Ann Arbor Public Schools | June 26, 2024

Analysis of 2023-24 Budget Variance

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June 26, 2024

To the Board of Education
Ann Arbor Public Schools

Re: 2023-24 Budget Variance Analysis

As requested, we provided assistance in connection with an analysis/comparison of the fiscal year 2023-24 General Fund original budget, adopted by the Board of Education (the "Board") on June 21, 2023, to actual year-to-date amounts, which results in an unfavorable variance approximating $13 million. This report outlines our findings and is not intended to express an opinion on Ann Arbor Public Schools' ("AAPS" or the "District") internal controls or financial statements in accordance with standards issued by the American Institute of Certified Public Accountants as those are separate and distinct engagements.

EXECUTIVE SUMMARY

Several key issues surfaced during our analysis:

- The budget process utilized by AAPS is reasonable.
- Spending by the District has not decreased to match declining student enrollment.
- The original budget contained the prior years' one-time disbursement of $14 million related to the Section 147c2 State Aid Categorical allocation (MSPERS one-time payment). This inclusion did not impact the District's Fund Balance since this payment was recorded as revenue and applied throughout payroll expenditures, resulting in a net zero impact.
- Approximately two/three months prior to the adoption of the original budget, the Board had approved increased raises for all employee groups. This increase approximated an additional $12 million/year in expenditures (costs) to AAPS. Not significantly decreasing

employee count required the District to obtain over 1,100 additional students enrolled in 2023-24 which did not occur.

- Total expenditures in the original budget presented to the Board were nearly the same as the prior year's amended budget. Increased expenditures should have been anticipated by the Board given the recent approval of salary and wage increases. Had the Board questioned management before adopting the original 2023-24 budget may have provided more insight into the issues in fiscal year 2023-24.

- The interviewees confirmed separately that many, including the Board and key union representatives, knew that expenditure reductions, which would likely include job cuts, were going to be needed at the time of the contract negotiations and when the contracts were approved.

In summary, the budget deficit is primarily due to the increased payroll costs approved by the District without the revenue to support this increase. The original budget presented was improbable without significant expenditure reductions. The obvious red flags should have been identified by management and the Board for which responsibility for the current situation is shared.

WORK PLAN

To perform our analysis, we:

1. Analyzed the budget workbook provided by the former CFO
2. Interviewed the former CFO and the former Superintendent
3. Watched the June 14, 2023 Board of Education meeting video during which the original proposed budget was presented
4. Watched the April 26, 2023 Board of Education meeting video during which the contracted wage/salary increases were approved
5. Analyzed District information
6. Performed research

AAPS' BUDGET PROCESS

The State of Michigan Uniform Budgeting and Accounting Act requires that a school district adopt a budget for the upcoming fiscal year no later than June 30 of the current fiscal year being operated. To assist the District with understanding the issues identified by our analysis, we outline the process historically utilized by AAPS to develop its annual budget, as follows:

- The starting point is the current fiscal year amended budget, meaning that the budget originally passed by the Board was modified; a common occurrence for districts based on changes that occur during the fiscal year. This starting point is called a "roll forward".

- A *Variance* column is utilized to identify changes that are known that would cause the next fiscal year budget to be different than the current fiscal year amended budget.

- The variance is built through input by three (3) primary individuals in the business office:
  - Director of Finance, Payroll & Fringe Benefits – responsible for payroll expenditures
    - There is a detailed analysis that is performed at this stage to extract data from the systems to project the various employee groups and benefits offered to project the impact.
  - Director of Finance, Procurement & Business Services – responsible for non-payroll expenditures
    - Current data is examined and compared against a major vendor contract spreadsheet that Linda maintains to identify potential for shifts in contracts. Contracts approved by the Board that take effect in the next fiscal year are also considered.
  - Director of Finance, Treasury & Grants – responsible for revenue projections and coordination of deliverables

- Factors that are built into the variance from current to next year budget include:
  - Status of the State of Michigan budget (i.e., how far along is the legislature in adopting the next year's budget for the State) and potential for an increase in foundation allowance per pupil
  - Projected changes in pupil count
  - Changes in funding associated with state and federal grants
  - Employment contracts and negotiated rates with union groups (e.g., approved provisions, % increase to base, stipends)
  - Office of Retirement Services ("ORS") Retirement Rate changes

    - Significant changes in non-payroll contracts, the largest of these being transportation, custodial, and EduStaff (Substitute employees)

- The three Directors of Finance submit their information to the CFO; the CFO compiles the information and then presents to and discusses the budget with the Superintendent. At times, the Superintendent and the CFO presents and discusses with Executive Cabinet. Based on the projected results of the initial budget developed, multiple iterations could be performed to adjust for feedback and factors gathered from other stakeholders. This discussion could also involve planned modifications to operational aspects of the District and program offerings.

