has elected to specify all of its funds as major.

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NOTE 1 - Summary of Significant Accounting Policies - Continued

Basis of Presentation - Fund Accounting

The accounts of the Academy are organized on the basis of funds. The operations of a fund are accounted for with a separate set of self-balancing accounts that comprise its assets, liabilities, fund balance, revenue and expenditures. Government resources are allocated to and accounted for in individual funds based on the purposes for which they are to be spent and the means by which spending activities are controlled. The various funds are grouped, in the combined financial statements in this report, into generic fund types in two broad fund categories.

Governmental Funds

A governmental fund is a fund through which most academy functions typically are financed. The acquisition, use and balances of the Academy's expendable financial resources and the related current liabilities are accounted for through a governmental fund.

General Fund - The general fund is used to record the general operations of the Academy pertaining to education and those operations not provided for in other funds. Included are all transactions related to the approved current operating budget.

Debt Service Fund - The debt service fund is used to record certain revenue and the payment of interest, principal and other expenditures on long-term debt.

Governmental funds utilize the modified accrual basis of accounting. Modifications in such method from the accrual basis are as follows:

a. Revenue that is both measurable and available for use to finance operations is recorded as revenue when earned. Other revenue is recorded when received.

b. Payments for inventoriable types of supplies, which are not significant at year end, are recorded as expenditures at the time of purchase.

c. Principal and interest of general long-term debt are not recorded as expenditures until their due dates.

d. The State of Michigan utilizes a foundation allowance funding approach, which provides for a specific annual amount of revenue per student based on a state-wide formula. The foundation allowance is funded from a combination of state and local sources. Revenue from state sources is primarily governed by the School Aid Act and the School Code of Michigan. The State portion of the foundation is provided from the State's School Aid Fund and so recognized as revenue in accordance with state law. A major portion of the Academy is considered to be economically dependent on this aid. The Academy's existence is dependent upon continued qualification for such aid.

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NOTE 1 - Summary of Significant Accounting Policies - Continued

Government Wide Financial Statements

The government-wide financial statements (i.e. the statement of Net Assets and the Statement of Activities) report information on all of the non-fiduciary activities of the primary government. The government-wide financial statements are prepared using the economic resources measurement focus and the accrual basis of accounting. This approach differs from the manner in which governmental fund financial statements are prepared. Therefore, governmental fund financial statements include reconciliations with brief explanations to better identify the relationships between the government-wide statements and the statements for governmental funds.

The government-wide Statement of Activities presents a comparison between expenses, and program revenues for each segment of the business-type activities of the Academy and for each governmental program. Direct expenses are those that are specifically associated with a service, program or department and are therefore clearly identifiable to a particular function. The Academy does not allocate indirect expenses to programs. Program revenues include charges paid by the recipients of the goods or services offered by the programs and grants and contributions that are restricted to meeting the operational or capital requirements of a particular program. Revenues not classified as program revenues are presented as general purpose revenues. The comparison of program revenues and expenses identifies the extent to which each program or function is self financing or draws from the general purpose revenues of the Academy.

Net assets should be reported as restricted when constraints placed on net asset use are either externally imposed by creditors, grantors, contributors, or laws or regulations of other governments or imposed by law through constitutional provisions or enabling legislation.

Cash and Cash Equivalents

The Academy's cash and cash equivalents are considered to be cash on hand, demand deposits and short-term investments with maturities of three months or less from the date of acquisition.

Receivables

Receivables at June 30, 2006 consist primarily of state school aid due from the State of Michigan. All receivables are expected to be fully collected in July and August of 2006 and are considered current for the purposes of these basic financial statements.

Prepaid Assets

Payments made to vendors for services that will benefit periods beyond June 30, 2006, are recorded as prepaid items using the consumption method. A current asset for the prepaid amount is recorded at the time of the purchase and an expenditure is reported in the year in which services are consumed.

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NOTE 1 - Summary of Significant Accounting Policies - Continued

Capital Assets and Depreciation

All capital assets are capitalized at cost (or estimated historical cost) and updated for additions and retirements during the year. The Academy follows the policy of not capitalizing assets with a cost of less than $1,000, and a useful life of less than one year. The Academy does not possess any infrastructure assets.

All reported capital assets, with the exception of land, are depreciated. Improvements are depreciated over the remaining useful lives of the related capital assets. Depreciation is computed using the straight-line method over the following useful lives:

Building and improvements	50 years
Furniture and equipment	5 - 20 years
Computers and software	5 years

Accrued Liabilities and Long-Term Obligations

All payables, accrued liabilities and long-term obligations are reported in the government-wide financial statements. In general, payables and accrued liabilities that will be paid from governmental funds are reported on the governmental fund financial statements regardless of whether they will be liquidated with current resources. However, the non-current portion of capital leases that will be paid from governmental funds are reported as a liability in the fund financial statements only to the extent that they will be paid with current, expendable, available financial resources. In general, payments made within sixty days after year-end are considered to have been made with current available financial resources. Other long-term obligations that will be paid from governmental funds are not recognized as a liability in the fund financial statements until due.

Net Assets

Net assets represent the difference between assets and liabilities. Net assets invested in capital assets, net of related debt consists of capital assets, net of accumulated depreciation, reduced by the outstanding balances of any borrowings used for acquisition, construction, or improvement of those assets. Net assets are reported as restricted when there are limitations imposed on their use either through the enabling legislation adopted by the Academy or through external restrictions imposed by creditors, grantors or laws of regulations of other governments.

Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results may differ from those estimates.

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NOTE 2 - Stewardship, Compliance and Accountability

Annual budgets are adopted on the consistent basis with accounting principles generally accepted in the United States of America and state law for the general fund. All annual appropriations lapse at fiscal year end and encumbrances are not formally recorded.

The budget document presents information by fund and function. The legal level of budgetary control adopted by the governing body is the function level. State law requires the Academy to have its budget in place by July 1. Expenditures in excess of amounts budgeted is a violation of Michigan law. The Academy is required by law to adopt a general fund and school service fund budget. During the year ended June 30, 2006 the budget was amended in a legally permissible manner.

The budget statement (budgetary comparison schedule - all governmental funds) is presented on the combined statement of revenue, expenditures, and fund balances. Budget overruns are as follows:

	Budget	Actual
General Fund		
General administration	$ 10,638	$ 11,113
Building administration	61,557	63,094
Operations and maintenance	59,589	61,177

NOTE 3 - Deposits and Investments

The Academy maintains cash balances at various financial institutions. The balances are insured by the Federal Deposit Insurance Corporation up to $100,000 per deposit account. The Academy's cash was fully insured as of June 30, 2006. The Academy's investments at June 30, 2006 were comprised of fund shares that had a carrying amount and market value of $253,690. These investments are held by a trustee for debt service on the Certificates of Participation as described in Note 8. The investments are in mutual funds that invest solely in US Treasury obligations.

NOTE 4 - Due From Other Governmental Units

Amounts owed from governmental units and other consist of the following:

State sources	$ 69,561
Federal sources	10,689
Total	$ 80,250

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NOTE 5 - Notes Payable

The Academy has obtained a business loan through the Michigan Public Educational Facilities Authority amounting to $150,000. The loan was issued to provide the Academy with funds to finance school operations at the beginning of the fiscal year. The loan is payable $15,515 per month, including interest at 6.26% through July 2006. Security for the loan is provided through future state school aid payments. The amount outstanding on the loan at June 30, 2006 was $15,436.

NOTE 6 - Accrued Expenses

Amounts accrued at year end consist of the following:

	Net Assets	Fund Level
University oversight fee	$ 2,018	$ 2,018
Salaries and payroll taxes	22,921	22,921
Interest	105,817	-
Total accrued expenses	$ 130,756	$ 24,939

NOTE 7 - Capital Assets and Depreciation

Capital asset activity of the Academy's governmental activities was as follows:

	Balance July 1, 2005	Additions	Balance June 30, 2006
Land	$ 100,000	$ -	$ 100,000
Building	1,950,503	-	1,950,503
Computers	42,243	-	42,243
Equipment and furniture	56,304	-	56,304
Subtotal	2,149,050	-	2,149,050
Accumulated depreciation	176,249	53,928	230,177
Net book value of assets	$ 1,972,801	$ (53,928)	$ 1,918,873

Depreciation expense was not charged to activities as the Academy considers its assets to impact multiple activities and allocation is not practical.

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NOTE 8 - Long-Term Obligations Payable

The following is a summary of long-term obligations for the Academy for the year ended June 30, 2006.