- When the budget is presented to the Board by management, it is presented with a document that contains the:
    1. Most recent audited financial statements (which would be one year behind the current fiscal year),
    2. Proposed amended budget for the current fiscal year, and
    3. Proposed original budget for the upcoming fiscal year – presented side-by-side in columnar format.

  A *Variance* column is presented that compares the amended budget (current year) to the proposed new budget (next year).

While the financial statements are audited annually, the budget is not audited nor is it expected to be audited by the State of Michigan.

ANALYSIS

As we performed our work, several key issues were revealed that, when analyzed holistically, convey the reasons for the confusion and cause of District's budget variance. We address these issues in the following subsections:

- **A. MSPERS one-time payment**
- **B. Anticipated revenue increase**
- **C. Increasing employee count vs. declining enrollment**
- **D. Increased costs**
- **E. Original budget presented to Board**
- **F. Assuming no job cuts**
- **G. Former Superintendent's plan**

A. MPSERS one-time payment

Many references have been made to the Michigan Public School Employees Retirement System ("MPSERS") one-time distribution in fiscal year 2022-23 to eligible districts.

STATE OF MICHIGAN
DEPARTMENT OF EDUCATION
LANSING

GRETCHEN WHITMER
GOVERNOR

MICHAEL F. RICE, Ph.D.
STATE SUPERINTENDENT

MEMORANDUM

DATE: February 23, 2023

TO: Local and Intermediate School District Superintendents
Public School Academy Directors

FROM: Dr. Diane L. Golzynski, Interim Deputy Superintendent
Finance and Operations

SUBJECT: Accounting Guidance for Section 147c(2) MPSERS One-Time Deposit

In FY 2022-23, Section 147c of the State School Aid Act (MCL 388.1747c) was amended to include a one-time distribution to districts, intermediate districts, and other participating entities of the Michigan Public School Employees' Retirement System (MPSERS) (Section 147c(2)) to forward to the state's Office of Retirement Services (ORS) as additional assets being contributed to the retirement system.

This funding is a one-time, state payment toward the MPSERS unfunded liability. Accordingly, districts may not allocate charges related to Section 147c(2) funding to federal grant programs. Section 147c(1) funds may continue to be charged uniformly across all employees (as previously advised by the Michigan Department of Education's legal counsel).

This approach is consistent with federal regulations that permit annual pension costs to be charged to federal funds only as authorized in established state policies [*See* 2 CFR 200.431(g)]. Michigan-established policies generally authorize districts to charge pension costs across federal and state funding sources in accordance with ORS's published contribution rate. In this instance, state law prevents ORS from including Section 147c(2) funding in the ORS-prepared contribution rate used by districts to charge pension costs. In addition, Section 147c(2) funds represent a one-time state deposit into MPSERS, rather than being part of the annual required contribution typically included in the established rate. For these reasons, allocating Section 147c(2) costs to federal funds is inconsistent with established federal and state requirements on pension allocations.

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>
> In accordance with Governmental Accounting Standards Board (GASB) Statement 68, similar to Section 147c distributions, districts must report these amounts as revenue and an equal amount of expenditures in their general ledger. Given the large amount of this one-time deposit, MDE has requested clarification from the U.S. Department of Education (USED) regarding the exclusion of these funds from maintenance of effort (MOE) and indirect cost calculations. MDE will provide an update to districts when it receives a response from USED regarding the exclusion of these funds from MOE and indirect cost calculations.
>
> To facilitate exclusion from these calculations, districts must account for Section 147c(2) expenditures using **Grant Code 263**. (Please note, Section 147c(2) funds must be accounted for in separate accounts). Districts are advised to charge Section 147c(2) expenditures across as many major function codes as practical. Section 147c(2) revenue should be recorded as Major Class 312, Suffix 0000.

AAPS received approximately $14 million related to this distribution and the amount was included as revenue and expenditures on the District's 2022-23 final amended budget. Accordingly, during the 2022-23 fiscal year, $14 million was recorded as revenues on the general ledger and $14 million was recorded as expenditures, as dictated by government accounting standards. Therefore, the net impact to Fund Balance was zero.

When AAPS prepared its 2023-24 original budget, it performed the normal "roll-forward" of the prior year's amended budget. The 2022-23 one-time distribution from the State of Michigan and the corresponding expenditures had not been removed when the original budget was adopted; the former CFO stated this was an oversight, yet the net effect to fund balance was zero. We have no reason to doubt this assertion. Since the budgeted revenues offset the budgeted expenditures, the impact on the fund balance remained unaffected and **did not cause the current budget variance**.

B. Anticipated revenue increase

The original budget included an estimate of increased revenue from State Aid as compared to the 2022-23 fiscal year of approximately $15 million comprised of the following:

- $8.3M – per pupil Foundation Allowance and Special Education funding increases
- $3.6M – Section 31aa (Mental Health Grant – per pupil funded) and Section 97 (School Safety)
- $3.5M – Section 31a (At risk), MPSERS UAAL, Section 35a (Early Literacy)

These additional revenue amounts were verified and are reasonable. There was also a decrease of $3 million for a prior year, one-time distribution from Washtenaw ISD resulting in a net increase of $12 million.

Coincidently, this increase is similar to the one-time MSPERS distribution amount outlined in the previous section and may be causing confusion within the District. The $12 million in additional anticipated revenue **is unrelated to the aforementioned $14 million MSPERS one-time payment**.

C. Increasing employee count vs. declining enrollment

On March 13, 2024, Marios Demetriou publicly presented a 10-year comparison of the District's financial activity. The slide on page 2 shows the annual number for FTE employees compared to the FTE students.

Table 1

Fiscal Year	FTE Employees	Change	FTE Students	Change
2014-15	1,647	-	16,834.32	-
2015-16	1,793	146	17,113.37	279.05
2016-17	2,034	241	17,460.62	347.25
2017-18	2,090	56	17,698.56	237.94
2018-19	2,075	(15)	17,945.78	247.22
2019-20	2,088	13	17,961.48	15.70
2020-21	2,131	43	17,881.90	(79.58)
2021-22	2,118	(13)	16,955.91	(925.99)
2022-23	2,176	58	16,943.73	(12.18)
2023-24	2,127	(49)	16,838.76	(104.97)
Total Change		480		4.44

1,123 decline

Mr. Demetriou presented that 417, or 87%, of the 480 FTE additions are teachers. In contrast, only 4.4 students were added for the 10 years shown. Isolating the last four years, we see that the number of FTE students declined by 1,123.

It is evident that AAPS did not decrease its employee count to match its enrollment decline. **This disparity inevitably contributed to the shortfall in AAPS' budget/fund balance**.

D. Increased costs

Both interviewees confirmed that there were increased costs that plagued the District, which was largely a result of the response to the pandemic. For example, annual expenditures for substitutes increased from $3 million (pre-pandemic) to $8 million (during and post-pandemic). Other increased costs included overtime by the cyber team, specifically when the power went out after the storm in August 2023. While we have not confirmed these assertions, they are reasonable as many (companies, districts, governmental entities) have seen cost increases for a variety of goods and services (food, fuel, repairs, etc.) **No matter the level of these cost increases, they negatively impact any budget** if revenue is not increasing at the same pace and other costs have not decreased.

E. Original budget presented to Board

The former Superintendent confirmed to us that discussions were held with the Board that there would need to be reductions in the cost structure of approximately $12 million in the next fiscal year to offset the increase in costs associated with the contracts approved in March/April of 2023. She conveyed that the Board knew, or should have known, of this reality given that the Trustees were briefed specifically about this issue in closed sessions prior to each presentation of the employee agreements which occurred on March 15, 2023 and April 26, 2023 with the District's legal counsel and the former CFO. Further, the former Superintendent stated that she had individual discussions with Board members.

The former CFO confirmed that she had nearly eliminated known expenditure increases expected in fiscal year 2023-24 in the original budget presented to the Board. As a result, the expenditures presented were *nearly the same* as the prior year 2022-23, as shown below:

ANN ARBOR PUBLIC SCHOOLS LEAD. CARE. INSPIRE.	2021-2022 Audited June 30, 2022	2022-2023 Proposed Amended Budget June 2023	2023-2024 Proposed Original Budget June 2023	Variance
Expenditures				
Instructional Services				
Basic Programs (111x)	$ 136,892,874	$ 148,468,776	$ 148,515,426	$ 46,650
Added Needs (112x)	39,585,909	42,158,557	42,183,868	25,311
Adult & Continuing Education (113x)	280,176	295,541	295,541	-
Total Instruction Services	$ 176,758,959	$ 190,922,874	$ 190,994,835	$ 71,961
Instructional Support Services				
Pupil (121x)	$ 36,189,833	$ 38,376,288	$ 38,396,392	$ 20,104
Instructional Staff (122x)	14,463,995	13,291,701	13,296,092	4,391
School Administration (124x)	17,154,038	17,031,046	17,039,221	8,175
Athletics (129x)	3,900,994	4,091,679	4,091,909	230
Total Instructional Support Services	$ 71,708,860	$ 72,790,714	$ 72,823,614	$ 32,900
Non-Instructional Support Services				
General Administration (123x)	$ 3,781,253	$ 3,439,447	$ 3,439,947	$ 500
Business Services (125x)	3,220,814	3,070,764	3,071,294	530
Operations & Maintenance (126x)	22,878,395	21,805,125	21,805,755	630
Transportation (127x)	7,856,982	9,624,057	9,625,507	1,450
Central (128x)	8,181,426	8,596,996	8,597,846	850
Total Non-Instructional Support Services	$ 45,918,870	$ 46,536,389	$ 46,540,349	$ 3,960
Community Activities	$ 1,162,894	$ 1,480,465	$ 1,487,965	$ 7,500
Other Financing Uses	(196,656)	155,799	155,799	-
Total Expenditures	**$ 295,352,927**	**$ 311,886,241**	**$ 312,002,562**	**$ 116,321**