	Balance July 1, 2005	Additions	Retirements and Payments	Balance June 30, 2006	Due Within One Year
Installment loan	$ 30,000	$ -	$ 22,023	$ 7,977	$ 7,977
Capital lease	-	15,000	1,115	13,885	4,741
Certificates of participation	2,480,000	-	-	2,480,000	2,480,000
Total	$ 2,510,000	$ 15,000	$ 23,138	$ 2,501,862	$ 2,492,718

The Academy has issued Certificates of Participation bearing interest at an average rate of 6% through the year ended June 30, 2031. The obligations require semi-annual interest payments due on December 1st and June 1st and an annual payment of principal due on June 1st beginning in 2005. The certificates are collateralized by a mortgage on the Academy's facility as well as a pledge for 20% of State School Aid payments and investments held in trust for debt service. Currently the above mentioned certificates are in default and therefore are classified as current.

Following are maturities of long-term obligations principal and interest for the next three years:

	Principal	Interest
2007	$ 2,492,718	$ 1,152
2008	5,226	666
2009	3,918	150

The Academy is the lessee of equipment held under a capital lease. The lease bears interest at 9.8% and expires in the year ending June 30, 2008, the lease is secured by equipment.

Minimum annual payments under capital leases coming due during the three years ending June 30, 2009 are as follows:

2007	$ 5,892
2008	5,892
2009	4,069
Total minimum lease payment	15,853
Less amount representing interest	1,968
Present value of minimum lease payments	$ 13,885

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NOTE 9 - Interfund Transfers

During the normal course of the school year the Academy transferred amounts between its two major funds as follows:

	General	Debt Service
Transfers In	$ -	$ 78,882
Transfers Out	(78,882)	-

As stipulated by the Academy's Certificates of Participation as described in Note 8, the Academy must transfer 20% of its state aid to a trustee. The trustee retains the required portion needed for debt service and returns the remainder to the Academy. This accounts for the major activity in the Academy's interfund transfer account.

NOTE 10 - Risk Management

The Academy is exposed to various risks of loss related to property loss, torts, errors and omissions and employee injuries (worker's compensation), as well as medical benefits provided to employees. The Academy has purchased commercial insurance for all claims. Settled claims relating to the commercial insurance have not exceeded the amount of insurance coverage in any of the past three fiscal years.

NOTE 11 - Going Concern

The Academy's financial statements have been presented on the basis that it is a going concern for the fiscal year ending June 30, 2007.

The Academy's student count has declined, which in turn, has lowered the amount of state aid funding. A new board of directors has been appointed and with the name change, the Academy hopes to increase its student body.

A forbearance agreement has been approved as of August 24, 2006 between the school and its bondholders regarding the indebtedness of the school building.

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INDEPENDENT AUDITOR'S REPORT ON SUPPLEMENTAL INFORMATION

To the Board of Directors
of Hillsdale Preparatory School

We have audited the accompanying basic financial statements of Hillsdale Preparatory School for the year ended June 30, 2006. Our audit was made for the purpose of forming an opinion on the financial statements taken as a whole. The additional information listed in the table of contents is presented for purposes of additional analysis and is not a required part of the financial statements of Hillsdale Preparatory School. This information has been subjected to the procedures applied in the audit of the financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole.

Croskey, Lanni & Company, P.C.

August 24, 2006
Rochester, Michigan

HILLSDALE PREPARATORY SCHOOL

REQUIRED SUPPLEMENTAL INFORMATION
BUDGETARY COMPARISON SCHEDULE - ALL GOVERNMENTAL FUNDS
FOR THE YEAR ENDED JUNE 30, 2006

	General Fund		
	Original Budget	**Final Budget**	**Actual**
Revenues			
Local sources	$ 21,242	$ 18,027	$ 18,027
State sources	354,063	382,411	382,423
Federal sources	-	67,662	60,334
Total governmental fund revenues	375,305	468,100	460,784
Expenditures			
Elementary school	136,063	157,919	156,849
Student support services	-	12,330	6,712
Improvement of instruction	-	48,138	47,483
General administration	4,950	10,638	11,113
Executive administration	31,563	29,606	27,931
Building administration	62,663	61,557	63,094
Operations and maintenance	50,045	59,589	61,177
Central support services	-	1,070	1,070
Debt principle and interest	17,325	35,165	28,990
Total governmental fund expenditures	302,609	416,012	404,419
Excess (deficiency) of revenues over expenditures	72,696	52,088	56,365
Other Financing Sources (Uses)			
Proceeds from long term debt	-	15,000	15,000
Operating transfers in	-	-	-
Operating transfers out	(70,813)	(75,489)	(78,882)
Total other financing sources (uses)	(70,813)	(60,489)	(63,882)
Excess of revenues and other financing sources over expenditures and other uses	1,883	(8,401)	(7,517)
Fund balance - July 1, 2005	21,328	21,328	21,328
Fund balance - June 30, 2006	$ 23,211	$ 12,927	$ 13,811