While the presentation to the Board regarding the original 2023-24 budget was misleading, the Board did not question that the expenditures were nearly flat from the prior year when, in March and April 2023 (approximately two/three months before the original budget adoption), the District had approved contract increases for all employee groups, including a 2% salary increase for Ann Arbor Education Association ("AAEA") members and a longevity payment to teachers who have been employed more than 18 years. Since most of the District's expenditures is comprised of payroll, this increase, which the District estimated to be approximately $12.3 million, is significant to the budget. The viewing of the Board of Education meeting held on April 26, 2023 revealed that the Trustees were informed of these wage increases by David Comsa, AAPS' legal representative during the negotiations, prior to approval[1].

During the presentation, the former CFO addressed the minimal variance between the two fiscal years by stating to the Board that, while the negotiated salaries and benefits have been accounted

[1] Trustee Gaynor did not approve the contracts because he deemed the 2% was not equitable to all pay levels.

for, alignment in the District's priorities is needed regarding AAPS' resources and have been discussed in recent months in the monthly budget monitoring reports.

It is illogical that expenditures did NOT increase to reflect these new contracts in the original budget. It would have been prudent for the Board to have questioned management regarding the minimal change in the expenses after the recently approved wage increases as well as the prioritization comment before the Board's adoption of the 2023-24 original budget. While this questioning may have occurred, we have no evidence to support that it did as the original budget was adopted as presented.

F. Assuming no job cuts

To eliminate the $12 million variance without job cuts, the analysis reveals a significant disparity when considering the data:

- AAPS required increased enrollment of, at least, another 1,130 students ($12 million ÷ $10,609 per student per **Table 2**). Pending no other information, declining enrollment trends should have triggered a proverbial alarm.

- Approaching it from the student count, the District had 16,839 students enrolled in 2023-24, as listed in **Table 1.** AAPS would have required the State of Michigan to increase the per student funding by another approximately $713/student ($12 million ÷ 16,839 FTE students) above the $507 increase already provided by the Legislature, as shown in **Table 2**. This requirement should have also caused significant concern since no recent historical per student increases have exceeded $507.

Table 2

Fiscal Year	Foundation Allowance	Change
2014-15	$ 9,100	$ -
2015-16	9,170	70
2016-17	9,180	10
2017-18	9,290	110
2018-19	9,410	120
2019-20	9,530	120
2020-21	9,530	-
2021-22	9,701	171
2022-23	10,102	401
2023-24	10,609	507
Total Change		$1,509

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It was difficult, if not impossible, for AAPS to achieve the anticipated 6% Fund Balance as projected without job cuts.

G. Former Superintendent's plan

To help reduce the $12 million variance, the former Superintendent shared that she had, "*planned to make reductions in a phased process over the next few years*." She described her approach as using a scalpel (precise) versus an axe (bulk). In an email to us subsequent to our interview with her, she stated that:

> *"Regular communications were shared with the Board regarding the reductions as they were occurring during 2023, examples include the reduction of elementary virtual programming and elimination of related positions, the realignment of the Early On program to the WISD, and a renegotiation of the WEOC agreement, voted by the Board."*

We have not had an opportunity to obtain these communications to confirm this assertion but can do so upon request. Nevertheless, if a plan was in place, it may not have resulted in the prompt actions needed to stabilize AAPS' fund balance.

NOTICE FROM THE STATE OF MICHIGAN

The District received a letter dated June 6, 2024 from the State of Michigan Treasury Department that "potential financial stress exists" at AAPS due to the likelihood of an increased deficit over the next two years. Within the next 60 days, the District will need to submit periodic financial status reports to Treasury or contract with an Intermediate School District to perform an administrative review. This notice emphasizes the culmination of AAPS' concerning financial condition that has been compounding over the past few years.

RECOMMENDATIONS

1. **Move forward with current financial modifications**

2. **Implement better training for board members**

    - AAPS administration previously trained members

- Consider sending members to be trained by the Michigan Association of School Boards (MASB)
- Research various other trainings available online that may be applicable to understanding financial statements for public schools.

3. **Ask questions of Administration during board meetings**

   - Implements timely accountability
   - Conveys engagement

SIGNATURE

Plante & Moran, PLLC

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