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Debt Service Fund		
Original Budget	**Final Budget**	**Actual**
$ -	$ -	$ 7,503
-	-	-
-	-	-
-	-	7,503
-	-	-
-	-	-
-	-	-
-	-	4,528
-	-	-
-	-	-
-	-	-
-	-	-
-	-	22,160
-	-	26,688
-	-	(19,185)
-	-	-
70,813	75,489	78,882
-	-	-
70,813	75,489	78,882
70,813	75,489	59,697
193,993	193,993	193,993
$ 264,806	$ 269,482	$ 253,690

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HILLSDALE PREPARATORY SCHOOL

SCHEDULE OF REVENUES - ALL GOVERNMENTAL FUNDS
FOR THE YEAR ENDED JUNE 30, 2006

	General	Debt Service
Local Sources		
Rental income	$ 13,200	$ -
Interest	785	7,503
Miscellaneous	4,042	-
Total local sources	18,027	7,503
State Sources		
State aid	370,081	-
At risk	12,342	-
Total state sources	382,423	-
Federal Sources		
Title I	35,896	-
Title V	39	-
Title IIA	6,616	-
REAP grant	17,783	-
Total federal sources	60,334	-
Total governmental fund revenues	$ 460,784	$ 7,503

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HILLSDALE PREPARATORY SCHOOL

SCHEDULE OF EXPENDITURES - ALL GOVERNMENTAL FUNDS
FOR THE YEAR ENDED JUNE 30, 2006

	General	Debt Service
Elementary School		
Purchased services - salaries	$ 129,543	$ -
Purchased services - payroll taxes	11,359	-
Teaching supplies and materials	15,415	-
Miscellaneous	532	-
Total elementary school	156,849	-
Student Support Services		
Guidance services	4,776	-
Materials and supplies	1,936	-
Total student support services	6,712	-
Improvement of instruction		
Purchased services	28,757	-
Workshops and conferences	12,344	-
Teaching supplies and materials	6,382	-
Total improvement of instruction	47,483	-
General Administration		
Professional services	6,773	4,528
Advertising	4,220	-
Dues and fees	120	-
Total general administration	11,113	4,528
Executive Administration		
Oversight fees	11,101	-
Management fees	16,830	-
Total executive administration	27,931	-

See independent auditor's report on supplemental information

HILLSDALE PREPARATORY SCHOOL

SCHEDULE OF EXPENDITURES - ALL GOVERNMENTAL FUNDS - Continued
FOR THE YEAR ENDED JUNE 30, 2006

	General	Debt Service
Building Administration		
Purchased services - salaries	53,516	-
Purchased services - payroll taxes	5,600	-
Equipment lease	1,392	-
Postage	689	-
Supplies and other	1,601	-
Miscellaneous	296	-
Total building administration	63,094	-
Operations and Maintenance		
Outside services	17,879	-
Utilities	28,887	-
Repair and maintenance	6,807	-
Liability insurance	5,066	-
Supplies and materials	2,418	-
Miscellaneous	120	-
Total operations and maintenance	61,177	-
Central Support Services		
Purchased services	1,070	-
Debt principle and interest	28,990	22,160
Total governmental fund expenditures	$ 404,419	$ 26,688

See independent auditor's report on supplemental information

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Report on Internal Control Over Financial Reporting and on Compliance and Other Matters
Based on an Audit of Financial Statements Performed in Accordance with
with *Government Auditing Standards*

To the Board of Directors
of Hillsdale Preparatory School

We have audited the basic financial statements of the governmental activities, each major fund, and the aggregate remaining fund information of Hillsdale Preparatory School as of and for the year ended June 30, 2006, which collectively comprise the Academy's basic financial statements and have issued our report thereon dated August 24, 2006. 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 Hillsdale Preparatory School's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, 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 Hillsdale Preparatory School'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 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 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 operations that we consider to be material weaknesses.

This report is intended solely for the information and use of management, the board of directors and others within the Academy and is not intended to be and should not be used by anyone other than these specified parties.

Croskey, Lanni & Company, P.C.

August 24, 2006
Rochester, Michigan